

Client Alert

SEC Adopts Final Rules on Standards of Professional Conduct for Attorneys and Extends Comment Period on Noisy Withdrawal Proposal

Introduction

On January 23, 2003, the SEC adopted final rules under §307 of the Sarbanes-Oxley Act of 2002 (SOA) that establish minimum standards of professional conduct for attorneys appearing and practicing before the SEC in the representation of an issuer.¹ The SEC's new rules require attorneys to report "up the ladder" within a company upon becoming aware of evidence of a material violation of the securities laws, a material breach of fiduciary duty or a similar material violation of federal or state law by a company that employs or retains the attorney. The final rules differ in significant respects from the rules originally proposed. For example, the final rules have limited application to non-U.S. attorneys, apply only if an attorney has an "attorney-client relationship" with an issuer and do not yet include the controversial proposed requirement that an attorney who does not receive an appropriate response to a reported violation withdraw from representation of the issuer and notify the SEC (a so-called "noisy withdrawal"). The new rules will become effective on August 5, 2003. In response to extensive comments, the SEC extended the comment period for its noisy withdrawal proposal and also published an alternative proposal in a separate release.²

¹ Securities and Exchange Commission Release Nos. 33-8185; 34-47276; IC-25919; File No. S7-45-02. A copy of the release is available on the SEC website at <http://www.sec.gov/rules/final/33-8185.htm>. The SEC originally proposed the rules on November 21, 2002. See Securities and Exchange Commission Release Nos. 33-8150; 34-46868; IC-25829; File No. S7-45-02. A copy of that release is available on the SEC website at <http://www.sec.gov/rules/proposed/33-8150.htm>.

² Securities and Exchange Commission Release Nos. 33-8186; 34-47282; IC-25920; File No. S7-45-02. A copy of the release is available on the SEC website at <http://www.sec.gov/rules/proposed/33-8186.htm>.

Attorneys Subject to the New Rules

SOA §307 directs the SEC to issue minimum rules of professional conduct applicable to all “attorneys appearing and practicing” before the SEC in any way in the representation of an issuer.³

Under the new rules an attorney⁴ is “appearing and practicing” before the SEC when providing legal services to an issuer with whom the attorney has an attorney-client relationship in connection with:

- transacting any business with the SEC, including communicating with the SEC;
- representing an issuer in an SEC administrative proceeding or in connection with an investigation, inquiry, information request or subpoena;
- providing advice in respect of U.S. securities laws or SEC rules or regulations regarding any document that the attorney has notice will be filed with or submitted to the SEC (or incorporated into a filing or submission), including providing advice in the context of preparing, or participating in the process of preparing, any such document; or
- advising an issuer as to whether information or a statement, opinion or other writing is required under U.S. securities laws or SEC rules or regulations to be filed with or submitted to the SEC (or incorporated into a filing or submission).

The adopted definition of “appearing and practicing” before the SEC is narrower than the SEC’s original proposal. For example, the rules will not apply to attorneys acting in a business, rather than a legal, capacity. In addition, the SEC’s rules generally do not apply to a non-U.S. attorney who:

- does not hold himself or herself out as practicing, and does not give legal advice regarding, U.S. securities laws; and
- is otherwise appearing and practicing before the SEC only incidentally to, and in the ordinary course of, the practice of law outside the U.S. *or* in consultation with a U.S. attorney.

³ The rules incorporate the definition of “issuer” from Section 3 of the Securities Exchange Act of 1934, which is an issuer the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that has not been withdrawn.

⁴ The term “attorney” applies equally to inside attorneys employed by an issuer and outside attorneys retained by an issuer.

Trigger for the Attorney Reporting Obligation

Under the new rules, an attorney must make a report within the issuer when he or she becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer. Evidence of a material violation is defined as “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”.⁵ “Material violation” is defined as (i) a material violation of applicable U.S. federal or state securities laws, (ii) a material breach of a fiduciary duty (arising under U.S. federal or state law) or (iii) a similar material violation of any U.S. federal or state law.

Up the Ladder Reporting

The rules require an attorney that becomes aware of evidence of a material violation to report the evidence to the issuer’s chief legal officer (CLO) or equivalent or to both the issuer’s CLO and CEO.

