Monday, May 22
2:30–4:00 pm

402 Current Issues In Corporate Governance
Legal Manager Track

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Proposed SEC Executive and Director Compensation Disclosure Rules

On January 27, 2006, the Securities and Exchange Commission ("SEC") issued proposed rules ("Proposed Rules") that would significantly revise proxy disclosure requirements regarding executive and director compensation for publicly traded companies.

The SEC is seeking public comment on the Proposed Rules during the 60-day period beginning on the date of issuance of the Proposed Rules. Final rules are anticipated later this year. The final rules are expected to be effective for proxy statements filed 90 days or later from the adoption of the final rules. Most companies would be required to comply when they file 2007 proxy statements (Form DEF 14A, which covers the most recent fiscal year — in this case, generally 2006).

General Overview

The Proposed Rules require much more extensive disclosure for all types of compensation. Disclosure would entail narratives, tables, and footnotes, in non-boilerplate, plain English.

Disclosure would begin with a Compensation Discussion and Analysis. The subsequent elements of disclosure would then fall into three often overlapping and somewhat redundant categories.

- Compensation for the last fiscal year (and the two prior fiscal years) would be quantified in a Summary Compensation Table ("SCT"), accompanied by a narrative and two additional tables with more narratives and footnotes. The SCT would present all current and deferred compensation (including equity), more than is currently required. The additional tables (and narratives) would provide much more detailed information on the equity components.

- Equity-based compensation received in prior fiscal years would then be described in narrative and tabular form.

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- Retirement and all other actual or potential post-employment compensation (including retirement plans, deferred compensation plans, certain defined contribution plans, post-employment benefits, and change in control benefits) would then be quantified and disclosed in narrative and tabular form.

General Format

- Disclosure would begin with a Compensation Discussion and Analysis ("CD&A"). The CD&A would describe the company's compensation program objectives, the method by which it incentivizes certain behaviors, each element of compensation and its rationale, the amount or formula for each such element, and the manner in which it facilitates the company's compensation objectives.

  The CD&A must include, among other things, the rationale behind immediate versus long-term compensation elements and cash versus other compensation; the basis for any stock award grant date; material performance criteria; the relationship between one compensation element (e.g., equity awards) and other elements (e.g., retirement benefits); accounting and tax implications; equity ownership requirements; a discussion of benchmarking undertaken by a company in establishing compensation programs; and the role of Named Executive Officers ("NEOs") in the compensation process. The NEOs include the chief executive officer ("CEO"), the chief financial officer ("CFO"), and the top three most highly compensated executive officers other than the CEO and CFO. The most highly compensated executive officers would be determined based on total compensation rather than on salary plus annual bonus, as currently required.

  The CD&A would replace the current Board Compensation Committee Report and the performance graph. Importantly, the CD&A would be deemed "filed," rather than "furnished," and consequently would be subject to more stringent liability standards for the companies and parties preparing and filing the disclosures.

- The Summary Compensation Table would detail NEOs' compensation for the last three fiscal years in the following format:

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
NEO Name and Principal Position	Year	Total ($)	Salary ($)	Bonus ($)	Stock Awards ($)	Option Awards ($)	Non-Stock Incentive Plan Compensation ($)	All Other Compensation ($)

Item (c) (Total) is the sum of items (d) through (i).

Earned but deferred compensation would be included in item (d) or (e), as appropriate (the same as currently), but deferred amounts would also appear in a footnote and in a subsequent table as well.

Comment: *This is the first of many items which may appear to be "double-counted," i.e., disclosed twice in the tables. There is a concern raised by many companies, practitioners, and even the SEC that, if items are double-counted, investors may incorrectly conclude that more compensation has been paid than is in fact the case.*

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The amounts disclosed in items (f) and (g) (Stock Awards and Option Awards) would reflect the grant-date "fair value" of an award granted that fiscal year, based on the FAS 123(R) expense to be reported in financial statements (rather than the number of shares, as currently required). Significantly, the company would include the full fair value of the grant in the year of the grant, rather than amortizing it over any vesting period, as would occur for financial accounting purposes under FAS 123(R).

Comment: Again, this will raise an issue of double-counting in the two supplemental tables discussed below. Additionally, the variance from the financial disclosure in the income statement may be confusing.

In item (h) (Non-Stock Incentive Plan Compensation), companies would report the dollar value of all non-equity performance-based compensation for the fiscal year in which the amounts vest, not the year of receipt.

In item (i) (All Other Compensation), companies would disclose all compensation not reported elsewhere in the SCT. This item has such significance that it will be covered in greater depth later in this alert.

A narrative would follow the SCT. This narrative would describe, among other things:

-- Material terms of written or oral employment agreements
-- Material modifications of equity awards
-- Terms of performance-based awards
-- Information about all defined benefit plans, nonqualified deferrals, and certain defined contribution plans

Importantly, in the SCT narrative, the company would also be required to disclose job descriptions and total compensation (but not names) for up to three non-officer employees whose total annual compensation exceeded that of any NEO.

Comment: This may be troublesome for companies who do not wish to disclose compensation for highly-paid individuals in high profile competitive positions, especially if they may be identifiable from their job descriptions (e.g., sales, marketing, development, or media talent).

The SCT would also be supplemented by two tables.

The Grants of Performance-Based Awards Table discloses information on equity and non-equity performance-based compensation. This is similar to the table currently required, except that it would also show estimated future payouts:

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Name of NEO	Performance-Based Stock and Stock Incentive Plans: Number of Shares, Units, etc. (#)	Performance-Based Options (#)	Non-Stock Incentive Plan Awards: Number of Units, etc. (#)	Amount of Consideration Paid ($)	Grant Date	Performance Period or Option Expiration Date	Estimated Future Payouts at Threshold, Target, and Maximum ($ or #)

The Grants of All Other Equity Awards Table would show awards that are unrelated to performance and granted in the prior fiscal year:

Name of NEO	Number of Securities Underlying Options Granted (#)	Exercise Price ($)	Expiration Date	Number of Shares or Units Granted (#)	Vesting Date	Grant Date

- Tables Showing Exercises and Holdings of Previously Awarded Equity

An Outstanding Equity Awards at Fiscal Year-End Table would disclose the "in-the-money" amount of both time-vested and performance-based equity grants:

(a)	(b)	(c)	(d)	(e)	(f)	(g)
Name of NEO	Number of Securities Underlying Unexercised Options/ Number Exercisable and Unexercisable (#)	In-the-Money Amount of Unexercised Options: Exercisable/ Unexercisable ($)	Number of Shares Held but not Vested (#)	Market Value of (d) ($)	Incentive Plans: Number of Nonvested Shares, etc. (#)	Market or Payout Value of (f) ($)

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An Option Exercise and Stock Vested Table would disclose amounts received if options were exercised or stock vested during the prior fiscal year:

(a)	(b)	(c)	(d)
Name of NEO	Shares Acquired or Vested (#)	Value of (b) ($)	Grant Date Fair Value Previously Reported in SCT ($)

Comment: This disclosure again potentially results in double-counting by requiring the value of stock when actually vested to be shown, although a value was also shown when the stock award was granted. Additionally, the charts may be confusing because the previously reported fair value under FAS 123(R) will rarely, if ever, be the same as the actual intrinsic economic value at vesting. Finally, this disclosure may distort the compensation of executives at successful companies or executives with long-term service.

- Post-Employment Compensation Tables

Disclosure regarding pension plans would be increased. New disclosure regarding certain nonqualified defined contribution plans and deferral arrangements would be required. Other compensation (e.g., change in control arrangements) would be disclosed and quantified. This is one of the most significant changes from the current disclosure requirements.

The Retirement Plan Potential Annual Payments and Benefits Table would require separate estimated projections of early and normal retirement benefits under each qualified and nonqualified defined benefit plan for NEOs, as well as a detailed narrative description of the arrangements. The chart would be formatted as follows:

NEO Name	Plan Name	Years of Credited Service	Normal Retirement Age	Estimated Annual Normal Retirement Benefit	Early Retirement Age	Estimated Annual Early Retirement Benefit

In the accompanying narrative, companies would be required to disclose (among other things): the current compensation (used to calculate the benefits); the currently elected benefit form; formulas and eligibility standards; lump sum values currently available (if elected); and the reason(s) for having multiple plans (such as SERPs).

