



SEC Sets Attorney Professional Conduct Standards under Sarbanes-Oxley Act

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Securities and Litigation Practice Teams

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On January 29, 2003, the Securities and Exchange Commission (SEC) adopted a new rule establishing minimum standards of professional conduct for attorneys practicing before the SEC (Final Rule)¹ as mandated by Section 307 of the Sarbanes-Oxley Act of 2002 (Act). The effective date of the Final Rule is August 5, 2003.

Prior to adopting the Final Rule, on November 21, 2002, the SEC circulated proposed rules relating to Section 307 of the Act (Original Proposed Rule).² The Original Proposed Rule provoked significant discussion among attorneys and academics. A substantial number of comment letters were submitted to the SEC, most of which were very critical of the Original Proposed Rule.³ The most controversial provision of the Original Proposed Rule was the “noisy withdrawal” requirement: counsel was directed to resign in a way that would make apparent that he or she had concerns about the client’s disclosure or other matters and to disavow any disclosure that the lawyer thought might be misleading. While the Final Rule does not include the “noisy withdrawal” provision, the SEC has proposed in a separate release a modified “noisy withdrawal” rule (New Proposed Rule).⁴ The SEC has asked for comments on the new proposal by April 7, 2003.

This Client Alert discusses the Final Rule, contrasting it with the Original Proposed Rule, and also summarizes the New Proposed Rule. In addition to outlining the scope of the obligations that have been imposed on lawyers by the Final Rule, this Client Alert also discusses some of the

controversy that the SEC’s actions have engendered.

In light of the Final Rule, issuers may wish to consider:

- Whether, under the circumstances, the company is sufficiently large that it would benefit from the formation of a Qualified Legal Compliance Committee (QLCC), a subcommittee of the board of directors, to handle reports of evidence of material violations. If the SEC adopts a “reporting out” requirement for attorneys, then we would recommend that all public companies establish a QLCC.
- Taking into consideration the size of the legal department, the number of attorneys employed by the company and the structure of the legal department, whether it would be advisable to establish a clear hierarchy within the company’s legal function. As a functional reporting matter under the Final Rule, interposing “supervisory attorneys” within the organization can limit the obligation of subordinate attorneys to pursue reports of material violations up to the board of directors or QLCC.

SUMMARY OF SECTION 307 AND THE FINAL RULE

Section 307

Section 307 of the Act requires that the SEC issue rules establishing “minimum standards of professional conduct for attorneys.” Specifically, it requires that attorneys report “evidence of a material violation of securities laws or breach of fiduciary duty or similar violation” by a company to the company’s chief legal officer (CLO) or chief executive officer (CEO). If the CLO or the CEO do not respond appropriately, the attorney must report to the company’s board of directors.

¹ 17 CFR 205; Release Nos. 33-8185 and 34-47276.

² Release Nos. 33-8150 and 34-46868.

³ 167 timely comment letters were submitted. These comment letters, including those which Pillsbury Winthrop attorneys helped draft, may be accessed at <http://www.sec.gov/rules/proposed/s74502.shtml>.

⁴ Release Nos. 33-8186 and 34-47282.



This requirement is often referred to as “up the ladder” reporting.

The Final Rule

The Final Rule requires attorneys who “appear and practice” before the SEC “in the representation of an issuer” to report up the corporate ladder any material violations of securities laws and breaches of fiduciary duty when they become aware of credible evidence of these violations.

Under the Final Rule, issuers may establish a QLCC. After reporting to a QLCC, an attorney would no longer be responsible for monitoring whether the issuer appropriately responds to the evidence regarding the violation because that responsibility would lie with the QLCC.

The Final Rule provides guidelines where attorneys may — but are not required to — disclose confidential issuer information to the SEC to prevent financial injury, fraud or perjury or to rectify prior violations.

There is no obligation under the Final Rule for attorneys to withdraw from representation of the issuer or to report any withdrawal to the SEC or the issuer.

Who is Covered

Which attorneys are covered by the Final Rule is determined by reference to three definitions: “appearing and practicing,” “attorney,” and “in the representation of the issuer.” Attorneys representing issuers in litigation before the SEC (with respect to the disclosure at issue) and certain foreign attorneys are explicitly excluded from the coverage of the Final Rule.

