808:Challenges of the New Attorney Professional Conduct Standards

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Faculty Biographies

Michael D. Cahn

Michael D. Cahn is senior associate general counsel—securities at Textron Inc. in Providence, Rhode Island. He is Textron's principal securities lawyer, advising Textron on issuances of securities, disclosure issues, SEC reporting, and corporate governance issues. He also advises Textron on acquisitions and dispositions, antitrust law, and other legal matters.

Prior to joining Textron, Mr. Cahn was an associate at Cahill Gordon & Reindel in New York City.

Mr. Cahn is secretary of ACCA's Council of Committees and has served on the Advisory Board for numerous issues of the *ACCA Docket.* He was also chair of ACCA's Corporate and Securities Law Committee. He previously served on the board of directors of the Rhode Island Legal/Educational Partnership, a non-profit organization that conducts Rhode Island's mock trial competition for high school students and legal courses for high school teachers, and continues to serve as a performance judge for the mock trial competition.

Mr. Cahn received a BA from Michigan State University and his JD from Harvard Law School.

Susan Hackett

Susan Hackett is senior vice president and general counsel of the Association of Corporate Counsel, formerly ACCA. Her responsibilities focus on ACC's advocacy efforts, including the amicus program, the development of in-house legal ethics and professionalism resources, testimony and representation before decision-making authorities, in-house corporate responsibility initiatives, multijurisdictional practice reform, multidisciplinary practice issues, attorney-client privilege protection, and civil justice reform, corporate pro bono and diversity initiatives, including diversity pipeline projects, liaisons with the bars of color, and CorporateProBono.Org, the provision of legal services and counseling to ACC and its board, and the development of new strategic resources benefiting general counsel and ACC's increasingly global membership and chapter network.

Before joining ACC, she was a transactional attorney at Patton Boggs, a large DC law firm, and clerked for several DC employers while in law school and sitting for the bar.

Ms. Hackett lectures regularly before a wide variety of legal audiences, and has authored articles on a number of professional and managerial topics for such publications as the *ACCA Docket, Legal Times,* The *Washington Post's* Online "Corporate Law Center," *National Law Journal, Litigation, Business Law Today,* and various law reviews and state bar publications. She is a member of the boards of directors of Equal Justice Works and Street Law, Inc., and a former member of the board of the Minority Corporate Counsel Association. She is an appointed liaison to several ABA Presidential Commissions and Task Forces, including the Commission on the Multijurisdictional Practice of Law, The Commission on Alternatives to the Billable Hour, the Joint Committee on Lawyer Regulation, the Task Force On Sarbanes-Oxley Section 307, and the Commission on Loan Repayment Assistance Programs (LRAPs).

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Ms. Hackett is a Honors College graduate of James Madison College at Michigan State University, and a graduate of the University of Michigan Law School, where she served as president of *Phi Delta Phi,* the international honorary legal fraternity.

Richard M. Humes

Richard M. Humes is associate general counsel at the U.S. Securities and Exchange Commission. He represents the commission in district court, appellate and administrative litigation in which the commission and/or its members or employees are defendants.

Prior positions include assistant general counsel, special trial counsel, and staff attorney in the Office of the General Counsel at the SEC. He was also special assistant to United States Attorney in the Office of the United States Attorney for the District of Columbia.
Mr. Humes received the SEC Distinguished Service Award in 1991 and the Presidential Meritorious Executive Award in 1996.

Mr. Humes received his BA from Brown University and his JD, *cum laude,* from Howard University School of Law.

Barry Nagler

Barry Nagler is the senior vice president, general counsel, and secretary of Hasbro, Inc., one of the world's leading makers of games, toys, and family entertainment products.
Prior to joining Hasbro, Mr. Nagler was with Reebok International Ltd., most recently as senior vice president and general counsel, and prior to that was with the Boston law firm of Foley, Hoag & Eliot.

Mr. Nagler is a member of ACCA's board of directors, as well as a member of ACCA's executive committee and the incoming ACCA advocacy chair. In addition, he is a member of the board of ACCA's Northeast Chapter.

Mr. Nagler received a BS from Franklin & Marshall College and is a graduate of Harvard Law School.

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Russell B. Stevenson, Jr. is senior vice president, secretary, and general counsel of CIENA Corporation, a leading provider of networking solutions for the communications industry. He has been engaged in business law as a teacher, regulator, private practitioner, and in-house counsel.

Before joining CIENA, Mr. Stevenson served as general counsel of ARBROS Communications, Inc. and CyberCash, Inc. Prior to that, he practiced law in Washington, DC. He was a member of the full-time law faculty at George Washington University where he taught corporations, securities regulation, international business transactions, and international economic development. During that time he was also a visiting professor at Cornell Law School and a Fulbright professor at the University of Paris II (Sorbonne). Mr. Stevenson later joined the staff of the Securities and Exchange

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Commission, where he served as deputy general counsel and later returned to the private practice of law. He is the author of two books on corporate law and has published numerous articles on securities regulation, corporate law, and the law of electronic commerce.

Mr. Stevenson has been active in the business law section of the ABA, the District of Columbia Bar, the International Law Association, and various community organizations.

Mr. Stevenson holds a degree from Cornell University and received his JD from Harvard Law School, *cum laude.* He is a member of the bar of the U.S. Supreme Court.

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Final Rule:
Implementation of Standards of Professional Conduct for Attorneys

Securities and Exchange Commission

17 CFR Part 205

[Release Nos. 33-8185; 34-47276; IC-25919; File No. S7-45-02]

RIN 3235-AI72

Implementation of Standards of Professional Conduct for Attorneys

Agency: Securities and Exchange Commission

Action: Final rule

Summary: The Securities and Exchange Commission ("Commission") is adopting a final rule establishing standards of professional conduct for attorneys who appear and practice before the Commission on behalf of issuers. Section 307 of the Sarbanes-Oxley Act of 2002 requires the Commission to prescribe minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers. The standards must include a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer up-the-ladder within the company to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and, if they do not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors. Proposed Part 205 responds to this directive and is intended to protect investors and increase their confidence in public companies by ensuring that attorneys who work for those companies respond appropriately to evidence of material misconduct. We are still considering the "noisy withdrawal" provisions of our original proposal under section 307; in a related proposing release we discuss this part of the original proposal and seek comment on additional alternatives.

Effective Date: 180 days after the date of publication in the *Federal Register*.

For Further Information Contact: Timothy N. McGarey or Edward C. Schweitzer at 202-942-0835.

I. Executive Summary

Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act") (15 U.S.C. 7245)[1] mandates that the Commission issue rules prescribing minimum standards of professional conduct for attorneys appearing and practicing before it in any way in the representation of issuers, including at a minimum a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer or any agent thereof to appropriate officers within the issuer and, thereafter, to the highest authority within the issuer, if the initial report does not result in an appropriate response. The Act directs the Commission to issue these rules within 180 days.[2]

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On November 21, 2002, in response to this directive, we published for comment proposed Part 205, entitled "Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission in the Representation of an Issuer." The proposed rule prescribed minimum standards of professional conduct for attorneys appearing and practicing before us in any way in the representation of an issuer. The proposed rule took a broad view of who could be found to be appearing and practicing before us. It covered lawyers licensed in foreign jurisdictions, whether or not they were also admitted in the United States. In addition to a rigorous up-the-ladder reporting requirement, the proposed rule incorporated several corollary provisions. Under certain circumstances, these provisions permitted or required attorneys to effect a so-called "noisy withdrawal" by notifying the Commission that they have withdrawn from the representation of the issuer, and permitted attorneys to report evidence of material violations to the Commission.

Our proposing release3 generated significant comment and extensive debate. We received a total of 167 timely comment letters: 123 from domestic parties and 44 from foreign parties. In addition to soliciting comments, on December 17, 2002 the Commission hosted a Roundtable discussion concerning the impact of the rules upon foreign attorneys. Many of these comments focused on the following issues: the scope of the proposed rule (including, particularly, its application to attorneys who either are not admitted to practice in the United States, or are admitted in the United States but who do not practice in the field of securities law); the proposed rule's "noisy withdrawal" provision (including the Commission's authority to promulgate this portion of the rule and the provision's impact upon the attorney-client relationship); and the triggering standard for an attorney's duty to report evidence of wrongdoing. In light of the compressed time period resulting from the 180-day implementation deadline prescribed in the Act, a number of commenters requested that the Commission allow additional time for consideration of several aspects of the proposed rule, including the application of the rule to non-United States lawyers and the impact of the "noisy withdrawal" and related provisions.

The thoughtful and constructive suggestions we have received from a broad spectrum of commenters have enabled us better to understand interested parties' views concerning the operation and impact of the proposed rule. As more specifically discussed below, the final rule we adopt today has been significantly modified in light of these comments and suggestions. Thus, the triggering standard for reporting evidence of a material violation has been modified to clarify and confirm that an attorney's actions will be evaluated against an objective standard. The documentation requirements imposed upon attorneys and issuers under the proposed rule have been eliminated, and a "safe harbor" provision has been added to protect attorneys, law firms, issuers and officers and directors of issuers. In response to the large number of comments requesting that we defer the immediate implementation of a final rule to accord affected persons adequate time to assess the duties imposed thereunder, we have deferred the effective date of the rule until 180 days after publication in the Federal Register.

We believe that the final rule responds fully to the mandate of Section 307 to require reporting of evidence of material violations up-the-ladder within an issuer, thereby allowing issuers to take necessary remedial action expeditiously and reduce any adverse impact upon investors. The final rule strikes an appropriate balance between our initial rule proposal on up-the-ladder reporting and the various views expressed by commenters while still achieving this important goal.

At the same time, the Commission considers it important to move forward in its assessment of rules under Section 307 requiring attorney withdrawal and notice to the Commission in cases where an issuer's officers and directors fail to respond appropriately to violations that threaten substantial

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injury to the issuer or investors. Accordingly, we are extending the comment period on the "noisy withdrawal" and related provisions of the proposed rule and are issuing a separate release soliciting comment on this issue. In that release, we are also proposing and soliciting comment on an alternative procedure to the "noisy withdrawal" provisions. Under this proposed alternative, in the event that an attorney withdraws from representation of an issuer after failing to receive an appropriate response to reported evidence of a material violation, the issuer would be required to disclose its counsel's withdrawal to the Commission as a material event. In the same release, we are soliciting additional comment on the final rules we are adopting, particularly insofar as adoption of the "noisy withdrawal" provisions of the proposed alternative might require conforming changes to the final rule.

Interested parties should submit comments within 60 days of the date of publication of the proposing release in the Federal Register. This will provide additional time for interested parties to comment on the impact of these provisions while still allowing for their implementation as of the effective date of the final rule.

II. Section-by-Section Discussion of the Final Rule

Section 205.1 Purpose and Scope

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

Proposed Section 205.1 stated that this part will govern "[w]here the standards of a state where an attorney is admitted or practices conflict with this part." In the proposing release, we specifically raised the question whether this part should "preempt conflicting state ethical rules which impose a lower obligation" upon attorneys.[4]

A number of commenters questioned the Commission's authority to preempt state ethics rules, at least without being explicitly authorized and directed to do so by Congress.[5] Another comment letter noted that the Constitution's Commerce Clause grants the federal government the power to regulate the securities industry, that the Sarbanes-Oxley Act requires the Commission to establish rules setting forth minimum standards of conduct for attorneys appearing and practicing before it, and that, under the Supremacy Clause, duly adopted Commission rules will preempt conflicting state rules.[6] Finally, several commenters questioned why the Commission would seek to supplant state ethical rules which impose a higher obligation upon attorneys.[7]

The language which we adopt today clarifies that this part does not preempt ethical rules in United States jurisdictions that establish more rigorous obligations than imposed by this part. At the same time, the Commission reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdiction in which an attorney is admitted or practices.

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Section 205.2 Definitions

For purposes of this part, the following definitions apply:

(a) *Appearing and practicing* before the Commission:

(1) Means:

(i) Transacting any business with the Commission, including communications in any form;

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2) Does not include an attorney who:

(i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii) Is a non-appearing foreign attorney.

The definition of the term "appearing and practicing" included in the proposed rule was based upon Rule 102(f) of our Rules of Practice, and covered, *inter alia*, an attorney's advising a client (1) that a statement, opinion, or other writing does not need to be filed with or incorporated into any type of submission to the Commission or its staff, or (2) that the issuer is not required to submit or file any registration statement, notification, application, report, communication or other document with the Commission or its staff. This broad definition was intended to reflect the reality that materials filed with the Commission frequently contain information contributed, edited or prepared by individuals who are not necessarily responsible for the actual filing of the materials, and was consistent with the position the Commission has taken as *amicus curiae* in cases involving liability under Section 10(b) of the Exchange Act (15 U.S.C. 78j(b)).

A number of commenters argued that the proposed definition of "appearing and practicing" was overly broad. The American Bar Association ("ABA") stated that the definition in the proposed rule would unfairly:

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subject to the rules attorneys who do not practice securities law and may have only limited or tangential involvement with particular SEC filings and documents. For example, it could inappropriately encompass non-securities specialists who do no more than prepare or review limited portions of a filing, lawyers who respond to auditors' letters or prepare work product in the ordinary course unrelated to securities matters that may be used for that purpose, and lawyers preparing documents that eventually may be filed as exhibits. . . . We also believe it is inappropriate for the Commission to include lawyers who simply advise on the availability of exemptions from registration.8

The ABA recommended that the definition be modified to apply "only to those lawyers with significant responsibility for the company's compliance with United States securities law, including satisfaction of registration, filing and disclosure obligations, or with overall responsibility for advising on legal compliance and corporate governance matters under United States law."9

On the other hand, several commenters supported the more expansive definition set forth in the proposed rule. A comment letter submitted by a group of 50 academics specifically affirmed their:

support [for] the Commission's inclusion of lawyers who advise and/or draft, but do not sign, documents filed with the Commission, as well as lawyers who advise that documents need not be filed with the Commission. Any other rule would facilitate circumvention of these rules by encouraging corporate managers and corporate counsel to confine lawyer signatures on Commission documents or filings to a bare minimum to ensure no up-the-ladder reporting of wrongdoing. That would risk gutting these rules and §307.10

The definition contained in the final rule addresses several of the concerns raised by commenters. Attorneys who advise that, under the federal securities laws, a particular document need not be incorporated into a filing, registration statement or other submission to the Commission will be covered by the revised definition. In addition, an attorney must have notice that a document he or she is preparing or assisting in preparing will be submitted to the Commission to be deemed to be "appearing and practicing" under the revised definition. The definition in the final rule thereby also clarifies that an attorney's preparation of a document (such as a contract) which he or she never intended or had notice would be submitted to the Commission, or incorporated into a document submitted to the Commission, but which subsequently is submitted to the Commission as an exhibit to or in connection with a filing, does not constitute "appearing and practicing" before the Commission.

As discussed below, commenters also raised concerns regarding the potential application of the rule to attorneys who, while admitted to practice in a state or other United States jurisdiction, were not providing legal services to an issuer. Under the final rule, attorneys need not serve in the legal department of an issuer to be covered by the final rule, but they must be providing legal services to an issuer within the context of an attorney-client relationship. An attorney-client relationship may exist even in the absence of a formal retainer or other agreement. Moreover, in some cases, an attorney and an issuer may have an attorney-client relationship within the meaning of the rule even though the attorney-client privilege would not be available with respect to communications between the attorney and the issuer.

The Commission intends that the issue whether an attorney-client relationship exists for purposes of this part will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer. Thus, whether the provision of legal services under particular

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circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under this part. This portion of the definition will also have the effect of excluding from coverage attorneys at public broker-dealers and other issuers who are licensed to practice law and who may transact business with the Commission, but who are not in the legal department and do not provide legal services within the context of an attorney-client relationship. Non-appearing foreign attorneys, as defined below, also are not covered by this definition.

205.2(b) provides:

(b) *Appropriate response* means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to §205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

The definition of "appropriate response" emphasizes that an attorney's evaluation of, and the appropriateness of an issuer's response to, evidence of material violations will be measured against a reasonableness standard. The Commission's intent is to permit attorneys to exercise their judgment as to whether a response to a report is appropriate, so long as their determination of what is an "appropriate response" is reasonable.

Many of the comments on this paragraph focused on the proposal's standard that an attorney has received an appropriate response when the attorney "reasonably believes," based on the issuer's response, that there either is or was no material violation, or that the issuer has adopted appropriate remedial measures. They suggested, among other things, that the paragraph be amended to state that the attorney could rely upon the factual representations and legal determinations that a reasonable attorney would rely upon,11 or that the Commission adopt the ABA's Model Rules' definition of "reasonably believes."12 Others opined that the "reasonably believes" standard was inappropriate because it would impose on lawyers who are not expert in the securities laws a standard based on the "reasonable" securities law expert.13 Others opined that the standard should be modified to require

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the lawyer's "actual understanding," rather than reasonable belief, regarding a "clear" material violation,14 while others urged that the standard must be objective.15

Other commenters felt that the paragraph did not properly address situations, which the commenters felt would be frequent, where an issuer's inquiry into the report of a possible material violation would be "inconclusive."16 Others expressed the belief that the rule did not give a reporting lawyer sufficient guidance "such that a reporting attorney can with confidence, and without speculation, determine whether he or she has received an appropriate response."17 Some comments questioned whether reporting attorneys would be able to judge whether discipline or corrective measures were sufficient to constitute an appropriate response.18 One suggested that the paragraph be modified to provide that an attorney has received an appropriate response when the chief legal officer ("CLO") states that he or she has fulfilled the obligations set forth in Section 205.3(b)(3), unless the attorney is reasonably certain that the representations are untrue.19 Some commenters found the term "and/or" in subparagraph (b)(2) of the proposed paragraph confusing.20 Others questioned whether the provision that the issuer "rectify" the material violation should be read to contemplate restitution to injured parties, with one stating that it did not believe Congress intended to impose upon attorneys an obligation to require issuers to make restitution,21 while others read the proposed rule as "impl[ying] that the appropriateness of a response need not include compensation of injured parties," and accordingly supported this standard.22 A few commenters noted that under subparagraph (b)(2) a response is appropriate only if the issuer has already "adopted remedial measures," and thus apparently does not apply if the issuer is in the process of adopting them. They urged that the Commission provide that an appropriate response includes ongoing remedial measures.23

A few comments were directed at the discussion accompanying the proposed rule. One suggestion was that the Commission make clear that the factors it will consider in determining whether an outside law firm's response that no violation has occurred constitutes an appropriate response include a description of the scope of the investigation undertaken by the law firm and the relationship between the issuer and the firm. They also urged the Commission to expressly state that the greater or more credible the evidence that triggered the report, the more detailed an investigation into the matter must be.24 One commenter also suggested that the Commission withdraw the statement in the release of the proposed rule that Section 205.2(b) "permits" attorneys "to exercise their judgment," finding that language both superfluous and conveying a signal that the Commission will be loathe to second-guess a lawyer's judgment that a response is "appropriate." 25

Several commenters suggested that the proposed rule should exempt internal investigations of reported evidence of a material violation.26 Commenters were concerned that the reporting and disclosure requirements in the proposed rules might discourage issuers from obtaining legal advice and undertaking internal investigations and that, as a result, some violations might not be discovered or resolved.27 Thus, some commenters urged that an issuer must be permitted "to retain counsel to investigate the claim and respond to it, including defense in litigation, without being at risk of violating the rule."28 Some commenters stated that "counsel conducting an internal investigation" should not be subject to the rule's reporting and disclosure requirements.29

The proposing release stated that "[i]t would not be an inappropriate response to reported evidence of a material violation for an issuer's CLO to direct defense counsel to assert either a colorable defense or a colorable basis for contending that the staff should not prevail. Such directions from the CLO, therefore, would not require defense counsel to report any evidence of a material violation to the issuer's directors."30 Several commenters were concerned over a possible chilling effect on an

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attorney's representation of an issuer in a Commission investigation or administrative proceeding if the attorney were subject to reporting and disclosure requirements.31 Some noted that an issuer's disagreement in good faith with the Commission over a matter in litigation should not raise a reporting obligation under the rules.32 Others suggested that the definition of "appropriate response" include the assertion of "a colorable defense or the obligation of the Commission staff to bear the burden of proving its case." 33 Some commenters stressed that an attorney representing an issuer should be able to take any position for which there is an evidentiary foundation and a nonfrivolous legal basis.34 The commenters did not want the final rules to impair an advocate's ability to present non-frivolous arguments. Some commenters noted that an issuer has no right to use an attorney to conceal ongoing violations or plan further violations of the law.35

The standard set forth in the final version of Section 205.2(b) requires the attorney to "reasonably believe" either that there is no material violation or that the issuer has taken proper remedial steps. The term "reasonably believes" is defined in Section 205.2(m). In providing that the attorney's belief that a response was appropriate be reasonable, the Commission is allowing the attorney to take into account, and the Commission to weigh, all attendant circumstances. The circumstances a reporting attorney might weigh in assessing whether he or she could reasonably believe that an issuer's response was appropriate would include the amount and weight of the evidence of a material violation, the severity of the apparent material violation and the scope of the investigation into the report. While some commenters suggested that a reporting attorney should be able to rely completely on the assurance of an issuer's CLO that there was no material violation or that the issuer was undertaking an appropriate response, the Commission believes that this information, while certainly relevant to the determination whether an attorney could reasonably believe that a response was appropriate, cannot be dispositive of the issue. Otherwise, an issuer could simply have its CLO reply to the reporting attorney that "there is no material violation," without taking any steps to investigate and/or remedy material violations. Such a result would clearly be contrary to Congress' intent in enacting Section 307. On the other hand, it is anticipated that an attorney, in determining whether a response is appropriate, may rely on reasonable and appropriate factual representations and legal determinations of persons on whom a reasonable attorney would rely.

Some commenters expressed confusion over the "and/or" connectors in the proposed subparagraph (b)(2), and they have been eliminated in the final rule. The Commission believes that the revisions to this subparagraph make clear that the issuer must adopt appropriate remedial measures or sanctions to prevent future violations, redress past violations, and stop ongoing violations and consider the feasibility of restitution. The concern that under subparagraph (b)(2) any issuer's response to a reporting attorney that remedial measures are ongoing but not completed must be deemed to be inappropriate, thereby requiring reporting up-the-ladder, appears to be overstated. Many remedial measures, such as disclosures and the cessation of ongoing material violations, will occur in short order once the decision has been made to pursue them. Beyond this, the reasonable time period after which a reporting attorney is obligated to report further up-the-ladder would include a reasonable period of time for the issuer to complete its ongoing remediation.

By broadening the definition of "appropriate response," subparagraph (b)(3) responds to a variety of concerns raised by commenters. Subparagraph (b)(3) permits an issuer to assert as an appropriate response that it has directed its attorney, whether employed or retained by it, to undertake an internal review of reported evidence of a material violation and has substantially implemented the recommendations made by an attorney after reasonable investigation and evaluation of the reported evidence. However, the attorney retained or directed to conduct the evaluation must have been

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retained or directed with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to 205.3(b)(3), or a qualified legal compliance committee.

Subparagraph (b)(3) also explicitly incorporates into the final rule our view, expressed in the proposing release, that "[i]t would not be an inappropriate response to reported evidence of a material violation for an issuer's CLO to direct defense counsel to assert either a colorable defense or a colorable basis for contending that the staff should not prevail."36 Subparagraph (b)(3) incorporates this standard into the definition of "appropriate response" by permitting an issuer to respond to a report that it has been advised by its attorney that he or she may assert a colorable defense on behalf of the issuer in response to the reported evidence "in any investigation or judicial or administrative proceeding," including by asserting a colorable basis that the Commission or other charging party should not prevail.37 The provision would apply only where the defense could be asserted consistent with an attorney's professional obligation. Once again, the attorney opining that he or she may assert a colorable defense must have been retained or directed to evaluate the matter with the consent of the issuer's board of directors, a committee thereunder to whom a report could be made pursuant to Section 205(b)(3), or a qualified legal compliance committee.

We noted in our proposing release our intention that the rule not "impair zealous advocacy, which is essential to the Commission's processes."38 The attorney conducting an internal investigation that is contemplated under subparagraph (b)(3) may engage in full and frank exchanges of information with the issuer he or she represents. Moreover, as noted above, subparagraph (b)(3) expressly provides that the assertion of colorable defenses in an investigation or judicial or administrative proceeding is an appropriate response to reported evidence of a material violation. Concerns over a chilling effect on advocacy should thus be allayed. At the same time, by including a requirement that this response be undertaken with the consent of the issuer's board of directors, or an appropriate committee thereof, the revised definition is intended to protect against the possibility that a chief legal officer would avoid further reporting "up-the-ladder" by merely retaining a new attorney to investigate so as to assert a colorable, but perhaps weak, defense.

The term "colorable defense" does not encompass all defenses, but rather is intended to incorporate standards governing the positions that an attorney appropriately may take before the tribunal before whom he or she is practicing. For example, in Commission administrative proceedings, existing Rule of Practice 153(b)(1)(ii), 17 CFR 201.153(b)(1)(ii), provides that by signing a filing with the Commission, the attorney certifies that "to the best of his or her knowledge, information, and belief, formed after reasonable inquiry, the filing is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law." An issuer's right to counsel is thus not impaired where the attorney is restricted to presenting colorable defenses, including by requiring the Commission staff to bear the burden of proving its case. Of course, as some commenters noted, an issuer has no right to use an attorney to conceal ongoing violations or plan further violations of the law.

205.2(c) provides:

(c) *Attorney* means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.

Commenters suggested that the proposed rule's definition of the term "attorney" was unnecessarily broad. A number of commenters suggested that it was inappropriate to apply the rule to foreign

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attorneys, arguing that foreign attorneys, and attorneys representing or employed by multijurisdictional firms, are subject to statutes, rules, and ethical standards in those foreign jurisdictions that are different from, and potentially incompatible with, the requirements of this rule.39 These points were amplified by foreign attorneys who attended a December 17, 2002 Roundtable discussion hosted by the Commission to address the issues raised by the application of the rule to foreign attorneys.

As noted above, and as set forth more fully below, the rule we adopt today adds a new defined term, "non-appearing foreign attorney," which addresses many of the concerns expressed regarding the application of the rule to foreign attorneys. In addition, other commenters argued that the proposed rule's definition of "attorney" applied to a large number of individuals employed by issuers who are admitted to practice, but who do not serve in a legal capacity. By significantly narrowing the definition of the term "appearing and practicing" as set forth above, we have addressed many of the concerns expressed by commenters concerning the application of the rule to individuals admitted to practice who are employed in non-legal positions and do not provide legal services.

205.2(d) provides:

(d) *Breach of fiduciary duty* refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

The definition we adopt today has been slightly modified from the definition included in the proposing release. Several commenters suggested that the definition in the proposing release should be amended to include breaches of fiduciary duty arising under federal or state statutes.40 The phrase "under an applicable federal or state statute" has been added to clarify that breaches of fiduciary duties imposed by federal and state statutes are covered by the rule.

205.2(e) provides:

(e) *Evidence of a material violation* means 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.

This revised definition of "evidence of a material violation" clarifies aspects of the objective standard that the Commission sought to achieve in the definition originally proposed.41 The definition of "evidence of a material violation" originally proposed prompted extensive comment because (read together with the rule's other definitions) it defines the trigger for an attorney's obligation under the rule to report up-the-ladder to an issuer's CLO or qualified legal compliance committee ("QLCC") (in section 205.3(b)). Some commenters, including some practicing attorneys, found the proposed reporting trigger too high.42 Many legal scholars endorsed the framework of increasingly higher triggers for reporting proposed by the Commission at successive stages in the reporting process but considered the Commission's attempt at articulating an objective standard unworkable and suggested changes to the language in the proposed rule.43 Nearly all practicing lawyers who commented found the reporting trigger in the rule too low and called instead for a subjective standard, requiring "actual belief" that a material violation has occurred, is ongoing, or is about to occur before the attorney would be obligated to make an initial report within the client issuer.44 The revised definition incorporates suggested changes into an objective standard that is designed to

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facilitate the effective operation of the rule and to encourage the reporting of evidence of material violations.

Evidence of a material violation must first be credible evidence.45 An attorney is obligated to report when, based upon that credible evidence, "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." This formulation, while intended to adopt an objective standard, also recognizes that there is a range of conduct in which an attorney may engage without being unreasonable.46 The "circumstances" are the circumstances at the time the attorney decides whether he or she is obligated to report the information. These circumstances may include, among others, the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult. Under the revised definition, an attorney is not required (or expected) to report "gossip, hearsay, [or] innuendo." 47 Nor is the rule's reporting obligation triggered by "a combination of circumstances from which the attorney, in retrospect, should have drawn an inference," as one commenter feared.

On the other hand, the rule's definition of "evidence of a material violation" makes clear that the initial duty to report up-the-ladder is not triggered only when the attorney "knows" that a material violation has occurred48 or when the attorney "conclude[s] there has been a violation, and no reasonable fact finder could conclude otherwise."49 That threshold for initial reporting within the issuer is too high. Under the Commission's rule, evidence of a material violation must be reported in all circumstances in which it would be unreasonable for a prudent and competent attorney not to conclude that it is "reasonably likely" that a material violation has occurred, is ongoing, or is about to occur. To be "reasonably likely" a material violation must be more than a mere possibility, but it need not be "more likely than not."50 If a material violation is reasonably likely, an attorney must report evidence of this violation. The term "reasonably likely" qualifies each of the three instances when a report must be made. Thus, a report is required when it is reasonably likely a violation has occurred, when it is reasonably likely a violation is ongoing or when reasonably likely a violation is about to occur.

