

A Proposal to Revise the SEC Instructions for Reporting Waivers of Corporate Codes of
Ethics for Conflicts of Interest

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Abstract:

Enron’s collapse focused attention on the application of that company’s Code of Ethics to related-party transactions. That focus produced Section 406 of the Sarbanes-Oxley Act of 2002, which intends to regulate conflicts of interest between officers and their companies through codes of ethics that public companies adopt. Pursuant to SOX Section 406(a), the Securities Exchange Commission issued new regulations requiring each public company to disclose whether it has a code of ethics, and if a company has not adopted such a code, to explain why it has chosen not to do so. SEC rules also require each company that has a code to disclose any waiver of the code, for certain officers that the SEC rules identify, in a timely manner under Item 5.05 of Form 8-K. However, some companies have adopted a hypertechnical interpretation of the SEC’s definition of a “waiver”—“the approval by the registrant of a material departure from a provision of the code of ethics”—so that these companies do not report the “approvals”, and the investment community does not learn of the officer’s conflict in a timely way. To remedy this shortcoming, this paper proposes an amendment to the SEC instructions for disclosures of code of ethics waivers so that every approval for senior officer participation in conflict-creating transactions and activities will be disclosed in a timely manner.

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I. INTRODUCTION

Enron’s collapse focused attention on the application of that company’s Code of Ethics to related-party transactions. That focus produced Section 406 of the Sarbanes-Oxley Act of 2002 [hereinafter “SOX”],¹ which intends to regulate conflicts of interest between officers and their companies through codes of ethics that public companies adopt.

Pursuant to SOX Section 406(a), the Securities Exchange Commission [hereinafter the “SEC”] issued new regulations requiring each public company to disclose whether it has a code of ethics, and if a company has not adopted such a code, to explain why it has chosen not to do so.² SEC rules also require each company that has a code to disclose any waiver of the code, for certain officers that the SEC rules identify, in a timely manner under Item 5.05 of Form 8-K.³

Some scholars have already argued that corporate codes of ethics will not work well because neither SOX nor the SEC regulation mandates any particular language to be included in the codes.⁴ These scholars argue that, absent more particular requirements, companies will adopt very narrow codes that prohibit few activities or transactions and therefore require few waivers that must be publicly disclosed.

¹ 15 U.S.C. § 7264.

² 17 CFR 229.406(a).

³ Form 8-K Current Report, Item 5.05.

⁴ Note, *The Good, The Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and The Problems With Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2135 (2003); John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor’s Perspective*, 76 U. COLO. L. REV. 57, 120 (2005).

A careful examination of the codes of ethics adopted by several companies, however, reveals a different problem. Under the SEC’s current definition of the term “waiver”—the approval for a material departure from a provision in the code of ethics—even the related-party transactions in the Enron case might not have been disclosed in a timely manner. Rather, as this paper shows, Enron’s code of ethics, and those of some companies today, provides for inside approval of conflict of interest activities or transactions so that the conflicts, once approved, comply with the codes. Given that compliance, the conflicts technically do not “depart” from the codes, and, by the SEC’s definition, the activities and transactions therefore go forward without any “waiver” that need be publicly disclosed.

To remedy this shortcoming, this paper proposes an amendment to the SEC instructions for disclosures of code of ethics waivers so that every approval for senior officer participation in conflict-creating transactions and activities will be disclosed in a timely manner.

II. THE ROLE OF CODES OF ETHICS IN REGULATING CONFLICTS OF INTEREST

This part reviews the role that Enron’s code of ethics played in the Enron scandal, and how Congress and the SEC reacted to that role.

A. The Enron Scandal and the Enron Code of Ethics

Enron’s collapse was triggered, in part, by the revelation of the related-party transactions between the company and its chief financial officer, Andrew S. Fastow. On October 17, 2001, the *Wall Street Journal* revealed transactions involving two limited partnerships that had been run by Fastow, relating those deals to a \$1.01 billion charge

that Enron had reported in its earnings announcement the preceding day.⁵ On the day of the *Wall Street Journal* article, Enron's closing price decreased by \$1.64 per share (from \$33.84 to \$32.2), whereas on the preceding day its price rose on the earnings announcement by \$0.67 (from \$33.17 to \$33.84).⁶ Following a series of reports about the partnership transactions, including disclosure of a related SEC investigation,⁷ Enron quickly collapsed. Its share price dropped to \$0.26 per share on November 30, and, on December 2, the company announced that it had filed for Chapter 11 protection in the federal bankruptcy court in the Southern District of New York.⁸ Only one and a half months passed between reports by the *Wall Street Journal* of the partnership transactions and Enron's bankruptcy petition.

Enron had a code of ethics [hereinafter "Enron's Code of Ethics], which was supposed to regulate conflicts of officers' interests with company interests. Enron's Code of Ethics set forth its conflict-of-interest policy so:

....An employee shall not conduct himself or herself in a manner which directly or indirectly would be detrimental to *the best interests of the Company* or in a manner which would bring to the employee financial gain separately derived as a

⁵ John Emshwiller and Rebecca Smith, *Enron Jolt: Investments, Assets Generate Big Loss—Part of Charge Tied To 2 Partnerships Interests Wall Street*, WALL ST. J. Oct. 17, 2001, at C1 (reporting that "[t]he company said the charge connected with the partnerships is \$35 million and involves the "early termination . . . of certain structured finance arrangements").

⁶ *Enron Corp. Reports Recurring 3rd Qtr Earnings of \$0.43 EPS Prize*, Oct. 17, 2001, PR NEWswire. Enron announced nonrecurring charges recognized in the third quarter of 2001, but it did not identify the cause of those charges. The company press release simply reported that the chair/CEO said: "After a thorough review of our businesses, we have decided to take these charges to clear away issues that have clouded the performance and earnings potential of our core energy businesses."

⁷ Rebecca Smith and John R. Emshwiller, *SEC Seeks Information on Enron on Dealings With Partnerships Recently Run by Fastow*, WALL ST. J. Oct. 23, 2001, at A3; John R. Emshwiller and Rebecca Smith, *Enron Partnerships Led by Fastow Face a Formal SEC Investigation*, WALL ST. J. Nov. 1, 2001, at A4.

⁸ "Enron files for Chapter 11 bankruptcy," REUTER NEWS, Dec. 2, 2001.

direct consequence of his or her employment with the Company.⁹

More specifically, the Code of Ethics provided:

[N]o full-time officer or employee should:

(a) Engage in any outside activity or enterprise which could interfere in any way with job performance;

(b) Make investments or perform services for his or her own or related interest in any enterprise under any circumstances where, by reason of the nature of the business conducted by such enterprise, there is, or could be, a disparity or conflict of interest between the officer or employee and the Company; or

(c) Own an interest in or participate, directly or indirectly, in the profits of any other entity which does business with or is a competitor of the Company, *unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has determined that such interest or participation does not adversely affect the best interests of the Company.*

....