Comments: Modest differences in age, marital status, form of payment, and actuarial assumptions can result in significant dollar value swings in the estimated annual benefit reported. The information to be disclosed is different from the information currently compiled on an annual basis by plan actuaries and, therefore, would require additional actuarial work. Companies may wish to evaluate

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which forms of payment to make available under nonqualified plans so that the disclosure can be more uniform from plan to plan and from year to year. Many companies are already evaluating the forms of payment in order to bring plans into compliance with Section 409A of the Internal Revenue Code ("IRC") (dealing with deferred compensation).

A Nonqualified Defined Contribution and Other Deferred Compensation Plans Table would disclose contributions, earnings, and balances under nonqualified defined contribution and deferral plans. Plan-by-plan disclosure would not be required:

Name of NEO	Executive Contributions Last Fiscal Year ($)	Company Contributions Last Fiscal Year ($)	Aggregate Earnings Last Fiscal Year ($)	Aggregate Withdrawals/ Distributions ($)	Aggregate Balance Last Fiscal Year End ($)

Because some of this information would have been previously disclosed, to reduce the risk of double-counting, a footnote would clarify the difference between compensation previously reported as additional currently earned compensation. Material plan features would also be disclosed.

Comment: The SEC does not discuss why qualified defined benefit plans require disclosure, as opposed to defined contribution plans. Additionally, company contributions and aggregate fiscal year earnings will be triple-counted as (1) they will also be disclosed in connection with the SCT and (2) the company contributions and earnings, which form a significant portion of the aggregate account balance, will have been previously disclosed in the year deferred. Further, long-term executives might be unfairly stigmatized because of large account balances, savings tendencies, or prudent investment direction.

In addition to the noted disclosures, the Proposed Rules would require a narrative regarding payments (contingent or otherwise) associated with resignation, severance, retirement, termination, change in responsibility, or change in control. Amounts payable would need to be quantified although uncertainties will likely exist as to the amount of payment. There is no prescribed table for this disclosure, but many companies are expected to develop customized tabular disclosure.

Comment: It is unclear how certain "potential" benefits (e.g., IRC Section 280G golden parachute payments and related "tax gross-up" payments, or post-termination medical coverage) would be valued for disclosure. Additionally, certain companies provide retirement benefits to former executives that may provoke skepticism from investors (such as continued use of corporate properties); in such cases, Compensation Committees may wish to decide if other, more traditional, benefits of equal value or cash may be appropriate.

Perquisites/Other Compensation

As discussed above, item (i) (All Other Compensation) of the SCT requires the disclosure of all other compensation. This includes certain earnings on nonqualified deferred compensation, the actuarial increase in pension values, and "perquisites and other personal benefits" ("Perks") with an aggregate value greater than $10,000. Many of these items will require item specific disclosure and valuation.

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The SEC has defined Perks very broadly. An item is not a Perk if it is integrally and directly related to the performance of duties (e.g., a larger office). Otherwise, if it confers a direct or indirect benefit that has a personal aspect, regardless of whether it also serves a business purpose or even the company's convenience, it is a Perk to be valued and disclosed as compensation, unless it is generally available to all employees.

Some examples of Perks include: club memberships not used exclusively for business entertainment; personal financial advice; personal use of company property; housing and other living expenses, including relocation assistance; and certain security protection provided at company expense.

Importantly, the item's "value" is the aggregate incremental cost to the company. Income tax rules do not apply in determining if an item is a Perk or in determining value.

Compensation of Directors

The Proposed Rules would require a new Director Compensation Table ("DCT"). The DCT would be in substantially the same format as the SCT and would require disclosure of total compensation, director fees earned or paid in cash, the fair value of stock awards, and other compensation, including perquisites. However, only compensation for the most recent fiscal year would be required. Additionally, all outstanding equity awards at fiscal year end would be disclosed.

Form 8-K Changes

The Proposed Rules would expand the group of executives subject to disclosure under Form 8-K.

Additionally, the Proposed Rules would expand disclosure for NEOs and directors to include descriptions of certain new compensation arrangements, new equity grants, and material modifications to existing arrangements.

Possible Interim Actions

Companies may consider adopting some "Best Practices" currently. These include preparation of "tally sheets," a revision of current compensation setting procedures (benchmarking and Compensation Committee procedures), and increased disclosure in current filings.

Companies may wish to perform a comprehensive review of compensation programs and philosophies. As part of this endeavor, companies may also want to examine whether some elements of compensation currently paid to executives might raise questions from shareholders, and if alternative arrangements may draw less scrutiny and criticism.

Finally, the Internal Revenue Service ("IRS") currently is well into an "Executive Compensation Audit Initiative." This IRS initiative is a comprehensive audit initiative on executive compensation, with a focus on IRC Section 162(m) regarding the $1 million tax deduction cap on pay not related to performance. An operational compliance review under IRC Section 162(m) and the new Proposed Rules should go hand in hand.

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Top Ten Things
Your Board Needs to Know About Effective Compliance and Ethics Programs

"Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account [the US Sentencing Guidelines]…." stated the Delaware Court of Chancery in the landmark Caremark case. And your company's board of directors (Board) needs to understand this given the Guidelines charge them with oversight and participation in corporate compliance programs. As in-house counsel you should understand these requirements as well and make sure your Board is aware of them.

Make no mistake however---this isn't just about criminal misconduct and sentencing. Rather, whether an organization has an effective compliance and ethics program (Program) that meets the Guidelines is an important consideration utilized by the Department of Justice, the SEC, and other regulators to determine whether or what type of action should be taken for corporate misconduct.

Here is what your Board needs to know about what the Guidelines require.

1. The Board Needs to Know About and Oversee the Program

The Board is charged with being knowledgeable about the content and operation of the Program, and reasonably overseeing its implementation and effectiveness. Basic information should be made available to the Board about its responsibility for the Program. Regular reports should be supplied about the Program's operations, resources and effectiveness.

2. There Must Be An Appropriate "Tone at the Top"

The company must have an organizational culture that encourages ethical conduct and commitment to compliance with the law by establishing an appropriate "tone at the top." A paper program just won't do it. Companies must not only "talk the talk" but "walk the walk." Establishing this culture begins with the Board. It also requires making sure that corporate leaders behave appropriately or are held accountable by the Board.

3. Individuals Responsible for the Program Must Have Effective Authority and Access

"High level" corporate personnel (i.e., those who have "substantial control over the [company] or who have a substantial role in making policy") should be assigned overall responsibility for the Program. Otherwise it is likely to undercut the Program and the establishment of an appropriate "tone at the top." Lower level individuals in the company may be delegated day-to-day operational responsibility for the Program, but should have access to the Board or the subgroup responsible for oversight of the Program (e.g., Audit Committee).

4. The Program Must Have Adequate Resources

What is adequate? Resources should be sufficient to reasonably prevent and detect misconduct and promote an organizational culture that encourages a commitment to compliance with the law. Factors which might be considered in determining resource adequacy could include: (a) size of the company (by number of employees or assets); (b) whether the company is highly regulated; (c) complexity of the company's transactions; (d) geographic range (i.e., local v. international); (e) benchmarks in the industry; (f) nature of the company's activities; or (g) potential areas of significant risk/liability and the need to address them.

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5. The Company Must Adopt Compliance Standards and Procedures

An employee code of conduct is essential. Required standards common to all companies address such matters as conflicts of interests, entertainment and gifts, prohibition against insider trading, and non-compliance reporting mechanisms. Other compliance standards are tailored to the nature of the company's business activities such as antitrust, the foreign corrupt practices act, or reports related to government contracting. Sarbanes-Oxley requirements such as up-the-ladder reporting for attorneys under section 307 should also be addressed. Finally, standards peculiar to the job duties of particular employees (e.g., those handling hazardous wastes) should be included.

6. Companies Need to Have Effective Compliance Training Programs and the Board Should Participate

The Guidelines require that companies have effective training programs that communicate their compliance standards and procedures to the Board, all levels of employees, and the company's agents if appropriate. The purpose of the training is not just to educate employees about the compliance requirements, but also to motivate them to comply with them. Training should be tailored; there is no template. Small organizations could provide training at orientation, staff meetings, or even one on one. Larger companies should have a formally documented program with sufficient dedicated resources and tools to measure its effectiveness.