Appearing and Practicing. Attorneys “appearing and practicing” before the SEC is a broadly defined term within the meaning of the Final Rule. It includes all communications with the SEC on behalf of an issuer as well as advising on the preparation of any document submitted to or filed with the SEC. However, the attorney must have notice that the document is going to be submitted or filed with the SEC in order to be considered “appearing and practicing.” In Final Rule comments on another provision, we note that the SEC used the term “reason to believe” instead of “notice,” apparently to emphasize that the concept of notice is an informal one.

A coverage exception is made for “non-appearing foreign attorneys.” This term is defined as an attorney admitted to practice law outside of the U.S. who does not practice U.S. federal or state securities laws, and who does not appear or practice before the SEC, except in very limited (and expressly defined) circumstances. In addition, attorneys retained or directed to investigate a reported violation are not required to report up the ladder regarding the reported violation if they were either retained by a QLCC to perform the investigation or if there is a colorable defense to the reported violation.

Attorney. The definition of “attorney” encompasses any person who is admitted, licensed or otherwise qualified to practice law in any jurisdiction, domestic or foreign (or who holds him or herself out to be so qualified). This definition includes in-house lawyers as well as outside counsel retained on behalf of issuers. It does not include an attorney who acts as a business person.

Representation of an Issuer. The definition of “in the representation of an issuer” has been clarified to mean “providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.” The SEC specified that, although state rules can be considered when evaluating the existence of an attorney-client relationship, the ultimate determination is a federal question.

This definition will have an impact on attorneys who represent investment advisers. If, in the course of such representation, an attorney prepares materials for a registered investment company that the lawyer has reason to believe will be filed or submitted with the SEC by or on behalf of the investment company, the attorney would be “appearing and practicing” on behalf of the investment company, even though the investment company is not the attorney’s client.

Evidence of a Material Violation

Under Section 205.2(e) of the Final Rule, an attorney is required to report “evidence of a material violation,” which 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.”

The SEC, although it revised the definition of this term from the Original Proposed Rule, chose to maintain an objective test (as opposed to a subjective standard, which would be based on what the attorney actually did believe). In its comments, the SEC states that the phrase “under the circumstances” permits consideration of

- the attorney’s professional skills,
- the attorney’s experience,
- the time constraints under which the attorney is acting,
- the attorney’s previous experience with the client, and
- the availability of other lawyers with whom the lawyer may consult.

In addition, the phrasing of the definition in the negative appears to have been intended to give attorneys some latitude in determining whether a report would be required. However, because the standard is an objective one, an attorney’s good faith conclusion not to report will be subject to after the fact second-guessing by the SEC if, for example, it turns out that a violation actually did occur.

To determine whether there is “evidence of a material violation,” several other definitions in the Final Rule must be considered.

Breach of fiduciary duty is a violation that must be reported. This term means any breach of fiduciary duty under an applicable federal or state statute or at common law. It matters not whether the breach amounts to a securities law violation. Thus, as discussed in greater detail below, this provision can be read to expand the scope of the SEC’s authority to include the regulation of matters that have historically been the province of state corporate governance laws and not federal securities laws.

Material violation is defined as a “material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.” “Material” is not defined because the SEC considers the meaning of the term, in the securities context, to be well established.⁵ The

definition includes a “catch-all” provision — “a similar violation” — which raises concerns because of its vagueness. This absence of clarity may require difficult “grey area” determinations, and thus cause bona fide disagreements between attorneys and issuer/clients about what constitutes a material violation. This issue is of less importance in the absence of a “reporting out” requirement.

Reasonable or reasonably means, “with respect to actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.” The SEC intends that a wide range of conduct could be considered reasonable.

Reasonably believes means “that the attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.” The SEC specifically notes that subjective elements have not been excluded. The SEC, in its commentary on “evidence of a material violation” discussed the meaning of “under the circumstances,” which is discussed above. It is likely that the comments are equally applicable to the definition of “reasonably believes.”

DUTIES TO CLIENT

Who is the Client?

The Final Rule provides that an attorney “owes his or her professional and ethical duties to the issuer as an organization.” The provision makes clear that an attorney’s duty is not to a company’s individual directors, officers or shareholders.

In this regard, the Final Rule is significantly different from the Original Proposed Rule. The Original Proposed Rule had been troubling in that it required the attorney to act “in the best interests of the issuer and its shareholders.” Among other things, this caused concern that an attorney would be required to second-guess the judgment of the issuer’s management of what was in the issuer’s best interests. In addition, it raised the question of whether there would be a fiduciary duty that an attorney owed the shareholders, thereby potentially giving the

⁵ See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (“there must be a substantial likelihood that the

disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”).



shareholders a private right of action under the Final Rule.