205.2(f) provides:

(f) *Foreign government issuer* means a foreign issuer as defined in 17 CFR 230.405 eligible to register securities on Schedule B of the Securities Act of 1933 (15 U.S.C. 77a *et seq.*, Schedule B).

We adopt the definition for this new term prescribed under Rule 405.

205.2(g) provides:

(g) *In the representation of an issuer* means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

The definition we adopt today has been modified from the definition included in the proposing release. The phrase "providing legal services" has been substituted for the term "acting." Some commenters objected that the term "acting" was both imprecise and overly broad, and that the concept of "representation of an issuer" should "apply only to attorneys who are rendering legal advice to the organizational client . . . . and therefore have the professional obligations of an attorney."51 The substitution of the term "providing legal services" responds to these concerns. We

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believe that this change, combined with the narrowing of the definition of the term "appearing and practicing" as set forth above, addresses the concerns expressed by the ABA and others.52

For the reasons explained in the proposing release,53 an attorney employed by an investment adviser who prepares, or assists in preparing, materials for a registered investment company that the attorney has reason to believe will be submitted to or filed with the Commission by or on behalf of a registered investment company is appearing and practicing before the Commission under this definition.

Although some commenters objected to this construction of the definition of "in the representation of an issuer,"54 those commenters did not contest either the fact that such an attorney, though employed by the investment adviser rather than the investment company, is providing legal services for the investment company or the logical implication of that fact: that the attorney employed by the investment adviser is accordingly representing the investment company before the Commission.55 Indeed, the Investment Company Institute ("ICI") opposes the Commission's construction of its rule because, the ICI asserts, the Commission's construction might make investment advisers limit the participation of attorneys employed or retained by the investment adviser in preparing filings for investment companies, thereby forcing the investment companies "to retain their own counsel" to do exactly the same work now performed by attorneys for the investment adviser.56

205.2(h) provides:

(h) *Issuer* means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78*l*), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term "issuer" includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

The definition for the term "issuer" we adopt today incorporates the definition set forth in Section 2(a)(7) of the Act, which in turn incorporates the definition contained in the Exchange Act. The definition has been modified to specifically exclude foreign government issuers, defined above.57

The definition also has been modified to make clear that, for purposes of the terms "appearing and practicing" before the Commission and "in the representation of an issuer," the term "issuer" includes any person controlled by an issuer (*e.g.*, a wholly-owned subsidiary), where the attorney provides legal services to that person for the benefit of or on behalf of an issuer. We consider the change important to achieving the objectives of Section 307 in light of the statutory reference to appearing and practicing "in any way" in the representation of an issuer. Under the revised definition, an attorney employed or retained by a non-public subsidiary of a public parent issuer will be viewed as "appearing and practicing" before the Commission "in the representation of an issuer" whenever acting "on behalf of, or at the behest, or for the benefit of" the parent. This language, consistent with the Commission's comment in the proposing release (although now limited to persons controlled by an issuer) would encompass any subsidiary covered by an umbrella representation agreement or understanding, whether explicit or implicit, under which the attorney represents the parent company and its subsidiaries, and can invoke privilege claims with respect to all communications involving the parent and its subsidiaries. Similarly, an attorney at a non-public

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subsidiary appears and practices before the Commission in the representation of an issuer when he or she is assigned work by the parent (*e.g.*, preparation of a portion of a disclosure document) which will be consolidated into material submitted to the Commission by the parent, or if he or she is performing work at the direction of the parent and discovers evidence of misconduct which is material to the parent. The definition of the term is also intended to reflect the duty of an attorney retained by an issuer to report to the issuer evidence of misconduct by an agent of the issuer (*e.g.*, an underwriter) if the misconduct would have a material impact upon the issuer. 58

205.2(i) provides:

(i) *Material violation* means 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.

The definition we adopt today modifies the definition set forth in the proposed rule by adding the phrases "United States federal or state" and "arising under United States federal or state law." This modification clarifies that material violations must arise under United States law (federal or state), and do not include violations of foreign laws. The final rule does not define the word "material," because that term has a well-established meaning under the federal securities laws59 and the Commission intends for that same meaning to apply here.

205.2(j) provides:

(j) *Non-appearing foreign attorney* means an attorney:

(1) Who is admitted to practice law in a jurisdiction outside the United States;

(2) Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and

(3) Who:

(i) Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or

(ii) Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

The final rule provides that a "non-appearing foreign attorney" does not "appear and practice before the Commission" for purposes of the rule. In brief, the definition excludes from the rule those attorneys who: (1) are admitted to practice law in a jurisdiction outside the United States; (2) do not hold themselves out as practicing, or giving legal advice regarding, United States law; and (3) conduct activities that would constitute appearing and practicing before the Commission only (i) incidentally to a foreign law practice, or (ii) in consultation with United States counsel. A non-United States attorney must satisfy all three criteria of the definition to be excluded from the rule.

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The effect of this definition will be to exclude many, but not all, foreign attorneys from the rule's coverage. Foreign attorneys who provide legal advice regarding United States securities law, other than in consultation with United States counsel, are subject to the rule if they conduct activities that constitute appearing and practicing before the Commission. For example, an attorney licensed in Canada who independently advises an issuer regarding the application of Commission regulations to a periodic filing with the Commission is subject to the rule. Non-United States attorneys who do not hold themselves out as practicing United States law, but who engage in activities that constitute appearing and practicing before the Commission, are subject to the rule unless they appear and practice before the Commission only incidentally to a foreign law practice or in consultation with United States counsel.

Proposed Part 205 drew no distinction between the obligations of United States and foreign attorneys. The proposing release requested comment on the effects of the proposed rule on attorneys who are licensed in foreign jurisdictions or otherwise subject to foreign statutes, rules and ethical standards. The Commission recognized that the proposed rule could raise difficult issues for foreign lawyers and international law firms because applicable foreign standards might be incompatible with the proposed rule. The Commission also recognized that non-United States lawyers play significant roles in connection with Commission filings by both foreign and United States issuers.

On December 17, 2002, the Commission hosted a Roundtable on the International Impact of the Proposed Rules Regarding Attorney Conduct. The Roundtable offered foreign participants the opportunity to share their views on the application of the proposed rule outside of the United States. The participants consisted of international regulators, professional associations, and law firms, among others. Participants at the Roundtable expressed concern about many aspects of the proposed rule. Some objected to the scope of the proposed definition of "appearing and practicing before the Commission," noting that a foreign attorney who prepares a contract or other document that subsequently is filed as an exhibit to a Commission filing might be covered by the rule. In addition, some of the participants stated that foreign attorneys with little or no experience or training in United States securities law may not be competent to determine whether a material violation has occurred that would trigger reporting requirements. Others stated that the "noisy withdrawal" and disaffirmation requirements of the proposed rule would conflict with the laws and principles of confidentiality and the attorney-client privilege recognized in certain foreign jurisdictions.

The Commission received more than 40 comment letters that addressed the international aspects of the proposed attorney conduct rule. Many suggested that non-United States attorneys should be exempt from the rule entirely, arguing that the Commission would violate principles of international comity by exercising jurisdiction over the legal profession outside of the United States. Others recommended that the Commission take additional time to consider these conflict issues, and provide a temporary exemption from the rule for non-United States attorneys. The majority of commenters asserted that the proposed rule's "noisy withdrawal" and disaffirmation requirements would conflict with their obligations under the laws of their home jurisdictions.

Section 205.2(j) and the final definition of "appearing and practicing before the Commission" under section 205.2(a) together address many of the concerns expressed by foreign lawyers. Foreign lawyers who are concerned that they may not have the expertise to identify material violations of United States law may avoid being subject to the rule by declining to advise their clients on United States law or by seeking the assistance of United States counsel when undertaking any activity that could constitute appearing and practicing before the Commission. Mere preparation of a document that

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may be included as an exhibit to a filing with the Commission does not constitute "appearing and practicing before the Commission" under the final rule, unless the attorney has notice that the document will be filed with or submitted to the Commission and he or she provides advice on United States securities law in preparing the document.

The Commission respects the views of the many commenters who expressed concerns about the extraterritorial effects of a rule regulating the conduct of attorneys licensed in foreign jurisdictions. The Commission considers it appropriate, however, to prescribe standards of conduct for an attorney who, although licensed to practice law in a foreign jurisdiction, appears and practices on behalf of his clients before the Commission in a manner that goes beyond the activities permitted to a non-appearing foreign attorney. Non-United States attorneys who believe that the requirements of the rule conflict with law or professional standards in their home jurisdiction may avoid being subject to the rule by consulting with United States counsel whenever they engage in any activity that constitutes appearing and practicing before the Commission. In addition, as discussed in Section 205.6(d) below, the Commission is also adopting a provision to protect a lawyer practicing outside the United States in circumstances where foreign law prohibits compliance with the Commission's rule.

205.2(k) provides:

(k) *Qualified legal compliance committee* means a committee of an issuer (which also may be an audit or other committee of the issuer) that:

(1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));

(2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under §205.3;

(3) Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in §205.3(b)(4));

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A) Notify the audit committee or the full board of directors;

(B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C) Retain such additional expert personnel as the committee deems necessary; and

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(iii) At the conclusion of any such investigation, to:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

A QLCC, as here defined, is part of an alternative procedure for reporting evidence of a material violation. That alternative procedure is set out in Section 205.3(c) of the rule.

The definition of a QLCC in Section 205.2(k) of the final rule contains a few modifications from the definition in the proposed rule. In the first clause of the definition, the final rule provides that an audit or other committee of the issuer may serve as the QLCC. As a result, the issuer is not required to form a QLCC as a new corporate structure, unless it wishes to, so long as another committee of the issuer meets all of the requisite criteria for a QLCC and agrees to function as a QLCC in addition to its separate duties and responsibilities. This change responds to comments that issuers should not be required to create a new committee to serve as a QLCC, so long as an existing committee contains the required number of independent directors.60

Subsection 205.2(k)(1) of the final rule, which addresses the composition of the QLCC, provides that if an issuer has no audit committee, the requirement to appoint at least one member of the audit committee to the QLCC may be met by appointing instead a member from an equivalent committee of independent directors. The Commission does not intend to limit use of the QLCC mechanism only to those issuers that have an audit committee. However, the Commission believes that the requirement that the QLCC be comprised of members who are not employed directly or indirectly by the issuer is warranted and appropriate, and thus disagrees with a commenter's suggestion to permit non-independent board members to be on the QLCC.61

Subsection 205.2(k)(3)(iii)(A) has been modified to clarify that the QLCC shall have the authority and responsibility to recommend that an issuer implement an appropriate response to evidence of a material violation, but not to require the committee to direct the issuer to take action. This modification responds to comments that the proposed rule would be in conflict with established corporate governance models insofar as the QLCC would have the explicit authority to compel a board of directors to take certain remedial actions.62

The proposed rule did not specify whether the QLCC could act if its members did not all agree. In response to comments expressing concern over this point,63 language has been included in subsections 205.2(k)(3) and (4) of the final rule to clarify that decisions and actions of the QLCC must be made and taken based upon majority vote. Unanimity is not required for a QLCC to operate; nor should an individual member of a QLCC act contrary to the collective decision of the

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QLCC. Accordingly, the final rule specifies that a QLCC may make its recommendations and take other actions by majority vote.

Commenters suggested both that issuers would have great difficulty finding qualified persons to serve on a QLCC because of the burdens and risks of such service,64 and that many companies will utilize a QLCC because reporting evidence of a material violation to a QLCC relieves an attorney of responsibility to assess the issuer's response.65 The Commission does not know how widespread adoption of the QLCC alternative will be, but encourages issuers to do so as a means of effective corporate governance. In any event, the Commission does not intend service on a QLCC to increase the liability of any member of a board of directors under state law and, indeed, expressly finds that it would be inconsistent with the public interest for a court to so conclude.

As in the proposed rule, the final rule provides that members of the QLCC may not be "employed, directly or indirectly, by the issuer." This language, which is also included in Section 205.3(b)(3), is drawn directly from Section 307 of the Sarbanes-Oxley Act. The Commission considers it appropriate and consistent with the mandate of the Act to ensure a high degree of independence in QLCC members and members of committees to whom reports are made under Section 205.3(b)(3). Accordingly, the Commission anticipates that these provisions will be amended to conform to final rules defining who is an "independent" director under Section 301 of the Act, upon adoption of those rules.

205.2(l) provides:

(l) *Reasonable* or *reasonably* denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

The definition of "reasonable" or "reasonably" is based on Rule 1.0(h) of the ABA's Model Rules of Professional Conduct, modified to emphasize that a range of conduct may be reasonable.

205.2(m) provides:

(m) *Reasonably believes* means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.

This definition is based on the definition of "reasonable belief" or "reasonably believes" in Rule 1.0(i) of the ABA's Model Rules of Professional Conduct, modified to emphasize that the range of possible reasonable beliefs regarding a matter may be broad -- limited for the purposes of this rule by beliefs that are unreasonable. Because the definition no longer is used in connection with the definition of "evidence of a material violation," the proposed rule's attempt to exclude the subjective element in "reasonable belief" has been abandoned.

205.2(n) provides:

(n) *Report* means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

The definition for this term has not been changed from the one included in the proposed rule.

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Section 205.3 Issuer as client.

205.3(a) provides:

(a) *Representing an Issuer*. An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.

This section makes explicit that the client of an attorney representing an issuer before the Commission is the issuer as an entity and not the issuer's individual officers or employees that the attorney regularly interacts with and advises on the issuer's behalf. Most commenters supported the second sentence of the subsection as it is consistent with a lawyer's recognized obligations under accepted notions of professional responsibility.66 Thus, this sentence remains unchanged in the final rule.

The proposed rule provided that an attorney "shall act in the best interest of the issuer and its shareholders." Commenters raised three principal concerns regarding that provision: it misstates an attorney's duty under traditional ethical standards in charging an attorney with acting in the "best interest" of the issuer; it suggests attorneys have a duty to shareholders creating a risk that the failure to observe that duty could form the basis for a private action against the attorney by any of these shareholders;67 and it appears to contradict the view expressed by the Commission in the proposing release that "nothing in Section 307 creates a private right of action against an attorney."68 As the Commission agrees, in part, with these comments, it has modified language in the final rule.

As to the first concern, the Commission recognizes that it is the client issuer, acting through its management, who chooses the objectives the lawyer must pursue, even when unwise, so long as they are not illegal or unethical. However, we disagree with the comment to the extent it suggests counsel is never charged with acting in the best interests of the issuer. ABA Model Rule 1.13 provides that an attorney is obligated to act in the "best interests" of an issuer in circumstances contemplated by this rule: that is, when an individual associated with the organization is violating a legal duty, *and* the behavior "is likely to result in substantial injury" to the organization. In those situations, it is indeed appropriate for counsel to act in the best interests of the issuer by reporting up-the-ladder.69 However, the Commission appreciates that, with respect to corporate decisions traditionally reserved for management, counsel is not obligated to act in the "best interests" of the issuer. Thus, the reference in the proposed rule to the attorney having a duty to act in the best interests of the issuer has been deleted from the final rule. The sentence has also been modified to make it clear the lawyer "owes his or her professional and ethical duties to the issuer as an organization."

As to the second concern, the courts have recognized that counsel to an issuer does not generally owe a legal obligation to the constituents of an issuer -- including shareholders.70 The Commission does not want the final rule to suggest it is creating a fiduciary duty to shareholders that does not currently exist. Accordingly, we have deleted from the final rule the reference to the attorney being obligated to act in the best interest of shareholders. This modification should also address the third concern as the Commission does not intend to create a private right of action against attorneys or any other person under any provision of this part. Indeed, the final rule contains a new provision, 205.7, that expressly provides that nothing in this part is intended to or does create a private right of action.

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205.3(b) provides:

(b) *Duty to report evidence of a material violation.* (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

Section 205.3(b) clarifies an attorney's duty to protect the interests of the issuer the attorney represents by reporting within the issuer evidence of a material violation by any officer, director, employee, or agent of the issuer. The section was broadly approved by commenters. Paragraph (b)(1) describes the first step that an attorney representing an issuer is required to take after he or she becomes aware of evidence of a material violation, now defined in Section 205.2. The definition of "evidence of a material violation" originally proposed was controversial and has been modified (as discussed above). Paragraph (b)(1), however, was otherwise generally approved. 71

Section 205.3(b)(2) in Proposed Rule: Withdrawn

(2) The attorney reporting evidence of a material violation shall take steps reasonable under the circumstances to document the report and the response thereto and shall retain such documentation for a reasonable time.

The language set forth from proposed subsection 205.3(b)(2) of the proposed rule has been withdrawn.

In the final rules we have eliminated all requirements that reports and responses be documented and maintained for a reasonable period. Under the proposed rule, a lawyer would have been required to document his or her report of evidence of a material violation (205.3(b)(2)); the CLO would have been required to document any inquiry in response to a report (205.3(b)(3)); a reporting attorney would have been required to document when he or she received an appropriate response to a report (205.3(b)(2)); and an attorney who believed he or she did not receive an appropriate response to a report would have been required to document that response (205.3(b)(8)(ii)).

The Commission proposed the documentation requirements because it believed that up-the-ladder reporting would be handled more thoughtfully if those involved memorialized their decisions. It was also the Commission's view that documentation would benefit reporting attorneys as it would provide them with a contemporaneous written record of their actions that they could use in their defense if their up-the-ladder reporting subsequently became the subject of litigation. To that end, the Commission proposed 205.3(e)(1) (which is codified in the final rule as section 205.3(d)(1)) that specifically authorizes an attorney to use "[a]ny report under this section . . . or any response thereto . . . in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue." Moreover, the Commission noted (*see* note 52 to the proposing release) that in at least one reported judicial decision, an associate at a law firm who had memorialized his reasons for resigning from the firm over a dispute regarding the adequacy of disclosures in a registration statement, was dismissed as a defendant in subsequent litigation over the

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appropriateness of those disclosures because his contemporaneous record demonstrated he had not participated in the fraud.

Nevertheless, the comments that the Commission received to the proposed documentation requirements were almost unanimously in opposition to its inclusion in the final rule. A number of commenters expressed concern that the documentation requirement could be an impediment to open and candid discussions between attorneys and their issuer clients. Those commenters were of the view it would stultify the consultation process because if the client knows the lawyer is documenting discussions regarding a potential material violation, managers are less likely to be honest and forthcoming.72

Other commenters expressed concern that the documentation requirement has the potential to create a conflict of interest between the lawyer and his or her client. For example, one commenter stated that it "places counsel to the issuer in the untenable position of having to protect himself or herself while trying to advise his or her client."73 Similarly, another commenter pointed out that documentation would "occur at exactly the time when there was disagreement between an attorney and the client. At the very least, requiring the attorney to produce such product by virtue of his or her separate obligation to the Commission is bound to present potential for conflict of interest."74 Indeed, it was pointed out, there may be occasions where the preparation of documentation is not in the best interests of the client.75

Additionally, commenters opined that the documentation requirement might increase the issuer's vulnerability in litigation. They noted that a report will be a "treasure trove of selectively damning evidence"76 and, while the Commission may be of the view that such documentation should be protected by the attorney-client privilege, the applicability of the privilege will be decided by the courts. Thus, there is considerable uncertainty as to whether it will be protected. At a minimum, it was contended, assertions of privilege will be met with significant and prolonged legal challenges.77

At least at the present time, the potential harms from mandating documentation may not justify the potential benefits. In all likelihood, in the absence of an affirmative documentation requirement, prudent counsel will consider whether to advise a client in writing that it may be violating the law.78 In other situations, responsible corporate officials may direct that such matters be documented. In those situations, the Commission's goal will be met, but not in an atmosphere where the issuer and the attorney may perceive that their interests are in conflict.

205.3(b)(2) provides:

(2) The chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer (or the equivalent thereof) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof. In lieu of causing an inquiry under this paragraph (b), a chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a qualified legal compliance committee under paragraph (c)(2) of this section if the issuer has duly established a qualified legal compliance committee prior to the report of evidence of a material violation.

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Paragraph (b)(2) (corresponding to paragraph (b)(3) of the proposed rule, as revised) describes the responsibilities of the issuer's CLO (or the equivalent thereof) in handling reported evidence of a material violation. The final rule adds a provision expressly allowing the CLO to make use of an issuer's QLCC. The revision eliminates the CLO's documentation requirement and, for the time being, the CLO's obligation, as part of the QLCC process, to notify the Commission in the unlikely event that the issuer fails to take appropriate remedial actions recommended by the QLCC after a determination by the QLCC that there has been or is about to be a material violation. It also changes language that would have required a CLO who reasonably believed that a material violation had occurred, was ongoing, or was about to occur to "take any necessary steps to ensure that the issuer adopts an appropriate response" to language that would, under the same circumstances, require the CLO to "take all reasonable steps to cause the issuer to adopt an appropriate response." These are the points on which the corresponding paragraph in the proposed rule was criticized.79 Reporting up-the-ladder was otherwise consistently supported. The CLO is responsible for investigating the reported evidence of a material violation for the reasons set out in the proposing release.80 The second sentence of this paragraph has been modified to clarify the circumstances under which the CLO must advise a reporting attorney that no violation has been found. Thus, the term "determines" has been substituted for "reasonably believes" in the second sentence. This change makes the second sentence consistent with the first sentence which requires the CLO to cause an inquiry to be conducted "to determine" whether a violation has occurred, is ongoing, or is about to occur. Other minor textual changes have been made to the paragraph that do not alter its substantive requirements.

205.3(b)(3) provides:

(3) Unless an attorney who has made a report under paragraph (b)(1) of this section reasonably believes that the chief legal officer or the chief executive officer of the issuer (or the equivalent thereof) has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to:

(i) The audit committee of the issuer's board of directors;

(ii) Another committee of the issuer's board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)) (if the issuer's board of directors has no audit committee); or

(iii) The issuer's board of directors (if the issuer's board of directors has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19))).

This paragraph describes the circumstances under which an attorney who has reported evidence of a material violation to the issuer's CLO and/or CEO is obliged to report that evidence further up-the-ladder within the client issuer. The paragraph tracks the statutory language in Section 307 of the Act, is not controversial, and is adopted without change from the corresponding paragraph in the proposed rule - (b)(4) - for the reasons set out in the proposing release.81

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205.3(b)(4) provides:

(4) If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's chief legal officer and chief executive officer (or the equivalents thereof) under paragraph (b)(1) of this section, the attorney may report such evidence as provided under paragraph (b)(3) of this section.

The basis for paragraph (b)(4) is implicit in Section 307 of the Act. This bypass provision, however, is not controversial, was not the subject of comment, and is adopted without any substantive change from the corresponding paragraph -- (b)(5) -- of the proposed rule for the reasons set out in the proposing release.82

205.3(b)(5) provides:

(5) An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(3), or (b)(4) of this section shall be deemed to be appearing and practicing before the Commission. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported under paragraph (b)(1), (b)(3), or (b)(4) of this section from a duty to respond to the reporting attorney.

Paragraph (b)(5) addresses circumstances in which those to whom evidence of a material violation is reported direct others, either in-house attorneys or outside attorneys retained for that purpose, to investigate the possible violation. It elicited only a few comments, all of them negative.83 The thrust of these comments was that issuers would be reluctant to retain counsel to investigate reports if those attorneys might trigger up-the-ladder reporting that could result in reporting out to the Commission. The definition of "appropriate response" in section 205.2(b) of the final rule has been modified to address these comments. Further, the modifications to the proposed rule reflected in final rule sections 205.3(b)(6) and (b)(7) below, will relieve attorneys retained or directed to investigate or litigate reports of violations from reporting up-the-ladder in a number of instances.

Paragraph (b)(5) is adopted essentially as proposed. This paragraph -- numbered (b)(6) in the proposed rule - makes two points: first, that the investigating attorneys are themselves appearing and practicing before the Commission and are accordingly bound by the requirements of the proposed rule; and, second, that the officers or directors who caused them to investigate remain obligated to respond to the attorney who initially reported the evidence of a material violation that other attorneys have been directed to investigate.

205.3(b)(6) and (b)(7) provide:

(6) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

(i) The attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof) to investigate such evidence of a material violation and:

(A) The attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof); and

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(B) Except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee; or

(ii) The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee.

(7) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if such attorney was retained or directed by a qualified legal compliance committee:

(i) To investigate such evidence of a material violation; or

(ii) To assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

As noted above in our discussion of paragraph (b)(5) of the final rule, a number of commenters expressed the view that the final rule should eliminate any requirement that attorneys report up-the-ladder when they are retained or directed to investigate a report of a material violation or to litigate whether a violation has occurred. New paragraphs (b)(6) and (b)(7) respond to these legitimate comments, and narrow considerably the instances when it is likely to be necessary for such an attorney to report up-the-ladder. Paragraph (b)(6) addresses the responsibilities of attorneys retained or directed to investigate or litigate reported violations by the chief legal officer (or the equivalent thereof); paragraph (b)(7) addresses circumstances where attorneys are retained or directed to investigate or litigate reported violations by a qualified legal compliance committee. Where an attorney is retained to investigate by the chief legal officer, the attorney has no obligation to report where the results of the investigation are provided to the chief legal officer and the attorney and the chief legal officer agree no violation has occurred and report the results of the inquiry to the issuer's board of directors or to an independent committee of the board. An attorney retained or directed by the chief legal officer to litigate a reported violation does not have a reporting obligation so long as he or she is able to assert a colorable defense on behalf of the issuer and the chief legal officer provides reports on the progress and outcome of the litigation to the issuer's board of directors. An attorney retained or directed by a qualified legal compliance committee to investigate a reported violation has no reporting obligations. Similarly, an attorney retained or directed by a qualified legal compliance committee to litigate a reported violation has no reporting obligation provided he or she may assert a colorable defense on behalf of the issuer.

205.3(b)(8) and (b)(9) provide:

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(8) An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section need do nothing more under this section with respect to his or her report.

(9) An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section shall explain his or her reasons therefor to the chief legal officer (or the equivalent thereof), the chief executive officer (or the equivalent thereof), and directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section.

As proposed, paragraphs (b)(8) and (b)(9) - numbered (b)(7) and (b)(8) in the proposed rule - elicited no comment (apart from negative comments on documentation provisions that have been eliminated in the final rule). They are adopted without any other substantive change for reasons explained in the proposing release.84

205.3(b)(10) provides:

(10) An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

Paragraph (b)(10) authorizes an attorney to notify an issuer's board of directors or any committee thereof if the attorney reasonably believes that he or she has been discharged for reporting evidence of a material violation under this section. This provision, an important corollary to the up-the-ladder reporting requirement, is designed to ensure that a chief legal officer (or the equivalent thereof) is not permitted to block a report to the issuer's board or other committee by discharging a reporting attorney.

This provision is similar in concept to paragraph (d)(4) of the proposed rule (as to which, as noted above, the Commission is seeking further comment), although it does not provide for reporting outside the issuer.

205.3(c) provides:

(c) *Alternative reporting procedures for attorneys retained or employed by an issuer that has established a qualified legal compliance committee.* (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

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(2) A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements under §205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c).

This alternative to the reporting requirements of section 205.3(b) would allow, though not require, an attorney to report evidence of a material violation directly to a committee of the board of directors that meets the definitional requirements for a QLCC. It would also relieve the reporting attorney of any further obligation once he or she had reported such evidence to an issuer's QLCC.

Under this alternative, the QLCC - itself a committee of the issuer's board of directors with special authority and special responsibility - would be responsible for carrying out the steps required by Section 307 of the Act: notifying the CLO of the report of evidence of a material violation (except where such notification would have been excused as futile under section 205.3(b)(4)); causing an investigation where appropriate; determining what remedial measures are appropriate where a material violation has occurred, is ongoing, or is about to occur; reporting the results of the investigation to the CLO, the CEO, and the full board of directors; and notifying the Commission if the issuer fails in any material respect to take any of those appropriate remedial measures.

More generally, the QLCC institutionalizes the process of reviewing reported evidence of a possible material violation. That would be a welcome development in itself. It may also produce broader synergistic benefits, such as heightening awareness of the importance of early reporting of possible material violations so that they can be prevented or stopped.

Probably the most important respect in which Section 205.3(c) differs from Section 205.3(b) is, as noted, that Section 205.3(c) relieves an attorney who has reported evidence of a material violation to a QLCC from any obligation "to assess the issuer's response to the reported evidence of a material violation." If the issuer fails, in any material respect to take any remedial action that the QLCC has recommended, then the QLCC, as well as the CLO and the CEO, all have the authority to take appropriate action, including notifying the Commission if the issuer fails to implement an appropriate response recommended by the QLCC.

Commenters generally approved of the QLCC in concept, although several proposed changes in how it would work. The American Bar Association agreed with the need for corporate governance mechanisms to ensure legal compliance once a material violation is reported to an issuer's board, but suggested that existing corporate governance reforms should be given time before new reforms are added.85 Another commenter suggested that the QLCC should be only one of a number of acceptable governance models, with issuers having freedom to craft techniques suitable to their own circumstances.86 The Commission recognizes these concerns, but believes the benefits of the QLCC model, as described above, and the absence of any requirement that an issuer form or utilize a QLCC, justify inclusion of this alternative in the final rule.

One commenter suggested that the Commission's final rules should make clear that, for a matter to be referred to a QLCC, the issuer must have a QLCC in place and is not permitted simply to establish a QLCC to respond to a specific incident.87 This comment has been addressed in Section 205.3(c), which authorizes referral only to a QLCC that has been previously formed.

