

## **.SEC Implements Standards of Professional Conduct for Attorneys**

PREPARED FOR THE AMERICAN CORPORATE COUNSEL ASSOCIATION

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*For a copy of ACCA's "Five Practical Steps" for corporate counsel interested in knowing what they need to do in response to the passage of these standards, please go to <http://www.acca.com/legres/corpresponsibility/307/steps.pdf>.*

### **I. INTRODUCTION**

On January 23, 2003, the Securities and Exchange Commission (the "SEC" or the "Commission") adopted final rules establishing standards of professional conduct for attorneys who appear and practice before the Commission on behalf of issuers. The rules were adopted pursuant to Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act"), which requires the SEC to promulgate rules establishing minimum standards of professional conduct for attorneys including a rule that obligates an attorney practicing before the Commission to report evidence of certain material violations "up the ladder" within the organization. The final rules differ in several key respects from the initial rules proposed by the SEC on November 21, 2002. These differences are highlighted below. The final rules, codified in Part 205 of Title 17 of the Code of Federal Regulations, take effect 180 days from their publication in the Federal Register.

The most controversial provision of the rules proposed in November obligate an attorney to withdraw from representing an issuer and notify the SEC of such withdrawal and to disaffirm any misleading documents filed with the SEC in the event the issuer does not adequately address the attorney's report of evidence of a material violation—the so called "noisy withdrawal" provision. The final rules do not contain the noisy withdrawal requirement. Instead, the Commission has left open the comment period on the proposed noisy withdrawal rule for an additional 60 days. The Commission has also proposed an alternative approach to noisy withdrawal which requires the issuer – not the attorney – to disclose to the Commission that its attorney has withdrawn from representation. Neither the noisy withdrawal approach nor the issuer disclosure alternative would apply if an issuer has enhanced its corporate governance systems by establishing a "qualified legal compliance committee" of the board (a "QLCC"). These provisions are also discussed below.

While the SEC rules establish federal standards of professional conduct for attorneys who appear and practice before the SEC on behalf of public companies, it is important that attorneys keep in mind applicable state ethical standards and the relationship of the federal and state standards. For example, Rule 1.13 of the Model Rules of Professional Conduct and its counterpart adopted by each state require lawyers for a corporation who know of wrongdoing likely to result in substantial injury to the corporation to proceed as is reasonably necessary in the best interest of the corporation, which may involve having to report up the ladder within the corporation, potentially to the board of directors. Other provisions, such as Rule 1.6, deal with confidentiality of client information and the limited circumstances when confidential information may be revealed, and Rule 1.16, along with Rules 1.2 and 4.1, deal with circumstances when a lawyer must withdraw from representation of a client.

## **I. FINAL RULES**

### **A. Attorneys Covered by the Rules**

The final rules make clear that an attorney represents the issuer as an organization and not the issuer's individual officers or employees whom the attorney regularly interacts with or advises. The final rules also clarify that they are intended to supplement standards of professional conduct of the jurisdictions in which attorneys are licensed to practice, but in the event the final rules conflict with such local standards, the SEC rules govern.

The SEC narrowed the scope of who is considered an "attorney appearing and practicing before the Commission" under the final rules. An "attorney" is "any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law." This definition includes both in-house and outside counsel and U.S. and foreign attorneys (although certain foreign attorneys defined as "non-appearing foreign attorneys" are not covered by the rules, as described below).

Unlike the proposed rules, the final rules require that an attorney be providing legal advice and that an attorney-client relationship exist in order for an attorney to be subject to the rules. Thus, employees of an issuer who are licensed attorneys but who do not practice law on behalf of their employer are not subject to the final rules. Attorneys for third parties who review part of an issuer's disclosure document or render a legal opinion to an issuer who is not their client also are not subject to the rules. In addition, foreign attorneys who are (1) admitted to practice in a jurisdiction outside of the U.S., (2) do not give legal advice regarding U.S. law, and (3) conduct activities that would constitute "appearing and practicing" before the Commission only (i) incidentally to foreign law practice or (ii) in consultation with U.S. counsel are considered "non-appearing foreign attorneys" and are not covered by the final rules. Accordingly, a foreign in-house attorney can avoid being subject to the rules by consulting with U.S. attorneys.