7. The Program Should Be Regularly Evaluated

Programs should not stagnate. They should be evaluated regularly and appropriately modified. This analysis may be internal (review by internal audit, self assessment, employee surveys, etc.), but periodic measurement by an outside third party is highly recommended. Evaluations of the program should take into consideration new business activities and updated corporate risk assessments.

8. The Approach to Compliance Should Be Both Carrot and Stick.

The Program should be promoted consistently within the company with incentives provided for compliance with the Program and disincentives provided for engaging in misconduct. For example, whether managers participate in the Program (e.g. take training), properly administer compliance activities in their department, and set an example that contributes to the appropriate "tone at the top," should be considered in their performance evaluation and resulting compensation. Similarly, misconduct should be met with appropriate sanctions regardless of corporate position.

9. Company "Hotlines" with Anonymity Features Are Required

The Guidelines also require the implementation of a mechanism that allows employees to anonymously report potential misconduct without fear of retaliation. For those companies that operate outside the United States, special care should be taken in addressing this requirement. The availability of the hotline needs to be communicated to employees. Evaluation of the hotline should be part of the regular assessment of the Program.

10. Risk Assessment Drives the Program

The elements of a company's Program will be driven by an analysis of the laws and regulations applicable to the operations of the company and the risks potential non-compliance creates. Periodically the company must reassess this risk and modify the Program accordingly.

Additional Resources

Text of the Federal Sentencing Guidelines for Organizations
http://www.ussc.gov/2005guid/8b2_1.htm

Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines (October 7, 2003) http://www.ussc.gov/corp/advgrprpt/advgrprpt.htm

[Add current ACC Resources re Compliance Programs]

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DRAFT RECOMMENDATIONS UNDER CONSIDERATION

Task Force on the Lawyer's Role in Corporate Governance

This Task Force was formed in March 2005 to review and make recommendations concerning the role of corporate lawyers with respect to the governance of public companies.

What follows is a summary of the principal recommendations under consideration by the Task Force which are presented for public comment, including at a forum to be held at the City Bar Association on May 9, 2006 (6 pm – 8 pm).[1] In addition to comments at the May 9 public forum, the Task Force solicits written comments which, to be timely, must be submitted no later than May 11, 2006, to:

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Introductory note

The Task Force's focus has been on the roles of advising and transactional counsel, both internal and external, representing public companies. It has not focused on the very different roles of lawyers representing companies in litigation or in other adversary settings, with the exception of internal investigations (Section VI below).

Most of the recommendations considered below consist of "best practices": the preferred way for lawyers to act, not the way in which they are obligated to act by law or ethical

[1] The Task Force has not adopted these draft recommendations, and its members may have differing opinions concerning various recommendations.

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rules.[2] Further, because of the wide variation in the size and other characteristics of America's over 6,700 active public companies and the law firms and in-house legal staffs that advise them, very few recommendations should be seen as having universal applicability: one size generally does not fit all.

I. The ethical and regulatory framework

Background and context

The Task Force has addressed itself to the broad question of how lawyers can be more effective in helping the public companies they advise avoid problematic conduct which, as WorldCom, Enron and other recent scandals have dramatically emphasized, can injure many thousands of investors, shareholders and employees. Based on the available public information, it appears that lawyers, even if not complicit in the corporate wrongdoing, were in a position potentially to have taken steps to either prevent or mitigate the effects of a significant number of these scandals.

What role should lawyers be expected to play – how they should act – when concerns of possible wrongdoing arise in the course of their representation? How can they reconcile their responsibilities to their corporate client and its shareholders with the interests of the general investing public?[3] Should they consider, for example, "reporting out" corporate wrongdoing to regulators when "reporting up" has not resulted in curative action?

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[2] Space considerations preclude an articulation of the full rationale behind each recommendation under consideration. The rationale for each of the recommendations ultimately adopted will be set forth in the Task Force's final report.

[3] The term "gatekeeping" is sometimes used to describe a role for lawyers in preventing wrongdoing by their corporate clients. The Task Force generally avoids using that term because of its ambiguity and potentially broad application.

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Recommendations under consideration

-- the interests of the investing public

As a general matter, lawyers counseling public companies should be mindful of the impact of their advice and of their client's conduct on the investing public. The securities laws governing public companies embody a strong policy of protecting the investing public. The companies unquestionably owe duties directly to investors trading or holding their securities. So, too, do the auditing firms that certify the companies' financial statements. Lawyers do not. Nonetheless, lawyers advising public companies, as a matter of best practice and as part of their duty to their clients, cannot prudently ignore the interests of the investing public, including the company's shareholders, whenever a concern arises about possible wrongdoing by the company, its officers or directors.

This view of the lawyers' appropriate role is consistent with existing regulations and ethical rules. There should seldom be a conflict between the public interest in preventing corporate fraud and a lawyer's duty of loyalty to his public company client, if the nature of the client and its interests are properly understood. Lawyers take their directions from corporate officers or directors, but their client is, and they owe their duty of loyalty to, the corporate entity. The true interests of the entity -- the only interests the law can recognize -- include compliance with the law, thereby avoiding the potential liability and damage to the company's reputation (or even its viability) that a material violation of law can cause.

-- reporting "up"

Accordingly, when in the course of her representation a lawyer (internal or external) learns of significant threatened or actual illegal conduct by a corporate agent, her duty of loyalty to the client makes clear her obligation to the client: report the problem to higher

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authorities within the corporation who have the authority to act. It is no longer either legal or ethical for a lawyer, confronted with knowledge of a corporate fraud, simply to remain passive and silent.

The "reporting up" regulations of the Securities and Exchange Commission ("SEC"), adopted in 2003 pursuant to the Sarbanes-Oxley Act ("SOX"), are premised on this understanding of the lawyer's duty to his client. They create an obligation to report up the client's corporate hierarchy, to the Board of Directors if necessary, "credible evidence" that a "material" violation of the securities laws or fiduciary duties is "reasonably likely." 17 C.F.R. Part 205. The impact of these regulations appears to have been salutary, though not as dramatic as some anticipated. The Task Force supports the continued role of the SEC in regulating the conduct of corporate lawyers when they advise public companies, an area of practice that has rarely received attention from state and local disciplinary bodies.

Largely consistent with these SOX regulations, in 2003 the American Bar Association ("ABA") amended Rule 1.13 of its Model Rules of Professional Conduct ("Model Rules") to require, presumptively, reporting up when a lawyer "knows" of action or inaction by a corporate officer or agent that violates the law and likely will result in "substantial injury" to the corporation.

New York's Code of Professional Responsibility, in Disciplinary Rule 5-109(b), makes such reporting up an option for a lawyer faced with client wrongdoing, but only the last option. By contrast, Model Rule 1.13(b) requires reporting up unless the lawyer reasonably believes that it is not in the best interest of the corporation to do so. In effect, Model Rule

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1.13(b) creates a presumption in favor of up the ladder reporting. New York should adopt Model Rule 1.13(b) and thus the presumption in favor of reporting up that it embodies.[4]

-- reporting "out"

For responsible public companies, particularly in today's scandal-sensitive climate, it would be surprising for an independent Board of Directors to take no action in response to a lawyer's report of an impending or ongoing securities fraud or other serious corporate misconduct. At the very least, one would expect that a Board would consider the report to determine, in good faith, whether it agreed or disagreed or deemed further inquiry necessary. But where a Board fails to act, or commits itself to an illegal course of conduct, the ethical rules and SEC regulations do recognize a limited discretion to "report out" the wrongdoing.

The maintenance of client confidences is among the primary ethical duties of all lawyers. However, there is and always has been a need to consider other interests and values that also should inform a lawyer's conduct. The SOX regulations, and consistent ethical rules, recognize that the public company lawyer's obligation to his or her client should not be divorced from the public interest in protecting investors, and the corporate client itself, from fraud.

Accordingly, the SEC's SOX regulations permit a lawyer to disclose client confidences to the SEC to the extent reasonably believed necessary, inter alia, "to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors," or "to rectify" the consequences of such

[4] The House of Delegates of the New York State Bar Association is currently considering a comprehensive revision of the Code of Professional Responsibility, and in that context will address which of the ABA's Model Rules should be adopted in New York.