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Commenters made a number of other suggestions regarding the QLCC provisions in the proposed rule. One commenter proposed that the Commission consider making creation of a QLCC mandatory for each issuer.88 The Commission believes that keeping the QLCC as an alternative reporting mechanism is preferable, and that attorneys should be permitted to report up-the-ladder through their chief legal officers. Another commenter suggested that the QLCC proposal be modified to remove the "noisy withdrawal" provision.89 The Commission has concluded that, in the extraordinary circumstance in which an appropriate response does not follow a QLCC's recommendation in response to evidence of a material violation, the QLCC should have the authority to take all appropriate action, including notifying the Commission, although it is not required to do so in every case. Another suggestion from a commentator was that the Commission offer a "safe harbor" for a chief legal officer who reports to a QLCC.90 The Commission has provided a form of "safe harbor" against any inconsistent standard of a state or other United States jurisdiction in Section 205.6(c), and against a private action in Section 205.7.

Section 205.3(d) Issuer Confidences

205.3(d)(1) provides:

(1) Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

Paragraph (d)(1) makes clear that an attorney may use any records the attorney may have made in the course of fulfilling his or her reporting obligations under this part to defend himself or herself against charges of misconduct. It is effectively equivalent to the ABA's present Model Rule 1.6(b)(3) and corresponding "self-defense" exceptions to client-confidentiality rules in every state. The Commission believes that it is important to make clear in the rule that attorneys can use any records they may have prepared in complying with the rule to protect themselves.

One comment expressed concern that this provision would empower the Commission to use such records against the attorney. That concern misreads this paragraph, which expressly refers to the use of these records "by an attorney" in a proceeding where the attorney's compliance with this part is in issue.

205.3(d)(2) provides:

(2) An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) 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;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C.

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1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) 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.

This paragraph thus permits, but does not require, an attorney to disclose, under specified circumstances, confidential information related to his appearing and practicing before the Commission in the representation of an issuer. It corresponds to the ABA's Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981-1982 and by the ABA's Commission of Evaluation of the Rules of Professional Conduct ("Ethics 2000 Commission") in 2000,91 and as adopted in the vast majority of states.92 It provides additional protection for investors by allowing, though not requiring, an attorney to disclose confidential information relating to his appearing and practicing before the Commission in the representation of an issuer to the extent the attorney reasonably believes necessary (1) to prevent the issuer from committing a material violation that the lawyer reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer or investors; (2) to prevent the issuer from perpetrating a fraud upon the Commission; or (3) to rectify the consequences of an issuer's material violations that caused or may cause substantial injury to the issuer's financial interest or property in the furtherance of which the attorney's services were used.

The proposed version of this rule provided that the attorney appearing or practicing before the Commission could disclose information to the Commission:

(i) To prevent the issuer from committing an illegal act that the attorney reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer from committing an illegal act that the attorney reasonably believes is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of the issuer's illegal act in the furtherance of which the attorney's services had been used.

Several comments stated that permitting attorneys to disclose illegal acts to the Commission, in the situations delineated by the proposed rule, would undermine the relationship of trust and confidence between lawyer and client, and may impede the ability of lawyers to steer their clients away from unlawful acts.93 Other comments expressed concern that this provision conflicts with, and would (in their eyes impermissibly) preempt, the rules of professional conduct of certain jurisdictions (such as the District of Columbia) which bar the disclosure of information which an attorney is permitted to disclose under this paragraph, particularly where it permits the disclosure of past client misconduct.94 Some aver that "it is not a lawyer's job" in representing an issuer before the Commission "to correct or rectify the consequences of [the issuer's] illegal actions, or even to prevent wrong-doing."95

Other commenters noted that these disclosure provisions should be limited to illegal acts that are likely to have a material impact on the market for the issuer's securities,96 or to ongoing criminal or fraudulent conduct by the issuer,97 while others suggest that attorneys should only be permitted to

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disclose information where there is a risk of death or bodily harm, and not where only "monetary interests" are involved.98 Many of the commenters voicing objections to this paragraph suggested that the Commission defer its promulgation until after further developments by state supreme courts99 or further discussion.100 Others, while criticizing the rule, noted that an attorney practicing before the Commission could comply with this permissive disclosure provision, but would have a duty to explain to the client at the outset this limitation on the "normal" duty of confidentiality.101

Commenters supporting the paragraph, however, noted that at least four-fifths of the states now permit or require such disclosures as pertain to ongoing conduct,102 and that those states that follow the minority rule "narrow[] the lawyer's options for responding to client conduct that could defraud investors and expose the lawyer to liability for legal work that the lawyer has already done."103 Several of these comments noted that the Commission could or should have required that lawyers make these disclosures to it when the client insists on continuing fraud or pursuing future illegal conduct,104 and urged the Commission to make clear that this paragraph does not override state ethics rules that make such disclosures mandatory.105 Many commenters also stated that it was proper for this paragraph to preempt any state ethics rule that does not permit disclosure.106 They also noted that the confidentiality interests of a corporate client are not infringed by lawyer disclosure under the circumstances required by the paragraph, as the paragraph addresses a situation where the lawyer reasonably believes that agents of an issuer are engaged in serious illegality that the issuer has failed to remedy; in that situation, an instruction by an officer or even the board of the issuer to remain silent cannot be regarded as authorized.107 Others generally supported the provision as injecting vitality into existing ethics rules, and stated that the Commission should not delay action on this provision.108 One commenter emphasized the need to protect from retaliation attorneys who engage in the reporting mandated by Part 205.109

The final version of this paragraph contains modifications or clarifications of the paragraph as proposed. In paragraph (2), the description of when an attorney may disclose client confidences is limited "to the extent the attorney reasonably believes necessary" to accomplish one of the objectives in the rule. In subparagraph (i), the term "material violation" has been substituted for "illegal act" to conform to the statutory language in Section 307. In subparagraph (ii), the final version identifies the illegal acts that might perpetrate a fraud upon the Commission in an investigation or administrative proceeding; each of the statutes now referenced in subparagraph (ii) were referenced in the release accompanying the proposed rule.110 The term "perpetrate a fraud" in this paragraph covers conduct involving the knowing misrepresentation of a material fact to, or the concealment of a material fact from, the Commission with the intent to induce the Commission to take, or to refrain from taking, a particular action. Subparagraph (iii) has been modified to cover only material violations by the issuer, and now this material violation must be one that has "caused, or may cause, substantial injury to the financial interest or property of the issuer or investors" before the provision may be invoked.

With regard to the issues raised by the comments on this paragraph, as explained below, the Commission either has addressed the concerns voiced by the commenters, believes that the concerns are adequately addressed by the paragraph, or has found the concerns to be insufficient to warrant further modification. Although commenters raised a concern that permitting attorneys to disclose information to the Commission without a client's consent would undermine the issuers' trust in their attorneys, the vast majority of states already permit (and some even require) disclosure of information in the limited situations covered by this paragraph,111 and the Commission has seen no evidence that those already-existing disclosure obligations have undermined the attorney-client

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relationship. In addition, the existing state law ethics rules support the proposition that generalized concerns about impacting the attorney-client relationship must yield to the public interest where an issuer seeks to commit a material violation that will materially damage investors, seek to perpetrate a fraud upon the Commission in enforcement proceedings, or has used the attorney's services to commit a material violation.

With regard to the comments that this paragraph would preempt state law ethics rules that do not permit disclosure of information concerning such acts, or the concerns expressed by commenters at the other end of the spectrum that this paragraph could be misread to supplant state ethics rules that require rather than permit disclosure,112 the Commission refers to Section 205.1 and the related discussion above. Section 205.1 makes clear that Part 205 supplements state ethics rules and is not intended to limit the ability of any jurisdiction to impose higher obligations upon an attorney not inconsistent with Part 205. A mandatory disclosure requirement imposed by a state would be an additional requirement consistent with the Commission's permissive disclosure rule. The Commission also notes that, as this paragraph in most situations follows the permissive disclosure rules already in place in most jurisdictions, the conflict raised by these commenters is unlikely to arise in practice.

As for the comments suggesting that attorneys be permitted to disclose only information that would appear to have a material impact on the value of the issuer's securities, the Commission has, where appropriate, modified the paragraph in a manner that responds to that concern. Subparagraph (iii) has been limited to material violations, and subparagraph (i) limits its application to material violations that are likely to cause substantial injury to the financial interest or property of the issuer or investors.

Finally, the Commission concludes that it is not appropriate for it to wait for further developments. The Commission believes there has been ample discussion of this paragraph in the comments received, and that the major issues concerning this paragraph have been well identified. In addition, delay pending further developments does not promise to be fruitful: most state supreme courts already have rules in place that are consistent with this paragraph, and there is no evidence when, if ever, state supreme courts (or legislative bodies) will revisit these issues, and the public interest in allowing lawyers appearing and practicing before the Commission to disclose the acts covered by this paragraph counsels against waiting indefinitely for further refinement of state ethics rules.

Subsection 205.3(e)(3) in Proposed Rule: Withdrawn

The proposed paragraph read:

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

Several commenters stated that it was uncertain if the Sarbanes-Oxley Act granted the Commission the authority to promulgate a rule that would control determinations by state and federal courts whether a disclosure to the Commission, even if conditioned on a confidentiality agreement, waives the attorney-client privilege or work product protection,113 and a few suggested that the proposed paragraph would conflict with Federal Rule of Evidence 501.114 They noted that this is an unsettled issue in the courts, or suggested that the Commission's proposed rule runs contrary to the bulk of decisional authority on this issue.115 A few also noted that proposed legislation before

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Congress in 1974, supported by the Commission, that would have enacted a provision permitting issuers to selectively waive privileges in disclosures to the Commission was ultimately not passed by Congress.116 The concern was expressed that attorneys might disclose information to the Commission in the belief that the evidentiary privileges for that information were preserved, only to have a court subsequently rule that the privilege was waived.117

The Commission has determined not to adopt the proposed rule on this "selective waiver" provision. The Commission is mindful of the concern that some courts might not adopt the Commission's analysis of this issue, and that this could lead to adverse consequences for the attorneys and issuers who disclose information to the Commission pursuant to a confidentiality agreement, believing that the evidentiary protections accorded that information remain preserved.

Nonetheless, the Commission finds that allowing issuers to produce internal reports to the Commission - including those prepared in response to reports under 205.3(b) - without waiving otherwise applicable privileges serves the public interest because it significantly enhances the Commission's ability to conduct expeditious investigations and obtain prompt relief, where appropriate, for defrauded investors. The Commission further finds that obtaining such otherwise protected reports advances the public interest, as the Commission only enters into confidentiality agreements when it has reason to believe that obtaining the reports will allow the Commission to save substantial time and resources in conducting investigations and/or provide more prompt monetary relief to investors. Although the Commission must verify that internal reports are accurate and complete and must conduct its own investigation, doing so is far less time consuming and less difficult than starting and conducting investigations without the internal reports. When the Commission can conduct expeditious and efficient investigations, it can then obtain appropriate remedies for investors more quickly. The public interest is thus clearly served when the Commission can promptly identify illegal conduct and provide compensation to victims of securities fraud.

The Commission also finds that preserving the privilege or protection for internal reports shared with the Commission does not harm private litigants or put them at any kind of strategic disadvantage. At worst, private litigants would be in exactly the same position that they would have been in if the Commission had not obtained the privileged or protected materials. Private litigants may even benefit from the Commission's ability to conduct more expeditious and thorough investigations. Indeed, many private securities actions follow the successful completion of a Commission investigation and enforcement action. Consequently, allowing the Commission access to otherwise privileged and inaccessible internal reports but denying access to others would not be unfair to private litigants but is appropriate in the public interest and for the protection of investors.

For these reasons, the Commission will continue to follow its policy of entering into confidentiality agreements where it determines that its receipt of information pursuant to those agreements will ultimately further the public interest, and will vigorously argue in defense of those confidentiality agreements where litigants argue that the disclosure of information pursuant to such agreements waives any privilege or protection.

Section 205.4 Responsibilities of Supervisory Attorneys

(a) An attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer is a supervisory attorney. An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.

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(b) A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in §205.5(a), that he or she supervises or directs conforms to this part. To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.

(c) A supervisory attorney is responsible for complying with the reporting requirements in §205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.

(d) A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under §205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.

Section 205.4 prescribes the responsibilities of a supervisory attorney, and is based in part upon Rule 5.1 of the ABA's Model Rules, which (1) mandates that supervisory attorneys (including partners at law firms and attorneys exercising similar management responsibilities at law firms) must make reasonable efforts to ensure that attorneys at the firm conform to the Rules of Professional Conduct; and (2) provides that a supervisory attorney may be held liable for violative conduct by another attorney which he or she knowingly ratifies or which he or she fails to prevent when able to do so.

Several commenters objected that the articulation of the responsibilities of supervisory attorneys included in the proposed rule rendered senior attorneys responsible for the actions of more junior attorneys whose activities they might not actually supervise or direct. For example, the ABA argued that defining a supervisory attorney to include individuals "who have supervisory authority over another attorney" would unfairly cover "all partners in a law firm and even senior associates," many of whom might not exercise actual supervisory authority regarding, or have any involvement with, the matter in question.118 On the other hand, comments submitted by a distinguished group of academics stated that the sections of the proposed rule prescribing the responsibilities of supervisor and subordinate attorneys were "necessary" and appropriate.119

The language we adopt today confirms that a supervisory attorney to whom a subordinate attorney reports evidence of a material violation is responsible for complying with the reporting requirements prescribed under the rule. This language modifies the proposed rule by clarifying that only a senior attorney who actually directs or supervises the actions of a subordinate attorney appearing and practicing before the Commission is a supervisory attorney under the rule. A senior attorney who supervises or directs a subordinate on other matters unrelated to the subordinate's appearing and practicing before the Commission would not be a supervisory attorney under the final rule. Conversely, an attorney who typically does not exercise authority over a subordinate attorney but who does direct the subordinate attorney in the specific matter involving the subordinate's appearance and practice before the Commission is a supervisory attorney under the final rule. The final rule eliminates the proposed requirement that a supervisory attorney who believes that evidence of a material violation presented by a subordinate attorney need not be reported "up-the-ladder" document the basis for that conclusion. The final rule also eliminates the requirement that a supervisory attorney ensure a subordinate's compliance with the federal securities laws.

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Section 205.5 Responsibilities of a Subordinate Attorney

(a) An attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)) is a subordinate attorney.

(b) A subordinate attorney shall comply with this part notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

(c) A subordinate attorney complies with §205.3 if the subordinate attorney reports to his or her supervising attorney under §205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.

(d) A subordinate attorney may take the steps permitted or required by §205.3(b) or (c) if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation under §205.3(b) has failed to comply with §205.3.

Section 205.5 is based, in part, on Rule 5.2 of the ABA's Model Rules (which provides that subordinate attorneys remain bound by the Model Rules notwithstanding the fact that they acted at the direction of another person). This section confirms that a subordinate attorney is responsible for complying with the rule. We do not believe that a subordinate attorney should be exempted from the application of the rule merely because he or she operates under the supervision or at the direction of another person. We believe that creation of such an exemption would seriously undermine Congress' intent to provide for the reporting of evidence of material violations to issuers. Indeed, because subordinate attorneys frequently perform a significant amount of work on behalf of issuers, we believe that subordinate attorneys are at least as likely (indeed, potentially more likely) to learn about evidence of material violations as supervisory attorneys.

This section attracted far less comment than section 205.4, and those comments which were received typically supported the concept of allowing a subordinate attorney to satisfy his or her obligations under the rule by reporting evidence of a material violation to a supervisory attorney.120 The language we adopt today clarifies that a subordinate attorney must be appearing and practicing before the Commission to come under the rule, and conforms this section to the language in section 205.4 by providing that a senior attorney must actually direct or supervise the actions of a subordinate attorney (rather than have supervisory authority) to be a supervisory attorney under the rule.

New language has been added to this section to provide that an attorney who appears and practices before the Commission on a matter in the representation of an issuer under the supervision or direction of the issuer's CLO (or the equivalent thereto) is not a subordinate attorney. Accordingly, that person is required to comply with the reporting requirements of Section 205.3. For example, an issuer's Deputy General Counsel, who reports directly to the issuer's General Counsel (CLO) on a matter before the Commission, is not a subordinate attorney. Thus, the Deputy General Counsel is not relieved of any further reporting obligations by advising the CLO of evidence of a material violation. Further, in the event the Deputy General Counsel does not receive an appropriate response from the CLO, he or she is obligated to report further up-the-ladder within the issuer.

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Section 205.6 Sanctions and Discipline

(a) A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.

(b) An attorney appearing and practicing before the Commission who violates any provision of this part is subject to the disciplinary authority of the Commission, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices. An administrative disciplinary proceeding initiated by the Commission for violation of this part may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the Commission.

(c) An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

(d) An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.

Paragraph 205.6(a) of the proposed rule tracked the language of Section 3(b) of the Act (which expressly states that a violation of the Act and rules promulgated thereunder shall be treated as a violation of the Exchange Act, subjecting any person committing such a violation to the same penalties as are prescribed for violations of the Exchange Act). Similarly, paragraph 205.6(b) of the proposed rule was based on Section 602 of the Act (adding Section 4C(a) to the Exchange Act, which incorporates that portion of Rule 102(e) of the Commission's Rules of Practice prescribing the state-of-mind requirements for Commission disciplinary actions against accountants who engage in improper professional conduct). Finally, paragraph 205.6(c) of the proposed rule stated that the Commission may discipline attorneys who violate the rule, regardless of whether the attorney is subject to prosecution or discipline for violation of a state ethical rule that applies to the same conduct.

Collectively, proposed section 205.6 (originally entitled "Sanctions") generated a number of comments. One commenter complained that sections 3(b) and 307 of the Act did not authorize Commission enforcement action against violators of the rule, and that violations should be handled in Commission disciplinary proceedings.121 Several other commenters argued that paragraph 205.6(a) should specifically state that the Commission will not seek criminal penalties for violations of the rule.122 Commenters also suggested that the juxtaposition of paragraphs 205.6(a) and (b) created confusion as to whether the Commission would treat violations of the rule as an Exchange Act violation or a violation of Rule 102(e). A number of commenters also suggested that the Commission should create a safe harbor, protecting attorneys who make a good faith attempt to comply with the rule and explicitly stating that the rule is only enforceable by the Commission and does not create a private right of action.123

The language we today adopt in Section 205.6 has been extensively modified in light of these comments. The amended section is now titled "Sanctions and Discipline," emphasizing that the Commission intends to proceed against individuals violating Part 205 as it would against other

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violators of the federal securities laws and, when appropriate, to initiate proceedings under this rule seeking an appropriate disciplinary sanction. Paragraph 205.6(a) has been amended to clarify that only the Commission may bring an action for violation of the part. Paragraph 205.6(b) incorporates the language of paragraph 205.6(c) of the proposed rule, and adds new language specifying the sanctions available to the Commission in administrative disciplinary proceedings against attorneys who violate the part.

New paragraph 205.6(c), consistent with section 205.1, provides that attorneys who comply in good faith with this part shall not be subject to discipline for violations of inconsistent standards imposed by a state or other United States jurisdiction. Paragraph 205.6(c) has been drafted to apply only to an attorney's liability for violating inconsistent standards of a state or other U.S. jurisdiction. Thus, it is not available where the state or other jurisdiction imposes additional requirements on the attorney that are consistent with the Commission's rules. Moreover, this paragraph has no application in actions or proceedings brought by the Commission relating to violations of the federal securities laws or the Commission's rules or regulations thereunder. Further, the fact that an attorney may assert or establish in a state professional disciplinary proceeding, or in a private action, that he or she complied with this part, and complied in good faith, does not affect the Commission's ability or authority to bring an enforcement action or disciplinary proceeding against an attorney for a violation of this part. Indeed, even if a state ethics board or a court were to determine in an action not brought by the Commission that an attorney complied with this part or complied in good faith with this part, that determination would not preclude the Commission from bringing either an enforcement action or a disciplinary proceeding against that attorney for a violation of this part based on the same conduct.

New paragraph 205.6(d) addresses the conduct of non-U.S. attorneys who are subject to this part, because they do not meet the definition of non-appearing foreign attorney. As noted above, the new definition of non-appearing foreign attorney in paragraph 205.2(j) responds to the large number of comments received from lawyers practicing in other jurisdictions stating that attorneys practicing in many foreign countries are subject to rules and regulations that render compliance with the part impossible. This point was also made at the December 17 Roundtable discussion. Several commenters also stated that attorneys who are admitted in United States jurisdictions but who practice in foreign countries are subject to similar restrictions. New paragraph 205.6(d) provides that attorneys in that situation must comply with the part to the maximum extent allowed by the regulations and laws to which they are subject.

Section 205.7 No Private Right of Action

(a) Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b) Authority to enforce compliance with this part is vested exclusively in the Commission.

In the proposing release, the Commission expressed its view that: "nothing in Section 307 creates a private right of action against an attorney. . . . Similarly, the Commission does not intend that the provisions of Part 205 create any private right of action against an attorney based on his or her compliance or non-compliance with its provisions."124 Nevertheless, the Commission requested comments on whether it should provide in the final rule "a 'safe harbor' from civil suits" for

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attorneys who comply with the rule.125 Numerous commenters agreed that the final rule should contain such a provision.

Several commenters suggested that the final rule contain a safe harbor similar to that provided for auditors in Section 10A(c) of the Exchange Act, 15 U.S.C. 78j-1(c), which provides that "[n]o independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report" to the Commission made by an issuer whose auditor has reported to its board a failure to take remedial action.126 Other commenters recommended that the Commission adopt language similar to that in the Restatement (Third) of Law Governing Lawyers, Standards of Care §52, which provides that "[p]roof of a violation of a rule or statute regulating the conduct of lawyers . . . does not give rise to an implied cause of action for professional negligence or breach of fiduciary duty . . . ."127 And others noted that the ABA Model Rules, Scope, & 20, provides that "[v]iolation of a Rule should not itself give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty has been breached."128 Finally, numerous other commenters were of the view that a safe harbor should be created to protect lawyers from liability where they have attempted in good faith to comply with this part.129

The Commission is persuaded that it is appropriate to include an express safe harbor provision in the rule, which is set forth in new Section 205.7, No Private Right of Action. Paragraph (a) makes it clear that Part 205 does not create a private cause of action against an attorney, a law firm or an issuer, based upon their compliance or non-compliance with the part. The Commission is of the view that the protection of this provision should extend to any entity that might be compelled to take action under this part; thus it extends to law firms and issuers. The Commission is also of the opinion that, for the safe harbor to be truly effective, it must extend to both compliance and non-compliance under this part.

Paragraph (b) provides that only the Commission may enforce the requirements of this part. The provision is intended to preclude, among other things, private injunctive actions seeking to compel persons to take actions under this part and private damages actions against such persons. Once again, the protection extends to all entities that have obligations under this part.

III. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 ("PRA")130 requires the agency to obtain approval from the Office of Management and Budget ("OMB") if an agency's rule would require a "collection of information," as defined by the PRA. As set forth in the proposing release, certain provisions of the rule, such as the requirement of written procedures for QLCCs, meet the "collection of information" requirement of the PRA. The information collection is necessary to implement the Standards of Professional Conduct for Attorneys prescribed by the proposed rule and required by Section 307 of the Sarbanes-Oxley Act of 2002. Specifically, the collection of information is intended to ensure that evidence of violations is communicated to appropriate officers and/or directors of issuers, so that they can adopt appropriate remedies and/or impose appropriate sanctions. In the rare cases in which a majority of a QLCC has concluded that an issuer did not act appropriately, the information may be communicated to the Commission. The collection of information is, therefore, an important component of the Commission's program to discourage violations of the federal securities laws and promote ethical behavior of attorneys appearing and practicing before the Commission.

The final rule would impose an up-the-ladder reporting requirement when attorneys appearing and practicing before the Commission become aware of evidence of a material violation by the issuer or

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any officer, director, employee, or agent of the issuer. An attorney must report such evidence to the issuer's CLO or to both the CLO and CEO. A subordinate attorney complies with the rule if he or she reports evidence of a material violation to his or her supervisory attorney (who is then responsible for complying with the rule's requirements). A subordinate attorney may also take the other steps described in the rule if the supervisor fails to comply.

If the CLO, after investigation, determines that there is no violation, he or she must so advise the reporting attorney. Unless the CLO reasonably believes that there is no violation, he or she must take reasonable steps to cause the issuer to adopt an appropriate response to stop, prevent or rectify any violation. The CLO must also report on the remedial measures or sanctions to the reporting attorney.

The rule also requires attorneys to take certain steps if the CLO or CEO does not provide an appropriate response to a report of evidence of a violation. These steps include reporting the evidence up-the-ladder to the audit committee, another committee consisting solely of independent directors if there is no audit committee, or to the board of directors if there is no such committee. If the attorney believes that the issuer has not made an appropriate response to the report, the attorney must explain the reasons for his or her belief to the CEO, CLO or directors to whom the report was made.

Alternatively, if an attorney other than a CLO reports the evidence to a QLCC, he or she need take no further action under the rule. The QLCC must have written procedures for the receipt, retention and consideration of reports of material violations, and must be authorized and responsible to notify the CLO and CEO of the report, determine whether an investigation is necessary and, if so, to notify the audit committee or the board of directors. The QLCC may also initiate an investigation to be conducted by the CLO or outside attorneys, and retain any necessary expert personnel. At the conclusion of the investigation, the QLCC may recommend that the issuer adopt appropriate remedial measures and/or impose sanctions, and notify the CLO, CEO, and board of directors of the results of the inquiry and appropriate remedial measures to be adopted. Where the QLCC decides, by a majority vote, that the issuer has failed to take any remedial measure that the QLCC has directed the issuer to take, the QLCC has the authority to notify the Commission. A CLO may also refer a report of evidence of a material violation to a QLCC, which then would have responsibility for taking the steps required by the rule.

The respondents to this collection of information would be attorneys who appear and practice before the Commission and, in certain cases, the issuer, and/or officers, directors and committees of the issuer. We proposed to require attorneys to document communications contemplated by the proposed rule. In response to commenters concerns, we are not specifying that the communications must be documented. We continue to believe that, in providing quality representation to issuers, attorneys report evidence of violations to others within the issuer, including the CLO, the CEO, and, where necessary, the directors. In addition, officers and directors already investigate evidence of violations and report within the issuer the results of the investigation and the remedial steps they have taken or sanctions they have imposed. Attorneys who believe that they were discharged for making a report under the proposed rule might notify the issuer of that fact. Except as discussed below, we therefore believe that the reporting requirements imposed by the rule are "usual and customary" activities that do not add to the burden that would be imposed by the collection of information.131

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Certain aspects of the collection of information, however, impose a new burden. For an issuer to choose to establish a QLCC, the QLCC must adopt written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation. We are adopting this requirement and its collection of information requirement largely as proposed.

We estimate for purposes of the PRA that there are approximately 18,200 issuers that would be subject to the proposed rule.132 We are unable to estimate precisely how many issuers will choose to form a QLCC. For these purposes, we estimate that approximately 20%, or 3,640, will choose to establish a QLCC. Establishing the written procedures required by the proposed rule should not impose a significant burden. We assume that an issuer would incur a greater burden in the year that it first establishes the procedures than in subsequent years, in which the burden would be incurred in updating, reviewing, or modifying the procedures. For purposes of the PRA, we assume that an issuer would spend six hours every three-year period on the procedures. This would result in an average burden of two hours per year. Thus, we estimate for purposes of the PRA that the total annual burden imposed by this collection of information would be 7,280 hours. We assume that half of those hours will be incurred by outside counsel at a rate of $300 per hour. Using these assumptions, we estimate the collection of information would result in a cost of $1,092,000.

We are not adopting at this time a requirement that attorneys make a "noisy withdrawal." We have amended the PRA submission to remove any burden from that collection of information. We are still considering that provision and, in a separate proposing release, we are requesting additional comments on it. In addition, we are separately proposing an alternative that, along with the "noisy withdrawal" proposal, also constitutes a collection of information under the PRA.

The Commission received two comments regarding the Paperwork Reduction Act section of the proposing release. One commenter indicated that the Commission has not considered the paperwork burdens of Part 205 on attorneys who do not specialize in securities law, but who may be considered to be appearing and practicing before the Commission under the rule.133 The Commission believes that as adopted, the rule imposes little, if any, paperwork burdens on attorneys regardless of whether they specialize in securities law, especially in light of clarification to the rule's scope in the definition of "appearing and practicing." Another commenter suggested that the Commission's original estimate that one quarter of the 18,200 issuers subject to the rule will form QLCCs may be understated, but offered no alternate estimate.134 The Commission estimated in the proposing release that one quarter of issuers would form QLCCs and received comments suggesting both that it would be difficult to find people to serve on QLCCs135 and, on the other hand, many companies would use QLCCs.136 Moreover, the Commission is not adopting at this time the "noisy withdrawal" proposal, which may tend to cause fewer companies to form QLCCs. Accordingly, the Commission estimates that under the rule, as adopted, 20% of issuers will form QLCCs.

The Commission submitted the collection of information to OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11, under the title of "Reports of Evidence of Material Violations." Because of the changes to the nature of the information collected and because of the separate proposal for an alternative to "noisy withdrawal," we have changed the name of the submission to "QLCC and Other Internal Reporting." OMB has not yet approved the collection; we will separately publish the OMB control number. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Compliance with the collection of information requirements is in some cases mandatory and in some cases voluntary depending upon the circumstances. Responses to the requirements to make disclosures to the Commission will not be kept confidential.

