SARBANES-OXLEY UPDATE

SEC Issues Final Rules Regarding Obligations of Attorneys to Report Evidence of Securities Law, Fiduciary Duty and Similar Violations

The Securities and Exchange Commission has adopted final rules to implement Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act"). The new rules become effective August 5, 2003 (the "Rules")[1] and establish minimum standards of professional conduct for attorneys who appear or practice before the SEC on behalf of issuers. However, the SEC deferred action on the previously proposed "noisy withdrawal" provisions.[2]

Summary of the Rules

- Attorneys "appearing and practicing before the Commission" "in the representation of an issuer" are required to report evidence of a "material violation" of the securities laws or breach of fiduciary duty or similar violation by the company or its agents. Reports will generally be made to the chief legal officer (the "CLO") or the chief executive officer (the "CEO"), but under certain circumstances, matters may be put directly before the company's independent directors.

- Only attorneys that provide legal services to the issuer (*i.e.* those who have an attorney-client relationship) are subject to the requirements of the Rules—the final rules provide relief for nonpracticing lawyers.

- If the recipient of a report does not provide an "appropriate response," the attorney must report the evidence to the audit committee, another committee of independent directors or the full board of directors (so-called "up the ladder" reporting).

- While not required, the SEC encourages companies to form a qualified legal compliance committee (a "QLCC") to coordinate and oversee potential internal investigations arising from the Rules.

- Under certain circumstances, an attorney may, but is not required to, disclose confidential information to the SEC or other applicable court or regulatory agency to prevent financial injury, fraud or perjury, or to rectify certain prior violations.

- The SEC deferred action on the "noisy withdrawal" provisions that would have required attorneys to resign under certain circumstances. However, the comment period for the noisy withdrawal provisions was extended to also allow for consideration of an alternative procedure.

Practice Considerations

- Issuers and attorneys should carefully review the adopting release—the Rules are both broad and detailed, with complex definitions that are crucial to an understanding of what is required.

- Companies should consider establishing a QLCC before any potential violations are reported under the Rules. Since reports can only be referred to a preexisting QLCC (*i.e.* issuers cannot establish a QLCC to respond to a specific incident), issuers need to plan accordingly. If a QLCC is not established immediately, consider amending the charter of an otherwise qualifying board committee to allow that committee to constitute itself as a QLCC in the future without further board action.

- Regardless of whether a QLCC is established, companies should consider how they would respond to and document any actions taken in accordance with the Rules. While the final Rules eliminated many of the documentation requirements contained in the original proposal, issuers should prepare appropriate policies and procedures to evidence their compliance with the Rules. Any documentation created as a result of such a process should be carefully prepared in contemplation of possible litigation or regulatory action.

WHO IS COVERED BY THE RULES?

Who is considered an "attorney appearing and practicing before the Commission" "in the representation of an issuer"?

Appearing and practicing

In response to criticism that the group of attorneys covered by the proposed rules was overly broad, the SEC narrowed the scope of the Rules to apply only to attorneys (whether serving as in-house or outside counsel) who provide legal services and/or advice regarding the federal securities laws to a '34 Act "issuer" in connection with the preparation of documents for filing with the SEC. Although the Rules only apply to attorneys that have established an attorney-client relationship with an issuer, the scope of the rules is still broad. For instance, the Rules govern attorneys whose advice causes materials not to be submitted to the SEC, as well as lawyers preparing documents that are submitted as exhibits to SEC filings.

However, an attorney who prepares a document that was not intended to be submitted to the SEC is not covered by the Rules. This is true regardless of whether the document is ever actually submitted to the SEC. Attorneys retained or directed by an issuer to investigate evidence of a material violation covered by the Rules are also considered to be "appearing and practicing" before the SEC and have certain obligations under the Rules.

In the representation

"In the representation" of an issuer has been defined in the Rules to mean providing legal services as an attorney for an issuer. However, an attorney does not necessarily have to be retained or empowered by an issuer to be acting "in the representation of an issuer." Under certain circumstances, activities performed by an attorney for a non-public subsidiary can also be subject to the Rules. For example, an attorney retained under an umbrella representation agreement or understanding under which the attorney represents the parent company and its non-public subsidiaries and can invoke privilege claims with respect to communications involving the parent and its subsidiaries, is subject to the Rules. Similarly, an attorney at a non-public subsidiary acts "in the representation of an issuer" if his or her work is at the direction of the parent and will be incorporated into materials submitted to the SEC by the parent (*i.e.* periodic reports).