If an investment of personal funds by an officer or employee in a venture or enterprise *will not entail personal services or managerial attention, and if there appears to be no conflict or disparity of interest involved, the*

⁹ *The Role of the Board of Directors in Enron's Collapse: Hearing Before the Permanent Subcomm. of Investigations of the Comm. on Governmental Affairs U.S. Senate, 107th Cong. 291–99, at 295 (2002) (emphasis added) [hereinafter “S. HRG. No. 107-511”].*

following procedure nevertheless shall be followed if all or any part of the business of the venture or enterprise is identical with, or similar or directly related to, that conducted by the Company, or if such business consists of the furnishing of goods or services of a type utilized to a material extent by the Company:

- (a) *The officer or employee desiring to make such investment shall submit in writing to the Chairman of the Board and Chief Executive Officer or Enron Corp. a brief summary of relevant facts; and*
- (b) *The Chairman of the Board and Chief Executive Officer of Enron Corp. shall consider carefully the summary of relevant facts, and if he concludes that there appears to be no probability of any conflict of interest arising out of the proposed investment, the officer or employee shall be so notified and may then make the proposed investment in full reliance upon the findings of the Chairman of the Board and Chief Executive Officer of Enron Corp.*

. . . .

In the event of a finding by the Chairman of the Board and Chief Executive Officer of Enron Corp. . . . that a material conflict or disparity of interest does exist with respect to any existing personal investment of an officer or employee, then, upon being so notified, *the officer or employee involved shall immediately divest himself or herself of such interest and shall notify the Chairman and Chief Executive Officer of*

*Enron Corp. . . . in writing that he or she has done so.*¹⁰

In summary, following a disclosure of the transaction in writing to the chairman of the Board and CEO (Kenneth L. Lay), the approval by the chairman and CEO was needed in order that an Enron officer or employee participate in, or hold a financial interest in, a related-party transaction. The Board chair and CEO could approve the officer or employee participation or interest only on the finding that such interest or participation did not adversely affect the best interests of the company.

1. Approvals for the Transactions Involving the CFO Under Enron's Code of Ethics

Enron CFO Fastow was involved in three partnerships—LJM1, LJM2, and LJM3—that transacted business with Enron. Kenneth L. Lay, who was Board chair and chief executive officer, waived the code of ethics for Fastow's role in all of the LJM partnerships.¹¹ In doing so, Lay found that Fastow's participation would *not* adversely affect the best interests of the company.

Moreover, in every instance, Lay “asked the Enron Board to ratify his decision, even though Board concurrence was not explicitly required by company rules.”¹² And the Board, in each case, ratified Lay's approval.¹³

As it turned out, the Board did not effectively monitor Fastow's involvement in the LJM partnerships after the approval. For example, a Senate report found that “no

¹⁰ *Id.* at 297–99 (emphasis added).

¹¹ PERMANENT SUBCOMM. ON INVESTIGATION OF THE COMM. ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S.PRT. No. 107-70, at 25 (2002) [hereinafter “S. PRT. No. 107-70”]. With regard to whether the approvals constituted “waivers,” see Part II A2.

¹² S. PRT. No. 107-70, at 25 (2002).

¹³ *Id.* at 24–26; WILLIAM C. POWERS, JR., ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP., at 69, 71–72 (2002), available at <http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf>.

Enron Board member requested or reviewed” LJM’s first annual report to its investors laying out its activities and returns, which would have shown “that LJM claimed to be making substantial profits from its deals with Enron” and which therefore might have prompted “reconsider[ation of] the conflicts of interest inherent in the [LJM] transactions.”¹⁴

2. Whether the “Approvals” Under the Enron Code of Ethics for the CFO Participation in Related-Party Transactions Constituted “Waivers” of the Code

Important for this paper was whether the “approval” by the Enron Chair and CEO was a “waiver” of the code. As the remainder of this paper demonstrates, this question is not an idle semantic detour but in fact the source of a hitherto unexamined problem in the disclosure of code of ethics waivers mandated by Congress and the SEC in the wake of the Enron debacle.

Some witnesses averred that Enron had “waived” its code for Fastow. The treasurer of Enron’s Global Finance Group said that “. . . I was taken by surprise . . . that the board was ultimately . . . asked . . . to *waive* their code of conduct.”¹⁵ Jeffrey Skilling also stated that “[o]n LJM1, there was a *waiver* of the code of conduct that was based on a fairness opinion that we had from an accounting firm that the transaction was in the interest of Enron shareholders.”¹⁶ And Enron’s internal documents used the term “waiver.”¹⁷

¹⁴ *Id.* at 28.

¹⁵ *The Financial Collapse of Enron—Part 2, Hearing before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, House of Representatives, 107th Cong. 38 (2002)* [hereinafter “H.R. HRG. No. 107-88”].

¹⁶ *Id.* at 116.

¹⁷ S. HRG. No. 107-511 at 268, Exhibit #19, “Key Elements of Transaction to Be Approved” (describing “1. Waiver of Code of Conduct, as Key Elements of Transaction to be approved”); at 271, Exhibit #20, “LJM2 Summary” (stating that “Finance Committee/Board of Directors action requested [r]atify[ing] decision of

While some directors insisted that the Chair and CEO approval was not a waiver,¹⁸ Senator Levin, for one, expressed open incredulity at that testimony.¹⁹ And

Office of the Chairman to *waive* Code of Conduct in order to allow A. Fastow's participation in LJM2 as General Partner.") (emphasis added).

¹⁸ The Audit Committee chairman of Enron testified that "I first want to note that the Board did not *waive* Enron's Code of Business Conduct when it approved Mr. Fastow's participation in LJM." (H.R. HRG. No. 107-88 at 98); and the Finance Committee Chairman also characterized the board action not as waiving the code but as simply ratifying the Chair/CEO determination that Fastow's participation in the partnerships would not adversely affect Enron (S. HRG. No. 107-511 at 17).

¹⁹ Here is an excerpt from the hearing:

Senator LEVIN: Now, you testified this morning that the Board did not waive the code of conduct.

Mr. WINOKUR: Yes, sir.

Senator LEVIN: That was your testimony this morning. Take a look at Exhibit 19, if you would.

Mr. WINOKUR: Sir, I know that the chart uses the term——

Senator LEVIN: That is your chart, is it not?

Mr. WINOKUR: No, this is management's chart.

Senator LEVIN: Was it presented to you?

Mr. WINOKUR: It was presented to us, and in the resolution that the Board approved, we ratified management of the Office of the Chairman's decision that permitting Mr. Fastow to participate in this would not be adverse to Enron.

Senator LEVIN: Well, that is a different issue. The question is whether or not it was considered inside Enron, as well as by the rest of us, as a waiver of your code of conduct. Your own document says, "waiver of code of conduct," yet you testified this morning that there was no waiver of a code of conduct. I am just presenting you with your own document.

Mr. WINOKUR: Sir, this is——

Senator LEVIN: It says it was.

Mr. WINOKUR: This was management's presentation to the Board. We applied the code of conduct. The Chief Executive has the ability to make a determination, as I said in my statement this morning, that permitting Mr. Fastow to make this investment would not have any probability of conflict of interest, and we ratified that decision, which is applying the code of conduct.

