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Problems with Potential Application of Selected Provisions of the Sarbanes-Oxley Act of 2002 to Small, Non-Public Banking Organizations

The Sarbanes-Oxley Act of 20021 (SOX or “the Act”) was passed by Congress as a response to a rash of corporate scandals involving companies such as Enron, WorldCom, and Global Crossing.2 In the banking industry, only public institutions3 are required to comply with the Act.4 Large non-public banking organizations5 technically are not subject to SOX,6 but these organizations are subject to other federal banking laws and regulations7 which contain provisions similar to those found in SOX. The Act’s provisions do not apply specifically to small, non-public institutions,8 and these organizations are not required to

3. For the purposes of this Note, the term “public banking organizations” refers to those banks, savings associations, and bank holding companies which have registered their securities with one of the four federal banking regulatory agencies pursuant to the Securities Exchange Act of 1934. See Federal Reserve Board SR Letter 03-8 from the Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, to the Officer in charge of supervision and appropriate supervisory and examination staff at each Federal Reserve Bank and to each domestic banking organization supervised by the Federal Reserve (May 5, 2003), http://www.federalreserve.gov/boarddocs/SRLETTERS/2003/sr0308.htm (last visited Feb. 7, 2004) [hereinafter Joint Statement to Non-Public Banks]; 15 U.S.C. § 78l(i) (2000) (codifying the portion of the Securities Exchange Act of 1934 under which public banking institutions register their securities with one of the four federal banking regulatory agencies).
4. See Joint Statement to Non-Public Banks, supra note 3.
5. For the purposes of this Note, the term “large non-public banking organizations” includes FDIC-insured banks, savings associations, and bank holding companies which have total assets of $500 million or more and are not public institutions. See supra note 3 (defining the term “public banking institutions”).
6. See Joint Statement to Non-Public Banks, supra note 3.
7. Specifically, large non-public banking institutions that are not subject to SOX are still subject to Section 36 of the Federal Deposit Insurance Act and its implementing regulations, found at 12 U.S.C. § 1831m (2000) and 12 C.F.R. § 363 (2003), respectively. See id.
8. For the purposes of this Note, the term “small non-public banking organizations” includes FDIC-insured banks, savings associations, and bank holding companies which have less than $500 million in total assets and are not public
comply with the aforementioned federal banking laws and regulations with which large non-public banks must comply.\textsuperscript{9} Despite the fact that Congress did not enact SOX to address these organizations, the Federal Deposit Insurance Corporation (FDIC) has issued guidance to the small non-public banks which it regulates that seems to strongly encourage practices similar or identical to those found in SOX.\textsuperscript{10} While apparently not going as far as the FDIC in promoting SOX practices,\textsuperscript{11} the other three federal bank regulators — the Federal Reserve Board (FRB), the Office of Thrift Supervision (OTS), and the Office of the Comptroller of the Currency (OCC) — have also issued joint guidance encouraging the small, non-public banking organizations which they supervise to “periodically review their policies and procedures relating to corporate governance and auditing matters.”\textsuperscript{12}

While the FDIC’s view appears to be stronger than that of the other federal regulators,\textsuperscript{13} such recommended compliance by all of the federal banking regulators could mean that at some point, small, non-public banking institutions may have to meet the same stringent auditor independence,\textsuperscript{14} corporate governance,\textsuperscript{15} organizations. See \textit{supra} note 3 (defining the term “public banking institutions”); Joint Statement to Non-Public Banks, \textit{supra} note 3 (stating that small non-public banking organizations are not subject to SOX).


11. See Laura K. Thompson, \textit{Conflicting Guidance for Small Banks on Sarb-Ox}, \textit{AM. BANKER}, May 16, 2003, at 1, 5 (describing the practical concerns of people in the community banking arena that the FDIC’s guidance could be perceived as requiring certain actions because the FDIC “strongly encourage[s]” small, non-public banks to improve their corporate governance and auditing procedures through SOX-type practices, while the joint guidance provided by the FRB, OTS, and OCC “merely advises” these banks to periodically review their corporate governance and auditing policies).


13. See Thompson, \textit{supra} note 11, at 1.

14. See \textit{infra} notes 42-50 and accompanying text.
and financial disclosure standards that public banks must meet, even though small, non-public institutions generally have fewer resources to use to satisfy such standards, and typically have less complex operations than public banks. Requiring small, non-public banks to meet the Act's standards not only would be inconsistent with the Act's purpose, but applying SOX provisions to small, non-public banks could also have a negative impact on these banks' regulatory compliance costs, their ability to meet regulatory standards, and their ability to select directors that allow them to succeed and grow.

Part I of this Note recounts the history and purpose behind SOX. Part II examines the requirements of the most important provisions of SOX that apply to non-public banks or with which bank regulators have encouraged non-public banks to comply. Part III discusses the current applicability of these specific provisions, and guidance thereon, across the entire banking industry, from public banks and large banks, regardless of public/private status, to small, non-public banks. Part IV explores potential negative consequences of applying the SOX provisions discussed in Part II to small, non-public banks.