WHAT ACTIONS ARE REQUIRED BY THE RULES?

When is a reporting requirement triggered?

Evidence of a material violation must be reported in all circumstances in which 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. Material violations include violations of the federal or state securities laws, a material breach of a fiduciary duty arising under federal or state law or a similar violation of any federal or state law. Although there was some discussion as to whether the original proposed Rules contemplated the application of a subjective standard to determine whether evidence of a material violation existed, the final Rules confirm that an attorney's actions will be evaluated against an objective standard. Furthermore, to be "reasonably likely," a material violation must be more than a mere possibility, but it need not be more likely than not.

What are the initial reporting requirements?

If a determination is made that it is reasonably likely that a material violation has occurred, is occurring or is about to occur, the attorney is directed to report the matter to the company's CLO, or to both the CLO and CEO.[3] If an issuer does not have a general counsel or a chief legal officer, the report should be made to the CEO. An attorney is also permitted (but not required) under the Rules to circumvent the CLO and CEO and to report the matter directly to the company's audit or other independent committee or its board of directors, if he or she reasonably believes that reporting the material violation to the CLO or CEO would prove futile.

The recipient of the report is responsible for investigating the matter and reporting the results of that investigation to the reporting attorney. If this person, committee or board of directors concludes that a material violation has occurred, is occurring or is about to occur, they must take reasonable steps to cause the company to adopt appropriate remedial measures and/or sanctions, including appropriate disclosures.

What happens after the initial report?

The reporting attorney has not satisfied his or her responsibilities under the Rules by merely making the initial report. Rather, the reporting attorney must determine whether he or she has received an "appropriate response" to the initial report of a potential violation. The reporting attorney must "reasonably believe" that either there is no material violation or that the issuer has taken proper steps to remedy any violation that may have occurred. The circumstances a reporting attorney might weigh in assessing whether he or she could "reasonably believe" that an issuer's response is appropriate include the amount and weight of the evidence of a material violation, the severity of the apparent material violation and the scope of the investigation into the report. An issuer will be deemed to have made an "appropriate response" if it reports that it has been advised by an attorney who has conducted an internal review of the reported evidence that it can assert a "colorable defense" in any investigation or proceeding relating to the reported matter. A reporting attorney's obligations under the Rules will be satisfied upon receipt of what he or she reasonably believes to be an "appropriate response" to his or her report of a material violation of the Rules.

However, if the issuer fails to provide an "appropriate response" within a reasonable period of time, the reporting attorney must then report such evidence to the company's audit committee, or if the company does not have an audit committee, then to another committee of independent directors,[4] or if the company does not have another committee of independent directors, then to the full board. This "up the ladder" reporting would then conclude the reporting attorney's obligations under the Rules.

What are the reporting requirements of attorneys investigating possible material violations?

Under certain circumstances, attorneys retained or directed to investigate or litigate reported violations are not themselves required to report such material violation. Where an attorney is retained to investigate a report of a material violation by the CLO, the attorney has no reporting obligation if the results of the investigation are provided to the CLO, and the attorney and CLO each reasonably believe that no violation has occurred, is ongoing or is about

to occur and provided the CLO reports the results of the inquiry to the issuer's board of directors, committee of independent directors or QLCC. If an attorney is retained or directed by the CLO to litigate (as opposed to investigate) a reported violation, he or she is also free of any reporting obligation if he or she can assert a colorable defense on behalf of the issuer and the CLO provides reasonable and timely reports on the progress and outcome of the litigation to the issuer's board of directors, audit committee, committee of independent directors or QLCC.

An attorney retained or directed by an issuer's QLCC (as opposed to its CLO) to investigate evidence of a material violation does not have any obligation to report evidence of a material violation under the Rules. Similarly, there is no reporting obligation if the attorney is retained or directed by the QLCC to assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee or agent) in any investigation or judicial or administrative proceeding relating to the evidence of a material violation.

Are there any alternatives to the reporting requirements?