Senator LEVIN: Applying the code of conduct. Let us take a look at Exhibit 20.2. Now, the second time it is presented to you as a waiver. It has got the Enron logo on there. Look at the bottom, Finance Committee, Board of Directors action requested. "Ratify decision of Office of the Chairman to waive—not apply—waive code of conduct in order to allow A. Fastow participation." Now, did you tell them, hey, wait a minute, do not present that to us as a waiver. Present that to us as an application. You did not tell them that, did you?

Mr. WINOKUR: When we approved it at the Board meeting, that is what we approved, the application.

Senator LEVIN: I understand that. That was the first time.

Mr. WINOKUR: The resolution following this meeting, which was in October 1999, has the same language.

Senator LEVIN: Right. I understand. But it is presented on Enron documents the second time now as a waiver. That is the way it was viewed inside Enron by the management. That is the way it is viewed by me. But you are saying, no, we did not waive it, we applied it. I am just asking you this question. When this was presented to the Board as a waiver in the Enron document Exhibit No. 20,1[,] did you object to the

the often-quoted Senate staff report on the Enron Board's role in the company's collapse expressly called the approval a "waiver," directly rejecting the understanding that the approval was not.²⁰

presentation of it to you as a waiver?

Mr. WINOKUR: I did not treat it as a waiver. I did not object to the words in this document.

Senator LEVIN: You did not tell management, hey, wait a minute. You are asking us to waive——

Mr. WINOKUR: Yes, sir.

Senator LEVIN [continuing]: For the second time. We are telling you, we are not waiving. We are applying. Did you do that?

Mr. WINOKUR: We did that in the Board approval.

Senator LEVIN: You told them, this is not a waiver? Did you ever use the words, "This is not a waiver" in the Board approval?

Mr. WINOKUR: No, sir.

Senator LEVIN: No.

Mr. JAEDICKE: Mr. Chairman, can I——

Senator LEVIN: Sure.

Mr. JAEDICKE [continuing]: Just inject that I think if you—I am not absolutely sure of this, but I think if you look at the minutes of that meeting, you will find that Fastow himself says in presentation—this slide does not say it, but that it requires the Board to ratify the decision of the Office of the Chairman——

Senator LEVIN: Right.

Mr. JAEDICKE [continuing]: That his—it requires a finding and a recommendation that it will not—that there appears to be a zero probability that it will be adverse to Enron.

Now, he did not use zero probability, but——

Senator LEVIN: That is his opinion.

Mr. JAEDICKE: But he presented it, I think, properly, is what the minutes indicate.

Senator LEVIN: He presented it in this document as a waiver. Was that proper?

Mr. JAEDICKE: The document——

Senator LEVIN: Is that proper?

Mr. JAEDICKE: No.

S. HRG. No. 107-511 at 59–60.

²⁰ The report states:

Enron's code of conduct for its employees expressly prohibited Enron employees from obtaining personal financial gain from a company doing business with Enron. This prohibition could be *waived*, however, *by the CEO upon a finding that a proposed arrangement would "not adversely affect the best interests of the Company."* In the case of the LJM partnerships, Mr. Lay *approved waiving* the code of conduct prohibition for Mr. Fastow, but also asked the Enron Board to ratify his decision, even though Board concurrence was not explicitly required by company rules.

S. PRT. No. 107-70, at 25 (emphasis added) (footnotes omitted).

In a footnote, the report added:

At the hearing, Mr. Winokur and Dr. Jaedicke contended that the Board did not actually "waive" the company's code of conduct, but "applied" it in the LJM matters. Hearing

B. The Current Regulations for Codes of Ethics Under SOX

Congress reacted to Enron’s waiver of its code of ethics for related-party transactions that contributed to the company’s demise by enacting SOX Section 406. That section and related SEC rules regulate codes of ethics in two ways: (i) by requiring SEC-reporting companies to disclose whether they have adopted a code, and, if so, to disclose the code itself; and (ii) by requiring companies having codes to disclose changes in the codes and waivers of the codes.

1. Adopting and Disclosing Codes of Ethics

SOX Section 406(a) provides that:

[T]he Commission shall issue rules to require each [SEC-reporting company], together with periodic reports required pursuant to . . . the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reason therefore, such [company] has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions.²¹

Responding to this statute, the SEC issued new or amended items to Regulation S-K,

Record at 17, 59–60. *However, all three LJM presentations explicitly request Board approval of a code of conduct waiver.* Hearing Exhibit 19, “Project LJM Board Presentation” (“Waiver of Code of Conduct”) at 8; Hearing Exhibit 20, “LJM 2 Summary” (“Ratify decision of Office of the Chairman to waive Code of Conduct in order to allow A. Fastow participation in LJM2 as General Partner”); Hearing Exhibit 56h, “LJM3 presentation to the Finance Committee,” page entitled “LJM3” (“Ratify decision of Office of Chairman to waive Code of Conduct in order to allow A. Fastow involvement as General Partner of LJM”), Bates EC 25373–80 and RJ903. 60 Hearing Exhibit 55, “Defendant Andersen Exhibit 763,” U.S. v. Arthur Andersen (USDC SD Texas, Criminal Action No. H–02–0121).

Id. at 25 n.59 (emphasis added).

²¹ 15 U.S.C. § 7264(a).

Form 8-K, and Form 10-K.²²

Regulation S-K, Item 406(a) requires a company to disclose whether the company has adopted a code of ethics that applies to the company’s principal executive officer, principal financial officer, and principal accounting officer or controller, or persons performing similar functions.²³ If the company has not adopted such a code, the company has to explain why not.²⁴

In addition to this SEC regulation—which *permits* companies to adopt a code (or not do so) and simply requires disclosure—stock exchange listing standards *require* codes. Each stock exchange—the New York Stock Exchange [hereinafter “NYSE”], the National Association of Securities Dealers Automated Quotation system [hereinafter “NASDAQ”], and the American Exchange [hereinafter “AMEX”]—requires listed companies to adopt a code of business conduct and ethics that is publicly available and applicable to directors, officers, and employees.²⁵

Even though a nonlisted, SEC-reporting company could, under SOX Section 406 and the related rules, decline to adopt a code and choose to explain that choice in its SEC

²² Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5,110 (Jan. 31, 2003); 17 CFR 229.406. The SEC also amended Regulation S-B (Item 406), Form 20-F, Form 40-F, Form 10-K, and Form 10-KSB. This paper will not separately discuss those changes.

²³ “Disclose whether the registrant has adopted a code of ethics that applies to the registrant’s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions.” 17 CFR 229.406(a). While SOX only required a qualifying code to cover financial officers, the SEC in its rulemaking added principal executive officers to the required coverage as well.

²⁴ 17 CFR 229.406(a).

