

# Codes Of Ethics, Complaint Channels And Whistleblowers – Applying The New Rules

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The Sarbanes-Oxley Act, and new rules from the SEC, the NYSE and Nasdaq, focus on business ethics as an important part of corporate governance. This article describes the new rules and highlights some of the challenges that companies may face in deciding how to comply. Companies will need to involve their audit committees in the implementation process, since Sarbanes-Oxley charges audit committees with responsibility in this area.

Sarbanes-Oxley contains three relevant provisions:

Section 301 and proposed SEC rules require audit committees to establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

Section 406 and final SEC rules require companies to disclose whether they have adopted a code of ethics applicable to the CEO, CFO and controller, as well as amendments or waivers of the code.

Section 806 prohibits retaliation against an employee because of any lawful act done to provide information about or assist in an investiga-

tion of potential violations of the securities laws.

The NYSE and Nasdaq have separately proposed rules which require listed companies to maintain a code of business conduct, and promptly disclose any waivers for directors or executive officers. Both rules are subject to review and approval by the SEC, and may change before they become final.

## Codes of Ethics

**Who's Covered?** While the SEC rule only applies to the CEO, CFO and controller, both the proposed NYSE and Nasdaq rules require that the code of ethics apply to directors, officers and employees.

**What's Covered?** The SEC and Nasdaq rules contain identical requirements as to subject matter -- honest and ethical conduct (including the ethical handling of actual or apparent conflicts of interest), full, fair, timely and understandable disclosure in SEC filings and public communications, compliance with law, prompt internal reporting of violations and accountability for adherence to the code. The SEC expects that the content of ethics codes will, and should, vary from company to company, and that decisions as to the specific provisions of the codes, compliance procedures and disciplinary measures should be left for individual companies to decide.

The NYSE rule has different

requirements as to content. These include conflicts of interest, corporate opportunities, confidentiality, fair dealing with third parties, protection and proper use of company assets, compliance with laws and encouraging the reporting of illegal or unethical behavior. The codes adopted by NYSE-listed companies must also comply with the SEC requirements.

**One Policy or Two?** Since the rules differ as to who and what must be covered, companies must decide whether to have a single policy of universal application or multiple policies covering different people in different areas. Either approach is acceptable to the SEC. Companies which already have a broad code of ethics in place may find it easier to revise that code to meet the new requirements, rather than introducing a new and separate code for senior officers. Companies may also want to consider whether all provisions of the code logically apply to directors in the same way they apply to employees.

Under the SEC rule, the code of ethics must be available to the public either (1) as an exhibit to the 10-K, (2) on the corporate website or (3) free of charge upon request. Companies must disclose their intention to use option 2 or option 3 in the 10-K. While this disclosure requirement is limited to the portion of the code covered by the SEC rule, many

companies may ultimately choose to disclose the entire code of ethics.

**Waivers.** The proposed NYSE and Nasdaq rules require that any waiver of the code for executive officers or directors may be made only by the board of directors (in the case of the Nasdaq rule) or the board of directors or a committee (in the case of the NYSE rule). Both rules require prompt public disclosure of any waiver.

The SEC rule requires that amendments or waivers of the code be disclosed by either (1) by filing a Form 8-K within five business days, or (2) disclosure on the corporate website. However, the SEC's disclosure requirements only apply to those elements of the code and those officers covered by the SEC rule.

The SEC rule covers both "waivers" and "implicit waivers" of the code. "Implicit waiver" is defined as a company's failure to take action within a reasonable time regarding a material departure from the code that has been made known to an executive officer.

### Complaint Channels

Section 301 of Sarbanes-Oxley charges the audit committee with responsibility for establishing procedures for the receipt, retention and treatment of accounting-related complaints. As a result, companies will need to document their existing procedures in this area, review and adjust those procedures in light of the new rules, and present them to the audit committee for consideration

and approval. Companies will also need to communicate the existence and operation of the complaint channel to employees, including those based outside of the United States.

Section 301 further requires the audit committee to establish a "confidential, anonymous" channel for the submission of employee complaints about accounting matters. This provision raises a number of questions, including (1) should the channel go direct to the audit committee (or through an intermediary), (2) should the channel be internal to the company or should it be maintained by a third party, (3) how should complaints be recorded and retained and (4) what procedures should the company establish to protect confidentiality and anonymity, both in the receipt of complaints and ensuing investigations (including situations where a thorough investigation may lead to the discovery of the complaining employee's identity). In its proposed rule, the SEC would leave the resolution of these questions, and the "nuts and bolts" of the complaint channel, to be decided by individual companies. However, the SEC is seeking comment on some of these issues. The final rule is due by April 26, 2003.

Most practitioners believe that the proposed SEC rule does not require the complaint channel to be a direct link to the audit committee. However, in situations where complaints will be received by an intermediary, the audit committee should establish a clear understanding as to (1) the types of complaints that will be

brought to the committee's attention on a real time basis and (2) when and how less significant complaints will be reviewed with the committee. The company may also want to take steps to ensure that complaints received by plant level management, local HR personnel and others are retained and transmitted up the chain.

A company should be able to use an internal complaint channel, assuming that the channel is designed to protect confidentiality and anonymity. Many large companies already have formal channels in place for the receipt and handling of complaints, and will probably prefer to use them (subject to appropriate refinements). However, smaller companies may prefer to use a qualified third party to provide this service.

### Whistleblowers

When preparing the code of ethics, establishing complaint channels, and designing response procedures, companies should emphasize compliance with Sarbanes-Oxley's prohibition on retaliation against whistleblowers. Companies should also consider adopting new, or modifying existing, human resource policies to recognize this provision and reviewing their standard form of separation and confidentiality agreements.

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