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SEC Proposes Professional Conduct Standards for Attorneys

Last month, the SEC published for comment Proposed Rules under Section 307 of the Sarbanes-Oxley Act setting new standards of professional conduct for attorneys. The SEC will issue Final Rules by January 26, 2003

Public companies are accustomed to heavy regulation, although historically the SEC has avoided regulating their lawyers differently than everyone else. That position changed with Section 307 of the Sarbanes-Oxley Act, which requires the SEC to issue "Rules of Professional Responsibility" for lawyers by January 26, 2003. Last month, the SEC released for comment its Proposed Rules (Release No. 33-8150), which set the "minimum standards" required by Congress and include several additional requirements.

The Proposed Rules are controversial, although in many respects the role of Company Counsel (in-house and outside) has not changed:

- Company Counsel represent the Company and not individual executives or directors.
- Company Counsel are expected to be honest in their dealings with the SEC and investors, and should insist on the same from others who speak for the Company.
- Company Counsel are gatekeepers, distinguishing potential wrongdoing within the organization from false alarms. There is nothing novel about Company Counsel investigating potential issues and recommending remedial action where warranted.
- Company Counsel most effectively serve the Company by communicating with management, the Board and each other, reaching consensus where possible, and

elevating unresolved issues where necessary.

Within those basic principles, the Proposed Rules call for some important changes with potentially significant implications, including:

- Section 307 and the Proposed Rules impose new reporting obligations and procedures on Company Counsel. For some Company Counsel, these may formalize existing practices.

- Corporate governance and compliance issues may consume greater time. Company Counsel may find themselves addressing more issues (and non-issues), and documenting their responses. It is possible that more issues will be elevated to the Board or Board committees.

- The Proposed Rules purport to allow issuers to disclose attorney-client privileged communications and attorney work product to the SEC without waiving those privileges and protections.

- Under some circumstances, outside Counsel may be required to effect a "noisy withdrawal" from their representation of a public company client (telling the SEC they are doing so for "professional considerations"), and both in-house and outside Counsel may be obligated to "disaffirm" the issuer's filings.

- Company Counsel may be sanctioned for violating the Proposed Rules, although it is unclear whether the SEC will prosecute attorneys with any greater frequency than it has under the existing laws.

The Proposed Rules Govern Those Who "Appear or Practice" Before the SEC

The Proposed Rules govern the conduct of attorneys who "appear or practice" before the SEC "in the representation of an issuer," including foreign private issuers. The SEC proposes a broad interpretation of "appearing and practicing" that includes in-house and outside counsel who:

> (i) communicate or transact any business with the SEC, including by representing any party in connection with an SEC administrative proceeding, investigation, inquiry or information request;

(ii) prepare any report, statement, opinion or other material that the attorney has reason to believe will be filed with or otherwise provided to the SEC, even if the attorney only prepares a portion of a document that is filed or submitted to the SEC by someone else; and

(iii) advise any party with respect to its obligation to file or provide the SEC with material, regardless of whether the party ultimately does so.

The SEC also defines "attorney" expansively to include those who are, or hold themselves out as, "admitted, licensed or otherwise qualified to practice law in any jurisdiction," including attorneys licensed and working exclusively in foreign countries. Thus, the Proposed Rules govern the conduct of in-house personnel who are licensed as attorneys and who prepare documents for submission to, or otherwise communicate with, the SEC, even if they work outside the legal department in a non-attorney capacity.

Finally, the SEC interprets the "in the representation of an issuer" prong of its Proposed Rules to include attorneys "acting in any way on behalf, at the behest, or for the benefit" of an "issuer" as defined in the Exchange Act, including those that have filed a registration statement to go public. Attorneys for a non-public subsidiary or affiliate of an issuer also must comply with the Proposed Rules if their work will be incorporated into material provided to the SEC.