The Commission addresses two situations where an attorney is subject to the rules even though not counsel for the issuer. An attorney employed by an investment adviser who prepares material for an investment company knowing it will be filed with the SEC is appearing and practicing before the Commission. Because "issuer" is defined to include a person controlled by

an issuer, an attorney for a controlled subsidiary can be deemed to be appearing and practicing before the Commission in the representation of the parent. For example, an in-house attorney for a controlled subsidiary can be covered if the attorney is acting for the benefit of the parent or operating under an umbrella representation agreement.

An attorney is “appearing and practicing before the Commission” if the attorney is (i) transacting any business with the Commission, including communications in any form, (ii) representing an issuer in an SEC administrative proceeding or in connection with an SEC investigation, inquiry, information request or subpoena, (iii) providing advice in respect of U.S. securities laws or the SEC’s rules and regulations regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, or (iv) advising an issuer as to whether information, or a statement, opinion or other writing is required under U.S. securities laws or the SEC’s rules and regulations to be filed with the SEC. The final rules narrow the definition of “appearing and practicing before the Commission” somewhat by requiring that an attorney have notice that a document that he or she is working on will be incorporated into an SEC filing. This still leaves the reach of the rules quite broad and can encompass non-securities specialists in many situations. For example, a non-securities specialist who prepares or reviews a discrete section of a disclosure document could be “appearing or practicing.” An issue that will need clarification is whether preparation of an agreement that will be filed as an exhibit with the SEC is enough to subject an attorney to the rules if the attorney is aware that it will be filed. It may be possible for a non-securities specialist subject to the rules to fulfill his or her obligation by reporting to a “supervisory lawyer” as described below. But this too will require clarification.

## **B. Scope of Issuer Conduct Covered by the Rules**

The final rules require reporting by an attorney when he or she is aware of “evidence of a material violation” by the issuer or by any of its officers, directors, employees or agents. “Evidence of a material violation” means “credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.” This is primarily an objective standard: once the attorney is aware of information, he or she must act reasonably in concluding whether there is credible evidence of a material violation. In determining whether an attorney has been reasonable, such factors as the attorney’s professional skills, background and experience and his or her familiarity with the client may be taken into account. The violation need only be “reasonably likely,” which the SEC indicates is less than “more likely than not.”

A “material violation” means a material violation of an applicable U.S. federal or state securities law, a material breach of fiduciary duty arising under federal or state statutory or common law, or a similar material violation of any U.S. or state law. Unlike in the proposed rules, the Commission did not define the meaning of “material” in the final rules. Instead, it notes in the adopting release that the term “material” is meant to have the usual meaning that it has under federal securities law as interpreted by the courts. The final rules also clarify that violations of foreign law are not considered “material violations.”

### C. **Obligation to Report Up the Ladder**

If an attorney subject to the rules becomes aware of evidence of a material violation, he or she must report that evidence “up the ladder” by first reporting to the issuer’s chief legal officer (the “CLO”) or to both the CLO and the issuer’s chief executive officer (the “CEO”). The final rules eliminate the requirement that a reporting attorney document the report of evidence of a material violation, along with eliminating the other documentation requirements.

Once the CLO receives a report of evidence of a material violation from the attorney, the CLO must cause an inquiry to be conducted into the possible violations outlined in the report. If the CLO determines that no material violation has occurred, is ongoing, or is about to occur, the CLO must notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the CLO reasonably believes that no material violation has occurred, is occurring or is about to occur, the CLO must take all reasonable steps to cause the issuer to adopt an appropriate response.