²⁵ The NYSE listing standards state: “Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees . . .” *Listed Company Manual* 303A.10. The AMEX’s listing standards state: “Each company shall adopt a code of conduct and ethics, applicable to all directors, officers and employees, which also complies with the definition of a ‘code of ethics’ as set forth in Item 406 of SEC Regulation S-K The code of conduct and ethics must be publicly available.” *Amex Company Guide* Sec. 807. NASDAQ’s listing standards state: “Each issuer shall adopt a code of conduct applicable to all directors, officers and employees, which shall be publicly available.” NASDAQ Manual § 4350(n).

filings, it appears that this is a very unusual choice.²⁶ Indeed, research disclosed a nonlisted public company that has adopted a code of ethics and granted a waiver, even though the company was not subject to the listing standards of the exchanges.²⁷

Item 406(b) of Regulation S-K defines a “code of ethics” as a set of :

written standards that are reasonably designed to deter wrongdoing and to promote: (1) [h]onest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) [f]ull, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant; (3) [c]ompliance with applicable governmental laws, rules and regulations; (4) [t]he prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and (5) [a]ccountability for adherence to the code.²⁸

When it first advanced a definition of a qualifying 406 code, the SEC proposed

²⁶ Before the SEC added Item 406 to Regulation S-K, the chairman of the ABA’s Committee on Federal Regulation of Securities said in a letter to the SEC that “we believe that most companies will take steps to avoid disclosing to investors that they do not have a code of ethics meeting the Commission’s requirements.” Letter from Stanley Keller, Chair, Committee on Federal Regulation of Securities, American Bar Association’s Business Law Section, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 19, 2002), *available at* <http://www.sec.gov/rules/proposed/s74002/skeller121902.htm>. After the SEC adopted its rules, one study searched in vain for even one company that had opted to say that it had no qualifying 406 code. Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253, at 285 n. 170 (2005) (stating that “[t]his research has not revealed a single instance to date of a public company that has elected the option, available under § 406, of disclosing that it has no code of ethics for senior financial officers and explaining why it has chosen not to adopt one”).

²⁷ See, e.g., Dresser, Inc. Form 8-K at 3 (October 4, 2005).

²⁸ 17 CFR 229.406(b). SOX Section 406(c) set out the first three substantive areas that codes must cover. The SEC in its rulemaking added the last two.

that such a code specifically address related-party transactions and promote “[a]voidance of conflicts of interest [by] disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict.”²⁹ The SEC explained that “a comprehensive code of ethics should set forth guidelines requiring avoidance of conflicts of interests and material transactions or relationships involving potential conflicts of interests without proper approval.”³⁰ In adopting final rules, however, the SEC eliminated from the definition of a qualifying code any specific requirement that codes mandate avoidance of related-party transactions. The SEC explained that it did so “because the conduct addressed by this component already is addressed by the first prong of the proposed definition, requiring honest and ethical conduct and the ethical handling of actual and apparent conflicts of interest.”³¹

With the more specific requirement concerning related-party transactions out of the definition of a qualifying SOX code of ethics, the final SEC rules do not mandate any particular related-party provisions be included in the codes, but rather, only that the codes be designed to promote the five general objectives set forth in Item 406. The listing standards of three exchanges—while providing more detail than Item 406—similarly require codes to address particular topics but do not demand that the codes include any particular language concerning related-party transactions.³² All of this leaves companies

²⁹ Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, 67 Fed. Reg. 66,207, at 66,215 (proposed Oct. 22, 2002).

³⁰ *Id.*

³¹ Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5,110, at 5,118.

³² The NYSE’s *Listed Company Manual, Commentary* to 303A.10 states that “[a] ‘conflict of interest’ occurs when an individual’s private interest interferes in any way—or even appears to interfere—with the interest of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and

considerable leeway.

A company has three ways of disclosing its code of ethics under Item 406(c) of Regulation S-K: (i) by filing with the SEC a copy of the code as an exhibit to its annual report; (ii) by posting the text of the code on the company's Internet Website, on condition that the company disclose in its annual report its Internet address and the fact that it has posted the code of ethics on its Website; or (iii) by (a) undertaking in its annual report filed with the SEC to provide to any person, without charge and upon request, a copy of the code, and by (b) explaining the manner in which a request for a copy may be made.³³ NYSE-listed companies must post their codes of business conduct and ethics on their Websites; and must state, in their annual proxy statements (or, if they do not file such proxy statements, in their annual reports on Form 10-K), that the codes are available on those Websites and that the information is available in print to any shareholder who requests it.³⁴

2. Code of Ethics Waivers

SOX Section 406(b) requires the SEC to issue rules mandating that companies with codes of ethics disclose any changes in the codes and any waivers of the code for senior financial officers:

effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern. The listed company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the listed company.”

Further, the NYSE's listing standard provides seven topics, including conflicts of interest, that all listed companies should address in their codes of ethics. The other topics are “corporate opportunities,” “confidentiality,” “fair dealing,” “protection and proper use of company assets,” “compliance with laws, rules and regulations (including insider trading laws)[,]” and “encouraging the reporting of any illegal or unethical behavior.”

³³ 17 CFR 229.406(c).

³⁴ *NYSE Listed Company Manual*, 303A.10.

The Commission shall revise its regulations concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the *immediate* disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.³⁵

In response to this law, the SEC adopted Item 5.05 for Form 8-K. Item 5.05 requires any SEC-reporting company with a code of ethics to disclose substantive changes in the code within four business days and to disclose, also within four business days, any waiver of the code granted to a principal executive officer, a principal financial officer, a principal accounting officer, or a controller. The company may disclose a change or waiver (i) by filing a Form 8-K, or (ii) by putting a posting on its Website, provided that the company has disclosed in its most recently filed annual report both its Internet address and its intention to disclose waivers in this manner.³⁶ The listing standards also require companies to promptly disclose waivers of the codes that the exchanges mandate, with the disclosed waivers covering not just the principal executive officer and senior financial officers but extending to any waivers to any director or any executive officer.³⁷

³⁵ 15 U.S.C. § 7264(b) (emphasis added).

³⁶ Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 69 Fed. Reg. 15,593, at 15,627 (discussing Item 5.05) (Mar. 25, 2004), with technical amendments, 69 Fed. Reg. 48,370 at 48,371 (same) (Aug. 10, 2004).

³⁷ *NYSE Listed Company Manual*, Section 303A.10 requires that companies “promptly disclose any waiver of the code for directors or executive officers.” Amex Company Guide, Section 807 also requires disclosure of code waivers for “directors or executive officers,” as does NASDAQ Manual, Section 4350(n). The commentary to Section 303A.02 of the NYSE Listed Company Manual states that “[f]or purposes of Section 303A, the term ‘executive officer’ has the same meaning specified for the term ‘officer’ in Rule 16a-1(f) under the Securities Exchange Act of 1934.” Rule 16a-1(f) defines “officer” as “an issuer’s president, principal financial officer, principal accounting officer (or, if there is no such accounting officer,

While SOX 406 did not define “waiver,” the SEC—in Instruction 2(i) to Item 5.05—defines “waiver” as “the approval by the registrant of a material departure from a provision of the code of ethics.”³⁸ The SEC regulations do not specify which body shall grant waivers of SOX 406 codes. Listing standards for the three exchanges require that waivers for directors or executive officers be granted by the board or a board committee and be promptly disclosed.³⁹ But none of the listing standards defines “waiver.”⁴⁰

III. HOW THE RULES GOVERNING CODES OF ETHICS HAVE WORKED IN PRACTICE

This part examines whether the current code of ethics requirements have worked well or poorly in regulating conflicts of interests between officers and companies, and whether the current requirements would have publicized the conflicts of interest that damaged Enron.

the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer.”