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a material violation, "in furtherance of which the attorney's services were used." 17 C.F.R. § 205.3(d).

The ABA Model Rules, again responding to SOX, were amended in 2003 to permit the disclosure of client confidences reasonably believed necessary "to prevent the client from committing a crime or fraud" -- or "to prevent, mitigate or rectify substantial injury to the financial interests or property of another" resulting from such a crime or fraud – "in furtherance of which the client has used the lawyer's services" (Model Rule 1.6(b)(2) and (3)). Even if the lawyer's services have not been used, disclosure of client confidences is permitted by the Model Rules, if "reporting up" has failed, when the lawyer believes a violation of law is "reasonably certain" to cause "substantial injury" to the corporation. (Model Rule 1.13(c)).

New York's ethical rule is more restrictive, but does permit disclosure of "the intention of a client to commit a crime and the information necessary to prevent the crime." (DR4-101.C.3).

New York should adopt the broader permissive disclosure provisions of ABA Model Rules 1.6(b) and 1.13(c), as have many other states. Under the extreme circumstances posited by these Model Rules, a lawyer should have the discretion to make limited disclosures – to regulators or others – when reasonably necessary to prevent or mitigate a substantial fraud. Corporate managers or directors engaged in such wrongdoing forfeit any right to demand that their lawyers, learning of such misconduct in the course of their legal representation, keep such wrongdoing secret regardless of the circumstances. The crime-fraud exception to the attorney-client privilege long ago removed any expectation of such rigid confidentiality. The Rules themselves permit disclosure of client confidences to establish or collect the lawyer's fee or to defend the lawyers against charges of misconduct.

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The SOX regulations and the ethical rules leave the decision of whether to disclose client confidences in this context to the lawyer's own judgment. Disclosure surely would not be undertaken lightly given the consequences. But if the violation is clear and the damage threatened by it is great, the twin premises of these permissive disclosure rules, the public interest often will be well served by timely disclosure to the SEC or other appropriate body.

-- professional courage

Rarely if ever will any lawyer for a major corporation be faced with a reporting-out decision. Sound and firm advice to clients, including directly to the Board when necessary, should be sufficient to address and redress nearly every instance of actual or potential wrongdoing. The essential need is for lawyers to give that advice clearly and not waver when the advice is unwelcome, no matter how important the client or how powerful the officer of director resisting the advice.

Not to waver or equivocate is no easy challenge for lawyers in some circumstances. A law firm partner's compensation – or even a small law firm's survival – may depend on the business referred by the CEO of a major client. A General Counsel's very job may depend on the support of that same CEO. In either situation, it may take genuine professional courage to provide unwelcome advice and stick to it. Absent sound judgment and this professional courage, regulations and ethical rules may have little ability to inspire a lawyer to provide the clear and unvarnished advice a client needs and deserves.

The Task Force has considered two possible modifications to existing law that, some urge, might help counter the pressures on lawyers to acquiesce in or even assist a client's wrongful course of conduct. One modification would be to recognize a cause of action for

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lawyers discharged in retaliation for advising against or making a report concerning possible violations of law. The other would be federal legislation to restore aiding and abetting liability for lawyers (and others) in private litigation under the securities laws. However, subject to hearing public comment, the Task Force is not inclined to recommend either of these measures at this time.

-- a cause of action for retaliatory discharge (further study needed)

A cause of action could be recognized for a lawyer discharged by her employer, whether a law firm or a company, in retaliation for reporting up or out under the SOX or ethical rules, or otherwise raising in good faith ethical issues. In certain of the recent major scandals, it does appear that internal lawyers were concerned that, if they “pushed” certain issues, they might lose their jobs. The existence of a cause of action for retaliatory discharge might give internal lawyers “strength” to raise unpopular but important issues, if necessary even to the Board, and likewise might encourage associates and partners in law firms to come forward with necessary advice. Those advocating recognition of such a cause of action urge that it would not likely result in frequent frivolous claims, given that the assertion of such a claim, especially if not clearly meritorious, would carry a significant career risk for the lawyer-claimant.

There is some limited protection against retaliation under existing law, which may militate against the need for creating this cause of action. SOX § 806 provides a claim for employees of public companies (including in-house lawyers) who suffer retaliatory employment actions for acting as whistleblowers in an investigation of fraud or securities violations. Further, ABA Model Rule 1.13(e) mandates that when a lawyer reasonably believes that he or she has been discharged because of reporting up the ladder pursuant to Rule 1.13, or withdraws in circumstances that require or permit such action, the lawyer must see that the Board of Directors

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is informed of the lawyer's discharge or withdrawal. The prospect of such an after-the-fact disclosure to the Board may tend to deter retaliatory discharges. ABA Model Rule 1.13(e) should be adopted in New York.

The concern about creating a cause of action for the retaliatory discharge is that it might give rise to much litigation without really benefiting corporate governance. The attorney-client relationship is a personal one, and all manner of reasons can motivate a client to discharge a lawyer. Retaliation as the motive for a discharge would be easier to allege than to prove. Further, it would be difficult at best for such a cause of action to reach more subtle types of retaliation, such as a reduction in the access of an internal lawyer to corporate decision-makers in response to some past or feared reporting up.

Some forty states are said to have whistleblower type protections that appear to include lawyers within their scope. At minimum, it would be useful to study their experience with whistle-blowing or retaliation claims by lawyers before recommending whether New York should adopt such a law.[5] At this time, the Task Force is inclined to recommend only that this issue be further considered by the Association's Committee on Professional Responsibility.

-- restore aiding and abetting liability (not yet)

Central Bank v. First Interstate Bank, 511 U.S. 164 (1994), eliminated aiding and abetting liability in private civil lawsuits under the securities laws. Some have argued that, were such liability restored, it might strengthen the resistance by lawyers to wrongful client conduct. This view is consistent with this Association's 1993 amicus brief in Central Bank unsuccessfully

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[5] The sole remedy for a New York lawyer raising ethical concerns comes from the Court of Appeals decision in *Wieder v. Skala*, 80 N.Y.2d 628 (1992), where the Court recognized a contract claim by a law firm associate for breach of an obligation implied in his employment-at-will contract. The *Wieder* Court declined to recognize a tort of retaliatory discharge saying, "[W]e have consistently held that 'significant alteration of employment relationships, such as [Wieder] urges, is best left to the Legislature.'" 80 N.Y.2d at 639 (citations omitted).

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urging that aiding and abetting liability was a necessary part of a "system that creates proper incentives for securities lawyers to exercise due care -- and avoid recklessness or intentional misconduct -- in securities transactions. . . ." Brief as Amicus Curiae, Sept. 9, 1993, at 4.

At present, outside law firms have only limited exposure, as a practical matter, to liability or other sanctions when their clients violate the securities laws, absent active participation in the fraud as a knowing primary violator. A firm appears to face little risk even if its conduct meets the traditional test for aiding and abetting liability: rendering "substantial assistance" to the primary violators.

This situation is the product of three circumstances. First, state and local disciplinary bodies have seldom taken an interest in the area of corporate practice. Second, as noted, the Central Bank decision eliminated aiding and abetting liability in private litigation.[6] Third, the SEC, which can assert aiding and abetting liability against law firms (and others), historically has been reluctant to proceed against outside lawyers. It appears not to have initiated an enforcement proceeding against a major outside law firm or its partners in the last quarter century, though in a few instances it has proceeded against solos or smaller firms.

This gap in meaningful enforcement risk appears far from ideal in advancing sound corporate governance and encouraging the legal advice needed to support it. Outside lawyers are faced with significant pressures, given the competitive nature of the profession and the limited allegiance of corporate clients to any firm, to facilitate problematic client conduct. We believe that lawyers and firms successfully resist these pressures with some consistency,

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[6] Some cases, most notably the decision denying Vinson & Elkins' motion to dismiss claims against it in the Enron class action litigation, have suggested that the concepts of primary liability can be stretched to include law firm conduct that used to fall under the aiding and abetting rubric. But there is substantial doubt whether this broad interpretation of primary liability will survive eventual Supreme Court review.