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IV. Costs and Benefits

Part 205 implements Section 307 of the Sarbanes-Oxley Act. Part 205 will affect all attorneys who appear and practice before the Commission in the representation of an issuer and who become aware of evidence that tends to show that a material violation of federal or state securities laws, a material breach of fiduciary duty, or a similar material violation by the issuer or an officer, director, agent, or employee of the issuer has occurred, is ongoing, or is about to occur. The rule we are issuing today implements a Congressional mandate to prescribe "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers . . . ." Prior to passage of the Sarbanes-Oxley Act, attorneys appearing and practicing before the Commission were regulated as to their professional conduct primarily by the ethics standards of the various states where attorneys happened to practice. By passing the Sarbanes-Oxley Act, Congress has implicitly concluded that the benefits of setting such minimum federal standards justify their costs. We enumerate and discuss these costs and benefits below.

Part 205 implements an up-the-ladder reporting requirement upon attorneys representing an issuer before the Commission who become aware of a potential material violation about which a reasonably prudent investor would want to be informed. It is expected that, in the vast majority of instances of such reports, the situation will be addressed and remedied before it causes significant harm to investors.

In addition to these requirements, the rule would authorize a covered attorney to reveal to the Commission confidences or secrets relating to the attorney's representation of an issuer before the Commission to the extent the attorney reasonably believes it necessary to: (i) prevent the issuer from committing a material violation likely to cause substantial harm to the financial interest or property of the issuer or investors; (ii) prevent the issuer from perpetrating a fraud upon the Commission; or (iii) rectify the consequences of the issuer's illegal act that the attorney's services had furthered.

A. Benefits

Part 205 is designed to protect investors and increase their confidence in public companies by ensuring that attorneys who represent issuers report up the corporate ladder evidence of material violations by their officers and employees. The Commission recognizes that some attorneys may already follow up-the-ladder reporting procedures, especially where the conduct at issue is directly related to the matter on which the attorney represents the issuer, but believes it will prove beneficial if all attorneys who appear and practice before the Commission comply with this requirement.

Part 205 should protect investors by helping to prevent instances of significant corporate misconduct and fraud. The rule requires that attorneys report up-the-ladder when they become aware of evidence of a material violation. Although many attorneys already do this, some may not, especially if the violation is unrelated to the purpose for which they were retained. The rule gives issuers the option of forming a QLCC, consisting of at least one member of the issuer's audit committee and two or more independent directors, which would investigate reports of material violations and would be authorized to recommend that the issuer adopt appropriate remedial measures. The Commission believes that these requirements will make it more likely that companies will address instances of misconduct internally, and act to remedy violations at earlier stages.

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Part 205 is intended to increase investor confidence. By requiring attorneys to report potential misconduct up-the-ladder within a corporation, the rule provides a measure of comfort to investors that evidence of fraud will be known and evaluated by the top authorities in a corporation, including its board of directors, and not dismissed by lower-level employees. Furthermore, investors will know that a company that forms a QLCC will have reports of misconduct evaluated by at least one member of the company's audit committee as well as two or more of its independent directors. Investors will also know that if an issuer fails to implement a recommendation that the QLCC has recommended, the QLCC, after a majority vote, may notify the Commission.

Part 205 should serve to deter corporate misconduct and fraud. Corporate wrongdoers at the lower or middle levels of the corporate hierarchy will be aware that an attorney who becomes aware of their misconduct is obligated under the rule to report it up-the-ladder to the highest levels of the corporation. In the event that wrongdoing or fraud exists at the highest levels of a corporation, those committing the misconduct will similarly know that the corporation's attorneys are obligated to report any misconduct of which they become aware up-the-ladder to the corporation's board and its independent directors.

Part 205 may improve the governance of corporations that are subject to the rule. By mandating up-the-ladder reporting of violations, the rule helps to ensure that evidence of material violations will be addressed and remedied within the corporation, rather than misdirected or "swept under the rug." The formation of QLCCs may also serve to improve corporate governance. The Commission believes that some issuers will choose to adopt QLCCs, and that they may prove to be a recognized and effective means of reviewing reported evidence of material violations. Because a QLCC must consist of at least two independent directors (as well as one member of the corporation's audit committee), it will give greater authority to independent directors. This should serve as an important check on corporate management.

Part 205 will give attorneys who appear and practice before the Commission guidance and clarity regarding their ethical obligations when confronted with evidence of wrongdoing by their clients. Part 205 requires that attorneys report up-the-ladder when they become aware of potential material violations and thus complies with an express Congressional directive to set minimum standards of professional conduct for attorneys who appear and practice before it. These benefits are difficult to quantify.

B. Costs

Part 205 will impose costs on issuers and law firms representing them. For issuers, the rule will require the chief legal officer of an issuer to investigate and, where necessary, cause remedial actions and/or sanctions to be taken and/or imposed. It also will cause the CEO, QLCC, and board of directors of the issuer to review evidence of material violations. We believe that most issuers already have procedures for reviewing evidence of misconduct. Similarly, we expect that most issuers already incur costs with investigating such reports.

Those companies that choose to form a QLCC to implement this provision will incur costs. These costs might include increased compensation and insurance for QLCC members, and administrative costs to establish the committee. Additionally, for purposes of the PRA, we assume that 20% of issuers will form such a committee and incur an annualized paperwork cost of two hours for a total annual burden of 7,280 hours. Assuming outside counsel accounts for half of these hours at a cost of

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$300 per hour,137 and inside counsel accounts for the other half at $110 per hour,138 this would result in a cost of $1,492,400.

For lawyers, the rule could have an effect upon malpractice insurance premiums, which could, in turn, increase the cost of attorney services to issuers. The Commission received three comments suggesting that the rule, and particularly the provisions requiring mandatory withdrawal and reporting to the Commission, would lead to an increase in the number of malpractice suits brought against attorneys.139 One of these comments, from an insurance carrier, indicated that the rule could cause malpractice insurance premiums for attorneys to rise by 10% to 50%.140 The Commission has made a number of changes to the rule in light of these comments. The Commission has clarified and made explicit in Section 205.7 that no private right of action exists based on compliance or non-compliance with the rule. In addition, the Commission has made it clear in Section 205.6(c) that an attorney who complies in good faith with the rule will not be subject to discipline or otherwise liable under an inconsistent state standard. Moreover, the rule, as adopted, will not require attorneys to withdraw or report to the Commission, but will only require reporting to the Commission in the very limited circumstances occurring when a majority of a QLCC determines that an issuer has failed to take remedial action that was directed by the QLCC. Accordingly, the Commission believes that the rule will not have as great an effect on malpractice insurance premiums as suggested by commenters in response to the proposed rule.

Part 205 may also encourage some issuers to handle more legal matters in-house and may cause other issuers to limit the use of in-house counsel and rely more heavily on outside counsel, possibly increasing the cost of legal services. The Commission received one comment indicating that issuers would refer more matters to in-house counsel141 and four comments indicating that the rule would result in more matters referred to outside counsel.142 None of the commenters attempted to quantify the costs associated with these shifts. To the extent that the rule, as originally proposed, provided some perceived incentives to transfer functions to or from outside counsel, principally because of the "noisy withdrawal" requirements, we believe that those perceived incentives are not present in the rule as adopted.

There may also be some additional costs of the rule imposed on the market that are exceedingly difficult to predict or quantify. The Commission received comments indicating that the rule, and particularly the proposal regarding "noisy withdrawal," would cause issuers to be less willing to seek legal advice and would result in issuers being less forthcoming with their counsel.143 However, no commenters presented data or attempted to quantify any costs associated with this effect. The Commission also received comments indicating that the rule would not cause any decrease in attorney-client communication.144 Since the rule, as adopted, will not require mandatory withdrawal or disclosure to the Commission, we believe that Part 205 will not have any adverse impact on attorney-client communications.

V. Effect on Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act (15 U.S.C. 78w(a)(2)) requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. In addition, Section 2(b) of the Securities Act (15 U.S.C. 77b(b)), Section 3(f) of the Exchange Act (15 U.S.C. 78c(f)), and Section 2(c) of the Investment Company Act (15 U.S.C. 80a-2(c)), require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or

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appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

Part 205 is intended to ensure that attorneys representing issuers before the Commission are governed by standards of conduct that increase disclosure of potential impropriety within an issuer so that prompt intervention and remediation can take place. Doing so should boost investor confidence in the financial markets. We anticipate that this rule will enhance the proper functioning of the capital markets and promote efficiency by reducing the likelihood that illegal behavior would remain undetected and unremedied for long periods of time. Part 205 will apply to all issuers and attorneys appearing before the Commission and is therefore unlikely to affect competition.

The Commission invited comment on this analysis, and received one comment on it.145 The commenter suggested that the rule could result in a large quantity of information being sent to a CLO or QLCC, which would be expensive and unwieldy to process, and would thus conflict with the goal of promoting efficiency, competition and capital formation. The Commission believes that Part 205 is consistent with the statutory goals and will substantially assist in attaining them by preventing corporate misconduct, restoring investor confidence and lowering the cost of capital.

VI. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the Regulatory Flexibility Act, 5 U.S.C. 601. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with 5 U.S.C. 603 and was made available to the public.

A. Need for the Rule

Part 205 complies with Section 307 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7245), which requires the Commission to prescribe "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers . . . ." The standards must include a rule "requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" to the CLO or the CEO of the company (or the equivalent thereof); and, if they do not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors.

B. Significant Issues Raised by Public Comment

The Commission received no comments in response to the IRFA.

C. Small Entities Subject to Part 205

Part 205 would affect issuers and law firms that are small entities. Exchange Act Rule 0-10(a) (17 CFR 240.0-10(a)) defines an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. As of October 23, 2002, we estimated that there were approximately 2,500 issuers, other than investment companies, that may be considered small entities. For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.146 We estimate that there are 211 small investment

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companies that would be subject to the rule. The revisions would apply to any small entity that is subject to Exchange Act reporting requirements.

Part 205 also would affect law firms that are small entities. The Small Business Administration has defined small business for purposes of "offices of lawyers" as those with under $6 million in annual revenue.147 Because we do not directly regulate law firms appearing before the Commission, we do not have data to estimate the number of small law firms that practice before the Commission or, of those, how many have revenue of less than $6 million. We sought comment on the number of small law firms affected by the rules, but received none.

D. Reporting, Recordkeeping and Other Compliance Requirements

Paragraph 205.3(b) prescribes the duty of an attorney who appears or practices before the Commission in the representation of an issuer to report evidence of a material violation that has occurred, is ongoing, or is about to occur. The attorney is initially directed to make this report to the issuer's CLO, or to the issuer's CLO and CEO.

When presented with a report of a possible material violation, the rule obligates the issuer's CLO to conduct a reasonable inquiry to determine whether the reported material violation has occurred, is occurring or may occur. A CLO who reasonably concludes that there has been no material violation must advise the reporting attorney of this conclusion. A CLO who concludes that a material violation has occurred, is occurring or is about to occur must take reasonable steps to ensure that the issuer adopts appropriate remedial measures and/or sanctions, including appropriate disclosures. Furthermore, the CLO is required to report up-the-ladder within the issuer and to the reporting attorney what remedial measures have been adopted.

A reporting attorney who receives an appropriate response within a reasonable time has satisfied all obligations under the rule. In the event a reporting attorney does not receive an appropriate response within a reasonable time, he or she must report the evidence of a material violation to the issuer's audit committee, to another committee of independent directors if the issuer has no audit committee, or to the full board if the issuer has no such committee. Similarly, if the attorney reasonably believes that it would be futile to report evidence of a material violation to the CLO and CEO, the attorney may report directly to the issuer's audit committee, another committee of independent directors, or to the full board.

Alternatively, pursuant to paragraph 205.3(c), issuers may (but are not required to) establish a QLCC, consisting of at least one member of the issuer's audit committee and two or more independent members of the issuer's board, for the purpose of investigating reports of material violations made by attorneys. Such a QLCC would be authorized to recommend to the issuer that it adopt appropriate remedial measures to prevent ongoing or alleviate past material violations, and empowered to notify the Commission of the material violation if the QLCC decides, by a majority vote, that the issuer has failed to take any remedial measure that the QLCC has directed the issuer to take. The QLCC would be required to notify the board of the results of any inquiry. An attorney other than a CLO may satisfy entirely his or her reporting obligations under the rule by reporting evidence of a material violation to a QLCC. Further, a CLO to whom a report of a material violation has been made may refer the matter to a QLCC.

Paragraph 205.3(d) sets forth the specific circumstances under which an attorney is authorized to disclose confidential information related to his or her appearance and practice before the

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Commission in the representation of an issuer. Pursuant to this provision, an attorney may use any contemporaneous records he or she creates to defend against charges of attorney misconduct. Paragraph 205.3(d)(2) also allows an attorney to reveal confidential information to the extent necessary to prevent the commission of a material violation that the attorney reasonably believes will result either in perpetration of a fraud upon the Commission or in substantial injury to the financial or property interests of the issuer or investors. Similarly, the attorney may disclose confidential information to rectify an issuer's material violations when such actions have been advanced by the issuer's use of the attorney's services.

We expect that the various reporting requirements required by Part 205 would, at least to a limited extent, increase costs incurred by both small issuers and law firms. We believe that many of these reports are, however, already being made by those affected by the rule. We are unable to estimate the frequency with which reports would have to be prepared by small entities. The time required for the actual preparation of a report would vary, but should not be extensive. Small issuers and law firms may bolster, and in some instances institute, internal procedures to ensure compliance - although the rule does not dictate how these procedures should be implemented.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the rule, we considered the following alternatives: (a) the establishment of differing compliance or reporting requirements that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of the reporting requirements for small entities; (c) an exemption from coverage of the requirements, or any part thereof, for small entities; and (d) the use of performance rather than design standards. As discussed above, the Sarbanes-Oxley Act directs the Commission to implement rules requiring up-the-ladder reporting. The Act does not contain any exemption or other limitation for small entities. Small business issuers may have some difficulty staffing a QLCC, as we presume that they may have fewer independent directors. We note that issuers are not required to have a QLCC under the rule.

The rule uses some performance standards and some design standards. While the rule establishes a framework for reporting evidence of material violations up-the-ladder, it does not set specific standards for how to comply with the rule's requirements. For the most part, rather than requiring reports to contain specific, detailed disclosures, the rule prescribes general requirements for reporting. This should give small entities flexibility in complying with the rule.

By permitting issuers to establish QLCCs as an alternative mechanism for attorneys to report evidence of misconduct or fraud, the rule presents a performance standard (as opposed to a design standard). A performance standard is characterized by the provision for alternative means of fulfilling the regulatory standard. It has the advantage of permitting market participants to choose the method of meeting the standard that presents the least cost to them. The provision of alternative reporting mechanisms within this rule should serve to lower overall costs to issuers attributable to the rule in precisely this manner.

We believe that utilizing different reporting or other compliance requirements for small entities would undermine the effective functioning of the reporting regime. The rule is designed to restore investor confidence in the reliability of the financial statements of the companies they invest in -- if small entities were not subject to such requirements, investors might be less inclined to invest in

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their securities. Further, we see no valid justification for imposing different standards of conduct upon small law firms than would apply to others who choose to appear and practice before the Commission. We also believe that the reporting requirements will be at least as well understood by small entities as would be any alternate formulation we might formulate to apply to them. Therefore, it does not seem necessary or appropriate to develop separate requirements for small entities.

VII. Statutory Authority

The Commission is adding a new Part 205 to Title 17, Chapter II, of the Code of Federal Regulations under the authority in Sections 3, 307, and 404 of the Sarbanes-Oxley Act of 2002,148 Section 19 of the Securities Act of 1933,149 Sections 3(b), 4C, 13, and 23 of the Securities Exchange Act of 1934,150 Sections 38 and 39 of the Investment Company Act of 1940,151 and Section 211 of the Investment Advisers Act of 1940.152

Text of Rule

List of Subjects in 17 CFR Part 205

Standards of conduct for attorneys.

For the reasons set out in the preamble, the Commission amends Title 17, Chapter II, of the Code of Federal Regulations by adding Part 205 to read as follows:

PART 205 - STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS APPEARING AND PRACTICING BEFORE THE COMMISSION IN THE REPRESENTATION OF AN ISSUER

Sec.

205.1 Purpose and scope.

205.2 Definitions.

205.3 Issuer as client.

205.4 Responsibilities of supervisory attorneys.

205.5 Responsibilities of a subordinate attorney.

205.6 Sanctions and discipline.

205.7 No private right of action.

Authority: 15 U.S.C. 77s, 78d-3, 78w, 80a-37, 80a-38, 80b-11, 7202, 7245, and 7262.

§205.1 Purpose and scope.

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement

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applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

§205.2 Definitions.

For purposes of this part, the following definitions apply:

(a) Appearing and practicing before the Commission:

(1) Means:

(i) Transacting any business with the Commission, including communications in any form;

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2) Does not include an attorney who:

(i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii) Is a non-appearing foreign attorney.

(b) Appropriate response means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

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(3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to §205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

(c) Attorney means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.

(d) Breach of fiduciary duty refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

(e) Evidence of a material violation means 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.

(f) Foreign government issuer means a foreign issuer as defined in 17 CFR 230.405 eligible to register securities on Schedule B of the Securities Act of 1933 (15 U.S.C. 77a et seq., Schedule B).

(g) In the representation of an issuer means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

(h) Issuer means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term "issuer" includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

(i) Material violation means 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.

(j) Non-appearing foreign attorney means an attorney:

(1) Who is admitted to practice law in a jurisdiction outside the United States;

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(2) Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and

(3) Who:

(i) Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or

(ii) Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

(k) Qualified legal compliance committee means a committee of an issuer (which also may be an audit or other committee of the issuer) that:

(1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));

(2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under §205.3;

(3) Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in §205.3(b)(4));

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A) Notify the audit committee or the full board of directors;

(B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C) Retain such additional expert personnel as the committee deems necessary; and

(iii) At the conclusion of any such investigation, to:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

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(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

(l) Reasonable or reasonably denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

(m) Reasonably believes means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.

(n) Report means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

§205.3 Issuer as client.

(a) Representing an issuer. An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.

(b) Duty to report evidence of a material violation. (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

(2) The chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer (or the equivalent thereof) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof. In lieu of causing an inquiry under this paragraph (b), a chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a qualified legal compliance committee under paragraph (c)(2) of this section if the issuer has duly established a qualified legal compliance committee prior to the report of evidence of a material violation.

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(3) Unless an attorney who has made a report under paragraph (b)(1) of this section reasonably believes that the chief legal officer or the chief executive officer of the issuer (or the equivalent thereof) has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to:

(i) The audit committee of the issuer's board of directors;

(ii) Another committee of the issuer's board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)) (if the issuer's board of directors has no audit committee); or

(iii) The issuer's board of directors (if the issuer's board of directors has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19))).

(4) If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's chief legal officer and chief executive officer (or the equivalents thereof) under paragraph (b)(1) of this section, the attorney may report such evidence as provided under paragraph (b)(3) of this section.

(5) An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(3), or (b)(4) of this section shall be deemed to be appearing and practicing before the Commission. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported under paragraph (b)(1), (b)(3), or (b)(4) of this section from a duty to respond to the reporting attorney.

(6) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

(i) The attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof) to investigate such evidence of a material violation and:

(A) The attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof); and

(B) Except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee; or

(ii) The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and

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outcome of such proceeding to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee.

(7) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if such attorney was retained or directed by a qualified legal compliance committee:

(i) To investigate such evidence of a material violation; or

(ii) To assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

(8) An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section need do nothing more under this section with respect to his or her report.

(9) An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section shall explain his or her reasons therefor to the chief legal officer (or the equivalent thereof), the chief executive officer (or the equivalent thereof), and directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section.

(10) An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

(c) Alternative reporting procedures for attorneys retained or employed by an issuer that has established a qualified legal compliance committee. (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

(2) A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements under §205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c).

(d) Issuer confidences. (1) Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in

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connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

(2) An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) 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;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) 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.

§205.4 Responsibilities of supervisory attorneys.

(a) An attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer is a supervisory attorney. An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.

(b) A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in §205.5(a), that he or she supervises or directs conforms to this part. To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.

(c) A supervisory attorney is responsible for complying with the reporting requirements in §205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.

(d) A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under §205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.

§205.5 Responsibilities of a subordinate attorney.

(a) An attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)) is a subordinate attorney.

(b) A subordinate attorney shall comply with this part notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

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(c) A subordinate attorney complies with §205.3 if the subordinate attorney reports to his or her supervising attorney under §205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.

(d) A subordinate attorney may take the steps permitted or required by §205.3(b) or (c) if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation under §205.3(b) has failed to comply with §205.3.

§205.6 Sanctions and discipline.

(a) A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.

(b) An attorney appearing and practicing before the Commission who violates any provision of this part is subject to the disciplinary authority of the Commission, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices. An administrative disciplinary proceeding initiated by the Commission for violation of this part may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the Commission.

(c) An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

(d) An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.

§205.7 No private right of action.

(a) Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b) Authority to enforce compliance with this part is vested exclusively in the Commission.

By the Commission.

Jill M. Peterson
Assistant Secretary

Date: January 29, 2003

Endnotes

1 Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act") (15 U.S.C. 7245) mandates that the Commission:

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shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule --

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

2 President Bush signed the Act on July 30, 2002.

3 *See* Release 33-8150 (Nov. 21, 2002), 67 FR 71669 (Dec. 2, 2002).

4 67 FR 71670, 71697 (Dec. 2, 2002).

5 *See* Comments of the Association of the Bar of the City of New York, at 28 ("There is nothing in Section 307 to suggest that Congress authorized the Commission to preempt state law and rules governing attorney conduct."); *see also* Comments of the American Bar Association, at 32; Comments of 77 law firms, at 2. While questioning the Commission's authority in this area, the American Bar Association ("ABA") nevertheless recognized that "the federal system of the United States may provide an arguable basis for the pre-emption of attorney-client and confidentiality obligations applicable to United States attorneys." *See* Comments of the American Bar Association, at 37.

6 *See* Comments of Susan P. Koniak *et al.*, at 28-29.

7 *See, e.g.*, Comments of Susan P. Koniak *et al.*, at 32; Comments of Richard W. Painter, at 8; Comments of Nancy J. Moore, at 3.

8 *See* Comments of the American Bar Association, at 12.

9 *Id.*; *see also* Comments of Sullivan & Cromwell, at 12-14; Comments of 77 law firms, at 7 (arguing that the scope of the definition of the term may incite efforts by attorneys to limit their involvement in certain matters in an effort to avoid coming within the purview of the rule).

10 *See* Comments of Susan P. Koniak *et al.*, at 33.

11 Comments of Thomas D. Morgan, at 5-6; Comments of Morrison & Foerster and eight other law firms, at 14 (paragraph 205.2(b) should be revised to read that in all situations it would be an appropriate response for an issuer to assert a colorable defense to any claim of material violation).

12 Comments of Palmer & Dodge, Attachment at 2 ("The Model Rules state that 'reasonable belief' or 'reasonably believes' when used in reference to a lawyer denotes that the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable." Model Rule 1.0(i)).

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"Reasonable" and "reasonably," in turn, are defined as "denot[ing] the conduct of a reasonably prudent and competent lawyer." Model Rule 1.0(h). Along similar lines, one group of commenters suggested that the paragraph include language paralleling the Model Rule definition, setting as the standard the conclusion of "a prudent and competent attorney, acting reasonably under the same circumstances" that a response was appropriate. Comments of Susan P. Koniak *et al.*, at 12-13, 15; *see also* Comments of the SIA/TBMA, at 18 (urging that the Commission modify this paragraph to protect an attorney whose judgment that an issuer's response was appropriate was "reasonable under the circumstances").

13 Comments of the American Corporate Counsel Association, at 10. This concern was also expressed by commenters who asserted that foreign lawyers, in particular, would not have sufficient practical knowledge of United States laws to determine what constitutes an appropriate response. *See, e.g.*, Comments of Nagashima Ohno & Tsunematsu, at 7; Comments of the SIA/TBMA, at 13 (reporting attorney's judgment should be evaluated in light of that attorney's training, experience and position).

14 Comments of Covington & Burling, at 3.

15 Comments of Susan P. Koniak *et al.*, at 12-13.

16 Comments of Covington & Burling, at 3.

17 Comments of Richard Hall, Cravath Swaine & Moore, at 6-7; Comments of the Association of the Bar of the City of New York, at 12; Comments of Carter, Ledyard & Milburn, at 3 (stating that requiring an attorney, in deciding whether an issuer has made an appropriate response, to determine whether a material violation is about to occur, is an "impossibly predictive standard"); Comments of the Japan Federation of Bar Associations, at 3 (opining that the term "appropriate response" cannot be easily construed on its face).

18 Comments of the SIA/TBMA, at 18; Comments of the Association of the Bar of the City of New York, at 12 ("[o]nce an attorney has reported and documented a possible violation, the attorney should be assured that good faith reliance upon the response protects the attorney).

19 Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 14; Comments of the American Bar Association, at 22 ("[w]e believe it is important that the Commission recognize that a reporting attorney may rely on the considered judgment of the CLO so long as that judgment is in the range of reasonableness even though the attorney would not necessarily come out that way"); Comments of Skadden, Arps, Slate, Meagher & Flom, at 9-10 (reporting attorney should be able to rely upon the stated belief of the officer to whom he has reported the evidence of material violation that no material violation has occurred).

20 Comments of JP Morgan & Chase, at 10-11; Comments of Debevoise & Plimpton, at 5.

21 Comments of JP Morgan & Chase, at 11; Comments of Debevoise & Plimpton, at 5-6.

22 Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 14.

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23 Comments of Carter, Ledyard & Milburn, at 3; Comments of Skadden, Arps, Slate, Meagher & Flom, at 9-10 (appropriate response should include a timely response that adequate measures are being taken).

24 Comments of Susan P. Koniak *et al.*, at 13; Comments of Schiff Hardin & Waite, at 4-5 (criticizing the examples in the release of the proposed rule as undercutting the proposition that attorneys will be permitted to exercise their reasonable judgment, and stating that the Commission should clarify that the reasonableness of an issuer's response will vary depending on the circumstances and will not necessarily depend on the existence of a written legal opinion from outside counsel to the issuer); Comments of the SIA/TBMA, at 18 (suggesting revisions to Section 205.2(b) that would state that an appropriate response should be reasonable under the circumstances, measured by the magnitude and quality of the evidence of the violation, the severity of the violation, and whether there is a potential for ongoing or recurring violation).

25 Comments of Susan P. Koniak *et al.*, at 12.

26 Comments of the SIA/TBMA, at 11 (stating that the Rules "should exempt outside counsel whom securities firms retain to conduct internal investigations").

27 Comments of Carter, Ledyard & Milburn, at 6 (noting risk that proposed rules "might discourage persons from seeking legal representation"); Comments of the SIA/TBMA, at 11.

28 Comments of Weil Gotshal & Manges, at 7.

29 Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 4; Comments of the American Bar Association, at 30.

30 67 FR at 71683.

31 Comments of Akin Gump Strauss Hauer & Feld, at 7-8; Comments of Cleary, Gottlieb, Steen & Hamilton, at 9 ("There would be an unavoidable chilling effect on the advocacy of lawyers who represent clients before the Commission in investigations and administrative proceedings if Rule 205 applies to them."); Comments of the Association of the Bar of the City of New York, at 19-20 (stating that it would be "unfair[] to include attorneys who are adverse parties in enforcement or administrative proceedings within the reporting and withdrawal requirements of the proposed rules"); Comments of Susan P. Koniak *et al.*, at 36 (final rules should "avoid chilling legitimate and vigorous advocacy").

32 Comments of Richard Hall, Cravath, Swaine & Moore, at 3.

33 Comments of Morrison & Foerster and eight other law firms, at 14.

34 Comments of Securities Regulation Committee, Business Law Section, New York State Bar Association, at 6 (stating that "a lawyer need not subjectively believe that he or she has the 'better side of the argument' or that it is a position likely to prevail. The attorney is permitted to undertake the representation if he or she, after a reasonable investigation, believes that there is (or will be) evidentiary support for the position and that the assertions of law are nonfrivolous. *See, e.g.*, Rule 11, Fed. R. Civ. P."). *See also* Comments of Cleary, Gottlieb, Steen & Hamilton, at 9 ("Lawyers

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representing clients before the Commission must be free to make all non-frivolous arguments to the staff.").

35 Comments of Susan P. Koniak, *et al.*, at 37.

36 The text of the final rule does not specifically include a reference to a "colorable basis for contending that the staff [or other litigant] should not prevail," nor does it specifically refer to requiring the Commission staff or other litigant to bear the burden of its case. The Commission, however, considers these and related actions permitted to an attorney, consistent with his or her professional obligations, to be included within the reference to asserting a "colorable defense."

37 Subparagraph (b)(3) thereby also addresses the concern of some commenters that an attorney representing an issuer in connection with a Commission investigation or administrative proceeding not be required to report the information. Under subparagraph (b)(3), asserting a colorable defense on an issuer's behalf in an investigation or administrative proceeding may constitute an appropriate response, and no further reporting would be required.

38 67 FR at 71673.

39 *See, e.g.*, Comments of Skadden, Arps, Slate, Meagher and Flom, at 16 (noting that foreign private issuers usually consult with United States counsel on securities matters, and suggesting that limiting the definition of "attorney" to lawyers licensed in United States jurisdictions "will avoid the unfairness of subjecting foreign lawyers to the Proposed Rules without compromising the effectiveness of the rules.").

