

Client Alert

SEC Proposes New Rules on Standards of Professional Conduct for U.S. and Non-U.S. Attorneys

A. Introduction

On November 21, 2002, the SEC released proposed rules that would implement §307 of the Sarbanes-Oxley Act of 2002 (SOA) regarding the establishment of minimum standards of professional conduct for attorneys appearing and practicing before the SEC in the representation of an issuer.¹ The proposed rules would apply to any attorney qualified to practice law *in any jurisdiction*, U.S. or non-U.S., and would require the attorney to follow specified procedures upon becoming aware of evidence of a material violation of securities laws, material breach of fiduciary duty or similar material violation by an issuer (or by any officer, director, employee or agent of the issuer) that employs or retains the attorney.² The procedures include “up the ladder” reporting within the issuer and, in some circumstances, withdrawal from representation of the issuer accompanied by notification to the SEC (a so-called “noisy withdrawal”) and disaffirming SEC documents that the attorney has participated in preparing. The requirements for withdrawing from representation and disaffirming documents are somewhat controversial because they go beyond the express requirements of SOA §307 and may impose obligations that are inconsistent with existing ethical obligations of attorneys.

The SEC has solicited comments on the proposed rules, due by December 18, 2002. The SEC is required to adopt final rules by January 26, 2003.

¹ Securities and Exchange Commission Release Nos. 33-8150; 34-46868; IC-25829; File No. S7-45-02. A copy of the Release is available on the SEC website at <http://www.sec.gov/rules/proposed/33-8150.htm>

² Under the proposed rules, “material” refers to conduct or information about which a reasonable investor would want to be informed before making an investment decision.

B. “Attorneys” Subject to the Proposed 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

The SEC proposal defines “attorney” as any person who is admitted, licensed or otherwise qualified to practice law in any jurisdiction, whether U.S. or non-U.S., or who holds himself or herself out as admitted, licensed or otherwise qualified to practice law. The term “attorney” is defined broadly so that it would apply equally to inside attorneys employed by an issuer, outside attorneys retained by an issuer and other qualified “attorneys,” whether or not they are acting as a legal advisor or counsel. However, the proposed rules distinguish in certain respects between the obligations of inside and outside attorneys.

The proposed rules would apply to any attorney “appearing and practicing” before the SEC, which is broadly defined to include:

- transacting any business with the SEC, including communicating with the SEC;
- representing any party to, or the subject of, or a witness in any SEC administrative proceeding;
- representing any person in connection with any SEC investigation, inquiry, information request or subpoena;
- preparing, or participating in the process of preparing, any statement, opinion or other writing which the attorney has reason to believe will be filed with or incorporated into any document that will be filed with or submitted to the SEC; or
- advising any party that (i) a statement, opinion or other writing need not or should not be filed with or incorporated into a document filed with or submitted to the SEC or (ii) the party is not obligated to submit or file a document with the SEC.

The SEC proposal identifies some issues of particular importance regarding the application of this definition, including that:

- the proposed definition covers all communications, oral and written;

³ The proposed rule incorporates the definition of “issuer” from Section 3 of the Securities Exchange Act of 1934 and includes 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.

- the proposed definition is broad enough to include attorneys who do not serve in the legal department of an issuer or act in their capacities as attorneys, but who otherwise transact business with the SEC or assist in the preparation of documents filed with the SEC; and
- special issues may arise in the case of a non-U.S. attorney retained by a non-U.S. issuer who prepares materials not intended to be submitted or filed with the SEC but that subsequently are so submitted or filed.

The proposed rules apply to attorneys appearing or practicing before the SEC “in the representation of an issuer,” which is defined as “acting in any way on behalf, at the behest, or for the benefit of an issuer, whether or not employed or retained by the issuer.”

C. Trigger for the Attorney Internal Reporting Obligation

Under the proposed rules, an attorney is obligated to make an internal 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. The proposed rules define “evidence of a material violation” as “information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring or is about to occur.”⁴ Under the proposed rules, a “material violation” means (i) a material violation of the securities laws (including any applicable state securities laws), (ii) a material breach of a fiduciary duty or (iii) a similar material violation.

Under the proposed rules, the issuer’s actions in areas where the applicable law is unsettled do not trigger the attorney’s duty. The SEC also notes that an attorney is not obligated to conduct an investigation into evidence of a material violation or to determine whether in fact there is a material violation.

The SEC notes that the function the attorney is performing for the issuer at the time that the evidence of the material violation is discovered is irrelevant. For example, a defense counsel who discovers evidence of a material violation – whether or not the evidence is an issue before the counsel, or an attorney acting in a non-legal capacity, would be subject to the proposed rules.

⁴ The SEC intends this definition to be an objective standard applicable regardless of whether the attorney subjectively believes the evidence of a material violation.

D. Internal “Up the Ladder” Reporting

Under the proposed rules, if an attorney becomes aware of evidence of a material violation, the attorney is obligated 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. If the CLO concludes that a material violation has occurred, is occurring or is about to occur, the CLO must take any necessary steps to ensure that the issuer adopts appropriate remedial measures and/or imposes appropriate sanctions to stop, prevent or rectify any material violation. Additionally, the CLO is obligated to report the remedial measures adopted and/or sanctions imposed to the CEO, to the audit committee of the issuer’s board of directors (if any), or to the issuer’s board, and to the reporting attorney.