Upon receipt of this report, the CLO must conduct an internal investigation to determine whether a material violation has occurred, is occurring or is about to occur. If the internal investigation reveals that no material violation has occurred, is occurring or is about to occur, the CLO is obligated to report this to the reporting attorney as well as the basis for the determination. If the CLO concludes that a 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, and the CLO must advise the reporting attorney of that response. As an alternative to conducting an investigation, the CLO may, but is not required to, report evidence of a material violation to a qualified legal compliance committee (discussed below) of the issuer, if one exists.

⁵ Although the SEC modified its originally proposed definition of evidence of a material violation – by adding, for example, the requirement that the evidence be “credible” – it remains an objective standard, requiring up the ladder reporting where it would be unreasonable 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.

If the reporting attorney receives an appropriate response⁶ from the CLO regarding the material violation that was the subject of his or her report, both the attorney and the CLO will have satisfied their obligations under the rules. If the attorney does not receive an appropriate response or does not receive a response within a reasonable time, the attorney must report the evidence to (i) the audit committee of the issuer's board, if there is one, (ii) if there is no audit committee, to another committee of independent directors or (iii) if there is no committee of independent directors, to the full board.

If the attorney reasonably believes that it would be futile to report to the CEO or CLO, the attorney may report the evidence directly to the audit committee of the issuer's board, to another committee of independent directors or to the issuer's full board.

Reporting to a Qualified Legal Compliance Committee

As an alternative to the reporting procedures described above, an issuer may elect to establish a qualified legal compliance committee (QLCC) comprised of at least one member of the audit committee (or, if the issuer has no audit committee, an equivalent committee of independent directors) who is a member of the issuer's board and two or more independent directors. A valid QLCC must have the authority and responsibility to:

- inform the CLO and CEO (or equivalents) of any report of evidence of a material violation;
- determine whether an investigation is necessary regarding any reported evidence of a material violation;

⁶ An "appropriate response" is a response "as a result of which the attorney reasonably believes: (1) That no material violation . . . has occurred, is ongoing, or is about to occur; [or] (2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or (3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made . . . or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either: (i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or (ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer . . . in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation." 17 C.F.R. § 250.2 (2003).

- if it determines an investigation is necessary, notify the audit committee or the full board of directors and initiate an investigation, which may be conducted either by the CLO, outside attorneys or additional experts;
- at the conclusion of any investigation, recommend that the issuer implement an appropriate response; and
- take all other appropriate action, including the authority to notify the SEC, in the event that the issuer fails in any material respect to implement an appropriate response.

A QLCC institutionalizes the process of reviewing reported evidence of material violations. If the issuer maintains a valid QLCC, an attorney may satisfy all of his or her reporting obligations under the rules by reporting evidence of a material violation to the QLCC without further action. Additionally, a CLO who receives a report of a material violation may refer the report to a QLCC in lieu of conducting his or her own inquiry.

Proposed Obligation to Keep a Contemporaneous Record—Withdrawn

The proposed rules that would have required an attorney who complies with the up the ladder reporting requirements to keep records of his or her report and the response thereto were withdrawn.

Reporting Obligations of Supervising and Subordinate Attorneys

An inside or outside “subordinate attorney” under the direction or authority of a “supervising attorney” has an obligation under the rules to report evidence of a material violation to the supervising attorney. An inside or outside supervising attorney is responsible for compliance with the reporting requirements after being notified of evidence of a material violation by a subordinate attorney. A subordinate attorney is *permitted, but not required*, to report up the ladder within the issuer if he or she reasonably believes that a supervising attorney to whom he or she has reported evidence of a material violation has not complied with the reporting requirements. The rules define “supervising attorney” broadly and automatically include any CLO.

Disclosure of Confidential Information

The rules *permit, but do not require*, an attorney appearing and practicing before the SEC in the representation of an issuer to disclose to the SEC confidential information related to the representation when the attorney reasonably believes it necessary:

- to prevent an issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
- to prevent the issuer from committing perjury or an illegal act likely to perpetrate a fraud on the SEC in an SEC investigation or proceeding; or
- to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services have been used.

