Southern Business Review

Volume 34 | Issue 2 | Article 3

June 2009

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Recommended Citation

Braswell, Michael K.; Foster, Charles M.; and Poe, Stephen L. (2009) "A New Generation of Corporate Codes of Ethics," *Southern Business Review*: Vol. 34 : Iss. 2 , Article 3.
Available at: https://digitalcommons.georgiasouthern.edu/sbr/vol34/iss2/3

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A New Generation of Corporate Codes of Ethics

Michael K. Braswell, Charles M. Foster, and Stephen L. Poe

In the early part of this decade, the business community in the United States was rocked by a series of corporate scandals. Companies such as Enron, Phar-Mor, Cendant, Tyco, Waste Management, Adelphia, Sunbeam, and Worldcom regularly made headlines as a result of accounting scams and other financial misdeeds. This wave of corporate impropriety triggered new calls for reform, with many emphasizing the need to protect investors through more effective promotion and regulation of business ethics in the corporate environment.

Congress was quick to respond, and President G. W. Bush soon signed the *Sarbanes-Oxley Act of 2002* (SOX), which set forth a number of initiatives designed to help stem the tide of corporate fraud, including the establishment of standards for a corporate code of ethics for senior financial officers. Shortly thereafter, the Securities Exchange Commission (SEC) issued final rules implementing many of the provisions of SOX, and amplified the scope and coverage of these standards by extending the corporate code to include the company's principal executive officer. At about the same time, in response to the perceived need for regulatory action, the major stock exchanges also proposed rules requiring their members to adopt and disclose corporate codes and take other actions to deter the occurrence of future scandals.

A common factor in each of these reform initiatives is the emphasis on the use of a code of ethics to implement change in America's corporate culture. The purpose of this article is to briefly outline the provisions of these initiatives that pertain to adoption of corporate codes and the resulting approaches many firms have taken when drafting or revising their codes in light of these initiatives. It then offers a commentary on the positive and negative consequences of these approaches and discusses additional steps that companies might take when drafting and implementing corporate codes of ethics.

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Development and Use of Corporate Codes of Ethics

Over the past two decades, many public companies have voluntarily developed and implemented codes of ethics that can be defined as specialized codes of behavior and standards for professional conduct for managers and employees. Typically, these codes state the companies' core values and provide guidelines for such matters as employee relations, relationships with customers and suppliers, conflicts of interest, confidential information, and other topics (Myers, 2003). Companies adopt such codes for many 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 regulatory community, and the public. Companies may also adopt such codes as part of their efforts to establish a program to detect and prevent violations of law—such a compliance program may reduce the penalties that a company would otherwise face if found liable as a result of its employees' criminal actions (Rafalko, 1994).

For more than forty years, corporate codes have also found great favor with legislators and regulators seeking to promote ethical standards within the corporate culture. Adoption of corporate codes have been included as part of the legislative solution in the wake of a series of business scandals occurring each decade since the 1960's (*Harvard Law Review*, 2003).[1] Also, as noted above, Congress determined in 1991 that corporate codes would be an important part of any compliance program that companies wished to adopt to serve as a mitigating factor under the Federal Sentencing Guidelines for Organizations.

Ultimately, however, as demonstrated by the corporate scandals of 2001 and 2002, the mere adoption of a corporate code of ethics has not usually been enough by itself to prevent corporate malfeasance. Nevertheless, it was in light of these scandals that Congress passed SOX and the SEC and the national stock exchanges adopted their rules regarding the use and disclosure of corporate codes of ethics by public companies.

Overview of Regulatory Responses Relating to Corporate Codes

Despite their widespread adoption and use by business corporations prior to the scandals of 2001 and 2002, corporate codes of ethics apparently did little to stop the outbreak of improprieties that resulted in these scandals. In an attempt to make codes more effective at regulating the ethical conduct of public companies, Congress enacted Section 406 of SOX (Newberg, 2005).[2]