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displaying both personal integrity and, at times, genuine professional courage. But these stellar qualities are hardly reinforced by knowledge that lawyers face little apparent jeopardy when they give the welcome "yes" answer to a valued client (or say nothing) when a firm "no" would be the proper advice.

Some commentators have urged that, to establish a desirable counterbalance to these market pressures operating on outside (as well as inside) lawyers, Congress should restore aiding and abetting liability in private class action litigation. Others, a group presumably including most corporate lawyers, would oppose such a step, in part asserting the danger of abusive class action claims brought to force settlements. This view places little confidence in the ability of the courts to prevent such abuse by identifying and dismissing frivolous claims at the pleading stage.

There is one other possible counterbalance which, if it proves to be meaningful, might provide an alternative to undoing Central Bank: the SEC's relatively new authority from Congress, in SOX, to establish and enforce "minimum standards of professional conduct" for the lawyers who practice before it representing public companies. The SEC's "reporting up" regulations are the most prominent exercise of this new authority, one specifically mandated by SOX itself.

The decision of Congress to place this authority in the SEC's hands was sensible, given the "magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally trade securities. . . ." Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, No. 04-1371, slip op. at 5 (U.S., Mar. 21, 2006). It is too early to determine whether the SEC will use its new authority in a way that will exercise a positive restraint on lawyer conduct inimical to sound corporate governance. So far no proceedings have been brought for any

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violations of the reporting up rules. If the SEC does develop a meaningful oversight and enforcement program directed toward the corporate bar, then the argument for restoring aiding and abetting liability will lose some of its force. But if the SEC proves unable or unwilling to so act, the argument for restoration will be strengthened.

We make no prediction in this regard, but rather turn to other possible recommendations that could be implemented without further legislative action.

II. The role of General Counsel and other internal lawyers

Background and context

There is no more critical role for lawyers with respect to ensuring compliance with the securities laws than that of General Counsel for a public company. It is also the most difficult role. As the docket of SEC enforcement actions and DOJ prosecutions demonstrates, it is inside counsel who, far more frequently than outside counsel, find themselves caught up in wrongdoing initiated by other corporate officers, or criticized for not doing more to prevent that wrongdoing. Many of the SEC cases involve situations where the General Counsels did not seem to benefit financially or receive extraordinary compensation. Rather, counsel either were engaged in a misguided attempt to help their corporate employers, or were simply unwilling to put their jobs at risk.

There is an inherent tension in role of the General Counsel that must be recognized and managed. General Counsels must ensure that their companies act lawfully and, more generally, act as guardians of the corporate reputation. Yet to be effective they also must maintain a close, open relationship with the CEO and be seen as partners to the business and advocates for their respective corporations. General Counsel and other internal lawyers, in dealing with this tension, must always keep in mind that their client is the corporation, not its management, and they must be able to recognize, and to have sufficient status and independence

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to deal with, situations where the interests of the corporation may not align with the desires of management.

Strengthening the role of General Counsel must be a high priority in any effort to minimize corporate fraud. Public companies and their legal departments come in all sizes and shapes. Thus the possible recommendations that follow should be viewed as general guidelines, not rigid prescriptions applicable to all companies. In some companies, the legal department is centralized at headquarters. In others, the legal function is decentralized, with reporting lines to divisional management. There are some highly efficient legal departments in major corporations with such a decentralized structure. However, as some recent scandals demonstrate – WorldCom among them – a company which has a diffuse legal structure and no strong General Counsel (or strong Board) may be unable to restrain management determined to skirt the bounds of propriety.

Recommendations under consideration

While there is no single right way to organize the legal function, there are certain principles that corporations should keep in mind with respect to the General Counsel's position.

-- General Counsel as corporate guardian, with Board support

The goals of the corporation should be defined by the Board of Directors and top management to emphasize "high performance with high integrity." The General Counsel's role in this regard should be clearly defined by the Board to include alerting appropriate decision-makers of potential law violations and potential damage to the corporation, as well as serving as a facilitator and counselor to senior management.

The Board of Directors should control the tenure and terms of compensation of the General Counsel. Specifically, the Board should approve the hiring and compensation of the

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General Counsel, articulate its expectations as to General Counsel's guardian role and approve any decision to discharge the General Counsel.

-- the required stature of General Counsel: access and reporting relationships

Structures, processes and procedures should be put into place to emphasize the importance of the General Counsel's "guardian" functions and to ensure that the General Counsel has the resources and authority necessary to perform these roles.

The General Counsel, to be effective, must be seen as a senior, influential and respected member of the company's senior management, recognized as having strong qualities of independence, judgment and discretion. His or her reporting relationships, access to management and the Board, and compensation all need to be consistent with senior status in the company.

The Board and senior management should ensure that the General Counsel has sufficient access directly to senior management and to the Board of Directors so that problems can be escalated and dealt with at the appropriate level.

The General Counsel should report to one of the highest ranked company executives, most often the CEO, and also to the Chair of the Board if this title is held by someone other than the CEO. He or she should have ready access, as well, to the COO, the CFO, any independent "lead director," the chair of the Audit Committee, and any other senior executives or directors responsible for compliance, governance or ethics issues, and any company ombudsman.

The General Counsel should have opportunities to meet with the independent (non-management) members of the Board separately from management. In most if not all

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companies, it may be advisable for the General Counsel regularly to attend meetings of the Audit Committee and any legal compliance committee.

-- internal lawyers

General Counsel should have ultimate authority with respect to all senior internal lawyers, including those assigned to subsidiaries or discrete business units. While such lawyers may have their direct reporting relationship to a relevant business manager, they should have at least a "dotted line" reporting relationship to the General Counsel, who should have a significant voice in their hiring, firing and compensation. These lawyers, and even junior lawyers, need to know that General Counsel will support them if they are inappropriately threatened with discharge or other prejudice in response to rendering sound and forthright advice.

Internal lawyers are generally most effective when they are viewed as "partners to the business" and have a thorough understanding of the clients they serve. Staffing levels, and definitions of the role of the legal department, should be such that this goal is attainable.

Processes and procedures should be put into place to ensure that internal lawyers of appropriate seniority are involved in decisions on matters involving legal disclosure or risk. For example a company should (x) ensure that internal lawyers are present at appropriate meetings or are members of relevant committees, (y) ensure that employees know where they can go within the internal legal department to raise concerns, and (z) establish employee hotlines and ensure that lawyers are involved in resolving any legal issues presented through that medium.

Internal lawyers should have training specific to their position to enable them to be more sensitive to their conflicting responsibilities and to be knowledgeable about appropriate ways to deal with them. Junior lawyers need to have access to sufficiently senior and

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experienced internal lawyers – if necessary including the General Counsel - to obtain support and to discuss and elevate issues where required.

Attorneys should be required to review the company's policy on "reporting up". One useful focus for training is a post-mortem on issues wrongly resolved or missed, focusing on how to avoid a repetition. The General Counsel should be sufficiently involved in such training to demonstrate its importance and to focus her own thinking about these problems.

-- <u>external lawyers</u>

The General Counsel should have authority as well over the selection of the principal external lawyers retained by the company and should clearly define their roles. It is essential that General Counsel's expectations of outside counsel, including to "report up" any apparent wrongdoing by corporate agents, be clearly understood by external firms, who should be provided with a copy of the corporation's Code of Conduct and its policy on "reporting up". They should have a designated contact within the legal department to whom they can "report up," should the need arise. General Counsel should also ask for the external firm's own policy regarding compliance with the SEC's lawyer conduct rules.

The General Counsel (of his/her designee), as a general matter, should meet regularly, at least once a year if not more often, with any outside firm performing substantial ongoing work for the company.

-- <u>equity compensation</u>

The compensation of internal lawyers should not be so weighted toward equity or bonuses as to undermine the independence of their legal advice, and deter them from raising and appropriately dealing with issues. Such a situation might be presented, for example, were the

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compensation of a lawyer overwhelmingly dependent on the short term profitability of the particular business division she served.

There is nothing improper in part of an internal lawyer's compensation consisting of equity, a very frequent practice today. The question is one of degree. The need is for the Board to review programs providing for compensation in stock options or other equity to ensure that any conflicts presented are adequately managed.