As an alternative to the previously discussed reporting procedures, the SEC has suggested (but is not requiring) that companies establish a QLCC to investigate reports of material violations made by attorneys. If such a committee is in place, an attorney subject to the Rules will fully satisfy his or her obligations by reporting evidence of a material violation to the QLCC. If a report is made to a properly constituted QLCC, the reporting attorney will then have no obligation to evaluate the appropriateness of the issuer's response to the report, nor to make any up the ladder reporting. Additionally, a CLO, in lieu of causing an inquiry to be conducted, may direct reports to the QLCC for investigation. In this case, the CLO must report to the reporting attorney that he or she has referred the report to the QLCC and the QLCC is then responsible for responding to the evidence of a material violation.

The QLCC must be composed of at least one member of the company's audit committee and two or more independent members of the company's board of directors. Such committee must also be responsible for and authorized to conduct any necessary inquiry into the reported violation, to require the company to adopt appropriate remedial measures to prevent an ongoing, or alleviate a past, material violation, and to notify the SEC of the material violation if the QLCC decides, by a majority vote, that the issuer has failed to take any remedial measure that the QLCC has imposed upon the issuer. In addition, the QLCC would be required to notify the board, the CLO and the CEO of the results of any inquiry and the remedial measures deemed appropriate by the QLCC.

Although it may be difficult for companies to recruit individuals to join their QLCC because of the added responsibilities, companies should consider establishing such a committee. Not only does the SEC highly recommend establishing a QLCC, a QLCC will assist the issuer and its employees by having a "central body" within the company to address matters relating to the Rules. In lieu of forming a new committee, a company could expand the responsibilities of its audit committee to also encompass those of the QLCC. At a minimum, issuers should consider amending the charter of an otherwise qualifying board committee to allow that committee to constitute itself as a QLCC in the future without further board action. These actions should be taken proactively, since an issuer may not establish a QLCC to respond to a specific incident. Reports may only be referred to a preexisting QLCC.

What are the sanctions for violating these Rules?

Authority to enforce compliance with the Rules is vested exclusively with the SEC—the Rules do not create a private right of action. The SEC may seek penalties including injunctions, cease and desist orders, and the barring of individuals from serving as officers or directors. Although the adopting release indicates that attorneys who comply 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, a single instance of highly unreasonable conduct or repeated instances of unreasonable conduct that result in violations of the Rules are subject to discipline.[5] In the event of a conflict or inconsistency between the Rules and state law, the Rules will prevail. However, the Rules do not preempt a state's ability to impose more rigorous obligations on attorneys provided such requirements are otherwise consistent with the Rules.

OTHER ISSUES TO CONSIDER

Under what circumstances is an attorney permitted, but not required, to disclose confidential information?

The Rules provide for several circumstances under which an attorney may, but is not required to, disclose confidential information to the SEC or other applicable court or regulatory agency.[6] Any report or response made under the Rules may be used by an attorney in connection with any investigation, proceeding or litigation in which the attorney's compliance with the Rules is at issue. Additionally, a reporting attorney may reveal to the SEC, without the issuer's consent, confidential information to the extent the attorney reasonably believes doing so is necessary to: (1) prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interests or property of the issuer or investors; (2) prevent the issuer from committing perjury or perpetrating a fraud on the SEC; or (3) rectify the consequences of a material violation by the issuer in the furtherance of which the attorney's services were used. We note, however, that there may be a potential issue involving the interplay between the permissible disclosure in clause (1) above, and state ethics rules that permit the disclosure of confidential client information in certain limited circumstances.

When is a "noisy withdrawal" permitted or required?

The SEC originally proposed[7] that an attorney who reports evidence of misconduct but does not receive an appropriate response from the company must withdraw from the representation and notify the SEC of his or her withdrawal for "professional considerations." Under those proposals, an attorney would also have to disaffirm any submission to the SEC that is tainted by the violation. In-house counsel would be required to quickly disaffirm any tainted submissions to the SEC, but would not be required to resign. These "noisy withdrawal" procedures would be mandated when the attorney reasonably believes that the reported material violation is ongoing[8] or is about to occur and is likely to result in substantial financial injury to the company or its investors. Additionally, a reporting attorney would be permitted, but not required, to make a "noisy withdrawal" in situations where the material violation had already occurred and has no ongoing effect but is reasonably believed by the attorney to have caused substantial injury to the financial interest of the company or its investors. The company would also be required to disclose to any successor attorney that the prior attorney withdrew based on professional considerations.