40 *See* Comments of Richard W. Painter, at 10-11 ("Breaches of fiduciary duty to pension funds under federal law such as ERISA, and other similar violations would thus clearly be covered, whereas arguably they are not under the current definition in the Proposed Rules.").

41 The proposed rule defines *evidence of a material violation* as "information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur" and *reasonable belief* as what "an attorney, acting reasonably, would believe."

42 *E.g.*, Comments of John Bullock, at 1 ("the threshold for mandatory reporting by an attorney should be the level of evidence that a responsible corporate officer should want to know, so that the client can pursue an investigation and take appropriate action. The standard should therefore be 'some credible information that a material violation may have occurred, may be occurring, or may be about to occur.'").

43 Comments of Richard W. Painter, at 6 (suggesting that "evidence that a violation is `possible' could trigger the duty to report to the Chief Legal Officer, whereas evidence that a violation is `likely' could trigger the duty to report to the full board or to the QLCC. Evidence that a violation was `highly likely' or a `near certainty' could trigger the requirement of a noisy withdrawal."); Comments of Susan P. Koniak *et al.*, at 9-11, 15-17 (emphasizing the importance of distinguishing between a violation and evidence of one and suggesting the use of the phrase "credible evidence").

44 Comments of Skadden Arps, Slate, Meagher & Flom, at 10 (proposing to define "*evidence of a material violation*" as "facts and circumstances known to an attorney which have caused the attorney to believe that a material violation has occurred, is occurring or is about to occur"); Comments of

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Chadbourne & Parke, at 7 (proposing "a subjective standard that an attorney 'knows' that a material violation has occurred, is occurring or is about to occur"); Comments of Sullivan & Cromwell, at 11 ("Evidence of a material violation means information of which the attorney is consciously aware that would, in the attorney's judgment, constitute a material violation that has occurred, is occurring, or is about to occur."); Comments of the American Bar Association, at 17 (recommending use of "the knowledge standard").

45 *See* Comments of Susan P. Koniak *et al.*, at 18.

46 Comments of Richard W. Painter, at 5-6.

47 Comments of the Association of the Bar of the City of New York, at 10.

48 The standard was suggested, *e.g.*, in Comments of the American Bar Association, at 5, 16-17.

49 Comments of Cleary, Gottlieb, Steen & Hamilton, at 5-6 (any lower trigger for reporting would be equivocal, would lead to disparate application of the rule, and would "chill" the attorney-client relationship).

50 The Commission intends the definition of the term "reasonably likely" to be consistent with the discussion of the term included in the adopting release for the recently adopted final rule governing disclosure of off-balance sheet arrangements, enacted pursuant to §401(a) of the Sarbanes-Oxley Act.

51 Comments of the American Bar Association, at 14 ("It is not uncommon for persons who were attorneys and may still retain their license to move into other non-legal capacities in the organization. . . .These persons should be subject to no greater obligations to the organization than someone who is not an attorney."). However, the ABA stated that it believed that the rule "appropriately applied to any attorney for the issuer" who renders legal advice to the issuer. *Id.*

52 We also note that the change should address concerns expressed that counsel to underwriters or similar persons might be covered by the rule.

53 67 FR at 71678-79.

54 *See, e.g.*, Comments of the Investment Company Institute at 1-5 (asserting that the Commission's construction of its rule may cause investment advisers to "limit or even eliminate the participation of their internal and outside lawyers in the preparation of fund filings and materials, and in providing day-to-day advice to advisory personnel responsible for managing funds, in order to ensure that such lawyers are not `involved in the representation of an issuer' or `practicing before the Commission' within the meaning of the proposed rule.").

55 On the correctness of this inference, *see, e.g.*, Comments of Thomas D. Morgan at 3-4 (pointing out that "current law" makes an attorney employed by an investment adviser the "legal representative" of an investment company under these circumstances, although one has to take "a logical step" to reach that conclusion) (citing *Restatement (Third) of the Law Governing Lawyers* § 51(4)(2000)). An attorney-client relationship does not depend on payment for legal services performed. However, the legal services provided by an investment adviser to an investment company are usually performed pursuant to an advisory contract along with other services (such as investment advice) and are covered by the overall investment advisory fee.

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56 Comments of the Investment Company Institute, at 4. As noted in the proposing release, 67 FR at 71678-79, and below in the discussion of Section 205.3(b), an attorney employed by an investment adviser who becomes aware of evidence of a material violation that is material to an investment company while thus representing that investment company before the Commission has a duty to report such evidence up-the-ladder within the investment company. For the reasons explained in the proposing release and noted below, however, such reporting does no violence to the attorney-client privilege. *See Restatement (Third) of the Law Governing Lawyers*, § 75 and cmt. d (explaining that in a subsequent proceeding in which the co-client's interests are adverse there is normally no attorney-client privilege regarding either co-client's communications with their attorney during the co-client relationship).

57 We also note that the changes should address concerns expressed that counsel to underwriters or similar persons might be covered by the rule.

58 An attorney who represents a subsidiary or other person controlled by an issuer at the behest, for the benefit, or on behalf of a parent issuer who becomes aware of evidence of a material violation that is material to the issuer should report the evidence up-the-ladder through the issuer, as set forth in Section 205.3(b) of the rule.

59 *See Basic, Inc. v. Levinson*, 485 U.S. 224, 231-36 (1988); *TSC Indus. v. Northway, Inc*, 426 U.S. 438 (1976).

60 Comments of the American Corporate Counsel Association, at 9-10; Comments of Association of the Bar of the City of New York, at 42; Comments of Corporations Committee, Business Law Section, State Bar of California, at 12; Comments of Skadden, Arps, Slate, Meagher & Flom, at 12, 20, 25.

61 *See* Comments of America's Community Bankers, at 5-6.

62 Comments of Business Law Section, New York State Bar Association, at 14-15; Comments of the Business Roundtable, at 2-3.

63 Comments of the American Bar Association, at 27; Comments of Business Law Section, New York State Bar Association, at 15.

64 Comments of Clifford Chance, at 4-5; Comments of Emerson Electric Co., at 5.

65 Comments of Susan P. Koniak *et al.*, at 11; Comments of Richard W. Painter, at 5; Comments of Thomas D. Morgan, at 12.

66 *See* ABA Model Rule 1.13, "Organization as Client," at 1:139.

67 *See, e.g.*, Comments of Cleary, Gottlieb, Steen & Hamilton, at 3-4; Comments of Corporations Committee, Business Law Section, The State Bar of California, at 7; Comments of the American Corporate Counsel Association, at 11; Comments of Task Force on Corporate Responsibility of the County of New York Lawyers' Association, at 2-3.

68 *See* Comments of the Association of the Bar of the City of New York, at 47-50.

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69 *See* ABA Model Rule 1.13, at 1:139.

70 Decisions in a number of states recognize that, under state law, an attorney for an issuer does not owe a fiduciary duty to shareholders. *See Pelletier v. Zweifel*, 921 F.2d 1465, 1491-92 n.60 (11th Cir.) *cert. denied*, 502 U.S. 955 (1991) (Under Georgia law "[I]t is a black letter principle of corporation law that a corporation's counsel does not owe . . . [a] fiduciary duty to the corporation's shareholders"). *See also Skarbrevik v. Cohen, England & Whitfield*, 231 Cal. App. 3d 692, 703 (1991) (Under California law, "[a]n attorney representing a corporation does not become the representative of its stockholders merely because the attorney's actions on behalf of the corporation also benefit the stockholders; as attorney for the corporation, counsel's first duty is to the corporation."); *Egan v. McNamara*, 467 A.2d 733, 738 (DC 1983) ("According to the District of Columbia Code of Professional Responsibility (Code), an attorney represents, and therefore owes a duty to, the entity that retains him. . . . When retained to represent a corporation, he represents the entity, not its individual shareholders, officers, or directors.").

71 The Comment of Federal Bar Counsel, at 12-13, for example, objected to "becomes aware" in (b)(1) but appears to have done so in connection with the proposed definition of "evidence of a material violation." The revisions made to that definition appear to address those objections.

72 *See, e.g.*, Comments of the American Bar Association, at 22; Comments of the American Corporate Counsel Association, at 5; Comments of the Association of the Bar of the City of New York, at 16; Comments of Cleary, Gottlieb, Steen & Hamilton, at 6.

73 Comments of Skadden, Arps, Slater, Meagher & Flom, at 23.

74 Comments of Corporations Committee, Business Law Section, the State Bar of California, at 10.

75 *Id*.

76 Comments of the American Corporate Counsel Association, at 5.

77 *See* Comments of Corporations Committee, Business Law Section, the State Bar of California, at 10.

78 *See* Comments of Cleary, Gottlieb, Steen & Hamilton, at 6.

79 *E.g.*, Comments of the SIA/TBMA, at 16 (CLO should be able to make use of the QLCC); Comments of J.P. Morgan Chase & Co., at 3 (CLO should not be required to notify the Commission that a material violation has occurred and disaffirm documents that the issuer has submitted to or filed with the Commission that the CLO believes are false or materially misleading); Comments of Compass Bancshares, at 2-3 (requiring CLO "to issue a response in writing to the attorney creates an undue burden on the CLO [in] responding to an issue which the CLO may not feel is warranted"); Comments of Charles Schwab & Co., at 1-2 (CLO "typically does not have authority to sanction employees outside of his or her chain of command, to require the business units to adopt new procedures, or even to make disclosure on behalf of the company without the concurrence of other executives").

80 67 FR at 71685-86.

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81 67 FR at 71686.

82 67 FR at 71686.

83 *See* Comments of Schiff Hardin & Waite, at 4 (paragraph (b)(5) as proposed goes "too far" in deeming a lawyer engaged by an issuer to conduct an internal investigation of a possible material violation of the securities laws to be appearing and practicing before the Commission and that issuers will be reluctant to retain independent counsel to investigate if the independent counsel have "an obligation to effect a noisy withdrawal if they disagree with the client's response to the finding or recommendation resulting from the investigation"); Comments of the Chicago Bar Association, at 3 (paragraph as proposed is overbroad in requiring an outside lawyer engaged to investigate whether a violation has occurred to withdraw and notify the Commission if it disagrees with the issuer); Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 4-5 ("attorneys conducting an internal investigation, and not otherwise interacting with the Commission or even known to the Commission at that point, do not have a sufficient nexus with the Commission's processes" to be covered by the Commission's rules; making them subject to the Commission's rules will "make issuers less willing to retain, and attorneys less willing to conduct, such investigations"; and is unnecessary because section 205.3(b)(2) requires an issuer's CLO "to assess the timeliness and appropriateness of the issuer's response").

84 67 FR at 71687.

85 Comments of the American Bar Association, at 27-28.

86 Comments of the American Corporate Counsel Association, at 9-10.

87 Comments of Richard W. Painter, at 5.

88 Comments of Edward C. Brewer III, at 4.

89 Comments of the Association of the Bar of the City of New York, at 41-42.

90 *Id.*, at 42-43.

91 ABA, *Report of the Commission on Evaluation of the Rules of Professional Conduct* (November 2000), recommended permitting a lawyer to disclose confidential "information relating to the representation of a client to the extent the lawyer reasonably believes necessary . . . to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services."

92 Thirty-seven states permit an attorney to reveal confidential client information in order to prevent the client from committing criminal fraud. *See Restatement (Third) of the Law Governing Lawyers* (2000) ' 67, Cmt. f, and Thomas D. Morgan & Ronald D. Rotunda, *Model Code of Professional Responsibility, Model Rules of Professional Conduct, and Other Selected Standards*, at 146 (reproducing the table prepared by the Attorneys' Liability Assurance Society ("ALAS") cited in the Restatement). The ABA's Model Rule 1.6, which *prohibits* disclosure of confidential client information even to prevent a criminal fraud, is a minority rule. In its *Carter and Johnson* decision

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(1981 WL 384414, at n.78), the Commission expressly did not address an attorney's obligation to disclose a client's intention to commit fraud or an illegal act.

93 *See* comments of Joseph T. McLaughlin, Heller Ehrman, at 2; Comments of the Los Angeles County Bar Association, at 2.

94 Comments of Eleven Persons or Law Firms, at 8-9; Comments of the American Bar Association, at 33 (urging the Commission to refrain from considering the proposed disclosure provisions unless and until it receives express Congressional authority to preempt state privilege rules); Comments of 77 law firms, at 2; Comments of Latham & Watkins, at 5-6; Comments of Theodore Sonde, at 2; Comments of Schiff Hardin & Waite, at 7-8; Comments of Sheldon M. Jaffe, at 7-9; Comments of Emerson Electric, at 2; Comments of the Federal Bar Council, at 9-10 & n.9; Comments of JP Morgan & Chase, at 11 & n.3 (citing treatise for proposition that only six states permit disclosure to rectify past fraud).

95 Comments of the Law Society of England and Wales, at 12.

96 Comments of the Los Angeles County Bar Association, at 2; Comments of Edward C. Brewer, III at 8; *see also* Comments of the Association of the Bar of the City of New York at 5 (supporting attorney disclosure of materials facts to avoid assisting a criminal or fraudulent act by the client, or to correct prior representations made by the lawyer and believed by the lawyer still to be relied upon by a third person where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud).

97 Comments of Theodore Sonde, at 2.

98 Comments of the American College of Trial Lawyers, at 6.

99 Comments of Conference of Chief Justices, at 4.

100 Comments of the Federal Bar Council, at 14.

101 Comments of the Law Society of England and Wales, at 12.

102 Comments of Morrison & Foerster and eight other law firms, Exhibit B (listing jurisdictions whose ethics rules permit or require attorneys to disclose clients' past and/or ongoing fraud); Comments of Edward C. Brewer, III, at 8 (the proposed rule for permissive disclosure of an issuer's "illegal act" is essentially no different than the existing Model Code provision).

103 Comments of Richard W. Painter, at 6.

104 Comment of Edward C. Brewer, at 8.

105 Comments of Susan P. Koniak *et al.*, at 26-27; Comments of Nancy J. Moore, at 2-3.

106 Comments of Susan P. Koniak *et al.*, 27, 31-32.

107 Comments of William H. Simon, at 3.

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108 *See, e.g.*, Comments of Manning G. Warren III, at 1; Comments of Douglas A. Schafer, Comment of Elaine J. Mittleman at 2; Comments of Thomas Ross *et al.*, at 6-8.

109 Comment of Elaine J. Mittleman at 2.

110 *See* 67 FR at 71693.

111 Comment of the American Corporate Counsel Association, at 7 (noting that permissive disclosure standards are "more in line with a majority of state professional rules of conduct").

112 Specifically, New Jersey requires an attorney to reveal confidential "information relating to the representation of a client to the proper authorities . . . to the extent the lawyer reasonably believes necessary to prevent the client: (1) [f]rom committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to result in . . . substantial injury to the financial interest or property of another" or (2) such an act that "the lawyer reasonably believes is likely to perpetrate a fraud upon a tribunal." New Jersey Rule of Professional Conduct 1.6(b). Wisconsin's corresponding rule is virtually identical to New Jersey's, except that it makes no reference to "proper authorities." Wisconsin Supreme Court Rule 20:1.6. Florida requires a lawyer to reveal confidential information "to the extent the lawyer reasonably believes necessary . . . to prevent a client from committing a crime." Florida Rule of Professional Conduct 4-1.6.

113 Comments of Richard W. Painter, at 9 ("the only effective method" of assuring lawyers that the attorney-client privilege is not waived by disclosure to the Commission "is to seek an act of Congress establishing selective waiver and preempting inconsistent state law"); Comments of the American Bar Association, at 32; Comments of Susan P. Koniak *et al.,* at 44.

114 Comments of Sheldon Jaffe, at 10. Fed. R. Evid. 501 provides that "[e]xcept as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience. However, in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege of a witness, person, government, State, or political subdivision thereof shall be determined in accordance with State law."

115 Comments of the American Bar Association, at 32 n. 21; Comments of Sheldon M. Jaffe, at 9-11; Comments of Edward C. Brewer, III, at 11; Comments of Latham & Watkins, at 5; Comments of Morrison & Foerster and eight other law firms, at 19.

116 Comments of the American Bar Association, at 32 n. 22; Comments of Morrison & Foerster and eight other law firms, at 19. The Commission notes that the proposal in Congress to which these commenters refer would have applied the selective waiver doctrine to *all* documents produced to the Commission, and was not limited to productions conditioned upon an express confidentiality agreement. *See Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1425 (3d Cir. 1991). Also, Congress did not reject the Commission's proposal; rather, the House Committee to which the proposal was submitted took no action. *See* SEC Oversight and Technical Amendments: Hearing Before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, 98th Cong., 2d Sess 341 at 34, 51 (1984). Therefore, that the proposal before that House Committee in 1984 was not ultimately enacted

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carries no significance. *NAACP v. American Family Mut. Ins. Co.*, 978 F.2d 287, 299 (7th Cir. 1992) ("unsuccessful proposals to amend a law, in the years following passage, carry no significance").

117 Comments of Richard W. Painter, at 9; Comments of Susan P. Koniak *et al.*, at 6; Comments of Latham & Watkins, at 5 ("[g]iven the high stakes associated with waiver of privilege, uncertainty as to interpretation of [Paragraph 205.3(e)(3)'s] requirements in this regard is troubling"); Comments of the SIA/TBMA at 15 ("[a]lthough we welcome this positive statement of Commission policy, given sharp disagreements among courts on the question of selective waiver, issuers and attorneys cannot be secure in their disclosures absent a statutory statement of express preemption").

118 *See* Comments of the American Bar Association, at 22-23. *See also* Comments of Skadden, Arps, Slate, Meagher & Flom, at 27 (arguing that the section should be eliminated entirely, or, alternatively, "narrowed to apply only to the supervisory attorney within a law firm or a law department who is directly responsible for the supervision of a subordinate attorney in connection with the representation of the issuer in the specific matter, regardless of whether the attorney supervises such subordinate attorney in other unrelated matters.").

119 *See* Comments of Susan P. Koniak *et al.*, at 42.

120 *See* Comments of the American Bar Association, at 22 ("We believe the Commission correctly approaches in Rule 205.5 the treatment of subordinate lawyers who report to a supervisory attorney and in Rule 205.4(c) the shifting of responsibility for compliance to the supervisory attorney to which the matter was reported").

121 *See* Comments of the Association of the Bar of the City of New York, at 43-44.

122 *Id.* at 46-47. *See also* Comments of Morrison & Foerster and eight other law firms, at 21.

123 *See* Comments of Skadden, Arps, Slate, Meagher and Flom, at 29; Comments of the SIA/TBMA, at 16; Comments of the American Bar Association, at 33; Comments of Sullivan & Cromwell, at 16-17.

124 67 FR 71697.

125 67 FR 71691.

126 *See* Comments of Attorney's Liability Assurance Society, Inc., at 20; Comments of the Association of the Bar of the City of New York, at 5.

127 *See* Comments of the American Bar Association, at 33-34; Comments of Morrison & Foerster and eight other law firms, at 21.

128 *Id.* Comments of the American Bar Association, at 33-34.

129 *See, e.g.*, Comments of Skadden Arps Slate Meagher & Flom, at 29; Comments of the SIA/TBMA, at 21; Comments of the Investment Company Institute, at 7.

130 44 U.S.C. 3501 *et seq.*

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131 *See* 5 CFR 1320.3(b)(2).

132 This estimate is based, in part, on the total number of operating companies that filed annual reports on Form 10-K (8,484), Form 10-KSB (3,820), Form 20-F (1,194) or Form 40-F (134) during the 2001 fiscal year, and an estimate of the average number of issuers that may have a registration statement filed under the Securities Act pending with the Commission at any time (100). In addition, we estimate that approximately 4,500 investment companies currently file periodic reports on Form N-SAR.

133 Comments of the Mid-America Legal Foundation, at 3-4.

134 Comments of Robert Eli Rosen, at 3.

135 Comments of Clifford Chance, at 4-5; Comments of Emerson Electric Co., at 5.

136 Comments of Susan P. Koniak *et al.*, at 11; Comments of Richard W. Painter, at 5; Comments of Thomas D. Morgan, at 12.

137 Estimate of outside counsel rate was obtained by contacting a number of law firms regularly involved in completing Commission documents. *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8138 (Oct. 22, 2002) and 33-8177 at n.69 (Jan. 23, 2003).

138 Estimate of inside counsel rate is derived from the Securities Industry Association "Report on Management & Professional Earnings in the Securities Industry 2002," and represents the SIA value for an Assistant General Counsel in New York City.

139 Comments of Chubb Specialty Insurance, at 2-3; Comments of the American Bar Association, at 26-7; Comments of Attorneys' Liability Assurance Society, Inc., at 8, 11.

140 Comments of Chubb Specialty Insurance, at 5.

141 Comments of Carter, Ledyard & Milburn, at 2.

142 Comments of Committee on Investment Management Regulation, Association of the Bar of the City of New York, at 4; Comments of the American Corporate Counsel Association, at 4-5; Comments of Investment Company Institute, at 4; Comments of Debra M. Brown, at 2.

143 *See, e.g.*, Comments of the American Bar Association, at 26.

144 *See, e.g.*, Comments of Susan P. Koniak *et al.*, at 24.

145 Comments of Los Angeles County Bar Association, at 7-8.

146 17 CFR 270.0-10.

147 13 CFR 121.201.

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148 15 U.S.C. 7202, 7245, 7262.

149 15 U.S.C. 77s.

150 15 U.S.C. 78c(b), 78d-3, 78m, 78w.

151 15 U.S.C. 80a-37, 80a-38.

152 15 U.S.C. 80b-11.

http://www.sec.gov/rules/final/33-8185.htm

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The in-house bar association[SM]

August 20, 2003

Dear 2003 Annual Meeting Registrant:

Regarding program number 808 on the SEC's Section 307 Attorney Conduct Standards:

The coursebook material on CD Rom had to go to publication before the best practice profiles on law department and law firm policies implementing Sarbox 307 attorney conduct standards were available for print.

By the time of the publication of this CD, however, these materials will be up and online for your review and use. Please feel free to check the resource out on ACCA's Best Practice Profiles homepage at:

http://www.acca.com/vl/practiceprofiles.php

The best practices resource on this subject will review how several companies and departments analyzed the 307 reporting issue and wrote policies to guide their lawyers' compliance. In addition, it will offer links to the policies they adopted, as well as additional resources you should consider as you adopt and amend your own policies and procedures.

Of particular interest will be the issue of law department and law firm policy coordination, which is for some companies and firms, proving to be a frustrating exercise. Watch our Sarbox 307 homepage for more info and advice on this topic, too.

http://www.acca.com/legres/corpresponsibility/attorney.php

For more information, or if you are having trouble find the documents promised, please contact Susan Hackett, ACCA's General Counsel, at 202/293-4103, ext. 318; hackett@acca.com.

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The New Sarbanes-Oxley Attorney Responsibility Stan

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By Broc Romanek and Kenneth B. Winer

Of all of the provisions in the Sarbanes-Oxley Act of 2002, § 307 likely will have the greatest effect on the day-to-day practice of law for in-house counsel of publicly held companies because this provision targets attorneys. The effect of § 307 might even be greater than first expected after the U.S. Securities and Exchange Commission ("SEC") completes its rulemaking under this section.

As mandated by the Sarbanes-Oxley Act, the SEC adopted Part 205 on January 23, 2003. This rulemaking established new standards of professional conduct for attorneys who appear and practice before the SEC in the representation of a public company. These standards will become effective August 5, 2003.[1] Most in-house counsel were somewhat relieved when the SEC adopted its new rules because the proposed rules had proved so controversial.

In addition, the SEC retreated—at least temporarily—from its most controversial proposal: the proposal to require, under certain circumstances, attorneys to engage in a so-called "noisy withdrawal." Under this proposal, an attorney would—under certain circumstances—have to withdraw from representing a company and notify the SEC that they have withdrawn for professional reasons. Unfortunately, the SEC extended the comment period for its "noisy withdrawal" proposal and offered an alternative proposal that would require the public company, not the withdrawing attorney, to notify the SEC of the withdrawal.

We begin this article by outlining the types of attorneys covered by the new standards, and then we discuss the specific obligations imposed by the standards and the approaches that in-house counsel can take to satisfy their new obligations. A sidebar includes ACCA's suggested steps for attorneys to take in advance of the new standards' effective date. See the sidebar on pages 44–49.

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APPLICATION OF THE STANDARDS

The professional standards set forth in Part 205 apply to (1) "attorneys" who (2) "appear and practice before the SEC" (3) "in the representation of" (4) an "issuer." The application of the standards turns on the SEC's definitions of these four key terms. Although the final rules are considerably narrower than the proposed rules, the new standards apply in quite a few instances that you would not expect under the plain meaning of the terms.

Definition of "Attorney"

The new standards define "attorney" to include any person licensed or otherwise qualified to practice law in any jurisdiction—with one significant exception.[2] In response to a storm of criticism from foreign lawyers, the SEC excluded "non-appearing foreign attorneys" in the final rules.[3]

Definition of "Issuer"

The new standards define "issuer" to mean any person that issues or proposes to issue securities that "are registered under Section 12 of the Securities Act of 1933, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn, but does not include a foreign government issuer." For the purpose of the definitions of "appearing and practicing before the SEC" and "in the representation of an issuer," the standards define "issuer" also to include "any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer." The SEC provided little guidance as to when an attorney representing a subsidiary would be deemed to be acting "on behalf of, at the behest of, or for the benefit of the issuer."[4]

Definition of "Appearing and Practicing before the SEC"

The new standards set forth a two-part definition of "appearing and practicing before the SEC."[5] Under this definition, an attorney "appears and practices" before the SEC if two requirements are met. First, the attorney must engage in one or more activities specified in the rule. Under §§ 205.2(a), 205.3(b)(5), and 205.4(b), these activities include the following:

- Transacting business with the SEC, including communications in any form.
- Representing a company in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request, or subpoena.
- Providing advice with respect to the federal securities laws regarding any document that the attorney has notice will be filed with or submitted to or incorporated into any document that will be filed with or submitted to the SEC.
- Advising the company as to whether information or a statement is required to be filed with or submitted to the SEC or incorporated into a document that is filed with or submitted to the SEC.
- Conducting an investigation on behalf of the company pursuant to Part 205.
- Supervising and directing an attorney who is appearing and practicing before the SEC in the representation of an issuer.

Further guidance on how to interpret the nature of these activities is needed, such as how to interpret activity regarding "providing advice . . . regarding any document that the attorney has notice will be filed . . . with the SEC." It is unclear whether an environmental attorney that comments on the two paragraphs relating to environmental matters in an SEC filing is caught under the final rules.

Second, the attorney must be engaged in the conduct "in the context of providing legal services to a

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company with whom the attorney has an attorney-client relationship." The adopting release states that the standards may apply even though communications would not be protected by the attorney-client privilege. Presumably, the standards would therefore apply—even if the privilege would not apply—if the attorney were acting only partially in a legal capacity. The adopting release specifies, however, that the standards will not apply to an individual who, although an attorney, is not providing legal services.

Definition of "in the Representation of an Issuer"

The new standards define "in the representation of an issuer" to mean "providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer."[6] The SEC has not provided clear guidance on when an attorney will be viewed as "providing services as an attorney for an issuer," even though the attorney is neither employed nor retained by the company.

WHO IS YOUR CLIENT?

Section 205.3(a) sets forth the first obligation imposed by the new standards:

> An attorney appearing and practicing before the SEC in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.[7]

The SEC probably viewed this standard as a simple statement of existing law. In light of the rules' broad definition of "issuer," however, an attorney may be deemed to act in the representation of an issuer even though a company (other than the issuer) or an individual is the attorney's client. This result is deeply troubling, and nothing in the SEC release indicates that it was intended.

ACCA's Practical Tips for Dealing with the New Attorney Responsibility Standards under the Sarbanes-Oxley Act

Tip #1: ENSURE THAT EVERYONE UNDERSTANDS THE ROLES AND RESPONSIBILITIES OF ATTORNEYS UNDER THE NEW SEC RULES, AND UNDER CURRENT AND POSSIBLE FUTURE REFORMED VERSIONS OF MODEL RULES OF PROFESSIONAL CONDUCT 1.13 AND 1.6.

You might consider and discuss the following:

- Which attorneys are "practicing before the SEC"? Which are subordinate? And which are supervisory?
- What events trigger "up-the-ladder" reporting requirements?
- How does the SEC define (or not!) such crucial terms as "material violation," "credible" evidence, "reasonable" behavior by an attorney?
- What protections are available to lawyers who act reasonably, and what penalties are mandated for those found lacking?
- Who is the client under the SEC's rule, and how does that determination affect your ability to work with daily management in the resolution of client problems?

Even if you work in a private company, it's our belief that the standards set by the SEC on these critical matters will become a benchmark for those looking to assess the role and response of lawyers investigating wrongdoing in their client companies by courts and others in the future. It's not beyond reasonable expectations to assume that other regulatory agencies will seek to copy these rules to regulate the behavior of attorneys practicing before them—or that state licensing organizations will seek to amend their rules of practice governing all attorneys in the jurisdiction to "raise the bar" on these issues.

Remember that Model Rule of Professional Conduct 1.13 (or your licensing state's version of this rule) suggests—but does not mandate—an up-the-ladder reporting response by all corporate lawyers who encounter evidence of a client's wrongdoing. It is considered very weak in terms of practical guidance for corporate lawyers caught in a sticky ethical dilemma. The rule is probably ripe for reform by state licensing authorities in response to post-Enron concerns.