I. HISTORY AND PURPOSE BEHIND THE ACT

Since 1999, several well-documented and harmful corporate scandals have come to light. The most significant of

15. See infra notes 51-60 and accompanying text.
16. See infra notes 61-70 and accompanying text.
17. Joint Statement to Non-Public Banks, supra note 3, at Attachment.
19. See infra notes 131-151 and accompanying text.
20. See infra notes 152-154 and accompanying text.
21. See infra notes 155-161 and accompanying text.
22. See infra notes 26-36 and accompanying text.
23. See infra notes 37-70 and accompanying text.
24. See infra notes 71-123 and accompanying text.
25. See infra notes 124-161 and accompanying text.
these was the debacle of Enron Corporation, as a result of which investors lost $64.2 billion. Enron executives stand accused of participating in several illegal actions, including approving overly aggressive accounting for off-balance sheet partnerships, concealing information from auditors, and insider trading; some Enron executives have already agreed to plea bargains in connection with charges brought against them for their participation in these schemes. Enron's relationship with its former auditor, Arthur Andersen LLP, raised concerns about auditor independence because Andersen performed both internal and external audit services, as well as other consulting functions for Enron. J.P. Morgan Chase & Co. and Citigroup, Inc. agreed to a $305 million settlement with the Securities and Exchange Commission (SEC) for their respective roles in some of Enron's questionable financing transactions. Enron has also sued these banks, along with Merrill Lynch & Co., Deutsche Bank AG, Barclays PLC, and Canadian Imperial Bank of Commerce, for their advice and assistance in facilitating and covering up Enron's questionable transactions. Finally, the federal government has already charged, or may yet charge, individual bankers, lawyers, accountants, and other professionals with crimes for their actions in the Enron scandal.

27. Id.  
28. See, e.g., John R. Emshwiller, Ex-Enron Accounting Chief Charged, WALL ST. J., Jan. 23, 2002, at A5 (noting generally some of the misdeeds in which Enron executives may have participated).  
29. Id.  
30. See Thaddeus Herrick & Alexei Barrionuevo, Were Auditor and Client Too Close-Knit?, WALL ST. J., Jan. 21, 2002, at C1. Andersen was also indicted by the federal government for its destruction of evidence relating to services it provided to Enron. See Frank et. al., supra note 26.  
33. See, e.g., Frank et al., supra note 26 (discussing among others, the fates of David Duncan, Andersen's lead auditor for Enron, who plead guilty in his trial for Enron-related activities and Nancy Temple, Andersen's in-house counsel, who may be charged because she wrote a memo instructing Andersen employees to alter
The debacle regarding Enron, Arthur Andersen, and the large banks with which Enron did business was not the only corporate scandal which captured attention; other scandals were discovered at such companies as Adelphia Communications Corp., Global Crossing Ltd., HealthSouth Corp., Qwest Communications International, Inc., Tyco International Ltd., WorldCom Inc., and Xerox Corp. \(^{34}\) The Sarbanes-Oxley Act of 2002 represents Congress' attempt to deal with the problems created by these numerous corporate scandals discovered since 1999.\(^ {35}\) In fact, the Act's stated purpose is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws . . . ."\(^ {36}\)

II. A BRIEF LOOK AT THREE SELECTED PROVISIONS OF THE ACT

Congress intended SOX to protect investors by improving corporate governance practices in, and disclosures by, all publicly-traded companies.\(^ {37}\) Even though the Act directly applies only to public companies, in the banking industry, the federal regulators generally have encouraged small, non-public banking organizations to improve their practices regarding auditor independence, bank governance, and financial disclosures.\(^ {38}\) While the FDIC's stance appears to be more explicit in encouraging small, non-public banking organizations specifically to adhere to SOX principles when feasible,\(^ {39}\) the FRB, OTS, and OCC also generally have jointly encouraged these banks to evaluate and improve their practices as appropriate.\(^ {40}\) The following provisions are the most important aspects of SOX with which the federal documents).

34. Id.
35. See, e.g., Perino, supra note 2, at 671.
37. Id.
39. See Thompson, supra note 11, at 1.
40. See Joint Statement to Non-Public Banks, supra note 3, at Attachment.
bank regulators have encouraged small, non-public banking institutions to comply.\textsuperscript{41}

A. \textit{Title II – Auditor Independence}

Before considering the discrete aspects of Title II of SOX, it is important to briefly consider changes made by Title I of SOX to the oversight regime of public accounting firms. Section 101 provides for the creation of a new Public Company Accounting Oversight Board (PCAOB), whose objective is to oversee the audits of publicly-held companies in order to protect investors’ interests in obtaining accurate and independent audit reports.\textsuperscript{42} Public accounting firms must register with the PCAOB in order to provide external audit services for public companies.\textsuperscript{43}

Title II of SOX deals with the independence requirements of registered public accounting firms that provide external audit services for companies that have issued publicly-traded securities.\textsuperscript{44} Section 201 states that registered public accounting firms may not provide certain non-audit services to their publicly-held clients while simultaneously providing external audit services to those clients.\textsuperscript{45} In addition, audit committees of publicly-held companies generally must now pre-approve all auditing and permitted non-auditing services provided by their external auditors\textsuperscript{46} and must


\textsuperscript{43} § 102(a), 116 Stat. at 753 (codified at 15 U.S.C.A. § 7212(a) (Supp. 2003)).


\textsuperscript{45} See § 201, 116 Stat. at 771-72 (codified as amended at 15 U.S.C.A. § 78j-1(g) (Supp. 2003)). Generally, the nine prohibited non-audit services are the following: bookkeeping, systems design, valuation services, actuarial services, internal audits, human resources functions, investment banking, legal services, and any other services that the PCAOB deems inappropriate. \textit{Id}.

disclose to investors the non-audit services performed by their external auditors. An external auditor also must report to its client’s audit committee on all of that client’s critical accounting policies and on alternative and preferred treatments of that client’s financial information after these treatments have been discussed with the client’s management personnel.