In Section 406, Congress instructed the SEC to enact rules requiring public companies to disclose whether they have adopted a code of ethics for senior financial officers or, if they have not adopted such a code, to explain why not. In addition, Congress directed the SEC to require public companies to immediately disclose any changes in or waivers to the code for senior financial officers. Six months later, the SEC implemented Section 406 by issuing a series of rules, which expanded the coverage of the Section 406 code requirements in two ways. First, the SEC rules directed that the company's code of ethics apply to the company's principal executive officer, as well as the senior financial officers of the firm. Second, the rules expanded the code of ethics requirement to include standards designed to deter wrongdoing and to promote (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest; (2) full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with the SEC and in other public communications; (3) compliance with applicable governmental laws, rules and regulations; and (4) the prompt internal reporting to appropriate personnel of code violations, and (5) accountability for adherence to the code.[3]

In 2003, the year following the enactment of SOX, the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the NASDAQ Stock Market (NASDAQ) all revised their respective listing rules to require public companies to adopt and publicly disclose corporate codes.[4] Although all three exchanges broadened the scope of corporate codes by requiring that they apply to all directors, officers, and employees, the NYSE standards went much farther. For example, the NYSE standards required that any waivers of the code for the benefit of senior officers or directors be granted only by the board of directors or a board committee with any such waivers being promptly disclosed to shareholders. Also, these standards imposed certain content requirements: each company's code cover

conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection and proper use of company assets, compliance with laws, rules and regulations (including insider trading laws), and the reporting of any illegal or unethical behavior. Finally, NYSE-listed companies were required to include certain code enforcement procedures, such as a means for employees to report potential conflicts to the company, and safeguards to ensure that employees knew that the company would not allow retaliation for reports made in good faith. As the NYSE initiative contained much more detailed guidance than the SOX provisions or the SEC rules for the drafting of codes, it has been especially influential among both listed and non-listed companies that have adopted or updated codes following the passage of SOX (Rogers, 2002).[5]

A New Generation of Corporate Codes of Ethics

In light of the increased emphasis on corporate codes of ethics resulting from the enactment of SOX, the SEC rules, and the revised listing standards of the national stock exchanges, a number of suggestions have been offered to guide corporations desiring to adopt and/or update codes to satisfy both the letter and the spirit of these regulatory initiatives. As public companies incorporate these suggestions into their codes, a new generation of corporate codes is taking effect. Most of these suggestions can be summarized and grouped into the following areas.

First, SOX and the SEC rules require company codes to address honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest. In order to meet this goal, employees need to know the company's definition of an "actual or apparent conflict of interest," so not only should these terms be defined, but examples of conflict-creating transactions and activities should be provided (Boudreaux & Steiner, 2005). To expedite the "handling" of such conflicts, the code should set forth procedures for the reporting of potential conflicts, the reviewing of such reports to determine whether a conflict actually exists, and the recommendation of any action the employee and/or the company should take if a conflict is found to exist (Pittman & Navran, 2003). In order to strengthen the company's commitment to guard against such conflicts, the code should both define and emphasize the importance that the company places on values that are relevant to this area, such as "fairness, integrity, and loyalty" (Pittman & Navran, 2003).

Codes following the requirements listed in the NYSE listing standards also should address related situations that may give rise to a conflict of interest. For example, the code should define the term "corporate opportunities," provide examples of same, and prohibit employees from taking such opportunities for themselves without the express consent of the company. Also, "confidential information" should be defined and employees should be directed to keep such information private, whether they have received it from the company or its customers, except when disclosure is legally required or allowed by the company (Boudreaux & Steiner, 2005). Codes should also impose a duty of fair dealing on the company's employees, stressing the importance of dealing fairly with the company's stakeholders and refraining from unfair-dealing practices. Finally, the code should require employees to protect company assets and use them only for legitimate business purposes unless express consent from the company has been obtained.

The second requirement a company must satisfy when adopting a code pursuant to SOX and SEC rules is to provide for full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with the SEC and in other public communications. To achieve this goal, the code should state the importance the company places on values that lead to such disclosure, such as honesty and fairness, and the company's commitment to comply with all laws, rules, and regulations regarding the provision of such disclosure to the SEC and the public

(Myers, 2003; Pittman & Navran, 2003). The code must also provide standards for accurate and timely disclosure of any changes in or waivers to the code's provisions. To comply with the SEC rules, the code should provide for the immediate disclose of any amendment to or waiver of the code's provisions for senior officers, either on Form 8-K or the company's website (Mayer, Brown, Rowe, & Maw, 2003). To comply with the NYSE listing requirements, the code must also stipulate that any such waiver for senior management may be made only by the board and then must be promptly communicated to the shareholders (*NYSE Listed Company Manual*, 2003).