III. The role of external counsel

Background and context

The ways in which large public companies use outside counsel have changed over the years. With the sprawling, multi-national operations of the Fortune 500, and increasingly specialized nature of securities practices, public companies tend to use a stable of experts from various firms, rather than, as in days past, rely on the sage advice of a trusted generalist. In-house General Counsel, often supported by large staffs, have taken on the general counseling role in many major corporations.

This specialization by outside firms comes at a price: outside counsel may have a limited understanding of a client's business and the general context of the transactions they are structuring or "papering." There is an increased risk, in this legal environment, that lawyers may unwittingly facilitate a client's misconduct.

The risk is magnified by another change in the legal profession: its increasingly "bottom line" and competitive nature. Both partners and clients are less tied to a given firm than was typical until roughly the 1970s. Today a partner's compensation may importantly depend on retaining a significant client, and a firm's profitability may depend on its ability to retain its partners with "portable business." At the same time, most public companies are no longer tied to a single law firm, a relationship that gave the firm a sturdy platform from which to render

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unwelcome advice. Today, public companies unhappy with the advice or service of one firm can and do readily switch their very profitable business to other firms. This competitive environment creates pressures on outside counsel to avoid confronting clients about questionable transactions or accounting treatments in order to maintain the client relationship.

Recommendations under consideration

What are the best practices for outside counsel in this challenging environment? In short, outside firms must consciously strive to avoid having these competitive pressures compromise their judgment, dilute their advice or limit their loyalty to their true client, the corporation and its shareholders.

-- understand the context

Outside counsel, through dialogue with the company's General Counsel or management, should always endeavor to be aware of the context in which and the purpose for which its services are being requested and used. Counsel cannot guarantee that her services will not be put to some improper purpose, but she can minimize this risk through appropriate inquiries.

-- inquire when a serious concern arises

When in the course of the representation outside counsel becomes seriously concerned about the company's actual or intended conduct, counsel should not limit his consideration to the question of whether the SOX reporting up requirement has been triggered. The best practice when the trigger point has not been reached, but counsel nonetheless has a serious concern, is to make reasonable inquiry of the company. If such inquiries do not allay the concern, counsel should strongly consider withdrawing from the representation, if this can be done without causing material prejudice to the client's interests (see DR2-110.C).

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-- withdrawal and disclosure

In the unusual situation in which outside counsel has withdrawn from a representation because of a concern about the company's conduct, counsel should disclose to successor counsel, with the client's consent, the circumstances causing the withdrawal. By the same token, proposed successor counsel, before accepting the engagement, should request that the company disclose such circumstances or authorize withdrawing counsel to do so.

-- reporting out: a serious option

If a company's board of directors declines to consider or take action in response to counsel's report of a threatened or ongoing material violation of law by the company, counsel should strongly consider reporting such material violation to the appropriate regulatory or governmental authorities (as permitted under the SEC's lawyer conduct rules and the ethics rules of most states). This best practice becomes compelling when where there is reason to doubt the independence of the company's directors.

IV. The role of law firms

Background and context

The law firms advising public companies come in as many different sizes as the companies they advise, ranging from mega-firms international in scope to small, local firms. They have in common at least one thing: they are potentially exposed to financial and reputation loss if their partners or associates act wrongfully.

This gives all firms an incentive to promote a culture of compliance with applicable regulations and ethical rules and to establish procedures to monitor and encourage such compliance. The need for larger firms consciously to focus on such matters seems especially critical since their sheer size may make more challenging the development and

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maintenance of a firm-wide standard of professionalism, as distinguished from variable standards applied by individual partners or practice groups.

Recommendations under consideration

-- written "reporting up" procedures

Every firm of 50 lawyers or more should adopt written procedures for implementing the "up-the-ladder" obligations imposed by the New York Code of Professional Responsibility and the SEC's lawyer conduct rules under SOX. The SEC's rules require supervisory attorneys to make reasonable efforts to ensure that subordinate attorneys conform to the rules, which necessarily requires a training program to stress compliance as an obligation of employment.

Firm procedures should include, among other things, mechanisms within the firm to report possible violations, education and training sessions, and the establishment of designated senior lawyers or committees to facilitate compliance. One example of such procedures, drawn from the procedures that several individual firms shared with the Task Force, is set forth in Attachment 1.

-- no retaliation

Among the more important aspects of a reporting up procedure is a clear assurance that lawyers – especially junior attorneys – will be protected against any retaliatory action by reason of reporting up a perceived problem. Absent such assurance, an associate reasonably may view such a report as a career-threatening move, especially when it focuses on some perceived misconduct or failure to act by a more senior lawyer.

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-- a statement of best practices

Law firm culture has a significant impact on how ethics rules are interpreted and enforced within a firm. Law firms also should adopt for the guidance of their attorneys a statement of best practices in advising public companies. One example of such a statement of best practices is set forth in Attachment 2. Adopting and publicizing a statement of best practices establishes a set of shared values and encourages a tone at the top that promotes compliance. The peer pressure that comes from the adoption of best practices by a critical mass of New York firms can have a salutary effect on all firms, and encourage lawyers in them to raise concerns.

-- the need for a clear privilege for internal advice

Law firm lawyers, when confronted with difficult ethical or other issues pertaining to clients, including application of the SOX reporting up rules, need to have access to confidential advice. New York law should be clarified to establish that the attorney-client privilege protects communications between lawyers and their firm's in-house counsel on matters of professional ethics involving clients of the firm. Protecting the attorney-client privilege for such communications will facilitate compliance with the rules, advance the culture of compliance, and enable the firm to enforce its ethical standards internally, thereby improving the role of the lawyer in corporate governance.

V. The attorney-auditor relationship

Background and context

Because so many of the recent financial frauds have concerned manipulations of financial statements, it is important to focus on the role of lawyers in dealing with their clients' financial disclosures and their clients' auditors. Among the issues considered are whether the lawyers and auditors for a common client can work together more effectively to reduce the

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incidence of financial frauds, and whether lawyers should take on greater responsibility for the accuracy of the company's financial disclosures.

Due diligence with respect to public offers is also an important concern, and lawyers play a key role in that process. The SEC has not formally updated its views on appropriate due diligence (Rule 176) for over 20 years. There is great current uncertainty, partly as a result of Judge Cote's decision in the WorldCom case, the SEC's silence and the new SOX environment, about the scope of due diligence (a) required to establish a due diligence defense under Sections 11 and 12A of the Securities Act, (b) appropriate to discharge a lawyer's professional obligation. This is particularly true as to the extent to which due diligence requires independent verification of facts represented by company management.

Subject to numerous exceptions, it appears that: (a) accelerated securities offering procedures (i.e., integrated disclosure and shelf registrations for "well seasoned" issuers) frequently result in perfunctory due diligence, a fact which is known to and accepted by the issuer and the lead underwriter or other placement agent but very likely not understood by investors (especially non-institutional); (b) due diligence tends to be delegated downward to the lowest professional or even quasi-professional rung (e.g., paralegals); (c) unless training, instruction and oversight are rigorous and vigorous, the due diligence effort is at high risk of being inefficient and ineffective; and (d) law firms and legal departments, generally speaking, need to improve their efforts in all these regards. Absent changes, it is unlikely that the limited due diligence possible (both with respect to the breath and depth of the review) will achieve its intended goal of protecting the investing public, except perhaps when "continuous due diligence" has been performed before the take-down of a shelf registration.

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Recommendations under consideration

-- mastery of accounting concepts

Because accounting concepts are so frequently central to issues on which companies require legal advice - - e.g., the adequacy of disclosures, choice of structure for transactions, revenue and expense recognition practices - - mastery of the basic accounting concepts relevant to a client should be viewed as an essential aspect of the professional competence a lawyer owes her public company client. Law firms should provide adequate training programs for their attorneys in this area.

-- lawyer certification of disclosures? (no)

Lawyers should not be required, as has sometimes been suggested, to certify the accuracy of a company's financial or other disclosures to the extent within the lawyer's area of responsibility. The cost of placing lawyers in a position responsibility to so certify would likely far exceed any benefits derived from such a certification process.