³⁸ Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 69 Fed. Reg. 15,593 at 15,627 (discussing Item 5.05); with technical amendments, 69 Fed. Reg. 48,370 at 48,371 (same).

³⁹ *NYSE Listed Company Manual*, § 303A.10, Commentary; *Amex Listing Standard*, Sec. 807, Commentary .01; *NASDAQ Manual*, 4350(n).

⁴⁰ Turning to review and approval of related-party transactions—as distinct from waivers of ethics codes to permit corporate actors to participate in, or hold an interest in, such transactions—the NASDAQ listing standard requires approval for all related-party transactions by the company’s audit committee or another independent body of the board of directors (*The NASDAQ Manual* § 4350(h)), whereas AMEX requires review and oversight by the audit committee or comparable body (*The Amex Company Guide* Sec. 120: “Related-party transactions must be subject to appropriate review and oversight by the company’s Audit Committee or a comparable body of the Board of Directors.”), and the NYSE simply requires “review and oversight” and states that the audit committee or comparable body “could be considered as the forum” for those tasks (*NYSE Listed Company Manual* § 307.00. The NYSE standard says only that “[t]he Exchange believes that the review and oversight of [potential conflict-of-interest] situations is best left to the discretion of listed corporations and corporations applying for listing on the NYSE. While no particular method of resolution is suggested, the Audit Committee or a comparable body *could* be considered as the forum for review and oversight of potential conflicts of interest situations.” [Emphasis added]).

A. Actual Waivers of the Code of Ethics for Conflicts of Interest

Research for this paper revealed information about disclosures of code of ethics waivers filed with the SEC through Form 8-K via the EDGAR system.⁴¹ The research counted all waivers—whether the company disclosed the waiver because of SOX 406 and SEC regulations or because of the listing standards (which, as set out above, require disclosure of waivers granted to a slightly different set of corporate actors). While public companies can choose to disclose their waivers on their Websites as an alternative to disclosure by 8-Ks, this paper focuses only upon the waivers disclosed in 8-Ks because of the difficulty and time that a search of all company Websites would demand.

Research through the EDGAR system disclosed twenty-six waivers granted by eighteen companies in the period from March 1, 2004 to February 28, 2006. In 2004, there were eleven waivers granted by eight companies;⁴² in 2005, thirteen waivers by nine companies;⁴³ and in 2006 until the end of February, two waivers by two companies.⁴⁴ These counts include waivers that both listed and nonlisted companies disclosed in 8-K filings.

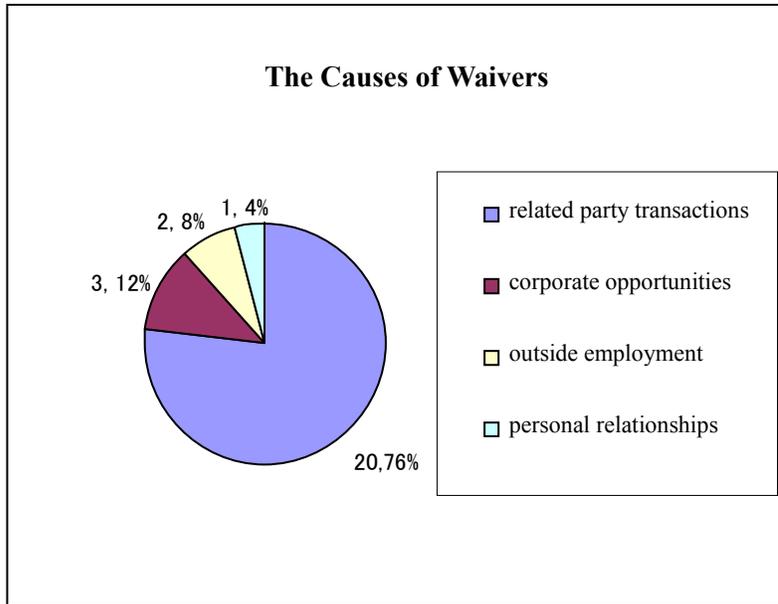
All of the twenty-six waivers were granted in conflict-of-interest situations; twenty of twenty-six waivers were granted for related-party transactions: three for corporate opportunities, two for outside employment, and one for personal relationships.

⁴¹ <http://www.sec.gov/edgar.shtml>.

⁴² Nuvelo, Inc. (NASDAQ listed); Intelligent Systems Corp. (AMEX listed); Red Robin Gourmet Burgers Inc. (2) (NASDAQ listed); Intermix Media Inc. (AMEX listed); PriceSmart Inc. (3) (NASDAQ listed); Ivax Corp. (AMEX listed at the time; but now merged into Teva Pharmaceutical Industries Ltd.); Lexington Corporate Properties Trust (NYSE listed); Integrated Electrical Services Inc. (NASDAQ listed).

⁴³ Ivax Corp. (2); Blue Gate Corp. (2) (nonlisted); Cheniere Energy (AMEX listed); Hybridon Inc. (AMEX listed); Select Medical Corp. (nonlisted); Salisbury Bankcorp Inc. (2) (AMEX listed); Presidential Realty Corp. (AMEX listed); Lawson Products Inc. (NASDAQ listed); Dresser Inc. (2) (nonlisted).

⁴⁴ Stepan Co. (NYSE listed); Fieldstone Investment Corp. (NASDAQ listed).



The data show that companies reported only a small number of waivers in the two-year period studied. The next section offers a possible explanation for the small number.

B. Variations in the Codes of Ethics That Affect the Number of Waivers Disclosed

While the SEC expected code waivers to be “relatively rare,”⁴⁵ the number found by the researcher for this paper is much smaller than even that predicted by the SEC. As we have seen in Part II B1, neither SOX nor the SEC rules include any specific language that codes must contain, but rather, they merely list the goals that the codes are supposed to promote. Some argue that a small number of the waivers result from narrow code provisions which prohibit few activities or transactions and, accordingly, require few waivers.⁴⁶ This paper, however, presents an alternative

⁴⁵ Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, 67 Fed. Reg. 66,207, at 66,225–66,226 (proposed Oct. 22, 2002) (“We believe that changes to a company’s code of ethics and waivers from a code will be relatively rare events. Therefore, we expect that on average, a company will file a Form 8-K to report such an event once every three years, resulting in a total increase of 4,400 filings on Form 8-K per year.”).

⁴⁶ Note, *supra* note 4 at 2137; Kroger, *supra* note 4 at 120.

explanation for the small number, which rests on the definition of the term “waiver.”