A reporting attorney who receives what he or she reasonably believes is an appropriate and timely response to a report has satisfied his or her obligations under the rules. If the CLO does not provide an appropriate response within a reasonable time, the attorney must report the evidence of a material violation to (i) the issuer’s audit committee, or (ii) if the issuer does not have an audit committee, to another committee consisting solely of directors who are not employed, directly or indirectly, by the issuer, or (iii) if the issuer does not have an audit committee or such an independent committee, to the issuer’s board of directors. If the attorney reasonably believes that it would be futile to report first to the CLO, the report may be made directly to the audit committee, the independent committee or the board of directors, as the case may be.

An “appropriate response” is one as a result of which the attorney reasonably believes (i) no material violation has occurred, is ongoing or is about to occur, (ii) the issuer has adopted appropriate remedial measures, or (iii) the issuer, with board or committee approval, has retained or directed an attorney to review the reported evidence and has substantially implemented remedial recommendations made by the attorney after a reasonable investigation or has been advised by the attorney that a colorable defense may be asserted, consistent with the attorney’s professional obligations, in any investigation or proceeding. In exercising professional judgment as to whether a response was appropriate, the attorney can take into account the relevant circumstances such as the amount and weight of evidence, the severity of the apparent violation and the scope of the investigation, so long as the attorney’s determination is reasonable. An attorney may also rely on factual representations and legal determinations where that reliance is reasonable.

As an alternative to the foregoing actions, either the reporting attorney or the CLO may satisfy his or her obligations under the rules by reporting to a QLCC, as described below.

The rules contemplate that an issuer may hire outside counsel or direct in-house counsel to investigate a report of evidence of a material violation. Those attorneys that are hired or directed to investigate a report do not have to report evidence of a material violation up the ladder if (i) the CLO reports the results of such attorney’s investigation to the board level, (ii)

such attorney was retained to assert a colorable defense on behalf of the issuer in any investigation or proceeding relating to evidence of a material violation and the CLO provides reasonable reports on the progress and outcome of the proceeding to the board level, or (iii) such attorney was retained by the QLCC to investigate evidence of a material violation or to assert a colorable defense on behalf of the issuer in any investigation or proceeding relating to such evidence.

If an attorney who was formerly employed or retained by an issuer and who has reported evidence of a material violation reasonably believes that he has been discharged for doing so, the attorney may notify the board of directors or any committee of the issuer of his or her discharge. An in-house attorney may have the benefit of the whistleblower protections under Section 806 of the Act. Whether this provision will override the traditional limitations on a lawyer's ability to claim wrongful discharge because of a client's fundamental right to choose counsel and protect its right to privileged communications (assuming that a suit would require revealing such communications) remains to be seen.

#### **D. Qualified Legal Compliance Committee Alternative to Up the Ladder Reporting**

The rules provide an alternative process to up the ladder reporting that attorneys and issuers may use when investigating and reporting evidence of material violations. Under this alternative, an issuer may establish a QLCC, which consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more independent members of the issuer's board of directors. A QLCC may be an existing committee, such as the audit committee, if it meets the requirements. A QLCC must be in place before a reporting obligation is triggered and must have the authority and responsibility to: (i) inform the CLO and CEO of any report of evidence of a material violation, (ii) determine if an investigation is necessary, and if so, conduct one, (iii) at the conclusion of any investigation, recommend that the issuer implement an appropriate response to the investigation, and (iv) take all appropriate action, including authority to notify the SEC if the issuer fails to implement its recommended response. As now written for purposes of up the ladder reporting, the QLCC would not be required to notify the SEC.

While not requiring it, the Commission encourages use of a QLCC to strengthen corporate governance and indicates that it intends that QLCC members do not have increased liability under state law.

An attorney who reports evidence of a material violation to a previously existing QLCC fulfills his or her obligation to report such evidence and is not required to assess the issuer's response to the reported material violation. A CLO may also refer a report of a material violation to a previously existing QLCC in lieu of causing an inquiry into the report.

#### **E. Permissive Disclosure of Client Confidences**

An attorney appearing and practicing before the Commission may reveal to the SEC confidential information related to the representation to the extent the attorney reasonably believes necessary to prevent the issuer from committing a material violation that is likely to

cause substantial injury to the financial interest or property of the issuer or to rectify the consequences of such a violation in furtherance of which the attorney's services were used. An attorney may also reveal confidential information to prevent perjury or a fraud on the Commission. As the reporting is permissive, an attorney will have to consider applicable state ethical rules which may circumscribe the attorney's ability to disclose client confidential information and whether the SEC's effort to override conflicting state rules is effective.