-- lawyer consultation on financial disclosure (yes)

However, it is vital that lawyers be actively consulted on matters of financial disclosure, as many accounting issues have taken on legal overtones. Processes and procedures should be set up (for example, the now frequently utilized "disclosure committee" format) to ensure that issues are properly vetted among all who have relevant input, including lawyers. In designing SOX 404 internal controls and procedures, companies should establish that the personnel responsible for preparation of the company's financial statements consult with internal and/or external counsel, with an appropriate level of seniority and responsibility relative to the process being controlled, to ensure that counsel are not aware of information calling into question the accuracy of the financial statements. For example, the finance staff should be

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required to consult with counsel on issues regarding legal or litigation reserves, collectibility of receivables and validity of important assets (such as patents), and whether the requirements have been met for special purpose entities.

The process that a company has developed to support the CEO and CFO certifications of financial statements mandated by SOX §302 should include consultation with the company's internal and external lawyers and, where appropriate given the nature and extent of the lawyer's work, subcertification or other written confirmation by the lawyers as to matters on which they have been engaged that are material to the financial statements.

-- <u>reports on claims directly to Audit Committee</u>

External counsel should report on asserted and unasserted claims (loss contingencies) not only to company management, but also to its Audit Committee, and include in that report a recommendation as to whether each unasserted claim should be disclosed to the company's auditors.

-- <u>revisit the 1975 ABA-AICPA "Treaty"? (comments solicited)</u>

The 1975 ABA-AICPA "Treaty" recommends how lawyers should respond to auditors' inquiries concerning asserted and unasserted claims. The Task Force has considered whether, in light of the evolution in ethical and regulatory standards since 1975, the Treaty's guidelines concerning the appropriate communications between attorney, client and auditor should be revisited. It would especially welcome public comments on this subject.

-- <u>due diligence: in need of rethinking</u>

Due Diligence practices and procedures should be improved. The SEC should address the effectiveness of due diligence under the highly accelerated system available for public offers by "well seasoned" issuers.

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The SEC should define, in terms more helpful and specific than Rule 176, the scope of appropriate due diligence obligations in the public offering context, mindful that one size can never fit all. It should pay particular attention to issues of (a) independent verification, (b) areas of specialized expertise, (c) distinctions between company counsel and underwriters' counsel, (d) what may be sufficient for a legal defense under the Securities Act and what is best practice, and (e) the CEO and CFO certifications and improved internal controls required by SOX as possibly lessening the role for due diligence.

-- negative assurance letters

As a matter of best practice, a lawyer giving a written "negative assurance" statement, whether to an auditor, to an issuer or to an underwriter, should describe succinctly the extent of the due diligence done, although in terms limited enough to preserve applicable privileges.

-- recognize an attorney-auditor privilege? (no)

The Task Force has considered whether to recommend that a privilege be recognized with respect to communications between a company's lawyers and its auditors. Relationships between auditors and companies, and the companies' lawyers, have become more difficult in recent years. Auditors are under pressure to obtain complete information in auditing a company's financials. The lawyers are reluctant to engage in non-privileged communications with auditors or to recommend that their clients waive the privilege with respect to attorney-client communications, given the ever present risk of later third party litigation. Open, less guarded and less adversarial communications would be helpful in ensuring the accuracy and completeness of financial disclosures. A limited privilege covering attorney-auditor

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communications could facilitate such communications and enable better evaluation of issues that might affect a corporation's financial position.

Nonetheless, subject to public comment, the Task Force is inclined not to recommend the recognition of such a privilege. Treating communications with an auditor as privileged seems inconsistent with the nature of the auditor's public certification of a company's financials and the relevance, in the event of later litigation or regulatory scrutiny, of all facts and procedures on which the certification was based. The company itself, such as in the person of the chair of its Audit Committee, can decide whether attorney-auditor communications on a particular subject are in order, recognizing they will not be privileged, and whether to waive the privilege on particular attorney-client communications.

-- working relationships between General Counsel

When feasible, the General Counsel of a company should develop a working relationship with the General Counsel of the auditing firm. The establishment of such a relationship can help facilitate the resolution of sensitive issues.

VI. The role of lawyers in conducting internal investigations

Background and context

The conduct of internal investigations for public companies, either self-initiated or at the request of a regulatory agency or court, has become a significant activity for internal legal staffs and outside law firms. The experience of the bar to date, including some notable failed investigations, highlights some issues that should be addressed at the outset of an investigation, and others that may predictably arise over the course of the investigation.

Recommendations under consideration

-- avoiding conflicts and safeguarding independence

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Before undertaking any investigation, counsel should consider, and discuss with the client, the following:

- Prior or current relationships, if any, counsel or counsel's firm has or has had with the company, or any of its officers, directors, or principal employees, and whether those relationships, including any role of counsel or counsel's firm as the company's regular outside counsel, will undermine the fact or appearance of counsel's independence or otherwise affect the investigation.[7]

- Who counsel should report to in connection with the investigation, and whether the reporting relationship will undermine the fact or appearance of counsel's independence or otherwise affect the investigation.

- The scope of the investigation, including any limitations on the scope.

Counsel should communicate clearly to regulators who counsel is reporting to in the company, the scope of the investigation, and whether any limitations have been placed on the scope.

Counsel should continually reassess whether the company has a reporting obligation to the regulators, or the markets, or others, and discuss with the company the pros and cons of voluntary self-reporting.

Counsel should exercise independent judgment in determining whether improper conduct has occurred and should be cognizant of pressures that might cause counsel to "under charge" (*i.e.*, be too lenient in judging corporate conduct) or "over charge" (*i.e.*, be too quick to find a violation).

In giving its advice, counsel should always consider the fiduciary duties of the company's officers and directors to safeguard the best interests of the company's shareholders

[7] In more than one recent instance, the performance of an investigation by the company's regular outside counsel materially undermined the credibility of the investigation.

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and should offer advice consistent with those interests, as opposed to any differing interests of individuals officers and directors, or counsel's own interest in his or her reputation or career.

-- <u>the role of General Counsel</u>

The extent of General Counsel involvement in internal investigations must depend upon the facts (particularly the existence of conflicts) and the capabilities of the relevant in-house department. The General Counsel and/or internal lawyers can and often should be involved many internal investigations. If appropriately staffed, the General Counsel's office can also handle many investigations.

However, given the position of the General Counsel and its inherent conflicts, certain investigations should be conducted by independent external counsel engaged by the Board. Determinations in this regard are heavily fact specific; one clear example would be where a material allegation is made involving the CEO.

Conflicts (or the appearance of conflicts) also should be taken into account in determining whether an internal lawyer should be in charge of an investigation of a peer or a major direct client or of a matter where the internal lawyer rendered significant legal advice. Where an apparent conflict could compromise an investigation, the investigation should be handled by an outside counsel or another internal lawyer who would not be similarly conflicted (e.g., a more senior in-house attorney or an attorney from an independent group, such as litigation).

In any investigation, General Counsels should take care that neither they nor any internal lawyer engages in any conduct that would appear intended to restrict the scope of the investigation, influence its outcome or otherwise compromise its independence.

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[8] Subcommittee chairs are noted by an asterisk.

[9] Judge Rakoff has recused himself from voting on the report.

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Attachment 1:

Model "Up-The-Ladder" Policy For New York Law Firms

Introduction

This memorandum sets forth the policies and procedures established by the Firm for addressing matters that potentially involve ""up-the-ladder"" reporting pursuant to the New York Lawyers Code of Professional Responsibility (the "Code") or the lawyer conduct rules that were promulgated by the SEC pursuant to the Sarbanes-Oxley Act of 2002 (the "SEC's lawyer conduct rules"). All lawyers in the Firm are expected to be familiar with these rules and to comply with the Firm's policies with regard to them.

Responsibilities Under the Rules of Professional Conduct

New York Disciplinary Rule ("DR") 5-109 sets forth New York's rule on ""up-the-ladder"" reporting. It applies to all lawyers for organizations, whatever their work. Under DR 5-109, when a lawyer knows that an officer or employee of a client is "engaging in action, intends to act, or refuses to act in a matter related to the representation" that violates the law and is "likely to result in substantial injury to the organization" the lawyer must "proceed as is reasonably necessary in the best interest of the organization," which may include referring the matter to the "highest authority that can act on behalf of the organization." [Attach text of DR 5-109].

