Code of Ethics Amendments Required by Section 406 of the Sarbanes-Oxley Act

Maria Pirrone
St. John's University

Joseph E. Trainor
St. John's University

We examine and provide evidence on the frequency, characteristics, and nature of code of ethic amendments filed by public companies. In addition, we propose a classification system that researchers can use to explore issues surrounding code of ethics amendments, waivers, and adoptions. Our study contributes to the growing stream of literature examining changes in business ethics in a global environment and the impact of regulation on firms' business practices. Finally, we provide background information on the provisions Section 406 of the Sarbanes-Oxley Act (SOX), an important, but less frequently discussed requirement of SOX.

INTRODUCTION

Most capital market participants were shocked when fraud played a leading role in the collapse of mega-corporations such as Enron, Adelphia and WorldCom at the beginning of the twenty-first century. These scandals cost investors billions of dollars, shook confidence in the public securities markets, and undermined the integrity of financial reporting. Responses to the financial crisis were diverse, but a common theme was the desire for increased transparency.

In order to restore investors' confidence in the financial reporting for public companies, Congress was quick to respond with the passage of the Sarbanes-Oxley Act of 2002 (SOX). This historic legislation redefined the roles and responsibilities of management, audit committees, and auditors. SOX sets forth a number of a number of initiatives to deter or prevent corporate fraud. Our paper examines Section 406 of SOX, one of the lesser discussed provisions. Section 406 establishes certain requirements and responsibilities regarding firms' corporate code of ethics. Our paper is motivated by the lack of empirical research on the requirements of Section 406 and seeks to provide preliminary and qualitative evidence about recent code of ethics amendments.

BACKGROUND ON SECTION 406

Outrage over the high-profile ethical and financial misconduct by certain executives at public companies led Congress to pass the Sarbanes-Oxley Act of 2002. The most sweeping securities legislation since the 1930s, SOX goal is to improve investors' confidence in the financial reporting of public companies. Among the various requirements under SOX, our paper examines Section 406. Section

406, which requires disclosures about firms' code of ethics, is generally attributed to certain corporate malfeasance that occurred at Enron. Specifically, the collapse of Enron is largely attributed to the use of Special Purpose Entities (SPEs) with related parties to hide debt off Enron's balance sheet. These related party transactions were in violation of Enron's code of ethics and waivers were issued by Enron's CEO and Board of Directors to allow the CFO, Andy Fastow, to engage in these related party transactions.

Section 406 of the Act, titled "Code of Ethics for Senior Financial Officers", requires the Commission (the "SEC") to promulgate rules regarding the disclosure of the existence of firms' code of ethics, waiver, and amendments to firms' corporate code of ethics. On January 15, 2003, the SEC issued those regulations requiring each public company to disclose whether it has a code of ethics, and if a company has not adopted a code of ethics, to explain why it has chosen not to do so. Firms are required to make these disclosures on Form 10-K or on the company's website. The company must comply with the disclosure requirements in its annual report for its fiscal year ending on or after July 15, 2003.

Additionally, the Commission adopted rules requiring a company to make "immediate disclosure" on Form 8-K if any change to the company's code of ethics. Form 8-K requires disclosure of the nature of any amendments to the company's code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or comptroller or persons performing similar functions and the nature of any waiver, including an implicit waiver, from a provision of the code of ethics. A "waiver" is defined by the SEC as the approval by the company of a material departure from a provision of the code of ethics. Disclosure on Form 8-K must be made within five days after the company amends its ethics code or grants a waiver. Alternatively, a company may use its website to release the information provided that the method of disclosure is fully explained on its most recently filed annual report. The purpose of the disclosure requirement was to ensure that changes in the policies are not made for improper purposes and that the code is made available to the public.

CORPORATE CODE OF ETHICS

A code of ethics outlines a set of basic principles and can be defined as specialized codes of behavior and standards for professional conduct for managers and employees. Codes of Ethics can be used both as the basis for operational requirements (things that must be done) and prohibitions (things that are prohibited behavior). Typically a code of ethics is founded on a set of core principles or values. The principles are illustrated with behavioral examples.

While most large companies have codes of ethics (Donaldson and Werhane, 1993; Murphy, 2005), Section 406 of SOX pertains only to employees of public companies who have financial disclosure-related responsibilities. Section 406 defines a code of ethics as,

> "written standards that 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 [company];Compliance with applicable governmental laws, rules and regulations; The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and, Accountability for adherence to the code."