#### **F. Supervisory and Subordinate Attorneys**

An attorney who supervises or directs another attorney who is appearing and practicing before the Commission must make all reasonable efforts to ensure that the subordinate attorney complies with the rules. The final rules are intended to clarify that only the supervisory attorneys who direct the subordinate attorneys that are appearing and practicing before the Commission are subject to the rules. A CLO is deemed to be a supervisory attorney, and therefore has the responsibility of a supervisory attorney, including apparently being treated as appearing and practicing before the Commission if any subordinate attorney is so appearing and practicing.

A subordinate attorney is deemed to have complied with the up the ladder reporting requirements of the rules if he or she reports evidence of a material violation to a supervisory attorney. A supervisory attorney who receives such a report from a subordinate attorney is then responsible for complying with the up the ladder reporting requirements of the rules. An attorney under the direct supervision of the CLO, such as a deputy general counsel, is not a subordinate attorney for purposes of being able to satisfy his or her reporting obligation by reporting to the CLO as the supervisory attorney and therefore has to follow the up the ladder reporting requirements.

#### **G. Sanctions and Disciplinary Actions; No Private Right of Action**

The final rules subject an attorney who does not comply with the rules to the civil penalties and remedies available to the SEC under federal securities laws. These include civil injunctions, money penalties and cease and desist orders. An attorney that violates the rules is not subject to criminal liability for such violation, but this does not prevent sanctions being imposed for violation of other legal requirements. An attorney is also subject to discipline and potential suspension under the SEC's rules of practice based on prevailing Commission standards for disciplining attorneys.

The final rules are intended to override state rules of professional conduct that are inconsistent with the rules. The rules provide that if an attorney complies in good faith with the provisions of the rules, he or she will not be subject to discipline under inconsistent standards imposed by any state in which the attorney is admitted to practice. The effectiveness of this provision remains to be seen. Foreign attorneys are not required to comply with the rules to the extent that such compliance is prohibited by applicable foreign law.

The final rules create an explicit safe harbor by providing that they do not create a private right of action against any attorney, law firm or issuer based upon compliance (or noncompliance) with the rules; the authority to enforce the rules is solely with the SEC.

## **II. PROPOSED RULES REGARDING MANDATORY WITHDRAWAL**

Because of the controversy surrounding its noisy withdrawal proposal, the Commission has extended the comment period on this proposal for an additional 60 days. It has also proposed an alternative which requires the issuer – not the attorney – to notify the Commission in the event the attorney withdraws from representation due to a failure of the issuer to remedy a material violation. Comments to the noisy withdrawal proposal raised concerns over the adverse impact the proposal would have on the attorney – client relationship and the ability of lawyers to effectively advise clients regarding legal compliance, as well as regarding the potential inconsistency of the proposal with state confidentiality requirements under lawyer ethical rules. [See e.g., ACCA’s comment letter dated December 18, 2002 at [www.acca.com/advocacy/307comments.pdf](http://www.acca.com/advocacy/307comments.pdf) and the ABA’s comment letter dated December 18, 2002 at [www.abanet.org/poladv/letters/other/comment\\_letter.pdf](http://www.abanet.org/poladv/letters/other/comment_letter.pdf).]

### **A. Noisy Withdrawal by Attorney**

The original proposed rule on noisy withdrawal (which is now open to another 60 days of comment) requires that if an attorney does not receive an appropriate response, (or a response within a reasonable time) to a report of evidence of a material violation, and if the attorney reasonably believes that a material violation is ongoing or is about to occur and likely to result in substantial injury to the financial interest or property of the issuer or investors, the attorney, if outside counsel, must withdraw from representing the issuer and notify the issuer of such withdrawal. The attorney must also notify the Commission within one business day of withdrawal indicating that the withdrawal was based on professional considerations. The attorney also must disaffirm to the Commission any document filed with the Commission that the attorney assisted in preparing that the attorney reasonably believes may be materially false or misleading. If the material violation has already occurred and is not ongoing, an attorney may, but is not obligated to, effect a noisy withdrawal.