Third, a code adopted by a company pursuant to Section 406 must require compliance with applicable governmental laws, rules and regulations. To provide meaningful guidance to employees, the code might provide examples of laws and regulations that are most likely to create ethical problems in the conduct of the company's particular business (Boudreaux & Steiner, 2005; Barker, 2004). For example, as noted by the NYSE listing standards, the code should remind employees to comply with laws that forbid insider trading, a practice that is both unlawful and unethical. Some codes have gone even further, urging employees "to seek the higher standard—the spirit or intent of the law rather than simply the letter" (Pittman & Navran, 2003; Myers, 2003).

Fourth, companies updating their code following the enactment of SOX must include provisions requiring the prompt internal reporting to appropriate personnel of code violations. In order to create a work environment that facilitates this objective, one commentator has noted that "two organizational actions" are needed (Pittman & Navran, 2003). The first such action is to provide protections from retribution or retaliation for employees who make such reports in good faith (Boudreaux & Steiner, 2005). For example, the code might provide procedures that facilitate the reporting of violations, such as a confidential hotline (Barker, 2004; Boudreaux & Steiner, 2005). The second organizational action is to provide assurances to employees that any such reports will be taken seriously. To this end, the code might underscore the company's commitment to thoroughly investigating claims made in any such reports (Boudreaux & Steiner, 2005; Breeden, 2004; Pittman & Navran, 2003), and designate an ethics compliance officer or special ombudsman to investigate these claims (Myers, 2003; Barker, 2004). The code should also remind employees of the important role such reports play in the furtherance of the company's ethical objectives.

Fifth, to satisfy the regulatory requirements adopted by the SEC and the national exchanges, the code must include provisions that ensure accountability for adherence to the code. To accomplish this goal, the scope of the code's coverage should be broadened to apply to all employees, as required by the listing standards, and not just to the company's senior officers, as required by Section 406 and SEC rules (Myers, 2003; Breeden, 2004). The code should also include procedures for the efficient handling of code violation reports, and enforcement provisions such as penalties, sanctions, and other disciplinary action for code violations (Rockness & Rockness, 2005; Breeden, 2004; Boudreaux & Steiner, 2005).[6] Rather than include "predetermined consequences" such as specific sanctions for specific violations, some advise that the code should provide a range of disciplinary actions, allowing management some discretion to determine accountability based on the individual facts of the particular violation (Pittman & Navran, 2003). Finally, employees need to be aware that code violators will be promptly and consistently disciplined (Boudreaux & Steiner, 2005), so the company may wish to publicize code violations and any resulting disciplinary consequences to its employees on a periodic basis (Pittman & Navran, 2003).

A Critique of the Renewed Emphasis on Corporate Codes of Ethics

What has been the effect of SOX, SEC rules, and the

(Rockness & Rockness, 2005; Turknett & Turknett, 2002; Pittman & Navran, 2003). Legislative and regulatory authorities might also better serve the public interest by seeking a more holistic approach to reforming corporate culture (Rockness & Rockness, 2005: 48-49). Now that attention has been paid to corporate codes of ethics and disclosure requirements, both business firms and regulatory authorities should consider more far-reaching initiatives for the creation and implementation of broad ethics and compliance programs. Such programs, for example, might include the following elements.

First, such programs should strive to meet the requirements of an effective ethics and compliance program under the Federal Sentencing Guidelines for Organizations of the U.S. Sentencing Commission. For example, the program should be designed to facilitate compliance by the company with the values and standards of its internal code of ethics and with governmental regulations that pertain to the company's business (Rafalko, 1994). Following the guidelines outlined below, the company should begin by establishing detailed ethics and compliance standards and procedures. As no "one size fits all," these standards and procedures must be tailored to the individual firm and clearly stated in the company's policies (Turknett & Turknett, 2002; Boudreaux & Steiner, 2005). In addition, the program should provide directives to ensure that proper care is taken when substantial discretionary authority is delegated to employees, that standards and procedures are effectively communicated to all employees and agents, that the program's procedures and results are properly monitored and audited, that discipline of employee violations is consistently enforced, and that responses to wrongdoing are prompt and any program deficiencies are timely remedied (Pittman & Navran, 2003).