Reporting "Material Violations"

The Proposed Rules set forth a mandatory reporting obligation if an attorney becomes aware of evidence of a "material violation," which the SEC defines as a material violation of the securities laws, a material breach of fiduciary duty or other similar material violation (which is not defined). "Evidence" of a "material violation" is information that would lead an attorney reasonably to believe that a violation has occurred, or is about to occur, about which a reasonable investor would want to know before making an investment decision.

The reporting standard established by the Proposed Rules is objective, rendering irrelevant an attorney's actual knowledge or belief as to whether a violation has occurred and is material. As a result, each attorney, whether or not he or she has specific securities law expertise, will

need to evaluate whether his or her information would lead an attorney reasonably to believe that a material violation has occurred.

Going "Up the Ladder"

The Proposed Rules require attorneys with evidence of a material violation to report it to the issuer's Chief Legal Officer (CLO) or to both the CLO and Chief Executive Officer (CEO). For issuers that do not employ in-house legal counsel, the report must be made to the CEO, who would be responsible for taking the actions required of the CLO under the Proposed Rules. The Proposed Rules require that the attorney document this report.

Upon receipt of a report, the issuer's CLO must conduct an inquiry designed to determine whether a material violation has occurred. If the CLO concludes that there has been no material violation, the CLO must notify the reporting attorney of this conclusion. If the CLO determines that a material violation exists, then the CLO must take reasonable steps to ensure that the Company adopts appropriate remedial measures (such as by appropriately disclosing the violation or disciplining those responsible) and report the steps taken to the CEO, the Audit Committee or the Board of Directors, and to the reporting attorney who started the process. The CLO must also document this inquiry. Significantly, the SEC takes the position that the CLO cannot discharge his duty under the Proposed Rules merely by directing or retaining another attorney to investigate the report of a material violation.

The Proposed Rules provide that if the reporting attorney reasonably believes that the CLO has not provided an appropriate response within an appropriate period of time, the attorney must report evidence of the material violation to the Audit Committee. If the reporting attorney believes that the Company still has not made an appropriate and timely response, the reporting attorney must explain the reasons for his or her belief to the CLO, the CEO or the directors to whom the violation was reported. The reporting attorney must document the response.

A reporting attorney will have satisfied his obligations under the Proposed Rules if he or she receives an appropriate and timely response and takes reasonable steps to document the report and the Company's response. This standard will require an attorney to determine

whether the Company's response is "appropriate," including evaluating the sufficiency of any remedial actions and other measures that the Company may have undertaken. As with the determination of the existence of a material violation, whether a reporting attorney will have satisfied the obligations of the Proposed Rules by concluding that the Company has appropriately responded will be measured against an objective standard, regardless of the attorney's subjective belief.

"Noisy" Withdrawal

A reporting attorney who has not received an appropriate and timely response, and who also believes that the material violation is either ongoing or about to occur and is likely to result in substantial injury to the issuer or investors, must:

> (i) withdraw immediately from the representation of the issuer;
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> (ii) provide written notice to the SEC that the withdrawal was based on "professional considerations" within one business day of withdrawing; and
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> (iii) promptly "disaffirm" any submission to the SEC that the attorney has prepared or assisted in preparing that the attorney reasonably believes is or may be materially false or misleading.

These obligations apply to both in-house and outside counsel, although in-house attorneys are not required to resign their positions or employment.

Reporting attorneys who reasonably believe that a material violation has occurred but has no ongoing effect, are permitted, but not required, to take the same steps outlined above. In addition, an attorney who is discharged by an issuer and who believes that the discharge resulted from his or her report of a material violation also is permitted to notify the SEC and disaffirm any submissions that the attorney participated in preparing. In connection with such a withdrawal, the CLO is obligated to report to any successor attorney that the prior attorney withdrew for professional considerations.

These so-called "noisy withdrawal" provisions are not specifically mandated by the Sarbanes-Oxley Act and are among the most controversial provisions of the Proposed Rules, as their

impact on existing state ethical rules and attorney-client privilege issues may be significant. The SEC has noted that it intends that the Proposed Rules would preempt state ethical rules that prohibit or would otherwise not mandate a "noisy withdrawal."