And unlike the new SEC rule—which applies only to lawyers for issuers who are practicing before the SEC—this model rule applies to any lawyer working

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REPORTING "UP THE LADDER"

The most important part of the standards is an extensive set of rules requiring each attorney who—in appearing and practicing before the SEC in the representation of a company—becomes aware of "evidence of a material violation" to report that evidence "up the ladder." In other words, the attorney is obligated to take the matter to successively higher levels of authority under certain circumstances. This attorney is known as a "reporting attorney." We will first describe the rules relating to when the reporting requirement is triggered and then discuss the alternative reporting requirements available under the standards.

Trigger for Reporting Requirement

The reporting requirement applies when an attorney, appearing and practicing before the SEC in the representation of a company, becomes aware of evidence of a material violation by a company or by any officer, director, employee, or agent of the company. The standards define "evidence of a material violation" to mean "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." (In this article, we will refer to a material violation that has occurred, is ongoing, or is about to occur as an "occurring material violation.")

The adopting release explains that the "circumstances" are all the relevant circumstances, including the reporting attorney's experience, expertise, and knowledge.[8] The standards define "material violation" to mean "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

for an organizational client. Your department should consider adopting a policy that sets standards or specific internal guidelines for how you wish to conduct up-the-ladder reporting. Even if your department is just one person, you should consider adopting procedures that you can share with your outside counsel, management, and the board.

Likewise, you may want to take another look at Model Rule 1.6, which governs an attorney's protection of a client's confidences, dictating when the lawyer is prohibited from, permitted to, or required to reveal client confidences to prevent or remedy the commission of certain kinds of client acts. When your lawyers are confronted with ethical and legal dilemmas that cannot be solved to their satisfaction by climbing up the ladder of management all the way to the board, this rule governs whether they may, must, or must not report their client to a third party. (Remember: if the SEC's new alternative proposal is approved, a new SEC-regulated system of withdrawal and reporting would be mandated for lawyers working for issuers that would "trump" Rule 1.6 in your state, if your state rules held you to a "lesser" reporting standard.)

Currently, every state permits lawyers to report evidence of a client's imminent intention to do substantial bodily harm to another, but when it comes to the lawyer reporting evidence of a client's ongoing or future financial fraud, state authorities are split. (It's particularly important to consider how to address this issue in your department if the department includes lawyers admitted in multiple states; these lawyers may have conflicting professional responsibilities about the operation of the privilege and the protection of client confidences—and thus could be "wild cards" to a planned approach that presumes that the state in which your offices reside is the state whose rules will apply.)

The issue of lawyers as "whistleblowers" is a hot topic that may divide members of your department and executives to whom lawyers daily report, particularly in light of recent events and new provisions of Sarbanes-Oxley (§ 806) that protect whistleblowing employees, presumably including whistleblowing lawyers who are employed or retained by the client. Depending on whether you're the lawyer who wants to blow the whistle—or the lawyer-supervisor who's trying to control another lawyer who's on a mission to report over your head—you'll need to get comfortable with how "up-the-ladder and out" reporting is handled.

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law."[9] The adopting release states that "material" should be interpreted in accordance with its well-established meaning under the federal securities laws.[10]

The adopting release also explains that "[t]o be 'reasonably likely,' a material violation must be more than a mere possibility, but it need not be 'more likely than not.'"[11] The standards define "breach of fiduciary duty" to refer "to any breach of fiduciary or similar duty to the company recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions."[12] If all duties of diligence, care, and loyalty are included, then almost any violation of law or any inept action by any employee of the company arguably would be subject to the rule.

Attorneys probably will often find it difficult, however, to determine whether the evidence of which they are aware qualifies as "evidence of a material violation." In making that difficult determination, an attorney can apply the following two criteria:

- Is it unreasonable under the circumstances for the attorney to conclude that that it is not reasonably likely that there is an occurring material violation? In applying this criterion, an attorney can resolve factual issues by making those reasonable credibility judgments and drawing those reasonable judgments that tend to indicate that it is not reasonably likely that a violation occurred, is ongoing, or is about to occur.
- Is it unreasonable under the circumstances for the attorney to conclude that the occurring violation is not material? Although a competent and prudent attorney could conclude that the indicated violation is material, another competent and prudent attorney could conclude that the indicated violation is not material.

Tip #2: REVIEW YOUR DEPARTMENT'S AND YOUR LAW FIRMS' POLICIES TO ENSURE THAT EVERYONE UNDERSTANDS AND AGREES TO A PLANNED APPROACH TO INVESTIGATE A REPORT OR FINDING OF POSSIBLY INAPPROPRIATE FINANCIAL BEHAVIORS.

Such policies may include (but are not limited to) the following:

- Which attorneys are considered "supervising," and which are considered "subordinate" attorneys under the rule, and what does that designation imply about their responsibilities? In larger departments, how will the department's chain of command work?
- Appropriate internal investigation procedures, including a decision tree for deciding when investigations will be done in-house and when they will be done outside.
- Development of some "objective" criteria to be considered in reaching a consensus of whether alleged violations have been successfully remedied or addressed under the rule and to the reporting attorneys' satisfaction.
- Which outside firms can be considered "independent," and which cannot?
- Prescreening for firms that could be contacted in an emergency to conduct an independent review.
- Approved methods for conducting witness interviews/evidence collection.
- Departmental and law firm documentation standards and policies.
- Client communication policies, including which in-house lawyers/teams will be charged with client contact regarding allegations of financial fraud and a possible redetermination of policy for the circumstances under which a law firm, rather than department members, will work directly with clients in investigating alleged wrongdoing.
- Language and circumstances for issuing corporate employees being interviewed the varying levels of "Miranda"-type warnings.
- Policies on joint or company-paid defense options for individually named corporate defendants (or those soon to be named individual defendants).
- How to gather the advice and experience of your outside firms on all of these issues, especially if they have their own policies in place or experiences that they can share.

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Reporting Requirements

The new standards set forth the following four approaches to reporting evidence of a material violation:

Reporting to the Company's CLO

The new standards provide that, if an attorney appearing and practicing before the SEC in the representation of a company becomes aware of evidence of a material violation by the company or by any officer, director, employee, or agent of the company, the attorney shall report such evidence to the company's chief legal officer or the equivalent ("CLO")—or to both the company's CLO and its chief executive officer ("CEO").[13] The final rules do not regulate the nature of the report, so it can be made orally, in writing, or electronically.[14] We refer to this approach as the "CLO approach."

Under the new standards, this report must be made "forthwith." The SEC did not, however, provide guidance as to how quickly the report must be made under this undefined and legally ambiguous term. In the absence of guidance, an attorney probably can take a reasonable amount of time to seek additional information or consult with advisers before reaching a conclusion that there is a material violation and preparing a report.

The new standards provide that, if a discharged reporting attorney reasonably believes that the discharge was related to that attorney's having submitted a report, the attorney may notify the board of directors (or a board committee) of this belief.[15]

Upon receiving a report, the CLO must take either of the following actions:

- Cause such inquiry into the evidence of a material violation as the CLO reasonably believes is appropriate to determine whether there is an occurring material violation.
- Refer evidence of a material violation to a qualified legal compliance committee ("QLCC") (if

Tip #3: FOR SEC-REGULATED COMPANIES, ASSESS THE PROS AND CONS OF ASKING THE BOARD TO DESIGNATE THE EXISTING AUDIT COMMITTEE OR A NEWLY CONSTITUTED BOARD COMMITTEE OF INDEPENDENT DIRECTORS TO SERVE THE ROLE OF A QLCC—A QUALIFIED LEGAL COMPLIANCE COMMITTEE.

Under the SEC's new proposal, a QLCC can receive reports of wrongdoing from the legal staff, absolving lawyers from further reporting responsibilities. The QLCC is then responsible for all future decisions regarding assessment and remedy of the legal concerns forwarded to them and may, for instance, hire outside counsel to investigate and report to them.

Because the QLCC is a new concept created by the SEC specifically as a part of this rule, there is no reliable intelligence on how it may work in practice. Indeed, although ACCA is generally supportive of the QLCC conceptually as an alternative that may provide a desirable option for some companies, we still have some questions about the possible pros and cons of adopting a QLCC.

Some of the issues that you may want to consider include the following:

- How much additional discretion or confidentiality can the QLCC add to the company's deliberations of how to respond to allegations brought to the QLCC? Will it be more or less than what's currently mandated as the process involving lawyers alone?
- Will your board be receptive to the idea of creating a new legal audit committee or additionally designating an existing committee (such as the audit committee) to fulfill that function, if the reason for doing so is to "absolve" the company's lawyers of responsibility for investigating, remedying, and reporting on alleged financial misconduct?
- Will independent directors who are already concerned about the level of financial acumen that they need to evidence be even more reticent about additional accountability for the requisite legal expertise/acumen needed to serve on a QLCC?

It is unclear under what circumstances, if at all, the QLCC is mandated to report the findings of its work to the SEC, and it is also unclear whether lawyers in the company who believe that the QLCC has not appropriately addressed the matter wouldn't still be responsible under the rule for withdrawal or additional reporting, anyway.

Another related issue of concern to many in-house counsel is the increasing and rather uncoordinated trend for individual board members, board committees,

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the issuer has already established a QLCC) and inform the reporting attorney that the report has been referred to a QLCC.

If the CLO causes an inquiry to be made, the CLO must determine whether there is an occurring material violation. If the CLO determines that there is an occurring material violation, the CLO must notify the reporting attorney and advise the reporting attorney of the basis for this determination. Unless the CLO reasonably believes that there is not an occurring material violation, the CLO must take all reasonable steps to cause the company to adopt an appropriate response, as well as advise the reporting attorney that action has been taken.[16] If the CLO refers the matter to the QLCC, the QLCC then becomes responsible for responding to the report.[17]

The new standards require the reporting attorney to evaluate whether the CLO or CEO has provided an appropriate response within a reasonable period of time. If the reporting attorney receives what the reporting attorney reasonably believes to be an appropriate and timely response, then the standards do not require the reporting attorney to take further action with respect to the report.[18]

If the reporting attorney receives what the reporting attorney reasonably does not believe to be an appropriate response within a reasonable time, then the standards require the reporting attorney to explain the reasons to the CLO and, if applicable, the CEO to whom the attorney made the report.[19] Unless the reporting attorney reasonably believes that the CLO or CEO has provided an "appropriate response" within a reasonable time, the standards require the reporting attorney to report the evidence of a material violation to the audit committee of the board of directors, another committee of independent directors, or, in the absence of an audit committee or other committee consisting of independent directors, the full board.[20] The standards further require the reporting attorney to form a belief

or the whole board to retain their own outside legal counsel to advise them on corporate legal matters. Although no one suggests that boards have not always had the ability to retain their own counsel, post-Enron, some boards seem intent on making an art form of the exercise. Some general counsel are examining strategies for working with their boards to somehow coordinate these outside advisors and their potentially competing advice.

Because a QLCC may be a prime group to wish to retain their own independent legal consultants on matters brought before them, this issue is something that the general counsel needs to carefully consider before rushing out to endorse the creation of a QLCC. Essentially, what the QLCC issue may boil down to for many general counsel is simply a decision about whether they want an outside counsel retained by the QLCC or an outside counsel retained by the general counsel to investigate and report on matters that the general counsel does not want to handle personally.

As a result of these uncertainties and although the QLCC will be an important resource for some companies to consider, we're withholding final judgment until we know more about how it will actually operate. Do note, however, that, if you are interested in the QLCC option, a QLCC must be in place *before* the report of an allegation of wrongdoing arises. It cannot consider a preexisting "legal hot potato."

Tip #4: COLLECT, CATALOGUE AND AUDIT ALL CURRENT "COMPLIANCE"-ORIENTED POLICIES AND PROCEDURES IN PLACE IN THE COMPANY THAT ARE INTENDED TO HELP EMPLOYEES UNDERSTAND AND LIVE UP TO THEIR LEGAL RESPONSIBILITIES.

For all of the headaches that corporate counsel tell us that they now have as a result of Sarbanes-Oxley and its progeny, there may be a silver lining for legal departments that have been trying to take a proactive approach to compliance and preventive counseling. Never has the interest of management been so high in preventing wrongdoing through a stronger ethical corporate culture and corresponding institutionalized compliance programs. Take advantage of the passage of this rule, as a part of Sarbanes-Oxley, to educate your managers about how the legal department can and will help the company succeed in adopting or buttressing its compliance agenda.

Here are some ideas for you to begin with:

- Conduct an audit of the effect of the company's existing policies and how they would work (or fail) if

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regarding whether the board has made an appropriate response and to explain his or her reasons to the directors if the attorney reasonably believes that the response was not timely and appropriate.[21]

The new standards identify three responses that are considered appropriate. A response is appropriate if, as a result of the response, the reporting attorney reasonably believes that—

- There is no occurring material violation.
- The company has adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence.
- The company, with the consent of the board (or another committee consisting of independent directors) or a QLCC, has retained or directed an attorney to review the reported evidence of a material violation and has completed either of the following steps:
  - Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence.
  - Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the company (or the company's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.[22]

We expect that many CLOs will adopt the third approach. The first two approaches require the reporting attorney to form a reasonable belief as to whether there was a material violation or whether a response was appropriate. This requirement can

one of several imagined catastrophic scenarios were to occur.

- Assess whether these policies are sufficient in breadth and coverage of your clients' potential risks.
- Assess whether such compliance initiatives are largely focused on "external" or field failures, rather than internal frauds or malfeasance: post-Enron, a lot of the focus on compliance has changed from a focus on problems in the field to include coverage of problems in the executive suite.
- Assess whether the corporate culture makes employees feel comfortable reporting evidence of infractions and how those complaints are collected and responded to. Consider how you will handle whistleblower situations, especially in light of the new whistleblower protections afforded employees under § 806.
- Assess the role of lawyers versus the role of managers in creating, implementing, and accounting for the success of compliance initiatives.

Use this opportunity to position the legal department as a center of ethical leadership for management interested in institutionalizing higher standards, ethics, and good corporate legal health through meaningful compliance initiatives.

Tip #5: IMPROVE PATHS OF COMMUNICATION (AND THE RESOURCES THAT SUPPORT THAT COMMUNICATION) BETWEEN LAW DEPARTMENT LEADERS AND RELEVANT MANAGERS, EXECUTIVES, AND DIRECTORS WITH WHOM DEPARTMENT LEADERS NEED TO ENJOY A RESPECTFUL AND TRUSTING RELATIONSHIP.

This assessment is as valuable for staff attorneys as it is for the chief legal officer: both need to understand how to work more effectively within the proper "spheres" of their bosses, clients, and reports.

- Do those with whom you feel comfortable communicating also feel comfortable communicating with you? Are you listening, as well as talking and educating?
- How regularly and under what circumstances do you communicate about your work or report to others? How might those opportunities be expanded or made more valuable for your audience(s)?
- Examine in greater depth the opportunities for the general counsel's office to serve a role as "bridge" between the executive management of the company and the board.

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impose a substantial burden on the company because it would have to furnish considerable information to the reporting attorney, particularly if the indicated violation is outside of the attorney's expertise. In addition, under the first two approaches, the judgment of the reporting attorney and the CLO that the response was appropriate is likely to be vulnerable to second-guessing by the SEC, particularly if these matters are likely to be outside their fields of expertise. In contrast, the third approach requires only that the reporting attorney and the CLO form a reasonable belief that the company retained or directed an attorney to take action. This approach will frequently impose less of a burden on the company and leave the reporting attorney and the CLO less exposed to being second-guessed by the SEC.

THE QLCC APPROACH CAN BENEFIT COMPANIES BY RELIEVING THE REPORTING ATTORNEY AND THE CLO OF THEIR OBLIGATIONS TO EVALUATE THE APPROPRIATENESS AND TIMELINESS OF THE COMPANY'S REPORT AND BY RELIEVING THE COMPANY OF THE NEED TO SATISFY THE REPORTING ATTORNEY.

Reporting to Board Committees

If the reporting attorney reasonably believes that it would be futile to report evidence of a material violation, the attorney may—but is not required to—bypass the CLO and CEO and report directly to the audit committee, another committee of independent directors, or the full board.[23] The standards do not expressly require the directors to take any action in response to such a report. The standards do, however, provide that, if the reporting attorney does not reasonably believe that the board entity has made an appropriate response within a reasonable time, it must explain the reasons to the directors to whom the attorney had originally reported the violation.

Reporting to the QLCC

In this rulemaking, the SEC gave issuers the option of having their boards establish a QLCC.[24] Because boards currently do not have such committees, any board that decides to form one likely will tap its existing audit committee or another board committee consisting of independent directors as the final rules permit. It remains to be seen, however, whether boards are willing to take on the burdens of maintaining a QLCC because they already have been tasked with considerable other duties under recent corporate governance reforms.

If the company has decided to form a QLCC, the reporting attorney may—but is not required to—make a report to the QLCC. In the adopting release, the SEC explained the role of the QLCC:

> Under this alternative, the QLCC—itself a committee of the issuer's board of directors with special authority and special responsibility—would be responsible for carrying out the steps required by Section 307 of the Act: notifying the CLO of the report of evidence of a material violation (except where such notification would have been excused as futile under section 250.3(b)(4)); causing an investigation where appropriate; determining what remedial measures are appropriate where a material violation has occurred, is ongoing, or is about to occur; reporting the results of the investigation to the CLO, the CEO, and the full board of directors; and notifying the SEC if the issuer fails in any material respect to take any of those appropriate remedial measures.[25]

An attorney that makes a report to a previously established QLCC has satisfied the obligation to report such evidence and is not required to assess the company's response.[26] In addition, the company does not need to inform each reporting attorney of the company's conclusions, the bases for those conclusions, or the remedial actions taken.

The new standards provide that an attorney retained or directed by a QLCC to investigate is excepted from any obligation to report such evidence.[27] Similarly, if the attorney was retained or directed by a QLCC to assert a colorable defense on behalf of the company in any investigation or judicial or administrative proceeding, the attorney need not report such evidence.[28] The SEC has not indicated that these exceptions depend on the investigation or proceeding being either pending or imminent.

The QLCC approach can benefit companies by relieving the reporting attorney and the CLO of their obligations to evaluate the appropriateness and timeli-

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- ACCA's committees, such as the Corporate and Securities Law Committee, are excellent knowledge networks and have listservs to join and other benefits. Contact information for ACCA committee chairs appears in each issue of the *ACCA Docket*, or you may contact Staff Attorney and Committees Manager Jacqueline Windley at 202.293.4103, ext. 314, or windley@acca.com, or visit ACCA Online℠ at www.acca.com/networks/ecommerce.php.
- ACCA's Corporate Responsibility page, which features timely post-Enron reform information, available on ACCA Online℠ at www.acca.com/legres/corpresponsibility/index.php.
- ACCA's executive summary of the rule and its provisions, available on ACCA Online℠ at www.acca.com/legres/corpresponsibility/307/summary.pdf.
- ACCA's § 307 "Questions and Answers," available on ACCA Online℠ at www.acca.com/legres/corpresponsibility/qa.php.
- American Bar Association's Preliminary Report from the Task Force on Corporate Responsibility, at www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.
- Kirsten Birkett and Anna-Maria Leonard, *Certification of Financial Reports: Applying the New Requirements,* Global Counsel Corporate Governance Handbook, 2003, available on *PLC Law Department* at www.practicallaw.com/A27020.
- *Corporate Governance and Directors' Duties,* Global Counsel Handbook, 2003, available on *PLC Law Department* at www.practicallaw.com/T2214.
- Ethics Officers Association, at www.eoa.org.
- Edward Fleischman, Larry Vranka, and Jason Manket, *Sarbanes-Oxley: Initial Requirements*, Global Counsel, 2002, VII(8), 47, available on *PLC Law Department* at www.practicallaw.com/A26318.
- Holly J. Gregory and Jane G. Pollack, *Corporate Social Responsibility,* Global Counsel, 2002, VII(2), 41, available on *PLC Law Department* at www.practicallaw.com/A22134.
- Broc Romanek, Linda L. Griggs, and Sandra Leung, "New Compliance Challenges under the Sarbanes-Oxley Act of 2002," *ACCA Docket* 20, no. 10 (November/December 2002): 22–41, available on ACCA Online℠ at www.acca.com/protected/pubs/docket/nd02/sarbanes1.php.
- SEC Final Rule: Implementation of Standards of Professional Conduct for Attorneys, at www.sec.gov/rules/final/33-8185.htm.
- SEC proposed rule on noisy withdrawals, at www.sec.gov/rules/proposed/33-8186.htm.
- John K. Villa, "A First Look at the Final Sarbanes-Oxley Regulations Governing Corporate Counsel," *ACCA Docket* 21, no. 4 (April 2003): 90–99, available on ACCA Online℠ at www.acca.com/protected/pubs/docket/am03/ethics1.php.
- Gretchen A. Winter and David J. Simon, "Code Blue Code Blue: Breathing Life into Your Company's Code of Conduct," *ACCA Docket* 20, no. 10 (2002): 72–89, available on ACCA Online℠ at www.acca.com/protected/pubs/docket/nd02/codeblue1.php.

ON PAPER:

- John K. Villa, Corporate Counsel Guidelines (ACCA and West 1999, with annual updates).

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ness of the company's report and by relieving the company of the need to satisfy the reporting attorney. On the other hand, both management and directors might believe that investigating the reports and developing a response should, in most instances, be the responsibility of management. Moreover, directors might be reluctant to join a QLCC before the time demands and legal risks of the position become more apparent.

Reporting to a Supervisory Attorney

For large companies with substantial legal departments, it probably will be awkward for junior attorneys to bypass their bosses and report the evidence directly to the CLO. So far, the extent to which the CLO approach will permit junior attorneys to consult with their direct supervisors is unclear. The standards offer an alternative that provides at least a partial solution to this awkwardness by providing that, when a subordinate attorney has reported to the supervisory attorney evidence of a material violation, the supervisory attorney is—and the subordinate attorney is no longer—responsible for complying with the reporting requirements.[29] An open question is whether a senior subsidiary attorney (or other senior attorney) that helps draft an SEC filing is subordinate to the securities attorney who is in charge of the filing even if the subsidiary attorney is at least as senior as the securities attorney and the securities attorney has absolutely no input into the subsidiary attorney's pay or promotion. What if the attorney providing input is more senior than the securities attorney—but is not the direct or indirect supervisor of the securities attorney, such as a deputy general counsel in charge of another area of the legal department?

Despite the lingering questions, clearly, the SEC contemplated that this approach would permit a junior attorney to satisfy the obligations by reporting to a supervising attorney. It is not clear, however, whether the SEC contemplated that a law firm partner could meet the obligations by reporting to the legal department attorney that directs or supervises the partner's work. The terms of the standards do, however, appear to permit this result.

CONCLUSION

As could be expected with any significant rulemaking, many issues inevitably remain open, and questionable results appear to be likely to arise because of these new standards. Even though some of the problematic provisions from the SEC's proposed rules were not adopted, these new standards impose a slew of new duties and potential liabilities on in-house attorneys. In-house counsel need to become familiar with the obligations imposed by the new rules and begin taking action well before the effective date of the standards.

NOTES

1. Part 205 of 17 C.F.R. is effective 180 days after February 6, 2003, the date that the final rules were published in the *Federal Register*, will be codified as Part 205 of 17 C.F.R., and can be found in SEC Rel. 33-8185 (Jan. 29, 2003) at www.sec.gov/rules/final/33-8185.htm ("Adopting Release"). The SEC reproposed the noisy withdrawal provision in SEC Rel. 33-8186 (Jan. 29, 2003) at www.sec.gov/rules/proposed/33-8186.htm. The SEC's original proposals were in SEC Rel. 33-8150 (Nov. 21, 2002) at www.sec.gov/rules/proposed/33-8150.htm ("Proposing Release"). In this article, we cite the releases as they appear on the SEC website.
2. Section 205.2(c).
3. Section 205.2(j) defines "non-appearing foreign attorney" to mean an attorney—
   - Who is admitted to practice law in a jurisdiction outside the United States.
   - Who does not hold himself or herself out as practicing and does not give legal advice regarding U.S. federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section).
   - And who either—
     - Conducts activities that would constitute appearing and practicing before the SEC only incidentally to and in the ordinary course of the practice of law in a jurisdiction outside the United States.
     - Or is appearing and practicing before the SEC only in consultation with counsel, other than a nonappearing foreign attorney, admitted or licensed to practice in a state or other U.S. jurisdiction.
4. Section 205.2(h).
5. Section 205.2(a).
6. Section 205.2(g).
7. Section 205.3(a).
8. Adopting Release at 12.
9. Section 205.2(i).
10. Adopting Release at 15.
11. Adopting Release at 13.
12. Section 205.2(d).
13. Section 205.3(b)(1).
14. Section 205.2(n). As noted above, the SEC dropped the proposed requirement that the reporting attorney document the report.

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15. Section 205.3(b)(10).
16. Section 205.3(b)(2).
17. Sections 205.3(b)(2) and 205.3(c)(2).
18. Section 205.3(b)(8).
19. Section 205.3(b)(9).
20. Section 205.3(b)(3).
21. Section 205.3(b)(9).
22. Section 205.2(b).
23. Section 204.3(b)(4).
24. The standards provide that the QLCC must—
    - Consist of at least one member of the audit committee (or, if the company has no audit committee, one member from an equivalent committee of independent directors) and two or more other independent members of the board of directors.
    - Have adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation by a reporting attorney.
    - Have been duly established by the board of directors, with the authority and responsibility—
        - To inform the CLO and CEO of any report of evidence of a material violation, except in cases in which the reporting attorney (reasonably believing that a report to the CLO and CEO would be futile) bypassed the CLO and CEO.
        - To determine whether an investigation is necessary regarding any report of evidence of a material violation by the company or its officers, directors, employees, or agents and, if it determines that an investigation is necessary or appropriate, to take a number of actions listed in the standards.
25. Adopting Release at 29.
26. Section 205.3(c)(1).
27. Section 205.3(b)(7).
28. Section 205.3(b)(7).
29. Sections 205.5(c), 205.4(c). The standards define "subordinate attorney" to mean "[a]n attorney who appears and practices before the SEC in the representation of a company on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the company's CLO)." The standards define "supervisory attorney" to mean "[a]n attorney supervising or directing another attorney who is appearing and practicing before the SEC in the representation of a company" and specifies that a company's CLO is a supervisory attorney.

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The in-house bar association[SM]

April 7, 2003

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609
Submitted Electronically: rule-comments@sec.gov

Re: File Number S7-45-02

On behalf of the American Corporate Counsel Association[1] (ACCA), we respectfully respond to the Commission's request to offer both our perspectives regarding the final rule regulating attorney conduct (promulgated under 17 CFR Part 205), as well as the Commission's ongoing and additional proposals regarding noisy withdrawal and alternative 8-K reporting, all flowing from Section 307 of the Sarbanes-Oxley Act of 2002.[2]

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[1] The American Corporate Counsel Association ("ACCA") is a bar association for lawyers who are employed by corporations as in-house counsel. With 14,000 individual members in 40 countries, ACCA members represent over 6,500 organizations worldwide. ACCA members' employers include the Fortune 1000, as well as small and mid-sized businesses and non-profits engaged in every conceivable industry. According to ACCA's 2001 census of the in-house legal profession, approximately 40% of in-house lawyers work in law departments of fewer than 5 people; within the ACCA membership, while the largest single segment of our members "by title" is constituted by those who serve as their company's chief legal officer, the majority of our members work in positions that report to the CLO. We have worked carefully to insure that the information and perspectives we bring to the Commission with this submission fairly represent the opinions and concerns of in-house lawyers at all levels of the law department.

[2] ACCA's comments to the Commission on the Commission's initial proposal can be found at www.sec.gov/rules/proposed/s74502/bnagler1.htm. We reaffirm those salient portions our previous comments regarding noisy withdrawal to avoid repeating them in detail in this letter.

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Comments of the American Corporate Counsel Association (ACCA)
April 7, 2003

Executive Summary of This Letter's Comments

Noisy withdrawal and alternative 8K reporting proposals:

1. We urge the Commission to forego both the noisy withdrawal and alternative 8-K proposals. These proposals will damage lawyer-client relationships and discourage clients from seeking legal counsel. While no rule can make lawyers more ethical or prevent clients who possess a criminal bent from doing wrong, these proposals may cause currently healthy lawyer-client relationships irreparable harm or discourage clients from consulting either honestly or at all with lawyers. Clients will be wary of welcoming lawyers into their businesses if the lawyer's exposure to almost any "credible" (even if unlikely) allegation could trigger a complicated process of mandated internal investigations leading to a possibly unwarranted report to the Commission. The resulting damage to the lawyer-client relationship (or its elimination) benefits no one – including the corporate entity, the company's stakeholders, or the public – and will likely preclude the very kind of preventive compliance initiatives that the Sarbanes-Oxley Act seeks to advance.

2. Alternatively, if the Commission nonetheless proceeds with either the noisy withdrawal or 8-K proposal, it should consider making them more appropriate and effective. In the case of noisy withdrawal, these amendments should include better defined triggering language, a reassessment of the roles of supervisory, subordinate and reporting attorneys, and safeguards that a company might put in place to protect itself against a lawyer determined to report an unfounded allegation, or blackmail or retaliation against the company or supervisors in the law department. In the case of the alternative 8-K proposals, we request a longer period before required reporting (including a period during which the company could consult offline with the Commission prior to any filing requirements) and the option of obtaining a second opinion from an independent counsel which could obviate the requirement to report at all in the event that the independent second opinion affirms that the allegation is unfounded or does not trigger this rule's application.