1. Inside “Approvals” for Potential Conflicts of Interests Instead of “Waivers” for Conflicts

As we saw in Part II B2, the SEC defines “waiver” as “the approval by the registrant of a material *departure* from a provision of the code of ethics.”⁴⁷ This definition has enabled some companies to avoid reportable “waivers” by adopting codes that provide for approvals, permissions, or authorizations [hereinafter, these three will be referred to as “approvals”], which are separate from “waivers” that must be disclosed publicly and in a timely manner pursuant to Section 406 of the SOX and Item 5.05 of Form 8-K.⁴⁸ As long as such a company complies with its code by providing the requisite approval, there is, at least arguably and in a technical sense, no “departure” from the code and, accordingly, no “waiver.”⁴⁹ The company might even state in its code, for example, that “complying with this code by obtaining approval where required will not be deemed to be a waiver of any provision of this code.”⁵⁰ Obviously, if a company can avoid creating a “waiver” in this way, it will file fewer 8-Ks to report waivers.

⁴⁷ See *Instruction 2(ii)* to Item 5.05 of Form 8-K, 69 Fed. Reg. 15,593 at 15,627, with technical amendments, 69 Fed. Reg. 48,370 at 48,371 (emphasis added).

⁴⁸ If such an approval, permission, or authorization is granted for a related-party transaction under Regulation S-K, Item 404, the transaction must be disclosed in the company’s annual proxy statement pursuant to Regulation S-K, Item 404. But that disclosure is usually long after the approval, permission, or authorization.

⁴⁹ Some law firms have recommended this strategy. See, e.g., Simon M. Lorne Munger, Tolles & Olson LLP, *Codes of Ethics, Codes of Conduct, Good Compliance and Good Management*, 1403 PLI/Corp 155, at 162 (stating that “it will be practical to draft a code with some inherent degree of flexibility. . . . [I]t might be preferable to provide that gifts may not be accepted without *the written approval* of a supervisory officer (or, in the case of the CEO, the Chairman of the Audit Committee). In such a manner, it might be possible to avoid unnecessarily cluttering the public record with essentially insubstantial ‘waivers’ (*since, if written approval is obtained, there is compliance with the code without the necessity of a waiver*) without in any way offending the public interest (as expressed by the Congress) in meaningful codes of ethics.”) [emphasis added].

⁵⁰ Cisco Systems Inc., *Cisco Code of Business Conduct as of July 13, 2006* (providing that “[c]omplying with this Code of Business Conduct by obtaining permission where required will not be deemed to be a waiver of any provision of this code for purpose of this [Waiver and Permission] paragraph,” at 16, available at http://media.corporate-ir.net/media_files/IROL/81/81192/corpgov/codeofconduct_050404_final.pdf).

With this in mind, we may usefully divide codes of ethics into four types, depending on their provisions for inside approval of potential conflicts of interest and the manner in which the companies determine whether an approval requires a reportable waiver.

a. Type (1)

The first type of code requires prior approval for activities or relationships that *may* create conflicts of interest—i.e., *potential conflicts of interests*. Some codes of this type set forth examples of potential conflicts—such as having an ownership or financial interest in competing businesses, having a relationship with a supplier, or receiving personal benefits as a result of a position in the company⁵¹—while other codes of this type do not. If a code provides examples, it is likely to say that the examples are not exhaustive and to require the affected officer to consult with some body inside the company, or the company’s general counsel, if it is unclear as to whether or not an activity or a relationship is a potential conflict of interest under the code.⁵²

With or without examples, codes of this first type urge principal executive officers and senior officers—and usually members of their family—to avoid potential conflicts of interest in the first place. These codes provide, however, that, with a prior approval specified by the code, the officers (or their family members) can engage in an activity or participate in a relationship that *may* produce a conflict.

This first type of code also provides that, if an *actual* conflict results from an

⁵¹ E.g., Johnson & Johnson, *Johnson & Johnson Policy On Business Conduct*, available at <http://www.investor.jnj.com/governance/conduct.cfm>.

⁵² E.g., Broadcom Corporation, *Code of Ethics and Corporate Conduct*, available at http://media.corporate-ir.net/media_files/irol/11/114961/cg/BRCM_codeofe.pdf; *Conflicts of Interest Policy*, at page 1, available at http://media.corporate-ir.net/media_files/irol/11/114961/cg/BRCM_conflictsofinterest.pdf.

activity or relationship that has been approved in the face of a *potential* conflict, then the principal executive officers or the senior financial officers must choose either to eliminate the conflict of interest or obtain a waiver.⁵³

Turning back to the prior approval for potential conflicts of interest, some of the codes of this first type set forth the substantive standard for such approval by providing that the relevant body within the company will approve an activity or transaction where the potential conflict “is not harmful to the company or otherwise improper,”⁵⁴ can be conditioned on “action . . . to ensure there will be no effect on the company,”⁵⁵ or does not involve “illegal or unethical conduct.”⁵⁶ Other codes of this first type do not include a substantive standard but only require an approval. One code of ethics, for example, provides simply that:

[a]ny potential conflict of interest that involves an officer of the Company, of a division or of a subsidiary must be approved in advance by the General Counsel and Chief Financial Officer. Any potential conflict of interest that involves a director or executive officer of the Company must be approved by the Board of Directors or its designated committee.⁵⁷

⁵³ Broadcom Corporation, *Conflicts of Interest Policy*, *supra* note 52 at page 2.

⁵⁴ *Johnson & Johnson Policy On Business Conduct*, *supra* note 51 (“Any activity which even appears to present such a conflict must be avoided or terminated unless, after disclosure to the appropriate level of management, it is determined that the activity is not harmful to the Company or otherwise improper”).

⁵⁵ *E.g.*, *AT&T Inc. Code of Ethics* (“Interests in other companies . . . where an otherwise questionable relationship is disclosed to the Board and any necessary action is taken to ensure there will be no effect on AT&T, are not considered conflicts of interests unless otherwise determined by the Board”), available at <http://att.sbc.com/gen/investor-relations?pid=5595>.

⁵⁶ Borders Group Inc., *Business Conduct Policy*, at 1 (“In instances where the facts are disclosed and no illegal or unethical conduct is involved, the Company could consent to the proposed activity even though a technical conflict of interest exists.”), available at http://media.corporate-ir.net/media_files/irol/65/65380/corpgov/businessconduct3.pdf.