Section 206, addressing auditor conflicts of interest, prohibits a registered accounting firm from auditing a public company if, during the preceding year, an executive in the client company was employed by the accounting firm and worked on the company’s audit. The Act also imposes an audit partner rotation requirement on registered accounting firms: lead or reviewing partners cannot work for more than five consecutive years on a public client’s external audit.

B. Title III – Corporate Responsibility

Audit committees of public companies are directly responsible for overseeing the work of the companies’ auditors. Consequently, the most significant provision of Title III of the Act is its requirement that each member of a public company’s audit committee be an independent director. Audit committee members may not accept any compensation from the company,

49. § 206, 116 Stat. at 774-75 (codified as amended at 15 U.S.C.A. § 78j-1(l) (Supp. 2003)). This provision addresses situations such as the one at Enron, in which there was an increased risk of collusion that ultimately abetted Enron executives’ corporate fraud. See Herrick & Barrionuevo, supra note 30, at C1 (describing how many former Andersen employees who had worked on previous Enron audits were hired by Enron, including Enron’s chief accounting officer and its chief financial officer, while Andersen continued to provide external audit services to Enron).
51. § 301, 116 Stat. at 775-77 (codified as amended at 15 U.S.C.A. § 78j-1(m) (Supp. 2003)). The portions of Title III of the Act which are most relevant to this Note are sections 301, 302, and 303; the other sections of Title III will not be discussed, as they are less relevant to this Note. See infra notes 51-59 and accompanying text.
other than that for service on the company's board of directors, and may not be an "affiliated person" of the company.\textsuperscript{53}

The chief executive and financial officers of a public company are directly responsible for certifying the company's annual and quarterly reports.\textsuperscript{55} The officers must sign these reports, verifying that they have reviewed the reports, that the reports are not misleading, and that the reports fairly present, in all material respects, the financial condition of the company.\textsuperscript{56} In addition, these officers' signatures on the company's reports represent their acknowledgement that they are responsible for maintaining the company's internal controls and that the reports include their recent evaluation of these controls.\textsuperscript{57} The chief

\textsuperscript{53} There appears to be some confusion as to what the term "affiliated person" means. The FRB has stated that "affiliated person" for the purpose of SOX § 301 is defined by reference to the Investment Company Act of 1940 (codified at 15 U.S.C. §80a-2(a)(3) (2000)) and includes any company officer or employee who owns more than five percent of the voting securities of that company. See Federal Reserve Board SR Letter 02-20 from the Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, to the Officer in charge of supervision and appropriate supervisory and examination staff at each Federal Reserve Bank and to each domestic and foreign banking organization supervised by the Federal Reserve (Oct. 29, 2002), available at http://www.federalreserve.gov/boarddocs/SRLETTERS/2002/sr0220.htm, at n.3 (last visited Feb. 7, 2004) [hereinafter FRB SR Letter 02-20]. However, Congress has given the federal bank regulators (including the FRB) the power to enforce rules adopted by the SEC relating to SOX section 301. See § 3, 116 Stat. at 749-50 (codified as amended at 15 U.S.C.A.§ 78j(i) (Supp. 2003)) (enabling the federal bank regulators to enforce SEC rules relating to 15 U.S.C. § 78j-1 (as amended by SOX), which is the statute that is amended by section 301 of SOX). The SEC has adopted a final rule which generally defines an "affiliated person" as someone who directly or indirectly controls a company. 17 C.F.R. § 240.12b-2 (2003). In addition to this apparent regulatory confusion, the banking world itself appears to be vexed as to how to satisfy the independent audit committee standard of SOX section 301. See Bill Stoneman, Special Report: Community Banking – Governance Reforms a Puzzle for Small Banks, AM. BANKER, Sept. 19, 2003, at 6A (describing a situation in which one bank, in its effort to comply with SOX, removed two directors from its audit committee because it was unsure of their independence: one director's construction company occasionally does repair work for the bank and bid unsuccessfully to construct a new branch building; the other director's environmental engineering firm advised the bank on wetlands issues when the new branch was built and occasionally reviews environmental issues regarding loan requests).


\textsuperscript{56} Id.

\textsuperscript{57} See id. (requiring the chief executive and financial officers' report to be based on an evaluation of the company's internal controls within the ninety days preceding issuance of the report).
executive officer and chief financial officer must also indicate any material changes in the company's internal controls that have occurred after the date of their internal control evaluation.\textsuperscript{58} They must certify that they have disclosed to the company's auditors and to its audit committee all significant internal control deficiencies, as well as any fraud related to internal controls uncovered by the organization.\textsuperscript{59} Finally, pursuant to section 404, a public company's auditor must report on the fairness of management's assertions regarding internal controls which are contained in the company's annual and quarterly reports.\textsuperscript{60}

C. Title IV – Enhanced Financial Disclosures

Title IV of the Act requires the SEC to implement rules requiring a public company to disclose whether its audit committee includes a member who is a "financial expert," as defined by the SEC in accordance with SOX.\textsuperscript{61} The SEC's final rule\textsuperscript{62} provides that the "audit committee financial expert,"\textsuperscript{63} should have experience as an auditor or in a position comparable to chief financial officer in a similar company, an understanding of generally accepted accounting principles (GAAP) and financial statements, experience with internal controls, and an understanding of audit committee duties.\textsuperscript{64} If a public company's audit committee does not contain a financial expert, the company not only must disclose this fact, but it must also disclose why the audit committee does not contain a financial expert.\textsuperscript{65}

