

Codes of Conduct in light of Sarbanes-Oxley, NYSE listing requirements, and the SEC

By Steve Priest and Jeff Kaplan, January 2003

Despite the fact that Enron and WorldCom had codes of conduct prior to their spectacular collapses, many organizations have issued opinions and directives promoting codes of conduct in the last twelve months. From a governance perspective, the most important voices in this chorus of code promoters are the New York Stock Exchange and the Securities Exchange Commission, especially in its role implementing the Sarbanes-Oxley Act.

Unfortunately, any time institutions of this magnitude speak about a compliance issue, legions of lawyers and consultants come forth to frighten companies into over-reacting. We would like to calm, rather than frighten. Most companies with existing Codes will have to make only minor changes in order to live up to the letter and spirit of the NYSE listing requirements and Sarbanes-Oxley/SEC requirements. At the same time, there is a danger that other organizations might be lead into the mistaken belief that meeting these mandates is not only necessary but is also *sufficient* to have an effective ethics and compliance program.

This article will address the major questions corporations are – or should be - asking about their Codes.

A separate code for financial executives?

Recently issued SEC regulations applying the Sarbanes-Oxley Act require that “a company will be required to disclose annually whether the company has adopted a code of ethics for the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If it has not, the company will be required to explain why it has not.”

Note that neither in the SEC regulations nor in the original Sarbanes-Oxley Act is a separate code for financial executives mentioned. The SEC regulations do amplify the requirement by defining a code of ethics “as written standards that are reasonably necessary to deter wrongdoing and to promote

1. honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
2. full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the Commission and in other public communications made by the company;
3. compliance with applicable governmental laws, rules and regulations;
4. the prompt internal reporting of code violations to an appropriate person or persons identified in the code; and
5. accountability for adherence to the code.”

Every one of these elements (with the exception of the specific mention of the SEC) is fundamental to the many good codes of ethics already in existence in corporate America. Creating an additional code of ethics that covers these elements is redundant, complicating, and potentially confusing for employees inside and outside the finance function.

Some corporations reacted to the Sarbanes-Oxley Act by requiring financial executives to read and sign off on the code created for financial executives by Financial Executives International. While probably no harm will come of this, we don't believe this is a necessary or sufficient remedy. Among other things, the FEI code – which was designed for membership in that organization more than for employment in a company - does not address the reporting and accountability elements required by the SEC rules. Communicating and enforcing one well written Code for all employees is the best remedy.

A separate code for board members?

After the New York Stock Exchange issued its requirement for listed companies “to adopt and disclose a code of business conduct and ethics for directors, officers and employees,” many companies reviewed their codes and noted that they did not explicitly apply to members of the board of directors. A number decided that the language in their codes was inappropriate for board members, and decided to write separate codes.

We believe that this is inadvisable. A company's code of ethics should apply to board members, when they are acting in their capacity as directors. If they are working for the company or representing the company, there is no reason to hold them to a different, often lesser standard.

The question of what are appropriate standards for directors, however, is distinct from the issue of how those standards are communicated. We believe that boards should receive training in their companies' codes, both so they understand the standards that are applicable to them and also to help them exercise their duty –under the Caremark case – to ensure that an ethics/compliance program is in place in their companies.

“One company and one code for all employees” should remain the guiding principle for companies.

Publicizing the code

The NYSE requires companies to disclose their codes of business conduct. The SEC states that “A company will be required to make available to the public a copy of its code of ethics, or portion of the code that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions.” The new rules will be effective 30 days from the date of their publication in the Federal Register.

Both the NYSE and the SEC even suggest how a company can publicize its code. The NYSE requires listed companies to post their codes on their websites. The SEC states “A company can make the code of ethics available to the public by filing it as an exhibit to its annual report, providing it on the company's Internet Web site, or as otherwise set forth in the final rule.”

Many companies have been posting their codes on their internet web site for years. They have faced few negative consequences, most notably “unwelcome” calls in to the Ethics Helplines, primarily from customers and others who have a complaint with the company. These are typically transferred to normal customer complaint channels. On the plus side, several companies have received important reports from vendors and the public as a result of posting the code. And Human Resource professionals report that the code is an asset in recruiting new employees.

Changing the code

The new twist in publicizing codes is the requirement to notify the public of changes to the Code. The SEC states that “A company, other than a foreign private issuer or registered investment company, also will be required to disclose any changes to, or waivers of, the code of ethics within five business days, to the extent that the change or waiver applies to the company's principal executive officer or senior financial officers. A company can provide this disclosure on Form 8-K or on its Internet Web site. Foreign private issuers and registered investment companies will be required to disclose changes to, and waivers of, such codes of ethics in their periodic reports or on their Internet Web sites.”

This means, of course, that most companies will not want to change their codes frequently. Most large corporations have adopted informal code revision cycles of roughly three to five years. We see no reason for this cycle to change. Laws, rules, technologies and risks will change; codes should evolve over time. Updating the company code periodically should not be seen as a negative by the investing marketplace. To the contrary, such updates should signal that the company’s code – and hence its ethics program – is dynamic.