Second, for the program to succeed it is critical that it be fully and openly supported by the firm's chief executive and its senior management. As "the tone is set at the top," the company's senior management should regularly and publicly demonstrate their commitment to the company's code, thus sending strong signals about its importance to the rest of the company (Boudreaux & Steiner, 2005; Breeden, 2004; Barker, 2004). The directors and senior officers should continually emphasize and remind employees of their support of the basic "core" values and behavioral standards that the company has adopted to govern the ethical behavior of its employees (Boudreaux & Steiner, 2005).[8] Also, once designed, senior management must commit to the program by ensuring that the officers designated to manage the program are given the necessary authority, resources, and access to the firm's top executives to successfully implement the program's standards and objectives (Finder & Warnecke, 2005).

Third, the program must be designed to allow employees to take ownership of the company's ethical initiatives (McNamara, 2008). To foster this sense of ownership, and to ensure that the program's values and standards are as relevant and credible as possible, the firm's senior management should seek input from as many departments and employee groups as possible when drafting the program's objectives and standards (Myers, 2003; Barker, 2004; Boudreaux & Steiner, 2005). To ensure accountability and responsibility, the program should include appropriate measures to enhance employee compliance with its standards and objectives (Rockness & Rockness, 2005). For example, the company should require employees to pledge their commitment to the company's ethical program by signing a form acknowledging they have read and understood the code and agree to comply with its provisions. The company should then put real teeth in the code by providing in their employee agreements that violation of the code will constitute "good cause" for dismissal—for all employees (Myers, 2003).

Fourth, as neither the code nor the other supporting materials used by the company for its ethics and compliance program can accomplish their purpose unless they

are comprehensible, companies should make sure that these materials are understandable and accessible to all employees, free of buzzwords and legalese (Barker, 2004). The company should offer periodic training and testing programs to ensure comprehension and to make sure the objectives of the code are clearly understood so they can be effectively implemented (Myers, 2003; Boudreaux & Steiner, 2005).

Fifth, for the program to positively influence employee behavior, the company should strive to create an open work environment in which employees feel free to discuss ethical issues and dilemmas. To facilitate such discussion, the program must make clear that the code's purpose is merely to serve as a general guide to employee behavior on the job, rather than a manual addressing every conceivable ethical situation (Boudreaux & Steiner, 2005). In cases not specifically addressed by the code, employees should be encouraged to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation and/or be trained to use the values and general principles stated in the code to guide their decision-making (Barker, 2004; Pittman & Navran, 2003). In order to facilitate an atmosphere of trust and open communication so that such a dialogue might take place, the program should allow for anonymous or confidential consultations and/or reporting by employees that could be utilized without fear of retaliation (Finder & Warnecke, 2005).

Sixth, to keep current and reflect changes in the company and its business practices, the program should provide a mechanism for periodic monitoring and updating of its contents and procedures, and both the program and its effectiveness at preventing, detecting, and responding to unethical conduct should be reviewed from time to time and amended when necessary (Boudreaux & Steiner, 2005; Pittman & Navran, 2003). For example, some companies have placed an expiration date in their code, which requires the board to review and update the code on a regular basis (Pittman & Navran, 2003). Of course, under SOX and the SEC rules, any such amendments to the code, as they apply to the firm's senior officers, must be promptly disclosed to the SEC and to the company's shareholders.

In addition to helping a company achieve its ethical objectives, a firm's adoption of a broad ethics and compliance program can serve other benefits. For example, studies have shown that such a demonstrated commitment to ethical values and objectives can lead to favorable business financial performance (Verschoor, 1998).[9] Also, as noted above, such a program may be considered as a mitigating factor to be considered under the Federal Sentencing Guidelines in determining whether to initiate enforcement actions against companies and how to assess penalties. In sum, comprehensive guidelines for such programs should be adopted by the companies themselves and/or promulgated by appropriate legislative and regulatory authorities so that these firms might have a better opportunity to achieve true reform.