⁵⁷ *E.g.*, The Coca-Cola Company, *The Code of Business Conduct*, at 14, available at http://www2.coca-cola.com/ourcompany/pdf/business_conduct_codes.pdf.

b. Type (2)

A second type of code requires a waiver for either a *potential* or an *actual* conflict. Research for this paper found two such codes. The Stepan Company adopted one of them.⁵⁸ Stepan's code provides that all employees, officers, and directors must avoid conflicts of interest, and should avoid situations that offer the potential for problems. By its terms, the code requires Stepan's principal executive officer, principal financial officer, principal accounting officer or controller, or any person fulfilling similar functions, to disclose immediately to the Audit Committee any material transaction or relationship that reasonably could be expected to give rise to a conflict.⁵⁹ The code then provides that:

[i]t is our policy that circumstances that pose a conflict of interest for [a director or executive officer] are prohibited unless a waiver is obtained [] . . . [and] [c]onsistent with New York Stock Exchange rules, any waiver of this conflict of interest policy for a director or executive officer may only be made by our Board or a committee of our Board, and any such waiver should be promptly disclosed to the Company's shareholders.⁶⁰

Thus, while an activity or relationship that would create a potential conflict would simply

⁵⁸ *Stepan Company Code of Conduct (Amended April 25, 2006)*, available at http://media.corporate-ir.net/media_files/nys/scl/corpgov/CodeofConduct_050106.pdf.

⁵⁹ *Id.* at 5. This means that related-party transactions subject to disclosure in annual proxy statements under Regulation S-K, Item 404 must be disclosed to the Audit Committee and be subject to waivers. Stepan Co. granted waivers for such related-party transactions. See Stepan Co., Form 8-K at 4 (February 17, 2006).

⁶⁰ *Stepan Company Code of Conduct*, *supra* note 58 at 5.

require an “approval” under a *Type (1)* code, that same activity or relationship would require a “waiver” under the Stepan *Type (2)* code.

PriceSmart Inc. has also adopted what appears to be a *Type (2)* code. The PriceSmart code requires that “employees fully disclose any situations that reasonably could be expected to give rise to a conflict of interest[,]” and then provides that “[c]onflicts of interest of our directors, executive officers or other principal officers may only be waived by our Board of Directors or the appropriate committee of our Board of Directors and will be promptly disclosed to the public.”⁶¹ The code speaks only of a waiver, not of an approval without a waiver.

c. Type (3)

A third type of code might require approval both for potential and actual conflicts of interest: prior approval for potential conflicts and subsequent approval for actual conflicts. Since even an activity or relationship creating an actual conflict is permitted by such a code after an approval, such an activity or relationship arguably does not involve any “departure” from the code and therefore does not require any “waiver” of the code.⁶² Research for this paper found no code expressly taking this approach. However, it is possible that companies with *Type (4)* codes operate, in practice, as though their codes were *Type (3)*.

d. Type (4)

Codes in the fourth category are so vague that it is not possible to determine

⁶¹ *Code of Business Conduct and Ethics of PriceSmart, Inc.* at page 4, available at <http://www.pricemart.com/IR/conduct.pdf>. PriceSmart Inc. granted waivers three times in 2004 approving related-party transactions. See PriceSmart, Inc., Form 8-K at 3 (September 3, 2004); Form 8-K at 3 (November 4, 2004); Form 8-K at 2 (November 30, 2004).

⁶² This paper does not endorse an interpretation of the SEC’s definition of “waiver,” which permits companies to substitute “approvals” that they do not disclose for “waivers” that they would have to disclose. The paper simply discusses the types of codes that such an approach either has or could produce.

whether they fall into any of the first three categories. That is, these codes do not clearly state whether they require an approval only, or a waiver only, or an approval of a potential conflict followed by a waiver if the potential conflict becomes an actual conflict.

For example, the codes of Microsoft Corporation state its conflict-of-interest policy very briefly.⁶³ *Microsoft Standards of Business Conduct* provides:

Conflicts of Interest: Microsoft employees are expected to act in Microsoft's best interests and to exercise sound judgment unclouded by personal interests or divided loyalties. Both in the performance of our duties for Microsoft and our outside activities, we seek to avoid the appearance of, as well as an actual, conflict of interest. If in doubt about a potential conflict, speak with your immediate supervisor, manager, another member of management, your Human Resources Generalist, or your Law and Corporate Affairs contact as specified in the Resources for Guidance and Reporting below.⁶⁴

It is unclear what happens when the responsible individual inside Microsoft determines

⁶³ Microsoft has two codes: *Microsoft Standards of Business Conduct*, available at http://download.microsoft.com/download/6/5/f/65f1aced-0ca6-4855-82ac-b10475d556d8/business_conduct.doc, and *Microsoft Finance Code of Professional Conduct*, available at <http://www.microsoft.com/about/companyinformation/corporategovernance/financecode.msp>. The CEO, CFO, corporate controller, and other employees of the finance organization must comply with the both codes.

⁶⁴ *Microsoft Standards of Business Conduct* also provides that “we seek to avoid the appearance of, as well as actual, conflict of interest. If in doubt about a potential conflict, speak with your immediate supervisor, manager, another member of management” (at 8). *Microsoft Finance Code of Professional Conduct* provides that “[a]ll employees covered by the Finance Code of Professional Conduct will [a]ct with honesty and integrity, avoiding actual or apparent conflicts of interest in their personal and professional relationships.”

that a potential conflict exists. Would a potential conflict have to be waived, unless it is not eliminated? Or, could it be approved? If so, by what criteria would it be approved?

Amgen has similar codes. The Amgen code applicable to all employees, including CEOs and senior financial officers,⁶⁵ provides that:

Amgen prohibits conduct that actually constitutes a conflict of interest, as well as conduct that could be perceived as creating a conflict of interest with Amgen's interests.⁶⁶

The code applicable only to CEOs and senior financial officers requires that:

[a]ll [c]overed [o]fficers . . . [e]ngage in and promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships[.]⁶⁷

Again, it is unclear whether an approval or a waiver will permit a conflict-raising activity or relationship to proceed.⁶⁸

⁶⁵ The *Code of Ethics for Senior Financial Officers* of Amgen Inc. says that “[t]his Code of Ethics is intended to supplement, but does not replace, the Business Conduct Guidelines (‘Doing the Right Thing’ handbook) and the policies referenced therein.” Available at http://www.amgen.com/investors/corporate_governance_ethics_officers.htm.

⁶⁶ Amgen Inc., *Do the Right Thing Business Conduct Standards* at page 22, available at <http://www.amgen.com/pdfs/dtrt2004.pdf>.

⁶⁷ Amgen Inc., *Code of Ethics for Senior Financial Officers*, *supra* note 65.

⁶⁸ Amgen Inc., *Do the Right Thing Business Conduct Standards* says: “Please refer to Amgen’s Current Conflicts of Interest Policy for additional details regarding the policy and the obligations of individuals subject to the policy.” (*supra* note 66 at page 22). But that policy is not on the company’s Website.

2. Problems with Current Code Waivers for Related-Party Transactions

Related-party transactions create conflicts. Congressional review of the Enron experience prompted Section 406, which was designed to require publicized waivers of related-party transactions between companies and senior financial officers in order to expose related-party conflicts to investors in a timely way. The current code of ethics regulations presents two obstacles to that goal.

First, the current regulations—read literally and technically—arguably permit an “approval” without a “waiver.” A *Type (1)* code permits approval of a related-party transaction, creating a potential conflict of interest. A *Type (3)* code would permit approval of a related-party transaction, even though it creates an actual conflict of interest. As set out above, an approval under such a code is arguably not a “departure” from the code and therefore, at least arguably, does not fall within the SEC’s definition of a waiver and does not require an 8-K filing.