Documentation

As noted above, a reporting attorney is required to make and retain a contemporaneous record of any report he or she has made to the CLO or otherwise "up the ladder" and the Company's response. The documentation would include the date, time, location, manner and substance of the report, the Company's response to the report and the identity of witnesses to either. An attorney is permitted to use this documentation to defend against any claim that he or she violated the SEC's professional conduct standards.

The Qualified Legal Compliance Committee Alternative

The Proposed Rules establish an alternative system for reporting evidence of material violations. An issuer may establish a Qualified Legal Compliance Committee (QLCC) composed of at least one member of the issuer's Audit Committee and two or more independent members of the issuer's Board. A QLCC must have the authority and responsibility to conduct any necessary inquiries, require the issuer to adopt any remedial measures and notify the SEC of material violations and disaffirm false or misleading SEC submissions.

The QLCC is required to notify the Board of Directors, the CLO and the CEO of the results of any inquiry and the remedial measures it deems appropriate. If the Company fails to take any proposed remedial measure, each member of the QLCC, the CLO and the CEO would be individually responsible for notifying the SEC of the material violation and for disaffirming any SEC submissions.

The QLCC may be an attractive alternative. If an issuer establishes a QLCC, a reporting attorney would satisfy his or her obligations under the Proposed Rules and would not be obligated to make additional reports within the organization or to effect a "noisy withdrawal." In addition, a CLO could refer any reports of a material violation to the QLCC in lieu of conducting his or her own inquiry.

Supervisors and Subordinates

The Proposed Rules outline the responsibilities of both in-house and outside supervising and subordinate attorneys. A supervising attorney is responsible for complying with the reporting and documentation requirements of the Proposed Rules after receiving a report from a subordinate of a material violation and also must take steps to ensure that subordinate attorneys comply with the Proposed Rules.

A subordinate attorney will have satisfied his or her obligations by reporting evidence of a material violation to a supervising attorney. A subordinate attorney who believes that the supervisor has failed to comply with the reporting requirements is permitted, but not required, to report the evidence "up the ladder." CLOs and law firms likely will review procedures followed by supervising and subordinate attorneys to ensure that the reporting and evaluation of potential material violations is completed in a timely and organized fashion.

Privilege and Waiver Issues

The Proposed Rules may reshape the operation of the attorney-client privilege in the public company context. Congress and the SEC have reiterated that attorneys who represent issuers must act in the interest of the issuer and its shareholders and, for this reason, the Company (and not its management) holds the privilege. However, the Proposed Rules may require attorneys to reconcile the issuer's ownership of the privilege with their new obligations to report -- over the issuer's objection and perhaps without its knowledge -- information which is either itself privileged or came to light in a privileged setting. For example, the SEC takes the position that the mandatory "noisy withdrawal" would not breach the attorney-client privilege because, although it sends "signals" to the SEC (accompanied by counsel's disaffirmance of submissions), it would not reveal the specifics of the "material violation" or the substance of the communication that lead to their withdrawal.

The Proposed Rules also permit an attorney to disclose to the SEC "confidential information related to the representation" without client approval to:

(i) prevent the commission of an "illegal act" that the attorney reasonably believes likely

will result in either "substantial injury" to the issuer or investors, or the perpetration of fraud on the SEC;

(ii) rectify past illegal conduct by the issuer that was aided by the disclosing attorney's services; and

(iii) defend himself or herself against charges of attorney misconduct by using the documentation of his or her response to reports of wrongdoing, for example, to rebut charges that he or she was not reasonable in believing that an issuer appropriately responded to a report of a violation.

The SEC has attempted to address the tension between its proposed standards of conduct and those imposed by state law, and has acknowledged that it may be requiring attorneys to disclose information where they otherwise would be forbidden to do so. The SEC takes the position that its Rules (given their stature as federal law) preempt any conflicting state professional standards. It also has suggested that, depending on the circumstances, an attorney's disclosure pursuant to the Proposed Rules would not constitute a waiver of any privilege because the attorney would not be acting as an "agent" of the issuer, which is a position that might be challenged on the basis that the attorney is obligated to maintain the issuer's confidences.