The CLO's Duty to Investigate

Section 205.3(b)(2) of the Final Rule addresses the duty of the CLO upon receiving a report of a material violation. Once such a report has been received, a CLO has a duty to investigate the evidence of the material violation as he or she deems reasonably necessary in order to determine if the material violation “has occurred, is ongoing, or is about to occur.”

The CLO is required to take steps necessary to ensure that the issuer adopts appropriate remedial measures, including appropriate disclosures and sanctions, to stop and remedy a discovered material violation. The CLO is then required to report promptly the remedial measures and any sanctions imposed to the CEO, to the issuer's audit committee and to the reporting attorney.

A reporting attorney's duty to monitor the issuer's handling of the reported evidence of a material violation will end upon the reporting attorney being informed and reasonably believing that:

- no material violation occurred, is ongoing or is about to occur;
- the violation has been stopped and remedied; or
- an attorney retained or directed to investigate the matter has advised that a colorable defense to the alleged violation exists.

Alternatively, the CLO may report the existence of evidence of a material violation to a QLCC, which will then have the obligation to investigate the evidence and to propose any necessary remedial measures. Involving a QLCC in the process will relieve the reporting attorney, including the CLO, of further obligations under the Final Rule.⁶

⁶ We note in this regard that the Final Rule and Section 307 of the Act provide an overlay, and not a substitute, for any fiduciary duties owed to the company under state corporate law and ethical obligations under applicable state professional responsibility standards. For instance, in states whose professional responsibility standards would mandate public disclosure of unaddressed, ongoing material violations, reporting

Duty of Attorneys Other than the CLO

Reporting Up the Ladder. If an attorney (including both in-house, non-CLO attorneys, and outside counsel) has made a report to the CLO or the CLO and the CEO, but has not received an appropriate response from the CLO or the CEO within a reasonable time, the reporting attorney is then required to report the evidence of a material violation to the board of directors. Once the reporting attorney receives an appropriate and timely response to his or her report of a material violation from the board, the attorney's duties have been fulfilled. An attorney, on the other hand, who does not receive an appropriate response within a reasonable time is required to explain his or her reasons for the belief that the response is inadequate to the CLO, CEO or directors to whom the original report was made. An attorney who believes he or she has been discharged for filing a report may report this belief to the board of directors.

There is no requirement that a reporting attorney must document the report or response from the company. The Original Proposed Rule had required the reporting attorney to document the report and the response to the report, and to retain this documentation for a reasonable time. Many commenters objected to this documentation requirement as creating a conflict of interest between attorney and client.

Attorneys Retained to Investigate a Report of Evidence of a Material Violation. An attorney who was retained or directed by the CLO or QLCC to investigate evidence of a material violation is not required to report evidence of a material violation “up the ladder” if the CLO discharges this responsibility or if the investigating attorney concludes that there is a “colorable defense” to the evidence of a material violation.

Supervisory and Subordinate Attorneys. Sections 205.4 and 205.5 of the Final Rule detail the respective responsibilities of supervisory and subordinate attorneys. These provisions specify that an attorney must actually direct or supervise an attorney to be a supervisory attorney, and require that a subordinate attorney report evidence of a

evidence of a material violation to a QLCC may not fully discharge an attorney's reporting obligations.



material violation to a supervisory attorney before considering a report “up the ladder.”

Subordinate attorneys may (but are not required to) report “up the ladder,” if the subordinate attorney “reasonably believes” his or her supervisor has failed to comply with the Final Rule. Although it may appear that there is some ambiguity with respect to the provision that the subordinate attorney “may” report, and Section 205.5(b)’s requirement that a subordinate attorney “shall” comply with the Final Rule, the specific (the “may” rule) should trump the general (the compliance mandate). As mentioned earlier, companies without clear hierarchies within the legal function may find some benefit to clarifying the reporting structure so that their attorneys know (and possibly limit) who is subject to the direct “up the ladder” reporting requirements.

It should be noted that attorneys who report directly to the CLO (for example, deputy general counsel), are not considered to be subordinate attorneys. They are supervisory attorneys governed by Section 205.4 and not Section 205.5 of the Final Rule.