Although SOX set forth requirements for the disclosure of the existence a corporate code of ethics, many corporations have voluntarily developed and implemented a code of ethics over the past twenty years to monitor professional conduct for managers and employees. Companies adopt codes for many different reasons, i.e., to encourage good behavior by employees, to prevent behavior that might lead to legal liability and to foster goodwill for the company with clients; investors; the business and the regulatory community; and the public. Sauser (2013) suggests that building corporate cultures focused on virtues that leaders must take proactive steps, the first of which he advises is to adopt a code of ethics that all employees in the organization can understand.

CLASSIFICATION OF AMENDMENTS

Although many formal codes exist, previous research suggests that ethics programs can vary in orientation. Citing several case histories, Paine (1994) found that ethics programs can emphasize values and counseling or can emphasize legal compliance, control, and discipline. She argues that programs emphasizing values are likely to have more desirable and long-lasting impacts than programs founded on rule compliance. Adoption of a values orientation is rooted in the ethical aspirations of employees and the development of shared values was found to be influenced only by top management's commitment to ethics. Adoption of a compliance orientation which emphasizes rules and discipline measures for misconduct was found to be influenced by executives' awareness of the United States sentencing guidelines as well as a commitment to ethics.

Weaver and Trevino (1999) also examine compliance and values oriented ethics programs and how these program orientations influence employees' attitudes and behaviors. The study finds that a values orientation makes a greater unique contribution to measured outcomes compared to a compliance orientation. The authors conclude that although both orientations are important, that values orientations is important factor related to outcomes in their single company case study setting. Erwin (2011) examines outcomes based on the quality of corporate code of ethics and finds that firms with higher quality code of ethics score higher on ethical rankings and have higher corporate social responsibility measures. Finally, Deloitte & Touche (2005) suggests that companies that follow both the letter and the spirit of the law by taking a "value-based" approach to developing their corporate code of ethics may have a distinct advantage in the marketplace. They suggest that companies should strive to make codes applicable to everyone in the company and worded in such a way that is clear and concise, but less legalistic in nature. Steven (2008) finds similar evidence suggesting that firm culture and effective communication are key components to a code's success. She finds that codes do not work when passed down from management as a mandate, rather that employees must perceive the ethical code as a personal document in which they have ownership.

Trevino, Weaver, Gibson, and Toffler (2014) find two additional orientations: programs that are oriented toward satisfying the expectations of external stakeholders, and programs oriented toward protecting top management from blame in the event of any legal or ethical improprieties. Derr (2012) finds that several ethical theories and principles exist and concludes that although these theories provide tools and guidance for business leaders, that not every theory is good for every situation.

Despite varying theory of firms' ethical theories and orientation, the extant literature has generally focused on compliance and values orientations for corporate code of ethics. Ethics codes can be characterized as values oriented or compliance oriented and need not be mutually exclusive. A strong values-based program can co-exist with some rules. Our study suggests that code of ethic amendments can also be classified as being primarily value-oriented or compliance-oriented. The classification of amendments into these categories may be useful for researchers and capital market participants seeking to evaluate firms' ethical behavior and the effects; if any, these amendments may have on firms' operations.

METHODOLOGY

Since prior studies have not examined amendments to firms' corporate codes of ethics, we study corporate code of ethic amendments made by publicly traded companies during the 2012 calendar year. We retrieve Form 8-K for those companies disclosing changes to the corporate code of ethics for 2012 and read each filing to determine the nature and scope of the change in the corporate code of ethic and classify these disclosures into three categories; new adoptions, amendments, and waivers. Amendments are then classified based on whether the change is compliance-oriented or values-oriented. Our final sample consists of 49 firms filing amendments to their corporate code of ethics.

RESULTS

The sample selection procedure results in 77 firms being identified as having filed an amendment, waiver, or adoption of a corporate code of ethics in Form 8-K filed with the SEC. Since our study is focused on amendments, we eliminate firms reporting waivers and adoptions. Our final sample consists of 49 firms filing amendments to their corporate code of ethics. Table 1 details the sample selection process. As noted in Table 1, amendments comprise the most common reason for firms to disclose a change in their code of ethics (49 filings out of 77 total filings), accounting for approximately 64% of all ethics related disclosures filed with the SEC. The next most prevalent reason for disclosure of a change in a firm's code of ethics was due to the adoption of a new or totally revised corporate code of ethics. Many reasons can result in a firm having to adopt a code of ethics such as being newly registered, as the results of a merger or acquisition, or other substantial change in the firm's operating structure.