Sanctions and Discipline

Attorneys who violate the rules are subject to all the civil penalties and remedies available generally to the SEC for a violation of the federal securities laws as well as administrative disciplinary proceedings, which could result in censure or a suspension or bar from practicing before the SEC.

The rules state that an attorney who complies in good faith with the rules will not be subject to discipline for violations of inconsistent standards imposed by a state or other U.S. jurisdiction.⁷ Also, an attorney practicing outside the U.S. will not be prosecuted to the extent that compliance with the rules is prohibited by applicable foreign law.

The SEC has exclusive authority to enforce compliance with the rules and the rules state that they do not create a private right of action against attorneys.

Proposals Regarding Noisy Withdrawals

The rules initially proposed by the SEC would have imposed a duty on an attorney to report evidence of a material violation to the SEC when the attorney has reported up the ladder (other than to a QLCC) without receiving an appropriate response under certain specified circumstances. Following extensive criticism from attorneys and issuers, the SEC deferred action on the noisy withdrawal requirement. Instead, the SEC re-proposed its original noisy withdrawal requirement and also proposed an alternative.

Original Proposal. Under these proposed rules, an attorney would have a duty to report to the SEC if he or she has reported up the ladder (other than to a QLCC) but has not received a response within a reasonable time or reasonably believes that the response received is not appropriate, and the attorney reasonably concludes that there

⁷ The SEC notes that this safe harbor is not available where an attorney violates additional requirements imposed by a state or other jurisdiction that are consistent with the SEC's rules.

is substantial evidence of a material violation that is ongoing⁸ or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors. The reporting obligation would differ for outside and inside counsel.

Under the proposed rules, outside counsel in such cases is *required* to:

- withdraw forthwith from the representation of the issuer, indicating that the withdrawal is based on “professional considerations”;
- notify the SEC of the withdrawal within one business day, indicating that the withdrawal is based on “professional considerations”; and
- promptly disaffirm to the SEC any opinion, document, affirmation, representation, characterization or the like in a document filed with or submitted to the SEC that the attorney has participated in preparing which is tainted by the violation leading to the withdrawal.

Under the same circumstances, the proposed rules state that inside counsel must notify the SEC and disaffirm any such filing or submission that the attorney has participated in preparing, but the attorney is *not required* to resign.

If an attorney formerly employed or retained by the issuer reasonably believes that he or she was discharged due to reporting evidence of a material violation and that he or she has not received an appropriate response to his or her report, the attorney *may, but is not required* to:

- notify the SEC of his or her belief that he or she was discharged for reporting evidence of a material violation; and
- disaffirm in writing any submission to the SEC that he or she has participated in preparing which is tainted by the violation.

If any attorney currently or formerly employed or retained by an issuer reasonably believes that a material violation has already occurred and has no ongoing effect, the attorney is *permitted, but not required*, to take steps similar to those described above, provided that the material violation is likely to have caused substantial financial injury to the issuer or investors.

⁸ An “ongoing violation” includes an inaccurate disclosure in a filing with or submission to the SEC that has not been corrected and may be relied upon by investors.

Alternative Proposal. The SEC's alternative proposal would not require inside or outside attorneys to disaffirm to the SEC any filing or submission that the attorney has participated in preparing and would not require outside attorneys to notify the SEC of the circumstances surrounding a withdrawal. Instead, the rules would require the issuer, rather than the attorney, to disclose in a Form 8-K filing that an inside attorney has notified the issuer that he or she has not received an appropriate response after reporting evidence of a material violation or that an outside attorney has withdrawn based on professional considerations. Under this proposal, the attorney would *be permitted, but not required*, to inform the SEC of the withdrawal or attorney's belief that he or she has not received an appropriate response from the issuer after reporting evidence of a material violation.

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The SEC requests that comments on its original and alternative proposals on noisy withdrawals be received no later than April 7, 2003. Comments may be submitted electronically to rule-comments@sec.gov. All comment letters should refer to File No. S7-45-02 (in the subject line if sent electronically).

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For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, at http://www.chadbourne.com/publications/sub_Publications.html. If you have any questions regarding the SEC's new rules or the proposed noisy withdrawal rules, please contact any of the following:

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