QUALIFIED LEGAL COMPLIANCE COMMITTEE

Under Sections 205.2(k) and 205.3(c) of the Final Rule, the issuer may establish a QLCC composed of at least one member of the issuer’s audit committee and two or more independent members of the issuer’s board.

The Final Rule clarifies that the QLCC may be an audit or other committee of the issuer. In addition, the existence of the QLCC must have preceded the report and the QLCC cannot have been created in order to respond to a specific incident. The SEC hopes that the creation of QLCCs, specialized subcommittees of boards of directors, will result in a systematic review of possible material violations.

The QLCC would have both the authority and the responsibility to:

- Notify the CEO and CLO upon receipt of a report,
- Determine if an investigation is warranted,
- Direct the CLO or outside counsel to conduct such an investigation, and notify the audit committee or board of the investigation, and

- Require the issuer to adopt appropriate remedial measures to prevent ongoing, or alleviate past, material violations.

An attorney may satisfy his or her reporting obligation under the Final Rule by reporting evidence of a material violation to the issuer’s QLCC. However, if the New Proposed Rule is adopted, the CLO (but no other reporting attorneys) may still have an obligation to “report out” to the SEC in the unlikely event the issuer fails to follow the QLCC’s recommendations.

REPORTING ISSUER CONFIDENCES

Section 205.3(d)(2) of the Final Rule permits (but does not require) an attorney to reveal to the SEC, without the issuer’s consent, confidential information

- to the extent the attorney reasonably believes necessary to prevent 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 or suborning perjury or committing a fraud on the SEC, 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 were used.”

Merely permitting, rather than requiring, disclosure of confidential information to the SEC, as provided in Section 205.3(d)(2) of the Final Rule, requires no preemption of state ethics rules. Attorneys may comply both with their state’s ethical requirements and other restrictions on the disclosure of client confidences, to the extent that they forbid disclosure, and with the Final Rule. Given the flexibility that this provision affords attorneys, it does not appear to be controversial.

SANCTIONS

Section 205.6 of the Final Rule discusses the manner in which violations of the Final Rule will be prosecuted by the SEC and the Final Rule’s relationship with existing standards of attorney conduct. The Final Rule provides that the SEC may discipline and sanction an attorney who violates the rule, subjecting the attorney to “the civil penalties and remedies for a violation of the

federal securities laws available . . . in an action brought by the Commission,” regardless of whether the attorney is also subject to discipline in the state where he or she practices. The SEC may also impose administrative penalties on an attorney who violates the Final Rule, including censure and a prohibition on appearing or practicing before the SEC. It appears that the possibility of criminal prosecution has been precluded. The Final Rule also provides that an attorney shall not be disciplined by any state as a result of the attorney’s good faith attempts to comply with the Final Rule. With preemption still at issue, it is uncertain if all the states will follow this provision.

NO PRIVATE RIGHT OF ACTION

Section 205.7 of the Final Rule clarifies that no private right of action is created by Rule 205. This is intended to preclude private causes of action for both injunctive relief and monetary damages.⁷

PREEMPTION OF STATE ETHICS RULES

Section 205.1 of the Final Rule states that the Final Rule preempts less rigorous, conflicting state ethics rules. The issue of whether the SEC has the authority to preempt state ethics rules drew significant comment and generated controversy during the comment period for the Original Proposed Rules. Much of the criticism was focused on the fact that the proposed “noisy withdrawal” provision (discussed below) was not mandated by Congress in Section 307 of the Act.

In the comments to the Final Rule, the SEC asserts that it has the authority to preempt state ethics rules pursuant to the requirement in Section 307 of the Act that the SEC establish rules of “minimum standards of professional conduct” for attorneys. The SEC’s statutory authority to regulate the securities industry is supported by the Commerce Clause of the U.S. Constitution, and, as a result of the Supremacy Clause, the SEC contends that duly adopted SEC rules should preempt state rules.