We have written codes that have been read by millions of employees around the world. Many of our codes include Q&As, stories, and other examples designed to bring the Code to life. Q&As and FAQs are most helpful when they are most specific. Because of the public nature of codes now, and because of the requirement to notify the public of changes to the Code, we are now asking companies to reconsider including question and answer sections in codes. We continue to promote use of Q&A in training and communications about the code, but simply suggest removing them from the code itself.

Waivers of the code

In the wake of the Enron fiasco, where the Board's repeated waiver of the Code for the company's CFO appears to have contributed to the company's demise, both the NYSE and the SEC have new rules on waivers. The NYSE states that "Any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders." As quoted in the previous section, the SEC requires public disclosure of any waiver of the Code for the CEO or senior financial officers within five business days.

The clear implication of these rules will be to essentially eliminate any waiver of company codes. So clearly company codes should be reviewed to ensure that they are written in such a way that waivers are not going to be required.

Some skeptics have predicted that the waiver requirement will lead to toothless codes. We disagree. With every major company's code on the web, it would be foolhardy for any company to weaken their code simply to avoid the possibility of a waiver.

Others have argued that the rules require disclosure of any instance in which a conflict of interest, no matter how de minimus, or the appearance of a conflict is approved under a company's ethics program (such as if the corporation determines that an employee may accept a gift or entertainment over the dollar limit or guideline stated in the company's code.) We do not believe this to be the case, particularly since the SEC has recently indicated that the codes need not prohibit all conflicts but rather mandate "the ethical handling of actual or apparent conflicts..."

What should be in the code

One of the most curious developments is that both the SEC and the NYSE have weighed in with suggestions for code content. The SEC suggestions are in the first section of this article. The NYSE suggests the following topics for inclusion: (see www.nyse.org for complete information.)

- Compliance standards and procedures
- Conflicts of interest
- Corporate opportunities
- Confidentiality
- Fair dealing "with the company's customers, suppliers, competitors and employees."
- Protection and proper use of company assets
- Compliance with laws, rules and regulations (including insider trading laws)
- Encouraging the reporting of any illegal or unethical behavior

Most company codes already include most if not all of these topics, and little if any revision to them is necessary in order to align with NYSE listing requirements or SEC requirements. To the extent that the list requires companies to revisit their codes, it will typically be in adding 1) corporate opportunities – which can usually be embraced within conflicts of interest but which nonetheless should be expressly articulated; and 2) fair

dealing, which – as the above-quoted language indicates – covers a number of different areas.

However, we urge companies to adopt a more comprehensive and more proactive approach. Good codes of conduct address the specific legal, regulatory, ethical and reputational risks that a company faces. Great codes not only look in the rear view mirror to remember and address risks that they and their competitors have faced; they look forward and try to anticipate the risks they are most likely to face in the next few years. These risks will obviously vary by industry and company, and in all likelihood will go beyond those identified by the NYSE and SEC.

Style counts

Lost in the discussion above is the critical importance of understandability. Codes must be read by employees, not just filed away. (Don't ever shrink wrap your Codes—this was a dead giveaway in one assessment we did when we asked several officers of the company if they had received the Code—and they proudly pulled shrink-wrapped Codes from their bookshelves to show us.) Most companies find that to be read, an attempt at professional design works wonders compared to an MS Word document on 8 ½ x 11 paper.

And yes, this applies to on-line versions as well. We recommend that companies provide a paper version as well as an on-line version—for something of the importance of a Code nothing beats a well-designed booklet or brochure.

Moving beyond graphic style, the writing style must be accessible as well. Documents written in legalese are sometimes not even understandable by fellow lawyers. Identify your core employee audience, and write the Code at a level and style appropriate for them. We highly recommend focus group testing of Codes—not to determine what a company's policies will be, but to identify key issues in the minds of employees, and test the Code for comprehensibility before it has been approved by the Board and posted on the Internet.

The relevance of codes to the overall program

As previously noted, some companies may need to supplement their codes, to add or amplify standards regarding fair dealing “with the company's customers, suppliers, competitors and employees.” If they do so, however, they should also think through the implications of this for other aspects of their programs.

That is, the various new code requirements cannot be thought of in a vacuum, but must be considered in connection with other ethics/compliance program mandates. For instance, the Sentencing Guidelines requires that, to have an effective program, a company “must have taken steps to communicate effectively its standards...”. Presumably that would require training on “fair dealing”, which many companies don't do.

Similarly this aspect of the Guidelines reinforces the above-stated view that companies should consider ethics training for their boards. Indeed, the recent – and apparently

precedent-setting – criminal prosecution of a Tyco director will presumably make many boards more receptive to such training than they might have been in the past.

Actions speak louder than words

Corporations are understandably concerned with reviewing and revising their codes in the wake of increased scrutiny upon them. But Codes must always be understood as only one element of an effective ethics and compliance programs. We have, unfortunately, conducted assessments where we find that 1) employees have never received the Code; 2) employees do not understand the Code; 3) employees laugh at the Code, citing example after example of violations of the Code, and subsequent management ignorance of violations.

Unless management is viewed as committed, and walking the talk, the most wonderfully written and designed Code will be worthless. As Sharron Watkins, the now famous accountant and whistleblower from Enron stated “It's not just a snappy little code of conduct or code of ethics that makes sure things are done right.”