Executive Summary

Effective for annual reports for fiscal years ending after July 15, 2003, each public company will be required to disclose whether or not it has adopted a code of ethics (the “Code of Ethics”) for its principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions, and will be required to make a copy of its Code of Ethics publicly available to investors. Public companies will also be required to publicly disclose any amendments to the key portions of its Code of Ethics, as well as any waivers thereto.

What is required to be disclosed?

New Item 406 of Regulation S-K and related implementing regulations will now require each public company to disclose in its annual report the following:

- whether the company has adopted a written Code of Ethics that applies to the company’s principal executive officer, principal financial officer, principal accounting officer or controller and persons performing similar functions (and to make the Code of Ethics publicly available); or
- if the public company has not adopted a Code of Ethics, an explanation of why it has not done so.

The new rules do not mandate that a public company adopt a Code of Ethics. However, most companies will choose to implement a Code of Ethics because their failure to do so would have to be publicly disclosed. Moreover, the adoption of a Code of Ethics should be taken seriously in light of the continuing focus upon corporate ethics. Public companies that do not already have a compliant Code of Ethics should immediately consider preparing a Code of Ethics that fulfills the requirements of Item 406.

A copy of the Code of Ethics must also be made publicly available through one of three methods. First, the Code of Ethics may be filed as an exhibit to the company’s annual report. Second, it may be made publicly available on the company’s website, if the company provides the appropriate website address and indicates in its annual report its intention to post the Code of Ethics on its website. Third, public companies may undertake in their annual report to furnish a copy of the Code of Ethics to any person without charge upon request.

What should be contained in the Code of Ethics?

Under the new rules, the term “Code of Ethics” is defined as written standards 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 SEC reports and documents and other public communications;
• compliance with applicable governmental laws, rules and regulations;
• prompt internal reporting of violations of the Code of Ethics to the appropriate person(s) identified in the Code of Ethics; and
• accountability for adherence to the Code of Ethics.

Despite public comments requesting that the SEC require the Code of Ethics to cover additional issues, the SEC elected to provide the general set of requirements listed above. However, in its comments accompanying the release of the new rule, the SEC strongly encouraged public companies to adopt codes that are broader and more comprehensive than necessary to meet the new disclosure requirements. In addition, the SEC clarified that the Code of Ethics may be part of a broader code that addresses additional issues and applies to additional persons, such as other executive officers and directors of the company.

Are there any additional disclosure requirements concerning the Code of Ethics?

The new rules also require public disclosure within five business days if either of the following occurs:

• any amendment to a provision of the Code of Ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, and that relates to any of the key elements of the Code of Ethics described above; or
• a waiver or implicit waiver of any key elements of the Code of Ethics.

These disclosures may be made on Form 8-K or via the company’s website by posting such information within five business days. In the case of website disclosure, the company has to have disclosed its website address, as well as its intention to disclose these events on its website, in its most recent annual report.

How does the new SEC requirement compare to the NYSE corporate governance rule proposal concerning codes of business conduct and ethics?

On August 16, 2002, the New York Stock Exchange (“NYSE”) submitted a proposal to the SEC that would require NYSE-listed companies to have a code of business conduct and ethics for directors, officers and employees. As originally proposed, the code of business conduct and ethics would be required to address the following topics:

• conflicts of interest;
• corporate opportunities;
• fair dealing;
• protection and proper use of company assets;
• compliance with laws, rules and regulations (including insider trading laws); and
• reporting of any illegal or unethical behavior.

Any waiver of the code for executive officers or directors could be made only by the board of directors, or a committee of the board, and would have to be promptly disclosed to shareholders. While the NYSE proposal may yet undergo revisions before it becomes final, NYSE-listed companies should review codes of ethics with both SEC and NYSE requirements in mind.

How does the new SEC requirement compare to the Nasdaq proposals concerning codes of conduct?

Nasdaq filed an amended rule proposal on January 15, 2003 that would require Nasdaq-listed companies to adopt a code of conduct applicable to all directors, officers and employees and to make the code of conduct publicly available. The code of conduct would have to meet the requirements of Section 406 of Sarbanes-Oxley and any rules issued by the SEC. Each code of conduct would be required to contain an enforcement mechanism that ensures enforcement of the code. The Nasdaq proposal also would provide that only the Board of Directors may approve any waivers of the code of ethics that are granted to executive officers or directors, and that any waivers be publicly disclosed to shareholders.
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Endnotes

2 New Item 406 will apply to companies required to file Form 10-K or 10-KSB reports, as well as foreign private issuers required to file Form 20-F and Canadian issuers required to file Form 40-F. For the sake of simplicity, this Advisory refers to these companies as “public companies.” The SEC adopted similar rules that apply to the requirements for registered investment companies and Forms N-SAR and N-CSR. See Final Rule: Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Release No. 34-47262 (Jan. 27, 2003).
3 Section 406 of Sarbanes-Oxley does not mandate that the principal executive officer be subject to the Code of Ethics. However, the SEC has chosen to include the principal executive officer within the purview of Item 406.
4 The term ‘waiver’ is defined as a material departure from a provision of the Code of Ethics. An ‘implicit waiver’ takes place when an executive officer of the public company becomes aware of a material departure from a provision of the Code of Ethics, and the company does not take action within a reasonable period of time concerning such material departure.
5 The SEC initially proposed a two business day deadline to be consistent with proposed changes to accelerated Form 8-K filing deadlines. The SEC intends to consider whether to shorten the deadline respecting Code of Ethics disclosures when it addresses the Form 8-K proposals. In addition, while the SEC strongly encourages foreign private issuers to make disclosures on Form 6-K or their websites, the new rules only require disclosures in such issuer’s annual reports on Form 20-F or Form 40-F.
6 The NYSE proposed rule is currently available at www.nysse.com.
7 The Nasdaq proposal is currently available at www.nasdaqnews.com.