The second problem with the current regulations is that companies with *Type (4)* codes of ethics—that are unclear about the scope of granting waivers—appear likely to allow related-party transactions without granting disclosed waivers. For example, Microsoft Corporation reported in an annual proxy statement a related-party transaction involving founder and director William Gates, but did not disclose a waiver for the transaction in any Form 8-K.⁶⁹ As set out above, Microsoft’s code states that “we seek

⁶⁹ Microsoft’s annual proxy statement filed on September 28, 2005; Form DEF14A other definitive proxy statements. Microsoft’s September 2005 proxy statement (at page 9) states that Mr. Gates (through a wholly owned company) engaged in one related-party transaction with Microsoft. SOX 406 and related SEC regulations would not have required Microsoft to report a “waiver” for Mr. Gates in connection with that transaction since 406 and the regulations apply only to principal executive officers or specifically identified financial officers, and Mr. Gates was neither. Microsoft, however, listed Mr. Gates as one of its executive officers, and as a director so that, if the company had granted a “waiver” to him under its NASDAQ-required code, Microsoft would have been required to disclose that waiver. But there is no such disclosure in any Microsoft Form 8-K, and research disclosed no such disclosure on the Microsoft

to avoid the appearance of, as well as an actual, conflict of interest,” but does not say anything about approval. It is unclear from the language of the code just why the related-party transaction reported in the proxy statement did not generate a waiver that the company had to disclose.⁷⁰

IV. PROPOSAL FOR AMENDING THE INSTRUCTIONS TO FORM 8-K ITEM 5.05

The current definition of a code of ethics “waiver” that the SEC includes in its Instructions to Item 5.05 of Form 8-K creates the problems set out above—with some companies “approving” conflict-of-interest activities and transactions without publicly disclosing the approvals. To prevent the substitution of undisclosed approvals for disclosed waivers, the SEC should change the Instructions to Item 5.05 to require disclosure, as a waiver, of every “approval” under a code of ethics that permits a principal executive officer or a senior financial officer to engage in an activity or transaction—including but not limited to any related-party transaction—that creates a conflict between the interests of the officer and the interests of the company. This step would stop companies from adopting or keeping codes of ethics that explicitly avoid disclosure of permitted conflicts of interest through internal “approvals” and would prevent companies with *Type (4)* codes from avoiding such disclosure through an internal “approval” process that is itself not clearly revealed to the investment community.

This proposal would still leave to each company the substantive standard for granting what amounts to a waiver from its code, and the proposal is accordingly

Website. Accordingly, it appears that the company did not, in its view, grant a “waiver” for Mr. Gates in connection with the related-party transaction.

⁷⁰ By an e-mail dated July 5, 2006, the author asked Microsoft Investors Relations why no waiver was disclosed for the Gates related-party transaction. Microsoft had not responded as of August 16, 2006.

consistent with the SEC's policy of avoiding mandatory language for codes.⁷¹ Each company could still tailor its code of ethics to its needs.⁷² But this proposal would ensure that every activity or transaction creating a conflict between the interests of a principal executive officer or a senior financial officer, on the one hand, and his or her company, on the other hand, would be timely disclosed to investors.⁷³ Although it is uncertain,⁷⁴ anticipated negative market reaction to the disclosure of approvals for such conflicts might discipline companies so that they are less likely to carelessly grant such approvals.⁷⁵

V. CONCLUSION

Congress concluded that, without adequate disclosure to investors, Enron had waived its code of ethics multiple times to permit its CFO to participate in related-party transactions with the company. When the truth about those transactions emerged, Enron collapsed.

⁷¹ The SEC has stated its belief "that ethics codes do, and should, vary from company to company and that decisions as to the specific provisions of the code, compliance procedures and disciplinary measures for ethical breaches are best left to the company." Final Rule, 68 Fed. Reg. 5,110, at 5,118.

⁷² See Note, *supra* note 4 at 2135 n. 73; E-mail from Dov Seidman, Chairman and Chief Executive Officer, LRN, The Legal Knowledge Company, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec.2, 2002) ("While we fully support the efforts to inculcated an ethical culture, there is an inherent risk in developing a long prescriptive list of principles. Once ethics is mandated, it is no longer about ethics, it is about compliance with a requirement. As a result, there is an inherent risk of downgrading the ethics discussion from one about doing right to one about formulaic satisfaction [of] requirements."), available at <http://www.sec.gov/rules/proposed/s74002/dseidman1.htm>.

⁷³ Related-party transactions involving such individuals who fall within the SEC's definition of "executive officer" should in any case be disclosed in annual proxy statements pursuant to 17 C.F.R. § 229.404. But disclosure of the "approval" within four business days under the revised Item 5.05 Instruction would provide information more quickly to the market in all cases except those in which the approvals were very close to the proxy statement filing date.

⁷⁴ Kroger, *supra* note 4 at 120 (arguing that "investors, markets analysts, and regulators were not paying any real attention to the company's financial statements in the first place, so placing an additional ethics waiver footnote in those statements would probably not have caused any additional analyst inquiry.").

⁷⁵ Note, *supra* note 4 at 2132, 2134–35 (stating that "the requirement of section 406 that waivers be disclosed reflects its drafters' hope that such disclosure will deter executives from carelessly waiving the strictures of their companies' corporate codes as Enron's executives did . . .").

In order to give investors early warning of company approval of conflicts of interests between companies and the top officers within them most responsible for financial reporting, Congress added Section 406 to the Sarbanes-Oxley Act. That section and the implementing SEC rules require companies to promptly disclose code of ethics “waivers” for principal executive officers and senior financial officers. However, some companies have adopted a hypertechnical interpretation of the SEC’s definition of a “waiver”—“the approval by the registrant of a material departure from a provision of the code of ethics.” These companies (i) have prepared codes of ethics that provide for internal approval for an officer’s participation in an activity or transaction creating an actual or potential conflict of interest, and (ii) have concluded that, with such an approval, the officer’s participation does not “depart” from the code and, accordingly, does not require a waiver. The result is that these companies do not report the “approvals,” and the investment community does not learn of the officer’s conflict in a timely way.

This paper proposes an amendment to the Instructions for 8-K disclosure of code of ethics waivers so that every “approval” for participation—by an officer covered by 8-K Item 5.05—in an activity or transaction raising a conflict of interest between the officer and his or her company—will be disclosed on the same schedule as would a code “waiver” permitting that participation.⁷⁶ Without that amendment, the hypertechnical reading of the current rules would have allowed even Enron to interpret its way around the disclosure of a “waiver” for its CFO, and the statute and related rules would not have reached the very example that gave them birth.

⁷⁶ The exchanges should also consider adopting a definition of “waiver” for the codes of conduct that they require, and they should include in that definition language stating that an “approval” of an activity or transaction raising a conflict of interest must be disclosed as a “waiver” when the company grants the approval to an executive officer or director.