If the attorney receives an appropriate response⁵ from the CLO regarding the material violation that was the subject of his or her report, both the attorney and the CLO have satisfied their obligations under the proposed rules. If the attorney does not receive an appropriate response or does not receive a response within a reasonable time, he or she 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 he or she has not received an appropriate response after reporting all the way “up the ladder” of the issuer, the attorney must take reasonable steps to document the response or lack thereof.

If the attorney reasonably believes that it would be futile to report to the CEO or CLO evidence of a material violation, 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.

⁵ Under the proposed definition, “appropriate response” means “a response . . . that provides a basis for an attorney reasonably to believe: (1) That no material violation . . . is occurring, has occurred, or is about to occur; or (2) That the issuer has, as necessary, adopted remedial measures, including appropriate disclosures, and/or imposed sanctions that can be expected to stop any material violation that is occurring, prevent any material violation that has yet to occur, and/or rectify any material violation that has already occurred.”

The SEC notes that this reporting obligation will not require an attorney to violate the attorney-client privilege because the attorney would be reporting to his or her client (the issuer).

E. Internal Reporting to a “Qualified Legal Compliance Committee”

The proposed rules provide an alternative to the above reporting procedures. An issuer may elect to establish a qualified legal compliance committee (QLCC), which would be a committee comprised of at least one member of the audit committee of the issuer’s board and two or more independent directors that institutionalizes the process of reviewing reported evidence of material violations. A valid QLCC must have the authority and responsibility to:

- conduct any necessary inquiry into the reported evidence;
- require the issuer to adopt appropriate remedial measures to prevent an ongoing, or alleviate a past, material violation; and
- notify the SEC of the material violation and disaffirm any tainted document submitted to the SEC.

If the issuer fails to take remedial measures as directed by the QLCC, each member of the QLCC, the CLO and the CEO would be individually responsible for notifying the SEC of the material failure and for disaffirming any tainted submission to the SEC. If the issuer maintains a valid QLCC, an attorney would satisfy all of his or her reporting obligations under the proposed 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.

F. Attorney’s Notification to the SEC Where There is No Appropriate Response

If an attorney has reported “up the ladder” of the issuer (other than to a QLCC) but has not received a response within a reasonable time, or the attorney reasonably believes that the response received is not appropriate, and the attorney reasonably believes that a material violation is ongoing⁶ 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 attorney has a duty to report to the SEC. The specific obligations differ for outside and inside counsel.

⁶ 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.

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 this violation.

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

If an attorney who was 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 reasonably believes that a material violation has already occurred and has no ongoing effect, the attorney is *permitted, but not required*, to take similar steps, provided that the material violation is likely to have caused substantial financial injury to the issuer.

The SEC proposal would also require the issuer’s CLO (or equivalent) to notify any attorney retained or employed (including an inside attorney to whom work is shifted) to replace an attorney who has withdrawn that the previous attorney withdrew based on “professional considerations.”

G. Obligation to Keep a Contemporaneous Record

Under the proposed rules, an attorney who complies with the “up the ladder” reporting requirements must keep a contemporaneous record of his or her report and the response the attorney receives. The SEC notes that a contemporaneous record that would satisfy this requirement would likely contain the date, time, location, manner and substance of the report and the response and identity of witnesses to either.

H. Reporting Obligations of Supervising and Subordinate Attorneys

An attorney under the direction or authority of a supervising attorney has the obligation under the proposed rules to report evidence of a material violation to the supervising attorney (and maintain a record of such report). A supervising attorney would be responsible for compliance with the reporting requirements and documentation obligations 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 and make a noisy withdrawal if he or she reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation has not complied with the reporting requirements. The proposed rules define “supervising attorney” broadly and would automatically include any CLO.

I. Disclosure of Confidential Information

The proposed rule permits an attorney to disclose confidential information related to the attorney’s appearing and practicing before the SEC in the representation of an issuer under specified circumstances, including:

- using his or her contemporaneous records to defend against charges of misconduct;
- where necessary to prevent an issuer from committing an illegal act that the attorney reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer or investors or perpetration of a fraud upon the SEC; and
- where necessary to rectify the consequences of the issuer’s illegal act in the furtherance of which the attorney’s services have been used.

The SEC notes that where an issuer, through its attorney, shares with the SEC information related to a material violation pursuant to a confidentiality agreement, such sharing of information shall not constitute a waiver of any otherwise applicable privilege or protection as to other persons.

J. Sanctions

Attorneys who violate the proposed rules would be subject to injunctions and cease and desist orders as well as administrative disciplinary proceedings, which could result in censure or a suspension or bar from practicing before the SEC. An attorney would be subject to discipline for:

- intentional or reckless conduct resulting in a violation of proposed rules, and

- highly unreasonable negligent conduct or repeated instances of unreasonable negligent conduct resulting in a violation of the proposed rules.

Nothing in the proposed rules would create a private right of action against an attorney. In addition, the SEC does not believe that violations of the proposed rules would, without more, meet the Exchange Act standard for the imposition of criminal penalties.

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The proposed rules present a number of interpretive issues that remain unresolved. In particular, although addressed at some length in the release, the interplay of the rules, if adopted, and state and local rules of professional conduct remains unclear. The release includes many questions the SEC has posed for the consideration of those who may wish to comment. We encourage our clients and friends to participate in the comment process.

The SEC requests that comments on the proposed rules be received no later than December 18, 2002. Comments may be submitted electronically to rule-comments@sec.gov. All comment letters should refer to File No. 33-8150.wp (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 this proposal, please contact any of the following:

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