Clarifications and reconsiderations to Part 205 as promulgated in the final rule:

1. The Commission should narrow and clarify the triggers that activate the rule's application: the language in several places is far too broad, confusing in its lack of definition, and places the Commission in the position of regulating attorney behaviors completely unrelated to securities violations. We recognize that much of this language is drawn from Section 307 of the Act, but for an attorney conduct rule to be effective and appropriate in its guidance, lawyers have to be able to understand how to apply the rule. As written, the rule can be triggered by virtually any and all allegations, which is not a proportionate or appropriate guideline to focus lawyers' attention on the most serious matters facing the client. We also request the Commission to additionally clarify some appropriate up-the-ladder reporting issues.

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2. The rules regulating reporting and subordinate attorney responsibilities should be revised to provide a clear-cut end to junior attorneys' responsibilities under the rule after they report and receive confirmation of a supervisory attorney's (or CLO's) actions taken in response. Subordinate or reporting attorneys may not be vested with the full knowledge or capacity required to evaluate the supervisory attorney's or CLO's decisions. It is appropriate to focus the rule's attention on the judgment and responsibility of the CLO and other supervisory attorneys in addressing the report, but not to force the subordinate or reporting attorney into a showdown over whose judgment should prevail if a difference of opinion between the CLO and the reporting or subordinate attorney ensues. Of course, ACCA supports the creation of a limited exception to this provision if there is an allegation that the CLO or supervisory attorney is complicit in the alleged fraud or wrongdoing.

3. We propose suggestions to improve the function of the QLCC to promote a more cooperative and less adversarial relationship between the QLCC and the CLO. Additionally, we urge the Commission to drop the requirement that the QLCC pre-exist the onset of a problem that may be reported to it.

I. Introduction / Overview

We compliment the Commission for its careful consideration of the concerns presented to it in the promulgation of the final rule constituting Part 205. We appreciate the Commission's considerable efforts and success in addressing a number of matters raised by the bars and others. The final rule is a far better rule than was the initial proposal. We also appreciate the opportunity to address not only the proposals yet to be decided, but our ongoing concerns in the final rule so that any issues or questions can be resolved before the rule goes into effect in August of 2003. Those concerns that we wish to bring before the Commission on behalf of the in-house bar are offered below.

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Corporate counsel are uniquely positioned to promote their corporate clients' culture of responsibility and compliance initiatives. They are acutely aware of the need for the in-house lawyer to carefully navigate the dual roles of independent professional counselor and member of the executive business team.

This is true for in-house counsel who work in both public and private corporations. While the Commission and these rules focus on certain lawyers working for issuers, lawyers for issuers who are not "appearing and practicing before the Commission," as well as lawyers working in private companies are watching this process and its results very closely. They know that their work is just a short step removed from the work of lawyers governed by these regulations: perhaps their next job will subject them to the Commission's regulation, or maybe they will handle a difficult matter that involves an issuer, exposing them to the application of these rules in a practical setting. They also know that for purposes of future professional rules adopted by the state bars, these

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rules will likely have an influence in directing the regulation of all lawyers working for any kind of corporate client.

Some suggest that the passage of these rules merely re-codifies already existing regulation common to a majority of states' bars; we do not agree. We believe that the promulgation of these rules represents a significant sea change. Accordingly, we need to examine the Commission's proposals with an equivalent scrutiny on their practical impact. Existing rules regulating lawyer conduct at the state level give the lawyer guidance in the exercise of professional behavior; in addition to removing the discretion exercised by the lawyer in the state rules, the Commission's final and proposed rules move us into new waters by assigning lawyers the professional responsibility for regulating not just their own behavior, but the behavior of their clients.

We believe that lawyers should play the role of learned and ethical counselors who exercise professional discretion and judgment, and that clients are ultimately vested with the power to choose to accept or reject their lawyer's advice. We do not support promulgating professional rules making lawyers responsible (and liable) for coercing clients to accept legal advice. The vast majority of the states' ethics rules *mandate* only that the lawyer withdraw in the face of continued client intransigence and malfeasance; this embodies an understanding that the better part of a lawyer's professionalism lies in the knowledge that he is not the client, but rather the client's counselor and legal confidante. In the end, while lawyers are responsible for doing their best to convince clients of what is right, the client must decide to do the right thing, or our system of professional legal representation fails. If we move toward regulations that turn lawyers into cops on the beat, we will be making a decision to fundamentally change the lawyer-client relationship from one based on trust and advice, to one inclined toward prosecutorial responsibilities.

ACCA believes that recent events require lawyers to play a significant and heightened role in preventing future corporate misconduct and helping clients create a culture of corporate responsibility. Indeed, we agree with those commentators at the Commission and within our membership who argue that that the bar risks missing the lessons of the entire Sarbanes-Oxley exercise if it continues to object to all efforts to heighten the responsibility of lawyers in the post-Enron world, especially if it does not have viable and preferable alternatives to suggest.

A number of critics even maintain that the exercise of the bars' concerns in letters such as these somehow indicates that the bars "just don't get it." ACCA's effort to embrace the larger issue of corporate governance reforms and aggressively look for a heightened role for corporate lawyers does not mean that we will support any reform proposed. Our duty is to assess whether the Commission's proposals help to fulfill the goals of offering practical, effective and professional guidance for lawyers who want to work more effectively with their clients in pursuit of their client's better corporate legal health and culture; where we are concerned that the Commission's proposals fall short of preparing our members to meet that goal, our letter will offer our suggestions for improvement.

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Comments of the American Corporate Counsel Association (ACCA)
April 7, 2003

II. The Commission's Noisy Withdrawal and Alternate 8-K Reporting Proposals

A. The Commission's ongoing noisy withdrawal proposal

We incorporate by reference our previous comments on the initial proposal. In summary, our concerns are:

1. Sometimes lawyers need to be reminded that clients do not have to hire or consult lawyers at all if they are unsure of the value that lawyers add or are wary of the headaches that working with lawyers may entail. If the effect of this rule is to suggest to some clients that their lives will be much easier if they simply forego legal counseling, then the purpose of encouraging more aggressive lawyer involvement under the Act is completely frustrated.

2. Complex frauds perpetrated on the company by rogue managers will never be prevented by this rule or others. Such frauds are less likely to be discovered and remedied by a corporate counsel shut out of the client's inner circle because the client perceives him to be a reporter or policeman for the government.

3. The majority of state bar ethics rules already provide for discretionary or permissive disclosure of certain kinds of financial frauds. Further, it is likely that the American Bar Association will push for the amendment of Model Rule 1.6 to encourage permissive disclosure in those jurisdictions that have not adopted it. Permissive disclosure through existing and future state bar rules offers the lawyer both a carrot and stick approach in working to resolve matters with a reticent client. Mandatory disclosure requirements remove the valuable tool of the carrot, and leave the lawyer little or no discretion in how to address a situation. The lone presence of the stick also sends a perverse message to the client: even if the client wants to correct its behavior, the lawyer may nonetheless be obligated to report a matter to the authorities, thus providing the client with a stronger incentive to cover up problems in the future, rather than risk working with lawyers to correct or prevent them. The Commission's mandatory disclosure approach is thus not a better or more effective replacement for the state bar's rules.

4. Further, the creation of a Commission-mandated noisy withdrawal requirement that trumps state regulation may discourage the minority of states without a permissive "reporting out" rule from joining the majority of jurisdictions in creating a consistent standard of permissive disclosure that regulates and improves the standards applicable to the behavior of *all* attorneys, and not just those appearing and practicing before the Commission.

5. An additional standard of mandatory reporting by the Commission adds yet another layer of confusion to the current patchwork by regulating only certain lawyers for certain kinds of corporate clients who are engaged in certain kinds of work at any given time. If ethics experts who have spent many hours studying these rules in detail are confused about how the rules should be interpreted, how can we expect the

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average overworked and time-pressured lawyer to successfully navigate the complexities of their competing obligations in multiple states and under the occasional regulation of the Commission's rules? The result may well be a focus on "C.Y.A." activity by lawyers who want to prove in 20/20 hindsight that their efforts complied with the uncertain standards of the rule, rather than reporting activity intended to encourage clients to right their wrongs and prevent costly problems and future corporate failures.

6. Sarbanes-Oxley seeks to define and promote more appropriate roles for management and the board in safeguarding the company and its stakeholders from illegal actions of senior management. Lawyers (and especially in-house lawyers) should be empowered by the Act and the rules to do the job that only they can do and that Congress explicitly mandated for them within the provisions of Section 307. The legislative record of the Act shows us that Congress did not intend Section 307 to diminish the attorney-client privilege. Indeed, the legislative history specifically points to the importance of supporting the lawyer-client relationship. Lawyers play a crucial role in *contributing to corporate compliance* as confidential counselors. Lawyers can improve their performance in that role. But improvements to corporate compliance efforts led by lawyers will be possible only where a strong foundation of a trusting and confidential lawyer-client relationship exists.

If the Commission nonetheless adopts a noisy withdrawal rule, it should consider:

- limiting such withdrawal to matters that involve a material violation of the securities law (as opposed to the wider definition of triggering violations);

- adopting a higher standard of certainty on the part of the lawyer that the violation was material and ongoing or about to occur before a noisy withdrawal is required;

- limiting the application of the rule regarding noisy withdrawal only to those matters in which the attorney's services would be used in the commission of the fraud; and

- extending the artificially short time periods in which the noisy withdrawal must be tendered (so as to allow the threat of withdrawal to provide one last meaningful sanity check opportunity for the reticent client).

B. The Commission's Alternative 8-K Proposal

The alternative proposal suffers from the same core deficiencies of the original noisy withdrawal proposal. We therefore oppose it. Admittedly, the alternative proposal provides a device by which a lawyer can avoid directly reporting a client's intransigence to remedy an allegation of fraud, and purportedly removes concerns about the lawyer thereby unilaterally breaching the client's confidences. But while the lawyer may not be the one who physically files the 8-K report, it is nonetheless the lawyer's action that triggers the board's responsibility for filing.

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Clients will see this for what it is: a distinction without a difference. They will have the same concerns they would under the original noisy withdrawal proposal. Indeed, clients may have an even stronger negative reaction, for two reasons. First, the alternative proposal distorts the proper balance between the company's directors and the company's lawyers in deciding which group is appropriately responsible for making decisions about the company's reports to the SEC. Second, the 48-hour 8-K reporting requirement of the alternative proposal denies the board any meaningful opportunity to assess and address the withdrawal with the Commission prior to the notice of the lawyer's withdrawal being widely publicized (as it will shortly after the posting of the 8-K hits the Internet and markets). Clients may need more time to meet with the Commission in order to discuss the reasons the board may have declined to take the lawyer's advice, including possible plans to pursue a colorable defense. It is not inconceivable that a board that refuses to take a lawyer's advice (knowing the significant consequences involved in that decision), could have a very important reason for choosing to accept the lawyer's departure rather than conform to the lawyer's demands, including the possibility that the lawyer involved was somehow inappropriately blackmailing the company as a result of personal grievances or dissatisfactions. Given the high likelihood of unproductive public speculation about the withdrawal, and the extreme potential impact of the 8-K report of a lawyer withdrawal on the company's stock and even its future viability, it seems only prudent to protect shareholders and other stakeholders from this kind of misdirected result.

If the Commission decides to proceed with the alternative proposal, then – in addition to the requests made of the Commission above regarding noisy withdrawal – the Commission should amend the provision to allow a board in receipt of a lawyer's withdrawal to have:

- more time to assess the lawyer's withdrawal (since the board may not have all the facts at their disposal) or the option of reporting privately to the Commission first if they wish to convince the Commission that a material violation has not actually occurred as reported by the withdrawing attorney; or

- an alternative option of obtaining a second opinion by an independent counsel (to determine if the withdrawing lawyer's assertion of a material breach has merit and if the lawyer has meaningfully pursued up-the-ladder remedies that might have adequately attended to the problem).

A company flagrantly ignoring good advice from its lawyers will not likely bother with another opinion; it will either comply with the Commission's requirements or ignore the requirements of the law at the risk of its directors' and senior managers' liability. If they are pursuing a colorable defense, presumably that case will be presented to the public and shareholders in the form of notice of a litigation pending. But if the company is truly in the grip of a rogue or inept lawyer or has not had time to meaningfully explore the lawyer's allegations, it will not be forced into a corner of reporting an unjustified withdrawal to the extreme and irreversible prejudice of the company's (and thus, the shareholders') interests.

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We request that Commission forego both the noisy withdrawal and alternative proposals. These proposals do not facilitate the kind of lawyer-client relationships that encourage clients to seek legal counsel in an open and honest fashion, and indeed, may cause currently healthy relationships irreparable harm. The results of this damage will not benefit corporations, their stakeholders, or the public interest, and may have the impact of precluding the very kind of preventive compliance initiatives that the Sarbanes-Oxley Act seeks to advance.

III. Clarifications Requested to Part 205:

A. Requested Changes to the Triggering Language and Definitions

Part 205.2(i) defines a material violation triggering the rule as one that involves a material violation of a state or US securities law, a material breach of fiduciary duty arising under a US or state law, or a similar material violation of any US federal or state law. Sarbanes-Oxley was clearly created to propose regulations to limit fraudulent financial activities. It was not intended to grant the Commission oversight of the lawyer's behavior in matters unrelated to the Commission's general authority. Under the language of the rule as currently written, the Commission's rules would trigger a lawyer's response for matters that are not related to financial fraud, securities law or even fiduciary duty.

Combined with language appearing elsewhere in the Rule – for instance, the definition of credible evidence in Part 205.2(e) – such a broad categorization of covered activities creates a trigger for nearly any kind of allegation brought to a lawyer's attention, even those that are improbable, but from a marginally credible source. While we all agree that illegal behavior is always an appropriate focus for a lawyer, not all matters brought to the attention of a lawyer should be investigated and pursued with the same level of priority and to the same standards of mandated behavior as this rule requires.

We request a corresponding amendment to Part 205.3(b)(1) to limit reporting responsibility to reports of evidence of a material violation that is based on information relating to the lawyer's representation. This means that tax lawyers aren't formally responsible for assessing the likelihood of a potential material violation stemming from a conversation overheard at the water cooler regarding a patent claim.[3] A good lawyer will always take the troubling conversation overheard at the cooler down the hall to an IP colleague or the CLO, but such an amendment of the rule appropriately limits the lawyers' responsibility for formally pursuing matters totally outside of his expertise or authority.

We join the American Bar Association in suggesting that a company be allowed to choose who will be in charge of matters relating to the reporting up-the-ladder

[3] This example has been widely discussed at several recent programs and was formulated by Professor Thomas Morgan of the National Law Center at George Washington University.

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requirements of this rule. This provides additional options for departments to designate a resident expert – who may not be the CLO – who is responsible for handling and ensuring the department's compliance with the complex technicalities of this rule's reporting requirements. Likewise, the Commission should allow the department the flexibility of designating additional representatives as supervisory attorneys if such is helpful to shaping a larger compliance initiative that builds-in the capacity to facilitate lawyer reporting consistent with the Commission's rules.

B. Supervising/Subordinate/Reporting Attorney Issues

The Commission's rule designates certain attorneys as "subordinate," others as "supervisory" and still others as "reporting." Each designation carries with it certain responsibilities, some of which are not yet fully explored or understood. Clearly, we all agree with the general concept that subordinate and reporting attorneys should be offered a pathway to insure that supervisory counsel and the CLO (as well as potentially others) hear and then address the subordinate or reporting attorney's concerns. Our interests lie in discerning how more junior subordinate or reporting attorneys will know when they have fulfilled their professional obligations and when they can presume that those who have been vested with greater seniority are appropriately responsible for making any further decisions about the merits of the report and how to proceed.

We recognize that Section 307 requires the Commission to create a rule governing all lawyers practicing before the Commission which instructs those lawyers to follow an up-the-ladder pathway of reporting that leads all the way to the board of directors, if necessary. The Commission chose to pursue this mandate by creating distinct roles for a variety of attorneys working in the corporate legal chain of command, rather than simply creating a single rule that applies equally to all lawyers who come across a triggering allegation. By writing a rule that creates separate roles for attorneys, however, the Commission has created some practical problems that we wish to address.

ACCA supports the permissive and discretionary reporting required of all attorneys under ABA Model Rules 1.13 and 1.6 (including the financial reporting permissions present in the majority of the states' rules, but not in Model Rule 1.6). We do not support the Commission's decision to invest junior attorneys with a mandate to assess and contest the CLO's final decisions. Giving such discretion to the role of a junior attorney does not further the operation of the rule as intended (to make sure that responsible lawyers take a matter to its proper level of attention within management and the board) while having a deleterious effect on the structure and smooth operation of law departments in general, and larger law departments specifically.

In smaller law departments,[4] issues sufficiently "material" to trigger reporting under this provision will probably be shared knowledge within the department. In-house

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[4] Indeed, a surprisingly large number of legal departments in the United States are one-person shops; the next largest category is departments with 5 or fewer lawyers. It is

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counsel in smaller departments will more likely engage in consensus-building around a commonly-agreed-upon-course of action, internal investigation procedures, and any necessary "up-the-ladder" plans. It is likely in the smallest departments that either only the CLO will be considered a supervisory attorney, or that everyone will be considered a supervisory attorney. Clearly, no matter how designated, there is less likelihood that divisions will exist between "decision-making supervisors" and those whose primary function should be the report of credible evidence to a supervisory attorney or the CLO.

Small department practitioners may not like that Part 205 will create differing standards of appropriate behaviors based on one's rank within the department; it contradicts and frustrates the creation of a department unified by common principles and standards. But the impact of the rule's disparate application between attorneys in small departments may not have as profound an impact on the way that these lawyers ultimately continue to relate to each other: these lawyers' relationships will continue to be founded upon the daily trust and communication that springs naturally from working closely together, all day, every day.

In larger departments, however, (or de-centralized departments where counsel are geographically dispersed) there is greater likelihood for the supervisory/subordinate/reporting attorney distinctions to have what we believe are unintended and deleterious effects on the department's efficient and effective operation in pursuit of the highest standards of client service.

First, while we agree that the CLO should report back to the reporting or subordinate attorney so that they will be aware that the matter is on track for resolution, it is not realistic to mandate that the CLO should report back the result *with the requirement* that the junior lawyer be allowed to judge whether the CLO's decisions and actions are appropriate. (In the case of a reporting attorney, a dissatisfied lawyer *must* report over the CLO's head to the board or its committees under Part 205.3(b)(3); in the case of a dissatisfied subordinate attorney, the subordinate attorney is *permitted* to not only question the response of the supervisory attorney to whom she reported, but to report over the CLO's head, if she believes it appropriate and necessary. The subordinate attorney's permissive right is authorized under the rule in Part 205.5(d).

The CLO of a larger department may have responsibility for a legion of attorneys (including outside counsel), many of whom do not regularly interact with the CLO or even with her direct reports. Many of these attorneys likewise serve a role of supervising attorneys under the rule. The information possessed by the CLO or other supervisory attorneys about the investigation of reported allegations, the persons and processes included in that investigation, the superior experience and judgment which makes the CLO the Chief Legal Officer (and makes the reporting or subordinate attorney her junior), and the executive hierarchy necessary to facilitate making

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unlikely that such tightly knit smaller departments (unless perhaps the few members are geographically dispersed) will be interested or practically able to seal off information of a report or its investigation.

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decisions on behalf of a large team, all combine to make reporting over the head of supervisory attorneys quite a potentially divisive and ill-considered event in the internal operation of a law department.

The CLO or supervisory attorney should provide a subordinate or reporting attorney with a report that the allegation was without merit, was appropriately remedied, is the subject of a continuing and significant investigation, or is the subject of the corporation's decision to pursue a colorable defense. We believe that the subordinate or reporting attorney's obligations and discretion under the Rule should be fully satisfied at this point in the process. It is illogical to acknowledge that seniority matters, but then insert a permissive or mandatory "override" function for a junior subordinate or reporting attorney to disagrees with the adequacy of the CLO's or supervisory attorney's actions. In addition to being disruptive to a chain of command that the Commission infers is appropriately in place, such a rule is not logically connected to a presumption that superior legal judgment is being exercised when the junior is allowed to override the senior to whom she reports. It is a common necessity of practice for senior lawyers direct the behavior junior lawyers; such is part of the learning curve and apprenticeship we all serve at the bar. This supervision of behavior and executive control of the client's work is presumed acceptable so long as the senior lawyer accepts responsibility for what he directs the junior to do, and does not ask the junior lawyer to violate the laws or rules of professional responsibility.

Model Rule 1.13, already governs the behavior of all lawyers, allowing them to report up-the-ladder in whatever fashion they believe is necessary in order to remedy client wrong-doing.[5] It is therefore unnecessary for the Commission to codify this rule again, but to do so in a fashion that is inefficient, inappropriate, and confusing to subordinate and reporting attorneys and the often-superior wisdom of their supervisors. The Commission's rule inappropriately burdens junior lawyers by encouraging or forcing them to question the results of an investigation (the facts of which they may not know) or the judgment of a supervisory attorney (which they may not be sufficiently expert to do).

A prudent CLO or other supervisory lawyer who reports her decision and actions to a subordinate or reporting attorney may correctly wish to limit the report to only general information. The rule – in that it presumes that subordinate or reporting attorneys must be convinced of the appropriateness of the handling of a matter – may in some situations work in contradiction to other legal obligations to the client. For example, to convince a skeptical reporting or subordinate attorney, the CLO may have to divulge details, for instance, on the termination or censure of an employee. If the reporting attorney is considered an uninvolved third party to the employee's evaluation process, employment law would create an additional and unnecessary exposure for the company, by opening it to claims of "excessive publication" by the

[5] Note that these up-the-ladder reporting responsibilities will likely become even more specific and meaningful in regulating an attorney's response under the proposed reforms to Model Rule 1.13 as suggested by the report of the ABA Corporate Responsibility Task Force; the Task Force's has only recently issued its final report.

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disgruntled employee. In-house lawyers are trained to exercise extreme discretion in parsing out information about ongoing and even settled legal matters to anyone outside of the "need to know" management team or control group. This rule thus puts the CLO or supervisory attorney in the tight spot of trying to balance which obligation is more important.

An exception appropriately may be made when the CLO is suspected of complicity in the alleged violation. Obviously, in such a circumstance, a reporting lawyer should go over the CLO's head to the CEO, the board, or the QLCC with her report. But the Commission should not create a general rule that elevates in the institutional knowledge, legal acumen or professional discretion of junior attorneys over that of the CLO or supervisory attorneys when the issue rotates around a disagreement over the proper legal course to pursue or the correct interpretation of company activities or corrective actions. By definition, the CLO or a supervisory are charged to make the executive decisions that move the department out of discussion and into action. Likewise, those same actors should be fully accountable for the exercise of proper discretion, legal judgment, and leadership decisions made in execution of their responsibilities.

We respectfully request the Commission to accordingly amend the reporting and subordinate attorneys' obligations currently articulated in 205.3(b)(3) and 205.5(d).

C. Regarding the Operation of the QLCC

When the Commission first introduced the QLCC concept, a number of corporate counsel initially responded with pleasure that an alternative reporting mechanism might be available to them. As the in-house community discussed the concept in greater detail, however, amazingly similar concerns have been repeatedly voiced.

First, quite a few general counsel worry that should they ask the board to designate a QLCC, the board may presume that the QLCC creates (at the CLO's request) an alternative route for reporting and investigating matters that completely bypasses the CLO's office. Thus, rather than presuming that the committee's work will be premised on a cooperative relationship with the CLO, the QLCC may presume that their first course of response should be to hire their own outside counsel to conduct investigations and make recommendations.[6]

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[6] In light of current events, boards are more likely than ever to forego additional consultation with company executives and staff, including existing company lawyers, in favor of retaining independent advisors to consult on virtually every aspect of the company's governance and compliance agenda. While in many cases, hiring outside advisors is most prudent, the practice has become almost mandatory even when no suspicion of executive incompetence or malfeasance exists: in today's climate, retaining outside advisors is considered necessary "cover" for directors concerned with their own liabilities and possible hindsight judgments made by shareholders and other stakeholders.

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Comments of the American Corporate Counsel Association (ACCA)
April 7, 2003

Because board members assigned to the QLCC can only focus on legal matters intermittently and will need to rely extensively on *someone* for assistance in sifting reports, investigating facts, proposing remedial actions, and so on, in-house counsel inclined to suggest a QLCC to their board would welcome some suggestion in the rules that that "*someone*" might appropriately include the CLO and the company's legal staff. Otherwise, many CLOs will be reticent to support the creation of a QLCC as it is currently outlined; they will not want to appear to be abdicating their responsibilities. In those cases that should be conducted by an outside firm, the CLO may prefer to hire and supervise his own choice of counsel, rather than simply sending it to the QLCC so that they can hire their own.

Indeed, CLO's regularly voice their concern that outside counsel hired by the QLCC might have little guidance or commitment to working sensitively and productively with managers to uncover and remedy allegations. Such firms can mistakenly believe that their retention by a group of directors indicates a presumed hostility to any cooperation with or presumption of good faith behavior on the part of management. In the pursuit of their mission to uncover evidence of the reported allegations, they may employ scorched-earth investigation tactics that could unnecessarily degrade employee morale and dignity, inappropriately disrupt the ongoing business of the organization, or permanently burn bridges to any future relationship between "surviving" managers and lawyers who seek to work cooperatively with them.

When sensitive matters are on the table, unless there is an assertion that the CLO is complicit in an alleged wrongdoing or the board or QLCC believes that the CLO is inept or not properly expert to handle the matter, the in-house CLO and his team is almost always better equipped to sift the merits of an allegation, conduct an investigation, propose and enact appropriate remedies, or supervise the conduct of an inquiry into the matter by an outside firm. The CLO has a fiduciary duty, a professional responsibility, and the same ethical mandates to the corporate client as any other member of the bar to provide independent, on-point, and superior legal advice. Yet, as it stands, the implicit assumption one would make of the QLCC as described by the Commission's rule is that it exists to bypass (rather than further employ) the services of the Office of the General Counsel in the furtherance of the client's legal representation.

Indeed, those CLOs we know who are ready to support the creation of a QLCC premised their support on the creation of some operational guidelines for the committee, including strategies for properly deploying the CLO's services in the conduct of the committee's work. Those committees that do not do so may suffer unintended and unpleasant consequences. For instance, in companies where the nature of the business includes sophisticated compliance efforts such as employee hotlines or other formal reporting mechanisms, there are correspondingly large numbers of complaints or allegations from the company's employees, suppliers, and others for someone to sift through and handle – often in the thousands every year. The unwary QLCC in such a company might find itself the recipient of an overwhelming number of reports (covering everything from trivial gripes to allegations of entity-threatening frauds), all made by folks who would much rather report their concerns directly to the top than to a tip line.

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Since the rules allow anyone to report directly to the QLCC, this is not an unlikely result, and may seriously detract from the QLCC's ability to function and the willingness of board members to place themselves in the middle of such an arduous and time-consuming process. It is not unreasonable to assume that even a QLCC in a company without a history of soliciting employee reports could easily receive 25-50 complaints every year . . . for a board committee meeting only a few times each year, even this could be an extraordinary oppressive workload that the committee is unprepared to meet.

For these reasons and more, the QLCC would be well served to work cooperatively with the general counsel to create guidelines that suggest the proper paths and processes for the resolution of matters brought before them, including, for instance, the creation of a preferred outside counsel list (offering a pre-screened group of independent firms that would not be used by the company for any other general matters, guidance on the types of matters that the in-house legal department will be presumed best situated to pursue, pre-arranged law firm retention terms (regarding billing/fees/disbursements, the establishment of reporting structures, staffing, investigation procedures), document and communications standards for maintaining attorney-client privilege, a "triage" process that allows the QLCC to determine which matters it will consider in what order and with what level of attention, and so on.

Board members meeting only intermittently may not have the time, interest or expertise to develop these guidelines, cull through reports sent to the Committee's attention, and supervise law firms operating under the Committee's retention. Especially when it comes to law firms working for the QLCC in an uncoordinated and unsupervised fashion, CLOs fear firms that may behave much like the proverbial bull in the china shop. An invasion of unsupervised and uncoordinated law firms conducting investigations can be more than cost-inefficient and disruptive; it can be totally counterproductive to the purpose of discovering fraudulent behavior and remedying improper management activities.

It is not our intention to suggest any guidelines which would serve to preclude the QLCC from addressing situations that require extraordinary measures or that they would prefer to conduct without the participation of the CLO. Indeed, on any given matter wherein the QLCC or an outside firm wished to override a pre-approved guideline, the full discretion to do so would reside with the QLCC.

While it is certainly possible for the QLCC and the CLO to establish such a relationship on their own without mandates from the Commission or the rule, the very act of creating a QLCC might suggest to some that it is necessary or appropriate policy to by-pass to the company's regular in-house counsel. The likelihood of that misperception arising could be minimized by the Commission's attempt to suggest means by which a natural cooperation between the CLO and the QLCC can develop.

Accordingly, we encourage the Commission to consider amending the QLCC portions of Part 205 to:

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• offer commentary to the rules regarding the establishment of operational standards that suggest that the QLCC may wish to enlist the CLO in creating the committee's guidelines and resources.

