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SEC ISSUES FINAL RULES ON CODE OF ETHICS DISCLOSURES

On January 23, 2003, the Securities and Exchange Commission released its final rules to implement the provisions of Section 406 of the Sarbanes-Oxley Act. The final rules require each public company to, among other things, disclose whether it has adopted a code of ethics for certain officers. Companies are required to provide the new disclosures in Form 10-Ks for fiscal years ending on or after July 15, 2003. The final rules impose several requirements for codes of ethics in addition to the requirements set forth in Sarbanes-Oxley. First, the final rules expand the scope of officers covered by the ethics code provisions of Sarbanes-Oxley to include a company's principle executive officer. Second, the final rules broaden the Sarbanes-Oxley definition of a "code of ethics."

It is important to note that the final rules have implications beyond Sarbanes-Oxley. A company's code of ethics often serves as the centerpiece of a company's ethics and legal compliance program. In addition, codes and compliance programs are subject to additional legal standards and guidelines from various governmental and private sector agencies. As such, when developing a new code of ethics, or revising an existing code, it would be shortsighted for a company to consider only the requirements of the final rules.

Requirements of the Final Rules

The final rules require all companies that file annual reports on Form 10-K or 10-KSB, on Form 20-F, or on Form 40-F to disclose whether the company has adopted a code of ethics for its principal executive officer, senior financial officer, principal financial officer, principal accounting officer or controller, or persons serving similar functions. If it has not, the company must explain why.

The final rules define "code of ethics" as a "codification of such standards as are reasonably designed to deter wrongdoing and to promote":

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- 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 registrant;

- Compliance with applicable governmental laws, rules and regulations;
- Prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
- Accountability for adherence to the code.

In response to commentators' suggestions that the SEC set forth additional ethical principles that a code of ethics should address, the SEC affirmed its belief that an ethics code should vary from company to company and that specific provisions, compliance procedures, and disciplinary measures for ethical breaches are best left to each company. Therefore, the final rules do not set forth specific language, procedures, or sanctions a company should implement. Rather, the final rules provide companies with the freedom to establish codes of ethics that suit their particular needs and structures.

The final rules explicitly recognize a company's ability to have separate codes of ethics for different types of officers. Therefore, a "code of ethics" within the meaning of the final rules may be a portion of a broader document that addresses additional topics or that applies to more persons than those specified in final rules.

The final rules further require disclosure, either by Form 8-K or internet posting, of any change in a company's code of ethics. In this same manner, a company must also disclose any waiver or implicit waiver of a provision of the code of ethics for any officer covered by the final rules. In an attempt to encourage companies to retain broad-based business codes, the final rules require disclosure of only those amendments or waivers relating to the specified elements of the code of ethics and the specified officers. Therefore, if a company amends or waives a provision of its code of ethics which is not required by the final rules, disclosure is not required. The final rules define the term "waiver" as the approval by the company of a material departure from a provision of the code of ethics. The term "implicit waiver" is defined as the registrant's failure to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer.

Where to Disclose Code of Ethics Information

A company will have to include the new code of ethics disclosure in its annual report filed on Form 10-K, 10-KSB, 20-F, or 40-F. If a company has a code of ethics that satisfies the final rules, the company can choose between three alternative methods of making its ethics code publicly available. First, a company may file a copy of its code of ethics as an exhibit to its Form 10-K. Second, a company may post the relevant text of its code of ethics on its internet website. In order for a company to take advantage of disclosure via its website, the company must disclose, in its most recently filed Form 10-K, that it intends to disclose the relevant portions of its code of ethics on its website and must provide the applicable website address in the filing. Third, a company may provide an undertaking in its annual report that upon request, the company will provide, without charge, a copy of its code of ethics.

In satisfying the publication requirements of the final rules, a company need only file, post or provide the portions of a broader document that constitutes a “code of ethics” as defined by the final rules and that apply to the persons specified in the final rules.

Form 8-K Disclosure Requirements for Amendments of or Waivers to a Code of Ethics

Consistent with the requirements of the final rules, the SEC amended Form 8-K by adding a new Item 10 to the list of Form 8-K triggering events to require disclosure of:

- The nature of any amendment to the company’s code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and
- The nature of any waiver, including an implicit waiver, from a provision of the code of ethics granted by the company to one of these specified officers, the name of the person to whom the company granted the waiver and the date of the waiver.

Under new Item 10 of Form 8-K, a company is required to disclose only those amendments or waivers relating to the specified elements of the code of ethics and the officers covered by the final rules. A company need not disclose technical, administrative or other non-substantive amendments to its code of ethics. Item 10 of Form 8-K, requires disclosure within five business days of the triggering event.

