SEC Rule Changes Require New York Stock Exchange and Nasdaq- Listed Companies To Adopt Codes of Conduct or Ethics Policies For All Directors, Officers and Employees

Employment and Labor Practice Team **January 28, 2004**

In November, 2003, the Securities and Exchange Commission ("SEC") approved new New York Stock Exchange (NYSE) and Nasdaq Stock Market ("Nasdaq") rules that require most listed companies to adopt codes of conduct or ethics policies applicable to all directors, officers, and employees. These requirements are much broader in application than the code of ethics provisions under the Sarbanes-Oxley Act of 2002, which apply only to the registrant's principal executive officer and principal financial and accounting officers. The NYSE and Nasdaq standards both contain general (but somewhat different) requirements regarding what listed companies must address in their codes. We describe those new requirements below. NYSE listed companies have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004 to adopt and disclose their business codes of conduct. Nasdaq-listed companies must comply by May 4, 2004.

I. Overview of Requirements

The Sarbanes-Oxley Act (the "Act") went into effect in July 2002. Section 406(a) of the Act and the related rules adopted by the SEC require publicly traded companies to disclose whether or not they have adopted a code of ethics that applies to the registrant's principal executive officer, principal financial officer, and principal accounting officer or controller, or persons performing similar functions. If those companies have not adopted such a code, the Act and related rules require them to disclose the reasons for not doing so.[1] Importantly, in contrast to the NYSE and Nasdaq listing standards discussed below, Section 406 and the related SEC rules mandate disclosure of such "codes of ethics" and do not strictly require adoption of such a code.

During 2002 and 2003, the NYSE and Nasdaq filed with the SEC several proposed rule changes and amendments to the NYSE's Listed Company Manual and the Nasdaq Marketplace Rules regarding various corporate governance issues. In November 2003 the SEC approved two specific rule amendments which require most companies listed on those exchanges to adopt a code of conduct/ethics applicable to all directors, officers, and employees.[2]

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[1] A "code of ethics" as defined by the SEC for purposes of the Act contains "written standards designed to deter wrongdoing and to promote: honest and ethical conduct; full, fair, accurate, timely and understandable disclosures in reports; compliance with applicable laws, rules and regulations; prompt internal reporting of violations of the code; and accountability for adherence to the code." *See* Item 406(b) of Regulation S-K. The rules adopted by the SEC under Section 406 also require domestic public companies to disclose any amendments to or waivers of the code of ethics on a Current Report on Form 8-K or, under certain circumstances, on its website.

[2] NYSE Listed Company Manual §303A.10 and Marketplace Rule 4350(n). The NYSE allows foreign private issuers to follow home country practices instead of these rules, but such issuers must disclose any significant ways in which their corporate governance practices differ from those followed by U.S. companies and to provide this disclosure either on their websites or in their annual reports.

Both the NYSE and Nasdaq rules require that the codes set forth an enforcement mechanism and be disclosed to the public. The new rules are designed to promote the full disclosure of conflicts of interest, fair dealing, protection and proper use of company assets, and compliance with all laws, rules, and regulations. The rules encourage executives as well as lower-level employees to report any illegal and/or unethical behavior without fear of reprisal or retaliation.

II. NYSE Section 303A.10: Business Code of Conduct and Ethics

A. Substantive Provisions of the Business Code of Conduct and Ethics

NYSE Section 303A.10 allows companies some flexibility, but mandates that every company's code should address certain specific topics, including:

- Conflicts of interest
- Usurpation of corporate opportunities
- Confidentiality of information
- Fair dealing
- Protection and proper use of company assets
- Compliance with laws, rules, and regulations (including insider trading laws)
- Reporting of illegal or unethical behavior

See Listed Company Manual §303A.10 and Commentary. The NYSE specifically provides that companies may write their codes in a manner that does not alter existing legal rights and obligations of companies and their employees, such as "at-will" employment relationships.

B. Public Disclosure of the Code of Business Conduct and Ethics

Codes of business conduct and ethics of NYSE-listed companies must also set forth compliance standards and procedures to facilitate effective operation of the code and to ensure prompt, consistent action against violations of the code. Companies must post their codes of business conduct on their websites. Companies must note in their annual reports on Form 10-K that their code of business conduct is available on their website and also available in print to any shareholder who requests a copy of the code.