\textsuperscript{58} Id.
\textsuperscript{59} Id.
\textsuperscript{60} § 404, 116 Stat. at 789 (codified at 15 U.S.C.A. § 7262 (Supp. 2003)).
\textsuperscript{63} The SEC defined the term "audit committee financial expert" in place of the term "financial expert as used in SOX because of opposition to the term "financial expert." Id. at 5112. The SEC believed that the term "audit committee financial expert" more accurately reflects the fact that the "expert" plays a key role on the audit committees of public companies. Id.
\textsuperscript{64} See id. at 5127.
\textsuperscript{65} Id.
Pursuant to section 406, the SEC has adopted a final rule that requires public companies to include with their annual and quarterly reports a statement as to whether they have adopted a code of ethics for senior financial officers to promote honest and ethical conduct. If a public company has not adopted a code of ethics for senior financial officers, the SEC requires the company to explain why it has not done so. Public companies also have to disclose promptly any changes in their ethics codes or waivers thereof for senior financial officers.

III. CURRENT APPLICABILITY OF, AND GUIDANCE ON, THESE SOX PROVISIONS

SOX applies only to public companies, including public banking institutions. While any non-public company may of its own volition choose to adhere to the principles and practices contained in the Act, SOX does not apply to non-public companies, including non-public banks, bank holding companies, and savings associations. However, large non-public banking organizations insured by the FDIC still must continue to comply with Section 36 of the Federal Deposit Insurance Act and its implementing regulations, which impose some requirements similar to those found in SOX. In addition, the FDIC has issued guidance that seems to strongly encourage all non-public banks, including small institutions, to adhere to the principles contained

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68. Id. at 5127.
69. Id.
70. See id. at 5128.
71. Joint Statement to Non-Public Banks, supra note 3, at Attachment.
72. Id.
75. See infra notes 85-110 and accompanying text (noting some of the similarities in the requirements of SOX and Part 363 of the FDIC’s regulations).
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The FRB, OTS, and OCC have also issued joint guidance to non-public banks which encourages them to review and adjust their governance, financial disclosures, and auditor independence policies as appropriate, even though it does not encourage compliance with SOX provisions as explicitly as the FDIC’s guidance. Finally, individual states may choose to implement laws which mandate SOX-like practices for banks to which SOX does not directly apply, however, because significant developments in this area have not yet occurred, a discussion regarding SOX-like requirements at the state level is beyond the scope of this Note.

A. Public Banking Institutions

Public banking institutions are those which have registered their securities with the SEC or one of the federal banking regulatory agencies as appropriate, pursuant to the Securities Exchange Act of 1934. Public banks and subsidiaries of publicly-held bank holding companies must comply with the SOX provisions discussed above in Part II. Selected sections of these SOX provisions are codified as amendments to section 10A of the Securities Exchange Act of 1934. The Act amends the federal

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76. See Thompson, supra note 11, at 1; FDIC Corporate Governance Letter, supra note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to FDIC-Supervised Banks with Less Than $500 Million in Total Assets That Are Not Public Companies.

77. See Thompson, supra note 11, at 1; Joint Statement to Non-Public Banks, supra note 3, at Attachment.

78. See Laura K. Thompson, Alabama’s New SOX?, AM. BANKER, Jan. 14, 2003, at 1 (discussing a proposed law that would require all Alabama state banks to comply with new rules regarding, among other things, audit committee, independent auditor, and codes of ethics for executive officers).

79. See id. at 1 (stating that “Alabama . . . is thought to be the first state to consider revising its standards since Sarbanes-Oxley took effect.”).

80. See supra note 3 (defining “public banking organizations”).

81. See Joint Statement to Non-Public Banks, supra note 3 at Attachment; FDIC Corporate Governance Letter, supra note 10.

securities laws to allow the federal bank regulators to enforce these SOX sections, as well as rules and regulations similar to those adopted by the SEC pursuant to other relevant SOX provisions against the public banking organizations.\textsuperscript{83} Other than to simply provide a brief overview of some especially important parts of SOX,\textsuperscript{84} the federal bank regulatory agencies have not issued any guidance to publicly-held banks regarding these provisions of the Act.

B. Large Non-Public Banking Institutions

Neither SOX nor the federal bank regulators specifically require non-public banks with at least $500 million in total assets to comply with Titles II, III, or IV of SOX.\textsuperscript{85} However, FDIC

\textsuperscript{83} See § 3(b)(4), 116 Stat. at 749-50 (codified as amended at 15 U.S.C.A. § 781(i) (Supp. 2003)). The changes adopted in SOX § 3(b)(4) allow the federal bank regulators to enforce all of the SOX provisions discussed in this Note. See id.; supra notes 44-70 and accompanying text (describing all of the relevant SOX provisions which the federal bank regulators may enforce).

\textsuperscript{84} See FRB SR Letter 02-20, supra note 53.