Special Responsibilities with Respect to Public Companies

The SEC's lawyer conduct rules impose special ""up-the-ladder"" reporting obligations on lawyers for public companies. Under these rules, when an attorney "appearing and practicing" before the SEC becomes aware of "evidence of a material violation" of U.S. federal or state securities law, a material breach of fiduciary duty arising under U.S. federal or state law, or a similar material violation of any U.S. federal or state law by an issuer, or by any officer, director

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employee, or agent of the issuer, the lawyer must report "up-the-ladder". "Evidence" of a material violation is "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's lawyer conduct rules are published at 17 C.F.R. Part 205. [Attach copy].

Reporting Obligations within the Firm

The Firm recognizes that the Code and the SEC imposes duties on individual lawyers. The Code also imposes obligations on law firms, however. It is therefore important to informed and measured application of all of our obligations that the Firm address matters which potentially involve "up-the-ladder" reporting with uniform policies and procedures that draw on the broad experience of the Firm in a variety of areas. Accordingly, the Firm has established a Corporate Governance Compliance Committee (the "Compliance Committee") for the purpose of coordinating and directing the Firm's compliance with the rules governing "up-the-ladder" reporting on a day-to-day basis and in specific situations that may arise in the course of our work. The current members of the Compliance Committee are [______].[10]

Specific Procedures

The following procedures shall apply to Firm attorneys worldwide:

1. An attorney who in the course of his or her representation of an organization becomes aware of facts and circumstances that may trigger an "up-the-ladder" reporting obligation imposed by the Code or the SEC's lawyer conduct rules *is required* to discuss such facts and circumstances with the partner or of counsel in charge of the matter.

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[10] It is recommended that the Compliance Committee include the General Counsel of the Firm, an Ethics Partner or the equivalent, and other senior lawyers with relevant expertise or experience (i.e., corporate & securities, professional responsibility, etc.)

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2. Where in the judgment of the partner or of counsel in charge there is at least possible issue as to whether "up-the-ladder" reporting is required by the Code or the SEC's lawyer conduct rules, the partner or of counsel may consult with his or her practice group leader or another appropriate senior lawyer to discuss the relevant facts and circumstances but *is required* to consult with a member of the Compliance Committee.

3. If after discussion the partner or of counsel in charge believes that an "up-the-ladder" obligation *could potentially* be required, he or she *must* promptly contact a member of the Compliance Committee. If after the partner or of counsel in charge concludes that there is no obligation to report, any other attorney involved in the matter who has a continuing concern as to whether the "up-the-ladder" reporting requirements of the Code or the SEC's lawyer conduct rules are being followed, that lawyer *is required to* discuss these concerns promptly with a member of the Compliance Committee.

4. If at any time any other lawyer, although not working on the particular matter giving rise to the possible obligation within the Firm, has any question as to whether there is a reporting obligation under the Code or the SEC's lawyer conduct rules in a particular case, the lawyer *is required to* consult with a member of the Compliance Committee.

5. While the potential need for "up-the-ladder" reporting is under discussion, no attorney may discard or destroy any documents (including e-mails and drafts) that are pertinent to the matter. The Compliance Committee may direct the attorneys involved in the matter to prepare appropriate internal memoranda for transmission to the Compliance Committee, and will determine what other documentation, if any, is appropriate.

6. If the Compliance Committee determines that any action is necessary, it will promptly (a) inform the Executive Committee of the Firm and (b) prepare the appropriate report,

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which may be written or oral as determined by the Compliance Committee. In connection with this determination, the Compliance Committee will consult with any lawyer in the Firm it deems appropriate, but the partner or of counsel in charge of the matter that gives rise to any reporting obligation shall not participate in the final determination as to whether a report shall be made.

7. Where a report is made, the Compliance Committee will monitor the response by the client as appropriate and determine how the Firm shall proceed, in consultation with senior management of the Firm and others as appropriate.

8. If any lawyer in the Firm believes that it is necessary or appropriate for the lawyer to disclose confidential information outside the client under DR 4-101(c)(3) or (c)(5) or the SEC's permissive disclosure rules, the lawyer *is required to* consult in advance with a member of the Compliance Committee.

Training

The firm will conduct mandatory training sessions for all Firm lawyers on the "up-the-ladder" requirements of the Code and the SEC's lawyer conduct rules. Each new lawyer joining the Firm will be required to attend such a session, or view a videotape of one, within two weeks of starting at the Firm. Thereafter the Firm will conduct periodic sessions to keep you informed of developments in the area. In addition, each practice group in each office shall take appropriate steps to insure that their attorneys are aware of their obligations under this memorandum.

Attorney Certification

To assure that all Firm lawyers are aware of the Firm's policy concerning compliance with the "up-the-ladder" obligations of the Code and the SEC's lawyer conduct rules, each lawyer will be required to sign an annual certification, in the form provided by the Firm from time to time, that

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he or she has read this policy, understands it and intends to abide by it. All lawyers newly joining the Firm will also be asked to sign such a certification promptly after joining the Firm.

Confidentiality

The members of the Compliance Committee will keep confidential all information conveyed to them to the extent consistent with the interests of the Firm, its clients and the legal obligations of each lawyer concerned. Absolute confidentiality may not be possible if action is necessary to protect clients or the Firm, or to comply with the SEC's lawyer conduct rules, the Code, or any other applicable legal requirement. The Firm expects and intends that all inquiries to the co-chairs of the Compliance Committee, who will be designated as co-general counsels of the Firm for matters relating to the firm's "up-the-ladder" reporting obligations, as well as deliberations, legal advice and other responses to inquiring lawyers, will be protected by the attorney-client privilege and other applicable protections. All participants should treat all communications accordingly.

Retaliation Prohibited

It is essential that lawyers raise concerns as directed in this memorandum so that the Firm can assure compliance with all applicable legal, ethical and other requirements. Accordingly, no report made in good faith under this memorandum will result in any adverse employment or other action. Any lawyer who believes that he or she has been subjected to adverse employment or other action because of complying with this policy must report that belief immediately to the Compliance Committee or to the Executive Committee.

Questions about these policies and procedures and their application in particular cases should be referred to the Compliance Committee or the Firm's General Counsel.

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Attachment 2:

Suggested Statement of Best Practices
For the Role of the Lawyer in Corporate Governance

1. **Set the Tone at the Top**. Managing partners, successful senior lawyers and other firm leaders should be prominent in the establishment and promotion of all initiatives concerning ethics and professional responsibility.

2. **Promote a Culture that Encourages Consultation with at Least Two Independent Partners.** Where difficult issues arise concerning the role of the lawyer in a corporate transaction the lawyer should consult with at least one partner who is not involved in the matter.

3. **Emphasize the Lawyer's Duty of Independence**. Lawyers should be encouraged to ask clients about their reasons for entering into corporate transactions that raise concerns with respect to propriety or legality, and offer advice and counsel on the wisdom as well as the technical legality of such transactions.

4. **Establish High Profile and Active Ethics Committees.** The Firm should identify and publicize the availability of a committee, a group, or several identified lawyers who keep current on developments in the field of lawyer regulation and are responsible for keeping lawyers abreast of important developments.

5. **Appoint a General Counsel, Ethics Partner and/or Ombudsperson**

6. **Set up User-Friendly Mechanisms for Associates to Raise Issues.** The law firm should provide several mechanisms for associates and young partners to raise issues. There should be a clear and well-known policy of non-retaliation for raising issues.

7. **Establish Written Policies for Raising Ethics and Professional Responsibility Issues.** At a minimum, every firm should have a written policy for how it is handling compliance

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with the up the ladder reporting obligations of the New York Lawyers Code of Professional Responsibility and the lawyer conduct rules promulgated by the SEC pursuant to the Sarbanes-Oxley Act.

8. **Conduct In-House CLEs.** In-house CLE's on professional responsibility issues should be held often. Department heads and other senior active, successful partners must take an visible role in these presentations.

9. **Distribute Firm-Wide Memos on Important Developments in the Law of Professional Responsibility**.

10. **Adopt a Compensation Structure that Encourages Active Participation in the Firm's Ethics and Professional Responsibility Initiatives**

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