NYSE-listed companies have until **the earlier of their first annual meeting after January 15, 2004, or October 31, 2004 to adopt and disclose their business codes of conduct.** See Listed Company Manual Rule 303A.

C. Approving and Disclosing Waivers

The codes of business conduct of NYSE-listed companies must require that any waiver of the code for executive officers or directors of the company may only be made by the board of directors or by a board committee. Moreover, any such waiver must be promptly disclosed to all shareholders. *See* Listed Company Manual §303A.10 and Commentary.

III. NASD Marketplace Rule 4350(n): Code of Conduct

A. The Substantive Provisions of the Code of Conduct Must Comply with Section 406 of the Sarbanes-Oxley Act

NASD Marketplace Rule 4350(n) also requires listed companies to maintain a business code of conduct. However, the Nasdaq counterpart specifically requires that the provisions of the code comply with the general definition of "code of ethics" set forth in Section 406(c) of the Sarbanes-Oxley Act and the related rules adopted by the SEC. Under Section 406(c), "code of ethics" means "such standards as are reasonably necessary 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 the periodic reports required to be filed by the issuer; and
(3) compliance with applicable governmental rules and regulations.

15 U.S.C. §7264(c).

The SEC has also promulgated rules related to Section 406 which further define "code of ethics" as "written standards that are reasonably designed to deter wrongdoing and to promote" (1) through (3) above, as well as:

(4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
(5) Accountability for adherence to the code.

Item 406(b) of Regulation S-K.

Similar to the NYSE rule, each code of conduct under NASD Rule 4350(n) must also contain an "enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations." While Rule 4350(n) does not specify that companies must post codes of conduct on company websites, each code must be made readily available to the public. See NASD Rule 4350(n) and Commentary.

Nasdaq-listed companies must adopt and disclose their codes by May 4, 2004.

B. Waivers Must Be Board-Approved and Disclosed in Public Filings

NASD Rule 4350(n) states that each code must require that any waiver of the code for executive officers or directors may be made only by the board of directors and must be promptly disclosed to shareholders, along with the justification for the waiver. Domestic issuers must disclose such waivers in a current report on Form 8-K within 5 days of the Board's approval of the waiver, and foreign private issuers must disclose such waivers in a Form 6-K or in the next Form 20-F. *See* NASD Rule 4350(n) and Commentary.

IV. Implications For NYSE-Listed And Nasdaq-Listed Companies

So what does this mean for covered companies with respect to employment practices?

In addition to enhanced financial reporting requirements and the risk of being de-listed for failure to comply with these rules, employers must now ensure that all employees throughout the organization have a reasonable understanding of all aspects of the company's code of ethics, including conflict of interest rules and any applicable legal requirements. For instance, many employees may not have much (if any) knowledge and/or experience in spotting or handling a potential conflict of interest or an incident of insider trading. In order to demonstrate that a company is making a reasonable effort to comply with the principles underlying these rules, some basic employee training will probably be needed.

Furthermore, publicly traded companies are now required to encourage all employees to report a wide range of behavior which may be illegal or unethical, much in the same way companies now regularly encourage employees to report allegations of discrimination and harassment. This requires a secure, publicized reporting procedure. Following the lessons learned in the discrimination and harassment contexts, companies may be wise to designate in their codes of conduct specific individuals or categories of individuals to whom complaints should be directed. Also beneficial are alternative complaint channels, confidential complaint procedures, unambiguous anti-retaliation provisions with possible penalties (applicable to supervisors as well as co-workers), and employee acknowledgement provisions.

While these rules do not expressly create a cause of action for whistle-blowing, the requirement of a reporting procedure coupled with the rules' anti-retaliation provisions may very well give rise to such claims based upon public policy wrongful termination and other theories.

Training of managers with respect to recognizing and handling complaints may also be important for reducing potential liability, as well as avoiding public relations and stock market disasters which might flow from perceived cover-ups and alleged retaliation against whistleblowers.

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