\textsuperscript{85} See Joint Statement to Non-Public Banks, supra note 3, at Attachment and FDIC Corporate Governance Letter, supra note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to Insured Institutions with $500 Million or More in Total Assets. However, the following relevant portions of SOX already apply directly or analogously to large non-public banks: sections 201 through 204 and 206 (all regarding auditor independence), section 301 (regarding audit committee composition), and section 404 (regarding auditor attestation of management's assertions about internal controls). See FDIC Corporate Governance Letter, supra note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to Insured Institutions with $500 Million or More in Total Assets. Part 363 of the FDIC's regulations contains applicable rules which are similar, but not identical, to SOX section 302 (regarding managerial responsibility for financial statements and internal controls, and reports thereon). See 12 C.F.R. § 363.2 (2003). While Part 363 requires the audit committees of FDIC-insured banks with over $3 billion in total assets to include members with banking or financial management experience, this requirement does not appear to be substantially similar to the requirement of SOX section 407 that public companies disclose whether their audit committees contain at least one "financial expert." Compare 12 C.F.R. § 363.5 (2003) with Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 745, 790 (codified at 15 U.S.C. § 7265 (Supp. 2003)). The FDIC has also said that it does not expect non-public banks to comply with the "financial expert" disclosure requirement of section 407. FDIC Corporate Governance Letter, supra note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to Insured Institutions with $500 Million or More in Total Assets. Finally, there is no provision in Part 363 that corresponds to SOX section 406 (regarding disclosures related to managerial codes of ethics). See 12 C.F.R. § 363 (2003) (containing no provision analogous to SOX section 406). However, the FDIC's guidance to non-
insured institutions with at least $500 million in total assets, whether they are public or non-public, have been subject to federal banking laws requiring independent audits and governing audit committees and financial reporting\(^6\) since the FDIC Improvement Act of 1991,\(^7\) which improved supervision of banking organizations in the wake of the savings and loan crisis in the 1980s.\(^8\)

The FDIC's regulations state that a bank's relationship with its external auditor should satisfy the independence requirements adopted by the SEC.\(^9\) Because the SEC adopted the auditor independence provisions of sections 201 through 204, and 206 of SOX,\(^10\) FDIC-insured, non-public banks with at least $500 million in total assets must follow the SEC regulations implementing these sections of the Act.\(^11\)

Part 363 of the FDIC's regulations also provides that each FDIC-insured bank with at least $500 million in total assets must maintain an audit committee comprised of independent outside directors\(^12\) to perform such functions as reviewing significant accounting policies with management and the external auditor, reviewing the adequacy of internal controls, and overseeing the bank's internal audit function.\(^13\) This requirement is effectively identical to the independent audit committee requirement in SOX public banks encourages compliance with section 406. FDIC Corporate Governance Letter, \textit{supra} note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to Insured Institutions with Less Than $500 Million in Total Assets.


\(^8\) See id. (listing the improvement of the supervision and examinations of banking organizations as the purpose of the Federal Deposit Insurance Corporation Improvement Act of 1991).


\(^12\) 12 C.F.R. § 363.5(a) (2003).

section 301. Also under Part 363, an FDIC-insured banking organization with at least $500 million in total assets must submit to the appropriate regulating agency a management report, signed by the bank’s chief executive officer and chief financial officer, which states that management is responsible for the preparation of the bank’s financial statements. In addition, this report must contain a statement of management’s responsibility for the bank’s internal controls and an assessment by management of the effectiveness of those internal controls as of the end of the bank’s fiscal year. These requirements are similar to the provisions in SOX regarding management’s responsibility for financial statements and internal controls; however, the FDIC recognizes differences between Part 363 and SOX, and has stated that a report that complies with SOX section 302 may not comply with Part 363 of the FDIC regulations. For example, one major difference in these reports is that a Part 363 report must contain a statement that management is responsible for preparing a company’s financial statements; on the other hand, a report in compliance with SOX section 302 must only state that management has no knowledge of a material misstatement in, or omission from, a company’s financial statements. However, the FDIC views the auditor’s report on management’s internal control assertions, which is required by SOX section 404, as substantially similar to the auditor’s report required by Part 363. Finally, Part

95. 12 C.F.R. § 363.2(b) (2003).
96. Id.
101. See FDIC Corporate Governance Letter, supra note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to FDIC-Supervised Banks with $500 Million or More in Total Assets (recognizing that the language used in SOX section 404 and Part 363 is substantially similar).
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363 requires any FDIC-insured bank with total assets in excess of $3 billion to have members on its audit committee who have "banking or related financial management expertise." This requirement is somewhat analogous to SOX section 407, which requires public companies to have at least one audit committee member who meets the SEC's definition of "financial expert;" however, by its terms, this provision of Part 363 is limited in its applicability only to very large banks and requires audit committee members to have different expertise than that required by SOX.

The FRB, OTS, and OCC stated in their joint guidance that they do not foresee applying these SOX provisions to any banks which they regulate and to which these provisions currently do not apply. However, in its guidance, the FDIC stated that it has considered possible amendments to Part 363 of its regulations, which would extend the provisions of SOX discussed in this Note to large non-public banks. Because the FDIC would develop these changes to Part 363 with the other regulatory agencies, it is unclear whether and to what extent any of the provisions of the Act not currently applicable to banks with at least $500 million in total assets would be applied to these banks. It is also unclear, if the FDIC decided on its own to attempt to apply SOX principles by analogy to the non-public banks which it insures but does not supervise, whether such banks would be subject to the FDIC's

102. 12 C.F.R. § 363.5(b) (2003).
104. See 12 C.F.R. 363.5(b) (2003) (requiring only FDIC-insured banks with more than $3 billion in total assets to have audit committee members with "banking or related financial management expertise").
106. Joint Statement to Non-Public Banks, supra note 3.
108. Id.
109. The FDIC insures but does not supervise state Federal Reserve System member banks (supervised by the FRB), national banks (supervised by the OCC), or savings associations (supervised by the OTS). See 15 U.S.C. § 78l(i) (2000).
decision or to their supervising agency's decision not to apply SOX principles to such banks.\textsuperscript{110}