For the moment, the issue of preemption in most situations will not be significant. The Final

Rule has been limited, for the most part, to those who really do practice before the SEC and, in the absence of a “noisy withdrawal” provision, are not in conflict with state ethics rules. It was this provision which many commenters found was inconsistent with some states’ ethics and evidence rules (including California and New York), as well as potentially in conflict with federal common law governing the attorney-client privilege pursuant to the Federal Rules of Evidence. However, should the New Proposed Rule be adopted and include a “noisy withdrawal” requirement, it is expected that the SEC’s position on preemption, as well as the interaction of the requirement with the federal common law governing the attorney-client privilege, will be tested in the courts.⁸

THE “NOISY WITHDRAWAL” PROPOSALS

Despite statements by the Congressional sponsors of Section 307 of the Act that no disclosure outside the company/client was mandated, the Original Proposed Rule included a “noisy withdrawal” requirement. That is, if the issuer did not take appropriate steps to remedy the situation after an attorney reported evidence of a material violation to the Company’s board of directors, in certain circumstances outside counsel would be required both to withdraw from representing the issuer and to “report out” to the SEC regarding the withdrawal, stating that the withdrawal was for “professional considerations.” The Original Proposed Rule further required that both in-house and outside counsel disaffirm public filings in which they participated that were “tainted” by the violation. In-house counsel was not required to resign from employment with the issuer.

Although the “noisy withdrawal” component is not included in the Final Rule, it is still under consideration and is the subject of the New Proposed Rule. Much of the controversy surrounding the noisy withdrawal requirement contained in the Original Proposed Rule was over concerns that the requirements violated the attorney-client privilege and attorneys’ ethical duty to maintain client confidences mandated by state ethical rules. The SEC asserted in its

⁷ While the SEC has disavowed any private right of action under the Final Rule, the mere existence of the rules might be used by plaintiffs to advocate that a high standard of conduct exists for attorneys.

⁸ Moreover, it is not clear whether following the rules will relieve attorneys of all potential liability, for example, the limits on the safe harbor protection provided by § 205.6(c) might be tested by libel actions.



comments to the Original Proposed Rule that noisy withdrawal would not violate the attorney-client privilege, but this claim was disputed by many commenters.

As a result of this controversy, the SEC both postponed the adoption of a noisy withdrawal requirement and included in the New Proposed Rule an alternative to noisy withdrawal. In a disclosure procedure like that required when an issuer's auditor resigns, the SEC has now proposed that the issuer rather than the attorney publicly report that the attorney's withdrawal was for "professional considerations." Because the issuer holds the attorney-client privilege, the issuer would not violate the privilege by making this report.

The SEC, by compelling disclosure by the issuer, would arguably be forcing the issuer to waive the privilege otherwise afforded it by state and federal law. The SEC states that the issuer would have the opportunity to remedy the alleged violation and thereby obviate this reporting requirement. The alternative proposal, however, may not help an issuer which disagrees in good faith with one of its counsel about whether there has been a violation; instead, it requires the issuer to reveal an otherwise confidential, privileged dispute to the public.

The SEC has asked for comments on the New Proposed Rule by April 7, 2003. Because this provision is not mandated by Section 307 of the Act, there is no deadline for adoption of any final rules covering noisy withdrawal or similar alternatives.

CONCLUSION

Section 307 of the Act and the Final Rule reflect a trend — the federalization of corporate governance, an area of the law that has historically been left to the states. For example,

the definition of "fiduciary duty" refers to both state and federal fiduciary duty laws. Except to the extent that breaches of fiduciary duty have resulted in securities violations, neither was previously under the SEC's jurisdiction. Although commenters proposed that the SEC limit the Final Rule's scope to breaches of fiduciary duty resulting in securities violations, the SEC declined to do so. The Final Rule provides that any breach of fiduciary duty could result in a "material violation." Because, under the Final Rule, the SEC has the power to hold an attorney responsible for violating federal securities laws if the attorney fails to follow the reporting requirements of the Final Rule with respect to breaches of fiduciary duty, the SEC has, effectively, brought this area of the law within its purview for the first time.

CONTACT PILLSBURY WINTHROP FOR MORE DETAILS

Pillsbury Winthrop monitors developments in the federal securities laws and at the SEC, the NYSE and the NASD. For a more complete discussion of the Act, see our website at www.pillsburywinthrop.com. Pillsbury Winthrop plans to distribute and post to its website additional materials relating to the Sarbanes-Oxley Act of 2002 and regulations thereunder as such information becomes available.

If you wish to develop a comprehensive strategy to meet your specific requirements in the reporting and compliance environment, please contact the Pillsbury Winthrop attorney with whom you work. Questions regarding this alert may be directed to David G. Keyko, Litigation (212.858.1604, dkeyko@pillsburywinthrop.com), in New York or Nathaniel M. Cartmell III, Corporate & Securities (415.983.1570, ncartmell@pillsburywinthrop.com), in San Francisco.

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