

Hale and Dorr LLP

Counselors at Law

“Up and Out”

New Professional Responsibility Rules for
Attorneys under the Sarbanes-Oxley Act

February 4, 2003

Section 307 and SEC Rulemaking

- > Attorneys who “*appear and practice*” before the SEC must:
 - report “evidence of a material violation” to the CLO or CEO; and
 - if the CLO or CEO does not “appropriately respond,” report to the Audit Committee or the Board.

(15 U.S.C. § 7245)



Section 307 and SEC Rulemaking

- > November 2002 - SEC proposed rules and solicited comments
 - Who is covered?
 - What triggers “up the ladder” reporting?
 - Where and how does it end?
- > January 2003 – SEC promulgated final rules and proposed additional rules



“Appearing and Practicing Before The Commission”

- > Final rules apply to attorneys who represent issuers and
 - transact business or communicate with the SEC (including in administrative actions, investigations and other proceedings); or
 - prepare, assist with, contribute to or provide advice regarding any document with “notice” that it will be submitted to the SEC; or
 - advise issuers on U.S. securities laws.



“Appearing and Practicing Before The Commission”

- > In-house and law firm counsel distinctions
- > Supervisors and subordinates
 - attorneys under direct supervision or direction of CLO are not subordinates
- > “Non-appearing” foreign attorneys



“Material Evidence” Standard

Reporting obligations triggered when attorney “becomes aware of evidence of a material violation,” *i.e.*:

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

(17 C.F.R. 205.2(e))



“Material Evidence” Standard

> Objective standard based on the “*prudent and competent*” attorney and

- *Credible evidence* – not “gossip, hearsay or innuendo”
- *Circumstances* – attorneys’ skill, experience, time constraints, and familiarity with client
- *Reasonably likely* – more than remote, but less than “more likely than not”
- *Material violation* – Federal and State securities laws, fiduciary duties, or “similar material violation”



“Going Up the Ladder”

- > Reporting to the Chief Legal Officer (CLO)
 - Obligation of CLO to conduct inquiry
 - Obligation of CLO to advise reporting attorney of response
- > Does the reporting attorney reasonably believe that there has been an “appropriate and timely response” ?
- > Reporting to the audit committee or the board
- > Exemptions for counsel retained to conduct investigations and defend issuer in response to reports of material violation



The QLCC Alternative

- > At least one audit committee member and two independent directors
 - may consist of audit or other committee of issuer
- > Authority to investigate, remediate and report to SEC
- > Must preexist – cannot be convened in response to a report
- > No need to evaluate response



“Noisy” Withdrawal

- > Original proposal – attorney reports out
 - “professional considerations”
 - disaffirmance of documents
 - notification to successor counsel
- > New proposal – issuer reports out
 - issuer 8-K reporting obligation
 - no disaffirmance
 - notification to successor counsel



Preemption and Privilege Issues

- > State law conflicts
- > “Self-defense” and other exceptions to client confidentiality
- > Waiver



Sanctions and Private Litigation

- > Exchange Act penalties
- > Administrative proceedings and federal court litigation
- > “Good faith” reliance defense to other federal and state offenses
- > No private right of action



Coming Attractions

- > Effective date
 - 180 days after publication in the Federal Register
- > Further rulemaking
 - comments on proposed rules due 60 days after publication in the Federal Register
- > Company decision to form QLCC
- > SEC enforcement



American Foods: Confronting Section 307 Situations

- > What are the obligations of Wise and Adviser under section 307 and the SEC's new rules?
- > Was Chaser's telephone call "credible evidence" of a "material violation" ?
 - If not, is Wise obligated to investigate?



American Foods: How Much Investigation is Necessary?

- > Did Money's statements trigger a Section 307 reporting obligation? Did Wise make a formal "report" to Boss?
- > Was Advisor entitled to rely on Wise's investigation?
- > Did AFI adopt "appropriate remedial measures" ?
- > Were the 10-Q and press release misleading?
 - If so, what issues arise under Section 307? For whom?
- > Apart from any obligation under Section 307, did Wise respond appropriately to the consumer's allegations?



American Foods: Dealing with Disagreement

- > Are Wise and Advisor now aware of “evidence of a material violation” ?
- > Does Section 307 compel public companies to follow their attorneys’ advice? What if clients receive conflicting advice?
- > How should Wise resolve her disagreement with Boss? Should she go to Board? QLCC?
- > How quickly must counsel and issuers respond to “evidence” of a violation?
- > Should AFI enlist the assistance of its auditors?



American Foods: Defining an “Appropriate and Timely” Response.

- > Was the Board’s response appropriate and timely?
- > What if Wise and Advisor believe that prior SEC filings and releases were materially misleading?
- > Was the conversation between Wise and Boss privileged? Does the privileged character of a communication change an attorney’s obligation under Section 307?
- > Assume the last 10-Q and press release were materially misleading to investors. Would such a violation be considered “ongoing”?



American Foods: Dealing with the SEC

- > Should AFI have notified the SEC or other agencies of its internal investigation before it was completed?
- > What “cooperation” can AFI now provide to the SEC? Is it too late?
- > What should AFI say in the upcoming 10-Q?
- > What, if anything, can AFI do to minimize its exposure to civil or criminal proceedings?



Suggested Practices

- > Plan ahead
- > Define the problem
- > Communicate
- > Seek guidance
- > Consider other legal and ethical obligations



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