C. Small Non-Public Banking Organizations

Neither SOX nor bank regulators compel non-public banks with less than $500 million in total assets to comply with Titles II, III, or IV of SOX; Part 363 of the FDIC regulations also does not apply to these banks.\textsuperscript{111} However, the FDIC has issued guidance encouraging the small non-public institutions that it supervises to adhere to SOX principles when feasible.\textsuperscript{112} Perhaps less explicit in their encouragement about adoption of SOX principles,\textsuperscript{113} the other bank regulatory agencies jointly issued their own guidance, which applies only to the small, non-public institutions that they supervise, regarding important provisions of the Act.\textsuperscript{114} While the two sets of regulatory guidance appear to take different tones with regard to how much the application of SOX principles to small, non-public banks is favored,\textsuperscript{115} both sets of guidance generally advise small, non-public banks to improve their auditor independence, corporate governance, and financial disclosure practices as appropriate, perhaps using SOX as a guide for improvement.\textsuperscript{116}

\textsuperscript{110} In such a case, only state banks which are not members of the Federal Reserve System would not be subject to conflicting guidance from the FDIC and another federal bank regulator because the FDIC would both insure and supervise these banks.

\textsuperscript{111} See Joint Statement to Non-Public Banks, \textit{supra} note 3; FDIC Corporate Governance Letter, \textit{supra} note 10.


\textsuperscript{113} See generally Thompson, \textit{supra} note 11.

\textsuperscript{114} Joint Statement to Non-Public Banks, \textit{supra} note 3.

\textsuperscript{115} See generally Thompson, \textit{supra} note 11. But see Rob Garver, \textit{In Brief: FDIC Reassures Privately Held Banks}, AM. BANKER, July 11, 2003, at 20 (stating that the FDIC has said that it will not apply SOX principles to a wider range of banks than will the other federal bank regulators).

For example, while none of the federal bank regulators require non-public banks with less than $500 million in total assets to obtain external audits, prior joint guidance from all four of the federal regulators has encouraged them to do so.\textsuperscript{117} This guidance was reiterated in both the FDIC's guidance on SOX to small non-public banks and the joint guidance released to non-public banks by the FRB, OTS, and OCC.\textsuperscript{118} Both sets of guidance generally state that if small non-public banks choose to obtain external audits, they are encouraged to employ independent auditors and to have independent audit committees.\textsuperscript{119} However, the FDIC perhaps goes further in its guidance, and specifically states, for example, that it encourages small, non-public banks to adopt codes of ethics for senior financial officers,\textsuperscript{120} as section 406 of the Act requires for publicly-held companies.\textsuperscript{121} The FDIC also encourages small, non-public banks to disclose periodically whether they have adopted such a code of ethics and the reasons for not adopting an ethics code if they have not done so.\textsuperscript{122}

On the other hand, the OTS, FRB, and OCC have not issued specific guidance regarding the adoption of codes of ethics


\textsuperscript{118} Joint Statement to Non-Public Banks, supra note 3 at Attachment; FDIC Corporate Governance Letter, supra note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to FDIC-Supervised Banks with Less Than $500 Million in Total Assets That Are Not Public Companies.

\textsuperscript{119} See Joint Statement to Non-Public Banks, supra note 3 at Attachment; FDIC Corporate Governance Letter, supra note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to FDIC-Supervised Banks with Less Than $500 Million in Total Assets That Are Not Public Companies.

\textsuperscript{120} FDIC Corporate Governance Letter, supra note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to FDIC-Supervised Banks with Less Than $500 Million in Total Assets That Are Not Public Companies.


\textsuperscript{122} FDIC Corporate Governance Letter, supra note 10, at Attachment: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to FDIC-Supervised Banks with Less Than $500 Million in Total Assets That Are Not Public Companies.
for senior financial officers in small non-public banks, or regarding the disclosure of the presence or absence of a "financial expert" on the audit committees of these banks. These agencies have said, though, that these organizations are encouraged to review periodically and revise their bank governance and financial disclosure practices when doing so is feasible, considering the size and complexity of each small, non-public bank.¹²³

IV. POTENTIAL CONSEQUENCES OF APPLYING SOX PRINCIPLES TO SMALL, NON-PUBLIC BANKS

While none of the four federal banking regulatory agencies currently apply the principles contained in SOX to any non-public banking institutions,¹²⁴ community banks are concerned that regulators may apply the Act's provisions to non-public banks.¹²⁵ Even absent formal application of SOX principles to non-public banks by the federal bank regulators, community banks are concerned that individual regulators might be able to pressure a small, non-public bank into a practice advanced in SOX by suggesting to the bank that such compliance is feasible and should be done.¹²⁶ While the goal of enforcing compliance with SOX among small, non-public banks would be to "[raise] the bar on corporate governance,"¹²⁷ such enforcement has at least three potential negative consequences for these banks: increasing regulatory compliance costs;¹²⁸ imposing an extremely difficult regulatory burden;¹²⁹ and restricting the growth of small, non-public banks.¹³⁰

¹²³. Joint Statement to Non-Public Banks, supra note 3 at Attachment.
¹²⁴. See id.; see also FDIC Corporate Governance Letter, supra note 10.
¹²⁶. See Stoneman, supra note 53, at 6A (containing a statement by the president of a small, privately-held bank in North Carolina that he believes bank regulators will pressure his bank to put a "financial expert" on his bank's audit committee).
¹²⁷. Id.
¹²⁸. See infra notes 131-151 and accompanying text.
¹²⁹. See infra notes 152-154 and accompanying text.
¹³⁰. See infra notes 155-161 and accompanying text.
A. Increasing Regulatory Compliance Costs

Some small public banks have decided to go private to avoid the extra costs that accompany compliance with SOX. Furthermore, experts also predict that many banks will decide not to go public in order to avoid the additional compliance costs associated with the Act. Some items contributing to the increased compliance costs may be auditing fees, director compensation, time and effort expended on compliance efforts, and record-keeping requirements associated with enhanced disclosures.