TABLE 1
SAMPLE SELECTION

	Number of Filings
Firms filing code of ethics disclosures	77
Less:	
Adoptions	(20)
Waivers	(4)
No disclosure	(4)
Total amendments	**49**

Next, we categorize amendments as either a value-oriented amendment or as a compliance-oriented amendment. The results of this classification appear on Table 2.

TABLE 2
ETHICAL ORIENTATION OF AMENDMENTS

	Number of Filings	%
Value-oriented	28	57%
Compliance-oriented	21	43%
Total	**49**	**100%**

The number of amendments containing value-oriented propositions clearly outweighs the number of compliance-oriented amendments with approximately 57% of all amendments containing language which suggests that firms are more focused on improving the ethical environment rather than pure compliance with laws and regulations. Despite the large number of value-oriented amendments, we do note that the number of compliance-oriented amendments is also significant.

To gain further insight into the classification of amendments into these two categories we break down the analysis even further in Table 3 to provide the most common classifications within values-oriented and compliance-oriented amendments. As noted in Table 3, the most common reason for values-oriented amendments is to emphasize values propositions and to align with ethical "best practices". In addition, many amendments were aimed at clarifying the language for users and to make the code of ethics easier to understand. On the other hand, the most frequent reason for amending for firms with a compliance-oriented framework was to comply with various laws and regulations specific to their business followed by compliance with the Foreign Corrupt Practices Act.

TABLE 3
EXAMPLES OF VALUE-ORIENTED AND COMPLIANCE-ORIENTED AMENDMENTS

	Number of Filings	%
Value-oriented amendments		
Emphasis of core values and/or best practices	6	12%
Improve wording and help employees understand Code	6	12%
Provide anti-retaliation and whistle-blower protection	5	10%
Update policies regarding gifts and conflicts of interest	4	8%
Statement on prohibiting forced labor or human trafficking	2	4%
Technical changes to the code	5	10%
Compliance-oriented amendments		
Compliance with various laws and regulations	6	12%
Compliance with Foreign Corrupt Practices Act	5	10%
Compliance with internal company policies	4	8%
Compliance with SEC, SOX, or other regulatory matter	3	7%
Technical changes to the code	3	7%
Total	**49**	**100%**

To gain further insight into the types of amendments, we present a sample of excerpts from various amendments from our sample. In the top panel, we include excerpts from amendments coded as compliance-oriented and in the bottom panel those classified as values-oriented amendments. Our analysis of the wording for compliance-oriented amendments shows a clear and consistent use of the word “comply” and/or “compliance”. As noted above, firms must comply with a variety of laws and regulations. The most common in our sample were the Foreign Corrupt Practices Act, SRO listing requirements, and the requirements under SOX.

Wording for values-oriented amendments tend to focus on supporting firms’ core values and/or implementing “best practices” in corporate governance, specifically best practices as to instituting a proper code of ethics. Many firms also elucidate the need to make their corporate code of ethics easier to understand for users and to provide more examples. Clearly, the legalistic boilerplate language adopted by many firms when the requirements first became effective under Section 406 left firms with codes of ethics that were difficult for employees to understand and implement.

TABLE 4
SAMPLE OF EXCERPTS FROM AMENDMENTS

Compliance-oriented disclosures
"The purpose of the changes was to ensure compliance with the rules of the New York Stock Exchange"
"The Code was amended to further address illegal payments to foreign government officials and the Company's commitment to compliance with The Foreign Corrupt Practices Act of 1977, as amended."
"… the amended Code addresses compliance with applicable laws, regulations, and guidelines…"
Values-oriented disclosures
"Transition from a 'principles' to 'values' orientation employing the formally-adopted 'shared values' -- Integrity, Respect for People, Customer Passion, Energy and Excellence -- as the focus of the Company's ethics and compliance effort…"
"The revised code emphasizes the Company's core values and its commitment to fair and ethical behavior in the conduct of its business"
"The overall purpose of amending and restating the Code was to generally update the Code, to make changes in language, appearance and style to improve its clarity and readability and to enhance the understanding of Company personnel of the Company's standards of ethical business practices."
"The amendments were made to generally update the Code and make it more user friendly"

CONCLUSION

Our paper examines amendments to corporate codes of ethics and classifies them as value oriented or compliance oriented. We find a tendency for firms toward value-oriented amendments versus compliance-oriented amendments. We also find that amendments are the most frequent reason for firms to file Form 8-K and disclose a change in the firm's code of ethics over waivers and adoptions. Our preliminary findings and the background information on Section 406 provide researchers and capital market participants the foundation for future research in this area. For example, future studies could examine the causes and consequences of code of ethics amendments.

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