Conclusion

In the aftermath of the wave of corporate scandals that rocked American business in 2001 and 2002, Congress, the SEC, and the national stock exchanges all enacted reform initiatives that included the implementation of corporate codes of ethics as a way of instituting change in America's corporate culture. Although these initiatives were well-intended, they have been criticized as being too general and for creating incentives for companies to adopt less than rigorous codes. In the years since 2002, research also has shown that these reforms have not been successful so far in stemming the tide of corporate wrongdoing, although misconduct has been reduced significantly at firms with strong ethical cultures (Ethics Resource Center 2007). As a result, it is apparent that in the future regulatory authorities, as well as the companies themselves, must consider more far-reaching measures to bring about the change in corporate culture that is

necessary to achieve true reform.

A comprehensive, management-backed ethics and compliance program has been shown to be a step in that direction. Specifically, firms should develop and implement a comprehensive ethics program that (i) facilitates compliance with both the firm's code of ethics and applicable governmental regulations, (ii) has the full and open support of the firm's chief executive and its senior management, (iii) ensures accountability and responsibility by including appropriate measures to enhance employee compliance, (iv) offers periodic training and testing programs to ensure employee comprehension,(v) creates an open work environment in which ethical issues and dilemmas can be freely discussed, and (vi) provides a mechanism for periodic monitoring and updating of the effectiveness of the program's contents and procedures. In this way, companies may develop and maintain a strong ethical culture that will protect investors and the general public through more effective promotion and regulation of business ethics in the corporate environment.

Notes

1. For a discussion of the history of the federal government's attempts to legislate ethical conduct on the part of corporations, see Rockness & Rockness (2005).

2. For a general discussion of the provisions of Section 406 and the SEC rules issued pursuant thereto, which remain in effect today, see Rogers (2002), Fried, Frank, Harris, Shriver, & Jacobson, LLP (2003), and Mayer, Brown, Rowe, & Maw (2003).

3. Although these rules provided general guidelines and objectives for the drafting of a code, the SEC decided that decisions as to specific code provisions, compliance procedures, and disciplinary measures for ethical breaches were best left to the judgment and discretion of the individual company. The SEC did, however, urge public firms to utilize broad, comprehensive code provisions in order to satisfy the requirements of the new rules (Mayer, Brown, Rowe, & Maw, 2003).

4. *NYSE Listed Company Manual*, Section 303A.10 (2003); *AMEX Company Guide*, Section 807 (2003); *NASDAQ Manual* Section 4350(n) (2006).

5. It appears than in some instances non-listed companies have also adopted and disclosed codes of ethics pursuant to these standards even though they were not required to do so (Mori, 2007). In fact, even

   privately held businesses and charitable organizations … are finding that certain aspects of [SOX] can benefit their overall operations and are cherry-picking those parts that will do them the most good (Savich, 2006),

   including code of ethics provisions.

6. Alternatively, the code might use an audit-based compliance system, which uses periodic "audits" of employees to ensure accountability to the code (Lere & Gaumnitz, 2007; Myers, 2003).

7. Many studies have examined the relationship between the development and implementation of a company's code of ethics and the ethical behavior of its employees. For a discussion and critique of some of these studies, see McKinney & Moore (2008), Ethics Resource Center (2007), and Long & Driscoll (2008). Although some have concluded that such codes have been effective in leading to more ethical employee behavior, others have not found a conclusive correlation (Newberg 2005; Lere & Gaumnitz 2007).

8. As Rockness & Rockness conclude,

   [t]he responsibility for ensuring an ethical culture must rest not only with the CEO but also with an independent Board of Directors. The Board must be responsible for the values and ethics they seek in officers of the corporation to ensure a culture that supports, nurtures, fosters, and attracts individuals of high personal integrity. The Board must provide the oversight necessary to ensure that ethical behavior is noticed and rewarded. Similarly, the culture must encourage the departure of those who violate the ethical principles regardless of their other contributions to the organization (2005: 49).

9. See also Verschoor (2005) and studies cited therein.

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