As discussed, the Act prohibits auditors from providing certain non-audit services to a client while serving as that client’s external auditor. As a result, external audit costs are expected to rise, because audits have historically served as loss leaders for accounting firms, which sold external audit services at low rates in order to attract clients to whom they could later sell more lucrative internal audit outsourcing, technology, and other consulting services. In addition, audit fees could rise because the Act requires auditors to spend more time reporting to their clients’ audit committees and to report on management’s assertions about internal controls.

A standard practice of community banks is to entice professionals to serve on their boards of directors by allowing them to earn fees by providing consulting services to the banks. Because SOX requires that all audit committee members be

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132. Id.
133. See infra notes 134-147 and accompanying text.
134. See supra note 45 and accompanying text (discussing SOX section 201).
136. See Coleman & Bryan-Low, supra note 135.
independent, banks could not implement this practice with regard to board members who would serve on the bank's audit committee. Payment for serving on the bank's board of directors might have to increase to compensate for the fact that banks could no longer lure professionals who would serve on a bank's audit committee by promising consulting opportunities to those professionals.

In addition, as many rural banks may not have access to independent “financial experts” to serve on their audit committees, these banks could have to resort to electing “financial experts” from metropolitan areas to serve on their boards of directors and audit committees, who could require increased compensation for their service. If these banks could not obtain “financial experts” for their audit committees, under SOX section 407, they would have to disclose in their financial statements that their audit committees do not contain “financial experts.” As a result, these banks could suffer “market consequences.” Presumably, such “market consequences” would include diminished investor and customer confidence in the financial reports issued by these banks, since their audit committees would not contain “financial experts.” Consequently, investors could discount the values of these banks' securities, and customers could take their business elsewhere.

The Act also requires corporate senior financial officers to take on additional responsibility for maintaining and reporting on a company's internal controls. As a result, these officers are likely to spend more time reviewing and testing a company's

139. Kuehner-Hebert, supra note 137, at 6.
141. See generally id. (stating that few individuals qualified to serve as “financial experts” on audit committees would be interested in joining the board of directors of a distant small bank).
144. See supra notes 55-60 and accompanying text (describing the Act’s requirements regarding management’s responsibility for maintaining and reporting on internal controls).
internal controls, and may cause banks to purchase expensive new compliance software to manage internal controls. These efforts go hand in hand with increased record-keeping requirements to document the senior financial officers' reviews and tests of internal controls. Finally, boards of directors must adopt codes of ethics for senior financial officers, which in turn necessitates additional time and effort to be expended by boards to develop, maintain, and keep records of these codes.

Smaller, non-public banks generally have fewer resources to devote to compliance with regulatory requirements and typically operate with less complexity than publicly-held banks. Non-public banking institutions with at least $500 million in total assets are already subject to many of these increased costs of complying with SOX. However, applying the principles contained in the relevant SOX provisions to non-public banks with less than $500 million in assets would put a severe strain on these banks' limited resources. Such application might also provide only minimal benefits to the banks and their investors, because investors in these banks probably are more familiar with the financial status of the banks than investors in public banks, and thus would not be protected by the additional strictures regarding auditor independence, corporate governance, and enhanced disclosures imposed by SOX.

146. See id.
149. See supra notes 85-110 and accompanying text (regarding the specific SOX provisions and other federal banking regulations with which large non-public banks must expend significant resources to comply).
150. See Thompson, supra note 131, at 1.
151. See generally id. (implying that some smaller public banks are going private because shareholders in small banks consider the time and cost savings achieved by not complying with SOX to be more valuable than any benefits that may be achieved by conforming to the Act).
B. **Imposing an Extremely Difficult Regulatory Burden**

If all of the principles contained in the relevant SOX provisions were applied to small, non-public banks, these banks would find it very difficult to procure separate external and internal auditing firms and to assemble a truly independent audit committee.\(^{152}\) In addition, non-public banks in rural locations could discover that finding a “financial expert” to serve on their audit committees may be problematic because of the lack of qualified individuals within these rural areas.\(^{153}\) Thus, small, non-public banks in rural communities could find it very difficult, if not impossible, to comply if bank regulators required them to satisfy SOX-like requirements regarding auditor independence, audit committee independence, and the presence of a “financial expert” on the audit committee.\(^{154}\) The additional provisions of SOX would simply add to the burden on these banks to comply with enhanced regulatory requirements, and could lead to such consequences as their acquisition by larger banks with the resources and ability to comply with SOX.