Website Disclosure Requirements for Amendments of or Waivers to a Code of Ethics

As an alternative to filing a Form 8-K to disclose any amendments to or waivers of a code of ethics, a company may use its internet website as a method for disseminating this disclosure. In order for a company to take advantage of disclosure via its website, the company must disclose, in its most recently filed Form 10-K, that it intends to disclose amendments to and waivers of its code of ethics on its website and must provide its website address in the filing. If a company elects to disclose this information on its website, it must do so within the same five-business day period as required under Item 10 of Form 8-K. Where website disclosure is used, the information must be maintained on the company’s website for a period of twelve months, and the actual disclosure must be retained by the company for a period of five years.

Is a Code of Ethics Mandatory?

While the adoption of a code of ethics that satisfies the requirements of the final rules is not mandatory, we anticipate that most public companies will adopt an appropriate code of ethics in order to stave off the possibility of negative attention for a failure to do so.

Practicable Considerations

If a company has a pre-existing code of ethics, it is important for the company to carefully review its current code of ethics to determine if it satisfies all of the requirements of the final rules. A company that maintains a code of ethics that does not meet all of the requirements set forth in the final rules will not be able to affirm, in its Form 10-K, that it has the type of code contemplated by the final rules.

A company with a pre-existing code of ethics may face another concern. Its existing code may contain information and policies for handling matters that are not required to be disclosed by the final rules. If a company determines that its current code satisfies the final rules and, without further review, files its code with the SEC, the company may disclose more information than is necessary. In this regard, it is important to recognize that the final rules require a company to disclose only those portions of its code that apply to the individuals covered by the final rules and that address the elements specified by the final rules.

In addition to reviewing the code of ethics for information the company will disclose, a company should review its code with an eye towards its obligation to disclose any waiver of a provision of its code of ethics. Because any amendment to, or waiver of, a code of ethics must be disclosed to the public, companies should avoid drafting a code of ethics in which amendments and/or waivers will be commonplace. It is likely that disclosures of any such amendment or waiver will be met with heightened scrutiny from the public.

Stock Exchange Rules

Public companies should be aware that the New York Stock Exchange, Nasdaq, and the American Stock Exchange have proposed rules that require listed companies on their respective exchanges to adopt and disclose a code of business conduct and ethics for its directors, officers, and employees. While the final rules encompass more than the proposed AMEX and Nasdaq rules, the final rules are not as comprehensive as the proposed NYSE rules. In addition to the elements covered by the final rules, the proposed NYSE rules cover confidentiality, fair dealing, protection and proper use of company assets, and corporate opportunities. Companies should carefully review their current or proposed codes of ethics to ensure that they comply with the final rules as well as the rules of the applicable exchange. We will have a better understanding of the implications of these rules once the exchanges finalize their rules.

Procedures for Handling Complaints and Concerns

Another key part of a corporate ethics and legal compliance plan is the program by which employees and others are encouraged to bring ethics and legal concerns to the attention of senior management and the board of directors. Such programs often take the form of so-called “ethics hotlines.” Section 301 of Sarbanes Oxley imposes new requirements relating to such programs. It requires audit committees to establish procedures for (1) the receipt, retention, and treatment of complaints received by the company regarding “accounting, internal accounting controls or auditing matters,” and (2) the confidential, anonymous submission by employees of the issuer of “concerns regarding questionable accounting or auditing matters.”

On January 8, 2003, the SEC approved proposed rules to implement this portion of Section 301. The rules basically restate the statutory provision and provide no additional requirements. In its order approving the proposed rules, the SEC explained its approach thusly:

We do not propose to mandate specific procedures that the audit committee must establish. Given the variety of listed issuers in the U.S. capital markets, we believe companies would be provided with flexibility to develop and utilize procedures appropriate for their circumstances. We expect each audit committee to develop procedures that work best consistent with its company's individual circumstances.

The SEC is seeking public comments on the proposed Section 301 rule. In its release, the SEC specifically seeks comments on whether it should prescribe or encourage specific procedures. For example, the SEC asked for response to the question, "Should we specify who could or could not be designated by the audit committee for the receipt and treatment of complaints?"

Under Sarbanes-Oxley, the SEC must adopt final Section 301 rules by April 26, 2003. Under the proposed rules, the stock exchanges must adopt listing requirements implementing the rules within one year of the SEC's publication of the final rules.

This e-mail alert is intended to provide general legal information and does not render legal advice or legal opinion. Such advice may only be given when related to actual fact situations.

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