With respect to in-house attorneys, under the original proposed rule, an in-house attorney is not required to withdraw from representing his employer. Instead, the in-house lawyer must disaffirm any document filed with the Commission that the attorney reasonably believes may be materially false or misleading.

### **B. Issuer Notification of Withdrawal**

The new alternative proposal (also open to comment for 60 days) requires an outside attorney to withdraw from representing the issuer and notify the issuer of such withdrawal if the attorney has reported evidence of a material violation up the ladder and there has not been an appropriate response and the attorney reasonably concludes that there is substantial evidence of a material violation that is ongoing or about to occur and likely to result in substantial injury to the financial interest or property of the issuer or investors. Similar to the proposed noisy withdrawal rule, in-house attorneys are not required to withdraw from representing their employer, but must cease participation in any matter concerning the material violation and notify the issuer that there has not been an appropriate response. Once the issuer has received such notice from either outside counsel or in-house lawyers, the issuer must, within two business days of its receipt of

such notice, report such notice and the circumstances related to it to the Commission on Forms 8-K, 20-F or 40-F, as applicable. If the issuer does not so report, the attorney *may* inform the SEC of the withdrawal for professional considerations. The Commission has asked whether there are circumstances that should excuse an issuer from having to report an attorney's withdrawal and whether the issuer should be able to report non-publicly to the SEC.

The withdrawal and issuer reporting requirements do not apply if the report of a material violation has been made to a preexisting QLCC as discussed above.

The new proposed rule does not obligate an attorney to withdraw from representing an issuer if such withdrawal is prohibited by the rules of any court or other administrative body having jurisdiction over the attorney. In such a case, however, the attorney must notify the issuer that but for such rules, the attorney would have taken action to withdraw from representation. With respect to in-house lawyers, the new proposed rules require an in-house attorney to report to the CLO if the attorney believes that he or she was discharged due to reporting evidence of a material violation. A CLO is required to notify a successor attorney of the prior attorney's withdrawal.

#### IV. ACTION ITEMS

The final rules do not take effect for 180 days from publication in the Federal Register; the Commission has indicated that it will accept additional comments. The Commission has extended the comment period on the noisy withdrawal proposal and the new alternative company notification proposal for 60 days. Companies and corporate counsel may file comments with the SEC or forward suggestions to Susan Hackett at ACCA ([hackett@acca.com](mailto:hackett@acca.com)).

The Commission's deferral of the effective date of the rules will allow lawyers and public companies to educate themselves regarding the rules' requirements and establish procedures to implement compliance. Law firms and law departments will want to put educational programs in place and consider compliance procedures involving reporting and consultation internally on potential violations to determine if action is required to comply with the rules. These might involve requirements to report to supervisory lawyers, relationship attorneys and specially created compliance committees or designated lawyers, as well as procedures for reporting back to an attorney who initiated consideration of the matter. The internal procedures might also involve documentation requirements. Companies may want to review their corporate governance systems and consider whether to establish a QLCC, particularly if the Commission decides to adopt a reporting out requirement which can be replaced by having a QLCC in place. As noted, a QLCC may be an existing committee, such as the audit committee, if it meets the requirements to be a QLCC.

Interested counsel may also wish to consider the "Five Practical Steps" document that ACCA has prepared for members which outlines the kinds of specific actions in-house lawyers may wish to consider as a response to the issuance of these rules: see. <http://www.acca.com/legres/corpresponsibility/307/steps.pdf>.

By enacting Section 307 of the Act, Congress responded to the question: “Where were the lawyers?” The SEC has implemented the Congressional response in part and is considering whether further implementation is necessary. The burden now shifts to lawyers, both in-house and outside, and to public companies to address compliance with this new lawyer regulatory regime.

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