C. **Restricting the Growth of Small, Non-Public Banking Institutions**

Arguably, applying the principles contained in the relevant SOX provisions to small, non-public banks could increase their ability to access the financial markets because these banks would not become or remain privately-held solely to avoid compliance with SOX.\(^{155}\) These banks would be subject to SOX regardless of their public/private status; thus they would not be dissuaded from entering the public markets simply to avoid compliance with SOX.\(^{156}\) The removal of this barrier to going public would allow

\(^{152}\) *Id.*

\(^{153}\) Davenport, *supra* note 140, at 6.

\(^{154}\) *Id.; see* Thompson, *supra* note 131, at 1.

\(^{155}\) *Contra* Thompson, *supra* note 131, at 1 (documenting at least five cases in which banks went private to avoid compliance with SOX). The Act currently may be causing some publicly-held small banks to go private, and it also may be causing some privately-held banks not to go public because of its stringent requirements. *Id.*

\(^{156}\) *Contra id.*
these banks easier access to capital, increased public exposure, and increased ability to attract qualified personnel, potentially resulting in growth of the banks that decide to go public.\textsuperscript{157}

On the other hand, small, non-public banks may want their directors to be local to a rural area in order to help these banks identify and solicit customers.\textsuperscript{158} In addition, these banks may feel that their boards should be comprised primarily of people whose expertise lends itself to developing the business of these banks, instead of simply directors whose expertise is in complying with bank regulations.\textsuperscript{159} If the audit committee independence and the audit committee “financial expert” requirements were applied to small, non-public banks, these institutions might have to try to elect directors from other areas in order to find persons who would qualify for service as independent directors or as “financial experts” on these banks’ audit committees.\textsuperscript{160} Furthermore, if these requirements were to apply to small, non-public banks, many of these banks would be put in the possibly undesirable position of having boards comprised of persons who are directors because of their expertise as “financial experts,” instead of their perceived ability to govern and grow these banks.\textsuperscript{161}

V. Conclusion

Congress passed SOX in an attempt to heighten investor protection after a wave of corporate scandals.\textsuperscript{162} The Act and the regulations implementing it amend the federal securities laws to require, among other things, increased auditor independence, better corporate governance, and enhanced financial disclosures


\textsuperscript{158} See Davenport, \textit{supra} note 140, at 6.

\textsuperscript{159} See \textit{id.} (stating the opinion of the chairman and chief executive officer of a small New York bank that “community banks would suffer if their boards were made up primarily of accountants, rather than business-development experts.”).

\textsuperscript{160} See generally \textit{supra} notes 152-54 and accompanying text (discussing the difficulty that small banks in rural communities could have in securing “financial experts” to serve on their boards of directors and audit committees).

\textsuperscript{161} See generally Davenport, \textit{supra} note 140, at 6.

\textsuperscript{162} See \textit{supra} notes 26-36 and accompanying text (discussing the history and purpose of SOX).
among all public companies. There are several provisions of the Act which are especially relevant to the banking industry; however, these provisions apply only to public banks. While the FDIC has made some of these provisions applicable to large non-public banking institutions, none of the relevant provisions of SOX are specifically applicable to small, non-public banks. However, community bankers are still concerned about the extent to which regulators may apply these provisions of the Act to small, non-public banks.

Nevertheless, there are at least three arguments against bank regulators applying the principles contained in the SOX provisions discussed to small, non-public banks. First, application of SOX to these banks would greatly increase costs of compliance to these banks, which generally have fewer resources to devote to compliance with bank regulations. The operations of these banks are less complex than publicly-traded banks, and investors in these banks probably are more familiar with the financial status of these banks than are investors in public banks. As a result, only slight benefits would come at significantly higher costs of compliance to small, non-public banks if SOX standards were applied to small, non-public banks.

Second, requiring these banks to comply with the principles in the relevant SOX provisions would be unduly burdensome.

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163. See supra notes 37-70 and accompanying text (outlining some of the most significant sections of the Act).
164. See id.
165. Joint Statement to Non-Public Banks, supra note 3; FDIC Corporate Governance Letter, supra note 10.
166. See supra notes 85-110 and accompanying text (discussing the applicability of SOX provisions and other federal banking regulations to large non-public banks).
167. See Joint Statement to Non-Public Banks, supra note 3; FDIC Corporate Governance Letter, supra note 10.
168. See America’s Community Bankers, supra note 125, at 46.
169. See supra notes 131-161 and accompanying text (arguing against the application of SOX-like standards to small, non-public banks).
170. See Thompson, supra note 131, at 1.
171. Joint Statement to Non-Public Banks, supra note 3, at Attachment.
172. Id.
173. See generally Thompson, supra note 131, at 1.
174. See supra notes 152-54 and accompanying text (noting the high degree of difficulty that small banks, particularly those in rural areas, could experience in their efforts to comply if they were required to satisfy the Act’s standards).
Even if small, non-public banks could cope with the increased costs of compliance created by the application of SOX principles, these banks would probably find it very difficult, if not impossible, to find independent auditors, audit committee members, and "financial experts," as would be required by the application of the principles contained in selected SOX provisions.175 Finally, requiring small, non-public banks to comply with the Act could lead these banks to choose their directors based on concerns about complying with the audit committee independence or "financial expert" requirements of SOX.176 Choosing directors on this basis could inhibit the growth of these banks because directors chosen primarily for SOX compliance purposes might be less qualified to develop the business of these banks.177 Regulators can avoid imposing burdensome compliance costs and restricting the growth of small banks by choosing not to apply the selected provisions of SOX to non-public banks with less than $500 million in total assets.

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175. Id.
176. See supra notes 155-161 and accompanying text.
177. Id.