Amid extensive criticism from the legal community claiming that this "noisy withdrawal" provision would erode client confidence in the attorney-client relationship and potentially violate existing state ethical rules, the SEC deferred action on these aspects of the proposed rules. However, an alternate noisy withdrawal provision has been proposed.

Under the alternative proposal, an attorney who has reported evidence of a material violation and has not received an appropriate and timely response, would be required to withdraw from representing the issuer and notify the issuer, in writing, that the withdrawal is based on professional considerations. The issuer would then be required to report the attorney's notice and the related circumstances to the SEC on Form 8-K within two business days. If the issuer fails to comply with these requirements, the attorney would be permitted to inform the SEC of his or her resignation and the surrounding circumstances. The SEC is accepting comments on both proposed noisy withdrawal provisions until April 7, 2003.

Are there different reporting requirements for supervisory and subordinate attorneys?

A "subordinate attorney" is an attorney who appears and practices before the SEC on a matter under the supervision or direction of another attorney, other than the issuer's CLO. Subordinate attorneys can satisfy their obligations under the Rules by reporting evidence of a material violation to their supervisory attorney. However, if a subordinate attorney reasonably believes that their supervisory attorney failed to comply with the Rules with respect to a reported matter, then the subordinate attorney is permitted to report further up the ladder. It should be noted that an attorney who appears and practices before the SEC under the supervision or direction of the issuer's CLO (or equivalent thereto) is not a "subordinate attorney" under the Rules. For example, an issuer's Deputy General Counsel, who reports directly to the issuer's CLO on a matter before the SEC is not relieved of any further reporting requirements by advising the CLO of evidence of a material violation, and is required to report further up the ladder in the event he or she does not receive an appropriate response from the CLO.

A "supervisory attorney" is a senior attorney who actually directs or supervises the actions of a subordinate attorney "appearing and practicing before the SEC." Supervisory attorneys, including the CLO, are required to make reasonable efforts to ensure that their subordinates comply with the Rules.[9] Additionally, a supervisory attorney becomes responsible for complying with the Rules' reporting requirements once he or she learns of a potential material violation from a subordinate attorney.

Should issuers adopt formal policies and procedures with regard to the Rules?

Issuers should consider formally enacting policies and procedures to facilitate and evidence compliance with the Rules. Although the SEC initially proposed various documentation requirements for reports and responses to instances of possible violations, the Rules eliminated these requirements. Nonetheless, issuers and reporting attorneys should consider what level of documentation is necessary or appropriate to induce and maintain compliance with the Rules. However, consideration should be given to the breadth and detail of any documentation since any record created may be discoverable in the event of litigation or regulatory proceedings.

Are foreign attorneys subject to the Rules?

Foreign attorneys who are not admitted in the United States, and who do not advise clients regarding U.S. law, are not considered to be "appearing and practicing before the Commission" under the Rules. However, foreign attorneys who provide legal advice regarding U.S. law are subject to the Rules to the extent they are "appearing and practicing" before the SEC (unless such advice is provided in consultation with U.S. counsel).

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Endnotes

1. SEC Release Nos. 33-8185; 34-47276, available at http://www.sec.gov/rules/final/33-8185.htm.
2. SEC Release Nos. 33-8186; 34-47276, available at http://www.sec.gov/rules/proposed/33-8186.htm.
3. The reporting attorney is not required to investigate evidence of a material violation or to determine whether in fact a material violation exists.
4. As adopted, a director is not "independent" under the Rules if he or she is "employed, directly or indirectly, by the issuer." However, the SEC anticipates that the definition of an "independent" director for purposes of new Part 205 will be amended to conform to final rules defining who is an "independent" director under Section 301 of the Act.
5. This conduct can be due to either intentional (including reckless) conduct, or negligent conduct.
6. Under the Rules, no circumstances exist under which an attorney is required to report confidential information to the SEC. However, this may change depending on the pending "noisy withdrawal" proposals discussed infra.
7. SEC Release Nos. 33-8150; 34-46868, available at http://www.sec.gov/rules/proposed/33-8150.htm.
8. A material violation would be ongoing if investors continue to rely upon false or misleading statements in earlier filings or submissions that have not been disaffirmed.
9. The Rules eliminate the initially proposed requirement that a supervisory attorney ensure a subordinate's compliance with the federal securities laws.