Finally, the Proposed Rules provide that issuers do not waive "any otherwise applicable privilege" when their counsel communicate "information related to a material violation" to the SEC under a confidentiality agreement. However, even if the SEC's attempted preemption of state ethical standards were to be upheld by the courts (which remains to be seen), it might not discourage other government actors and private litigants from arguing that the fact of the disclosure constituted a waiver. In addition, preemption would not afford any protection to foreign attorneys under foreign law.

Sanctions

Attorneys who violate the Proposed Rules would be subject to the array of penalties, which include injunctions, cease and desist orders and civil money penalties presently available under the Exchange Act. They also would be subject to administrative disciplinary

proceedings for intentional or reckless conduct and, under some circumstances, for negligent conduct, which could result in censure or temporary or permanent suspension of the right to practice before the SEC. In every event, attorneys disciplined under the Exchange Act or the Proposed Rules would remain subject to prosecution or discipline for the same conduct, including federal criminal prosecution and actions by state bar authorities.

Suggested Practices

It is premature to predict the impact of Section 307 and the Final Rules (when adopted) on the practice of Company Counsel, which no doubt will vary by issuer. In the short term, however, Company Counsel may wish to:

- Define the Problem. Compliance with Section 307 and the Final Rules will require Counsel to gather key information because without the facts it is impossible to evaluate whether "evidence" of material violations, as opposed to an insignificant error, exists.

- Communicate. Section 307 and the Proposed Rules are largely about communication - among counsel, management and the Board. As in the past, the best response to a client problem is one reached by consensus, based on a common understanding of the facts and shared concern for the Company.

- Keep a File. The Proposed Rules require Company Counsel to document their responses to potential situations. This may be easier said than done; corporate crises often emerge quickly, which sometimes makes it difficult to document the string of conversations and documents upon which decisions are made. At a minimum, Company Counsel should segregate contemporaneous notes, email etc., which can be organized later. Company Counsel also should evaluate the Company's document preservation policies whenever new issues arise.

- Protect The Privilege. Remember that the Company is the client, and not its management. Personnel may need to be reminded that their communications with counsel are not privileged with respect to others in the Company, that they have an obligation to preserve the privilege, and that the Company has the right to waive the privilege.

- Think Outside The 307 Box. Section 307 and the Proposed Rules do not supplant the

other obligations of the Company and its Counsel. Information of wrongdoing, regardless of whether it constitutes "evidence" of a "material violation" for Section 307 purposes, may require investor disclosure or trigger other reporting federal, state, or contractual obligations.

- Plan Ahead. Counsel cannot anticipate corporate crises, much less "material violations" that trigger Section 307 obligations. For now, we recommend that you simply understand the proposals, and advise subordinates (for whom the CLO is responsible) and management of their provisions. The Board similarly should be advised as to the SEC's definition of their responsibilities. The Company may also wish to consider whether it would designate a QLCC, if the Final Rules were to retain that alternative.

- Seek Guidance. Section 307 and the Proposed Rules are new. Predictably, questions will arise as to how a "reasonable" attorney would interpret "information," whether a violation is "material," whether a proposed response is "appropriate," and whether everyone has acted in timely manner. We encourage you not to exercise judgment on these issues in isolation.

The Coming Weeks

The SEC must issue Final Rules by January 26, 2003. The SEC will accept comments on the Proposed Rules until December 18, 2002; several already have been submitted, including from Hale and Dorr and other attorneys who represent public companies. The SEC has indicated that the Final Rules issued by this deadline will at least establish minimum professional conduct standards, which it may supplement with further rulemaking.

We look forward to discussing the important issues presented by the Proposed Rules, and to work together as we practice under the Final Rules that will be promulgated in January.

We also invite you and your colleagues to attend a program to address the Final Rules and their relevance to your practice as in-house counsel, which will be held on Tuesday, February 4, 2003, at 8:30 a.m. at our Boston office.

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