• limit those who may make a report directly to the QLCC to the CLO, those whom the CLO or CEO recommend to it, or those whose allegations include a claim that the CLO is complicit in the alleged fraud reported. This will encourage those with "normal" legal concerns to make the CLO's offices the offices of first resort, encourage a cooperative relationship between the CLO and the QLCC which suggests that the CLO is a helpful resource to the QLCC's regular work, and preserve the time, resources, and attention of this board-level committee for those matters that either have been vetted by the CLO or may involve inappropriate activity amongst the company's top legal leaders. Given the additional pressures that many directors face in the post-Enron world, we believe that such an option not only serves the interests of the CLO, but also will be viewed as an incredibly important service to directors. If such a service is not performed, it is not hard to imagine the QLCC being swamped with issues that effectively negate its ability to provide any meaningful service.

• remove the "pre-existing" requirement in the rules that mandates that the QLCC must be in place prior to the report of an allegation that would be made to it. There is no reason to assume that the pre-existence of the QLCC does anything to change the appropriateness or ability of a board committee to perform a legal auditing role of this kind. To require that the QLCC be created prior to any experience with the kinds of problems and issues that this committee is intended to cover, means that some CLOs will be less likely to support the adoption of a QLCC without a clear sense of its need or the practicalities of its operation. And for the reasons set out above, most CLOs are unwilling to "casually" suggest that an existing (qualified) committee of the board be designated as a QLCC should a matter arise in the future that needs board attention. To do so would forego the kind of preparation and support that the QLCC will need. Should everyone (including, obviously, the board) decide that a matter has arisen is most properly handled by a QLCC, what is the harm in creating one at that time and supporting its work in a fashion that is consistent with the needs of the matter at hand? The point of the QLCC is to ensure board consideration of serious legal matters and to create more flexibility in how the report will reach the board. Removing the pre-existing requirement does no harm to the efficacy of the rule or the committee's function, and offers even more flexibility to those struggling to assess the practical issues involved in navigating the unexplored territory covered by this rule.

IV. Conclusion

We thank the Commission for the opportunity to comment on these proposed regulations and the final rule. We stand ready to assist the Commission to ensure that the final rules are both practical and useful, and understood by corporate counsel who need to apply them to their practices. Please feel free to contact us to discuss any of these issues further.

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Comments of the American Corporate Counsel Association (ACCA)
April 7, 2003

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Questions and Answers: The SEC's Sarbox 307 Attorney Conduct Regulations

(SEC Rules Codified at 17 CFT Part 205)
(first published, August 25, 2003)

This document was created on under the leadership of John Villa, author of the ACCA/West treatise "Corporate Counsel Guidelines" and partner at Williams & Connolly in Washington, DC. It is intended as a tool providing practical strategies for considering Sarbox 307 issues, but is not intended as legal advice. This document is an ongoing draft, and it will be amended regularly. The most updated version will reside on ACCA's Corporate Responsibility/ Section 307 homepage at http://www.acca.com/legres/corpresponsibility/attorney.php, along with other material explaining attorney reporting responsibilities under the rules.

I. Who Is Covered by the Reporting Requirements?

1. I am licensed to practice law but I hold a position in management in which I do not give legal advice. Do I need to worry about the up-the-ladder reporting requirements?

   No. The obligations only reach attorneys who are practicing law. Section 205.2(g) provides: "'In the representation of an issuer' means providing legal services as an attorney for an issuer . . . ." The Commentary makes clear that the rule was modified from the proposed rule expressly to clarify that the regulation's reach is only to lawyers who are providing legal services to the issuer.[1]

2. I am licensed to practice law, but I am not in our general counsel's office. I hold a business position in the company where I frequently make decisions that involve legal issues. I rarely call upon our general counsel's office and rely principally on my own understanding of the governing legal principles. I express my views on legal issues to other team members on projects. Do I need to worry about the Reporting Requirements?

[1] *Implementation of Standards of Professional Conduct for Attorneys; Final Rule and Proposed Rule*, 68 Fed. Reg. 6296, 6302 (Feb. 6, 2003) (to be codified at 17 C.F.R. pts. 205, 240, & 249).

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Yes. The fact that you are not in the legal department of the corporation does not automatically exempt you from the up-the-ladder reporting rules. As the Commentary states, "[u]nder the final rule, attorneys need not serve in the legal department of an issuer to be covered by the final rule, but they must be providing legal services."[2] You should note that whether you hold a legal position and whether your services constitute "appearing and practicing before the Commission" are separate and distinct issues.

3. I regularly work on the corporation's proxy statements and, for that reason, would clearly be covered by the up-the-ladder reporting requirements for that aspect of my work. As an expert in employment law, I also oversee our employment litigation. In the course of my oversight of age discrimination litigation, I've become aware of facts that could lead a reasonable lawyer to conclude that the corporation has engaged in age discrimination. Am I required to apply the reporting procedures to employment-related issues that would not independently constitute appearing and practicing before the Commission.

Yes, although it is a separate question whether these particular facts must be reported. The reporting rules apply to attorneys and not to "matters." Thus once you are subject to the reporting rules for one matter, you are covered for all matters. Because you regularly work on the issuer's proxy statements, you are appearing and practicing before the Commission in the representation of an issuer.

4. I am currently required to follow the up-the-ladder reporting requirements because of work I do from time to time reviewing my issuer-employer's SEC filings. I have recently learned of a material violation through my other (non-securities) legal work. If I am relieved of securities law duties from now on, do I still need to follow the Reporting Requirements regarding the information I just learned?

Yes. The fact that you learned of the material violation while you were appearing and practicing imposes the up-the-ladder reporting requirements with regard to the information that you have recently learned.

5. I previously held a position in which I reviewed my issuer-employer's SEC filings. I left this position six months ago, and currently conduct no work that would be deemed appearing and practicing before the Commission. This week, I learned of a material violation. Do I need to follow the Reporting Requirements?

Probably not. While the Reporting Requirements do not delineate how long after an attorney ceases to perform work that constitutes appearing and performing she is deemed to no longer be appearing and practicing before the

[2] 68 Fed. Reg. at 6298.

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Commission, it would certainly seem that a person who ceased such work six months ago is no longer appearing and practicing before the Commission.

6. My only responsibilities are the oversight of major civil litigation against the corporation and a determination has been made that I therefore have no up-the-ladder reporting obligations. I am told that I cannot, under any circumstances, discuss my work with any lawyer in the chief counsel's office who is covered by the rules. Am I doing anything wrong in following that direction?

No. The rules do not prevent issuers, or law firms for that matter, from erecting walls between "covered" lawyers and those lawyers not covered by the reporting rules. Practically speaking, the company's general counsel will likely learn of any *material* violations stemming from your litigation work and as a CLO, she will fall within the definition of "appearing and practicing." Thus, the general counsel has made herself responsible for reporting material violations related to your litigation work. You have not done anything wrong in following that direction.

7. I am an attorney who generally does not practice securities law, but I have written comments to the SEC on behalf of my issuer client providing my client's views on proposed SEC regulations. Am I subject to the Reporting Requirements based on this conduct?

Yes. "Appearing and practicing before the Commission" includes "[t]ransacting business with the Commission, *including communications in any form*." § 205.2(a)(1)(i) (emphasis supplied). Because you communicate with the SEC in the representation of an issuer, you are covered by the Reporting Requirements.

8. I am an attorney who represents an issuer. I do not generally practice securities law. However, I recently advised my client that it did not have to file with the SEC certain documents relating to a proposed securities offering to qualified institutional buyers. Does this advice subject me to the Reporting Requirements?

Yes. Under § 205.2(a)(1)(iv), an attorney appears and practices before the Commission if she advises "an issuer as to whether information . . . is required . . . to be filed with . . . the Commission." The Commentary notes that "[a]ttorneys who advise that, under the federal securities laws, a particular document need *not* be incorporated into a filing, registration statement or other submission to the Commission will be covered by [this] definition."[3]

9. I regularly draft and negotiate portions of acquisition agreements that deal with environmental issues. I am aware that, for larger transactions, the acquisition agreements are often appended to securities filings, but I have no role in the decision on whether to do so. I am not, in general, familiar with securities law issues. Am I covered by the reporting rules?

[3] 68 Fed. Reg. at 6297-98 (emphasis supplied).

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Probably not, but it is a close call so watch SEC guidance on this issue. This question raises two questions. First, are you providing "advice in respect of" the securities laws or regulations? And, second, are you on "notice" that documents you participate in preparing will be appended to SEC filings? With regard to the first question, because your work is restricted to environmental issues, you are probably not providing advice "in respect of" the securities laws. With regard to the second question, you probably are on notice that documents you work on will be included in SEC filings, given that it happens consistently. You might argue, however, that you do not "know" whether any particular document that you work on will be filed with the SEC. Authors' note: The literal application of this regulation is clear but the result is probably not a happy one for Commission staff. First, SEC staff may attempt to read the "in respect of" provision out of the rule and contend that an attorney who has knowledge that her work will be incorporated in an SEC filing is covered regardless of whether she provides any securities law advice. Second, SEC staff may advance a very liberal definition of the term "know" to try to reach attorneys who have a general idea that some of their work is likely to find its way into SEC filings. Therefore, counsel should either assume that she is covered *or* monitor Commission pronouncements to determine how the SEC intends to interpret this point.

10. I work on employment litigation and have no securities advisory responsibilities. In the course of my work, I am asked by the general counsel to provide or review descriptions of the major litigation for which I am responsible. I am not told, however, for what purpose the descriptions will ultimately be used. When I read the company's annual report, I recognize the descriptions I drafted or reviewed included verbatim. Am I covered by the reporting requirements?

Based on these facts, you likely are on notice that the documents you work on will be incorporated in SEC filings. However, you are, nevertheless, probably not covered by the requirements because you are not providing advice regarding securities law. Author's note: See the response to the previous question for a discussion of the tension between the literal wording of the Reporting Regulations and the likely aims of the SEC staff.

11. Our general counsel is very cautious and it is his practice to e-mail to all members of the legal department the final draft of the securities filings several days before they are submitted. His cover e-mail asks that any member of the office who sees anything significantly in error contact him immediately. Does this make every one of us covered by the up-the-ladder reporting rules?

Yes, it probably does. If you are all being asked for your advice regarding the company's SEC filings, then you are all presumably "[p]roviding advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding" a document you have notice will be filed with the Commission. This probably constitutes "appearing and practicing before the Commission" pursuant to the literal language of the regulation.

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12. Last month, while I was representing an issuer-client as litigation counsel in a contract dispute lawsuit, I learned that the issuer had improperly recognized a material amount of revenue on the contract at issue in the first quarter of the year when that revenue should have been recognized over the term of the three year contact. At that time, I was not "appearing and practicing before the Commission," so I was not subject to the Reporting Requirements. This month, I met with SEC staff in response to an inquiry to my client. I know that this new assignment constitutes "appearing and practicing before the Commission," but does it mean that I have to report the material violation I learned of last month before I was "appearing and practicing before the Commission"?

Reading the Reporting Regulations literally, the answer is "no." The rules require reporting when "an attorney, appearing and practicing before the Commission in the representation of an issuer, *becomes aware* of evidence of a material violation . . . ." § 205.3(b) (emphasis supplied). Because you were not appearing and practicing before the Commission when you became aware of the evidence of a material violation and you did not "become[ ] aware" (because you were already aware) of evidence of a material violation after you began appearing and practicing before the Commission, you are not covered by this rule. Author's note: For a slight twist on this issue, see the next question and response.

13. Last month, while I was representing an issuer-client as litigation counsel in a contract dispute lawsuit, I learned that the issuer had improperly recognized a material amount of revenue on the contract at issue in the first quarter of the year when that revenue should have been recognized over the term of the three year contract. At that time, I was not "appearing and practicing before the Commission," so I was not subject to the Reporting Requirements. This month, I met with SEC staff in response to an inquiry to my client. Yesterday, I found out that the company still has not restated its financial statements although such restatement is required by the securities laws. Do I have a duty to report?

Yes, you probably do. While you probably do not have a duty to report the original misstatement of income (see previous response), you do have a duty to report the ongoing material violation – the currently inaccurate financial statements – which you became aware of after you began appearing and practicing before the Commission.

14. I am an in-house attorney specializing in non-securities regulatory law. I was asked to review and advise on whether the risk disclosures in our SEC filing fairly presented the regulatory risks facing the company. Am I covered by the Reporting Requirements?

This is a difficult question. You clearly are participating in the preparation of a document that you have notice will be filed with the Commission. The issue is whether you are providing advice "in respect of" the securities laws. Because the securities laws require disclosure of material risks and you are advising on whether the proposed disclosure is full and accurate, you arguably are providing

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advice "in respect of" the securities laws and are therefore (at least arguably) subject to the Reporting Requirements.

15. I am the general counsel of an issuer and I don't want all of my outside litigators covered by the Reporting Requirements. To that end, I have instructed all outside litigators that they are not to give securities advice in any way. I have told them that they may review descriptions of litigation that they are working on for our SEC disclosures, but that they may only review for factual accuracy, they may *not* provide any predictions on likely or possible outcomes, and they may not advise on whether particular litigation should or should not be included in the filing. Is this policy sufficient to keep my outside litigators from being subject to the Reporting Requirements?

You are walking a fine line. If the attorneys are only providing a review of the accuracy of the facts set forth in the proposed filings then they would not seem to be providing advice "in respect of" the securities laws. However, you should be aware that at least some at the SEC would take the position that because the lawyers are providing advice regarding a document they have notice will be filed with the Commission, they are subject to the Reporting Requirements. See the response to question number 9.

16. I work in the legal department of a foreign subsidiary of a United States issuer. I perform work, often at the request of the parent company's general counsel, related to the parent's SEC filing requirements. Am I subject to the up-the-ladder reporting rules?

It depends. The work you do falls within the definition of appearing and practicing before the Commission in the representation of an issuer. You will be excluded from the reporting rules, however, if you are a "non-appearing foreign attorney." Assuming you are licensed in your foreign jurisdiction and do not hold yourself out as practicing United States federal or state securities laws, you can qualify as a non-appearing foreign attorney if you perform your securities work in consultation with counsel admitted in a United States jurisdiction.

17. I am an attorney for a subsidiary company (which is not an issuer) that is wholly owned by an issuer. In undertaking my work, which sometimes entails communications with the SEC, I, of course, always try to benefit my client, the subsidiary. This, of course secondarily benefits the issuer as the subsidiary is an asset of the parent and everything that benefits the subsidiary benefits the parent. I am not, however, providing legal representation for the parent. Am I covered by the Reporting Requirements?

This is a gray area and you should probably assume you are covered. An attorney is acting "in the representation of an issuer," as that phrase is used in the rules, if she provides legal services to any person controlled by an issuer "for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer." § 205.2(h). The subsidiary is clearly a person controlled by an issuer, and the SEC is likely to contend that your work is "for the benefit of the

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issuer." We think the better reading of that provision is to reach lawyers who are in effect representing the issuer out of the subsidiary's offices.

18. I am counsel to an investment adviser that is not an issuer. In the course of my duties I provide legal advice regarding the preparation of registered investment materials that my company is preparing for its clients who are issuers. These materials are filed with the SEC by the respective issuers. Am I covered by the Reporting Requirements?

Yes. Even though you do not represent an issuer as that term is generally understood, you are acting "[i]n the representation of an issuer" as that term is defined in the Reporting Requirements. *See* § 205.2(g). The Commentary states that "an attorney employed by an investment adviser who prepares, or assists in preparing, materials for a registered investment company that the attorney has reason to believe will be submitted to or filed with the Commission by or on behalf of a registered investment company is appearing and practicing before the Commission under this definition."[4]

II. WHAT CONDUCT TRIGGERS THE REPORTING REQUIREMENTS?

ALL QUESTIONS IN THIS SECTION ASSUME THAT THE INQUIRING LAWYER IS COVERED BY THE REPORTING REQUIREMENTS.

19. I have heard from a friend in marketing that a corporate officer has been taking kickbacks. Am I under any obligation to take action?

Your question presents two issues. First, do you have any obligation to take action as to a matter where you are not providing legal services? The answer to that is 'yes.' Unlike the ABA's Model Rules, the up-the-ladder reporting rules do not require that the information "relate to the representation." The second question is what level of certainty you must have before a reporting obligation is triggered. The Commentary makes clear that you are not required (or expected) to report "gossip, hearsay [or] innuendo."[5] Thus, if that is all your friend is providing, then you probably have no reporting obligation. However, if the information is (to your knowledge) based on a credible source (e.g., if your friend has documentary evidence of the kickbacks), then you are required to report the alleged violation assuming it is or may be material.

20. I am a lawyer covered by the Reporting Requirements. Am I equired to report violations of non-securities laws, such as environmental and employment laws?

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[4] 68 Fed. Reg. at 6302. The Commentary goes on to state: "Although some commenters objected to this construction of the definition of 'in the representation of an issuer,' those commenters did not contest either the fact that such an attorney, though employed by the investment adviser rather than the investment company, is providing legal services for the investment company or the logical implication of that fact: that the attorney employed by the investment adviser is accordingly representing the investment company before the Commission." *Id.* (footnote omitted).

[5] 68 Fed. Reg. at 6302.

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While the rules are not entirely clear on this point, you would be wise to report such violations if they are material. The rules require reporting of "material violations," which include, in addition to securities law violations, "a similar material violation of *any* United States federal or state law." § 205.2(i) (emphasis supplied). The question is whether the violation is "similar" to a violation of the securities law or breach of fiduciary duty. While it is impossible to know what this means, one can predict that if the violation has a material impact on the issuer's securities then the SEC staff will argue that it is "similar."

21. I understand that the Reporting Requirements do not require reporting based on "gossip, hearsay, [or] innuendo."[6] According to the Federal Rules of Evidence, most out of court statements are considered hearsay. Does this mean that I can ignore any verbal evidence if it is not under oath?

No. It is quite unlikely that the regulations intended any distinction based on whether the statement was under oath or not. More likely, it was intended to reach the common definition of "hearsay," which is "rumor,"[7] meaning that the speaker is speaking not about what she observed, but rather about what someone else told her. If a person tells you what she has observed, you would be wise not to dismiss the statement for that reason. Instead, you should evaluate the reliability of the statement.

22. I am a former federal prosecutor and members of management and other lawyers often pass by me conduct about which they may have questions. Often they know or provide me with very few of the facts and I cannot reach any final judgment about whether illegal conduct occurred. I don't think that this is credible evidence on which one could reach a judgment that a reportable incident occurred. Once I hear of one of these problems, am I under any obligation to investigate it or tell others about it so someone else can investigate?

Probably not. The Commentary indicates that a lawyer (other than the CLO) does not need to investigate every piece of information that could potentially lead to a reportable violation. You should be careful, however, that you are not ignoring information that reasonably should be interpreted as credible evidence indicating the reasonable likelihood of a violation. Author's note: By consulting frequently and casually about potentially questionable conduct, a lawyer places himself in an exposed position under the Reporting Requirements. Ironically, this realization may lead lawyers to refrain from making themselves available for consultation leading to issuers receiving less legal advice and making it more difficult for issuers to follow the law.

23. Every day I hear of business decisions in our corporation that make me shake my head in disbelief. One after another have turned out to be stupid and lost money. I am no expert in fiduciary duties. How am I supposed to decide whether this is a reportable breach of a fiduciary duty or not?

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[6] 68 Fed. Reg. at 6302.

[7] *Webster's Third New International Dictionary of the English Language Unabridged*, 1987 (1993).

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This is a difficult question. While an attorney (other than the CLO) is probably not required to perform a *factual* investigation where there is no credible evidence that a material violation is reasonably likely, an attorney is required to use reasonable *legal* judgment in evaluating the facts that he knows. This likely would include consulting a colleague if you have one who has the requisite legal expertise, even if you do not have that expertise. This conclusion is reinforced by the Commentary's enumeration of "the availability of other lawyers with whom the lawyer may consult" as one of the "circumstances" which will be considered in determining the reasonableness of an attorney's conduct under the rules.[8]

24. I am clearly covered by the reporting rules as I assist in the preparation of periodic securities filings. A lawyer in our office who works on litigation matters tells me privately that he is concerned about an issue that I recognize would probably need to be disclosed if known by a lawyer subject to the reporting obligations. Do I now need to report it?

Yes. The reporting rules make no distinction regarding the source of the evidence of a material violation that you receive. As long as you are appearing and practicing before the Commission in the representation of an issuer and you become aware of credible evidence of a material violation, you must report the evidence.

25. I have learned that a corporate officer has violated the domestic law of a foreign country. This conduct does not appear to violate U.S. law. Must I report this?

Probably not. The underlying misconduct is a violation of foreign law and the Commentary expressly states that the reporting obligations "do not include violations of foreign laws."[9] You must take care, however, to assure yourself that the violation of foreign law is not also a violation of United States law or of fiduciary duty. Prominent examples of foreign law violations that are also U.S. law violations include bribes to foreign government officials, which violate the Foreign Corrupt Practices Act;[10] violations of foreign currency regulations, which are violations of the money laundering statutes; and violations of child labor laws. A violation of a foreign law could also be a breach of fiduciary duty if it subjects the corporation to significant liability.

[8] 68 Fed. Reg. at 6302.
[9] 68 Fed. Reg. at 6303.
[10] Pub. L. No. 95-213, 91 Stat. 1494, 1498 (1977) (codified at 15 U.S.C. §§ 78a, 78m, 78dd-1, 78dd-2, 78ff).

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26. I am an attorney covered by the Reporting Requirements. I have recently discovered evidence that the board of directors has made important decisions without what I think is due consideration for all relevant factors. Although I have no doubt that the board members are acting in good faith, I firmly believe they are not fulfilling their duty of care to the corporation. Do I have a duty to report this?

Yes, sadly you do, but be sure you know what you're talking about. The term "material violation" includes breaches of fiduciary duty in addition to violations of federal or state law. Even a board acting in good faith can breach its fiduciary duty if it fails to fulfill its duty of care to the company. This duty generally requires a director to exercise his duties in good faith, with the care an ordinarily prudent person in a similar position would exercise under similar circumstances, and in a manner the director reasonably believes to be in the best interest of the company.[11]

27. I have seen a few memos from a senior marketing person that could reasonably be read to reflect an agreement to fix prices. The information is only fragmentary and I have not interviewed the author or pursued any investigation. Am I required to report this information?

Yes, you probably are. The Commentary "makes clear that the initial duty to report up-the-ladder is not triggered only when the attorney 'knows' that a material violation has occurred or when the attorney 'conclude[s] there has been a violation, and no reasonable fact-finder could conclude otherwise."[12] **The standard is whether it is "reasonably likely" that a violation has occurred: "To be 'reasonably likely' a material violation must be more than a mere possibility but it need not be 'more likely than not.'"**[13] **In this case, it appears that you have concluded that a material violation of the antitrust laws is "reasonably likely" based on the documents you have seen.**

28. I am an attorney covered by the Reporting Requirements. I recently learned of a *past* material violation, i.e., a major embezzlement by a district manager. This manager has been terminated and public disclosures have made it known that the company lost this money, although they have not indicated how or that there was any theft or criminal activity. The company has taken adequate steps to make sure that this sort of thing cannot happen in the future. Do I have a duty to report this past violation?

This question raises the issue of whether an attorney must report a past violation that was material at the time it occurred but is no longer material by the time the

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[11] *See* 2 Model Bus. Corp. Act § 8.30(a) (3d ed. 1996).
[12] 68 Fed. Reg. at 6302 (footnote omitted).
[13] 68 Fed. Reg. at 6302. The Commentary states that "[t]he Commission intends the definition of the term 'reasonably likely' to be consistent with the discussion of that term included in the adopting release for the recently adopted final rule governing disclosure of off-balance sheet arrangements, enacted pursuant to § 401(a) of the Sarbanes-Oxley Act." 68 Fed. Reg. at 6302 n.50.

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attorney learns of it. The Reporting Regulations do not make this clear, but presumably if the violation is no longer material at the time the attorney learns of it, then the attorney does not need to report it. Author's note: An attorney should be aware that an aggressive member of the SEC staff may take a different view. Thus, to be safe, an attorney may want to report this sort of no-longer-material violation pursuant to the Reporting Requirements.

29. I am an attorney for an issuer, and I advise on securities filings. I have learned that the outside underwriting firm that is underwriting a securities offering for my client has engaged in unlawful agreements with third parties that will have the effect of propping up the stock price. No one at the issuer has had anything to do with this misconduct. Am I required by the Reporting Requirements to report this prospective material violation by the underwriter?

According to the Commentary, the answer is clearly "yes." The Commentary states that the definition of the term "issuer" is "intended to reflect the duty of an attorney retained by an issuer to report to the issuer evidence of misconduct by an agent of the issuer (e.g., an underwriter) if the misconduct would have a material impact upon the issuer."[14] The definition referenced by the Commentary, *see* § 202.5(h), does not actually make this clear. Rather, this conclusion can be more clearly drawn from the duty to report provision which requires the reporting "of evidence of a material violation by the issuer or by any officer, director, employee, or *agent* of the issuer." § 205.3(b) (emphasis supplied).

30. I am an in-house securities attorney at an issuer. The CEO of my company is a family friend and I know that he sits on the board of directors of several other companies. I recently learned that the CEO has committed a material breach of his fiduciary duties in connection with his board service for another company. This breach involved providing inside information "tips" to family members about the business of this other issuer. This action does not directly affect our company. Am I required to report the material violation under the Reporting Requirements?

Reading the Reporting Requirements literally, the answer surprisingly is "yes." The rules require you to report any material violation by an agent of the issuer whom you represent. Because the CEO is an agent of that issuer, his material violation qualifies. The rules do not require that the material violation be committed by the agent *within* his capacity as an agent of the issuer.

31. I am outside counsel to an issuer and I advise on securities filings. I have recently learned of an ongoing violation of federal law that is likely to get the issuer sued. I think the issuer would have significant exposure in such a lawsuit but I imagine that most of any judgment or settlement would be covered by insurance, making the civil exposure from the lawsuit not material to the issuer. However, I am not certain as I am not privy to the issuer's insurance coverage. Do I have a duty to report?

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[14] 68 Fed. Reg. at 6303.

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This is a close call, but you probably do. The rules require you to report evidence that suggests that a material violation is "reasonably likely." "To be 'reasonably likely' a material violation must be more than a mere possibility but it need not be 'more likely than not.'"[15] Here, while you suspect that the existence of insurance coverage will render the perceived violation immaterial, the fact that you do not know anything about that insurance coverage suggests that a material violation is more than a mere possibility in your mind.

32. I have been retained by an issuer to represent and advise the issuer's chief financial officer in connection with his signing of the issuer's periodic reports to the SEC. During an attorney-client meeting, the CFO confided in me that she has authorized a number of "off-book" partnership transactions in which she has (1) hidden a large amount of the issuer's losses from the financial statements and (2) personally made several million dollars. Under the Reporting Requirements, do I have a duty to report this information that I learned from my client in confidence?

Under a literal interpretation of the rules, the answer would be "yes." The Reporting Requirements require a report where "an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer." § 205.3(b)(1). For purposes of the phrase "in the representation of an issuer," the term "issuer" "includes any person controlled by an issuer, where an attorney provides legal services to such person . . . at the behest[ ] or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer." § 205.2(h). Thus, because you were retained at the behest of the issuer, you would appear to be covered by the Reporting Requirements even though you represent the CFO in her personal capacity. However, this outcome conflicts with and would largely eviscerate the CFO's attorney-client privilege. Although historically a state law principle, the attorney-client privilege was made part of federal statutory law in 1975 when Congress enacted Federal Rule of Evidence 501.[16] That rule provides that "[e]xcept as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a . . . person . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience."[17] FRE Rule 501 thus provides that the attorney-client privilege (and other federal privileges) can only be altered by common law decision-making by courts, by the United States Constitution, by act of Congress, or by the Supreme Court. Thus, an SEC rule-making cannot properly eviscerate the attorney-client privilege unless Congress so allows. As a result, although the rules require you to report, the federal statutory attorney-

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[15] 68 Fed. Reg. at 6302.
[16] *See* Pub.L. 93-595, 88 Stat. 1933 (1975).
[17] Fed. R. Evid. 501. The rule also states that "in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege . . . shall be determined in accordance with State law." *Id.*

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client privilege should prevail. You should be aware, however, that the SEC staff may not see it this way.

33. I was hired by an issuer to represent one of the issuer's employees who was subpoenaed to testify in an SEC investigation. While preparing this employee for his testimony, I learned from my client that the issuer has continually overstated its profits by more than 25% and that this has resulted in an overvalued stock price. Am I required to report this under the Reporting Requirements?

Just as in the previous question, you were retained at the behest of the issuer to represent a person controlled by an issuer. Once again, however, the attorney-client privilege should prevail and prevent you from reporting privileged information.

34. I am an in-house securities lawyer at an issuer. I have learned that members of senior management and the board of directors have been improperly charging personal expenses to the company by abusing the company's plane. These improper charges are in the hundreds of thousands of dollars and this amount of money is clearly not material to the stock price of the company, which has a market capitalization of more than $60 billion. Am I required to report these violations?

This is a difficult question. At first glance, it would not appear that you would need to report these violations because the amount of money is not material. However, the fact that senior managers and directors are engaging in this kind of clearly unethical behavior at the expense of the company they serve reflects on the integrity and judgment of management and the board of directors and is therefore probably material to the average investor. As a result, you probably do have an obligation to report.

35. My area of expertise is limited to executive compensation and I am therefore called upon to advise on portions of my employer's proxy materials. In short, I am covered by the Reporting Requirements. I have just been shown a memorandum on off-shore tax arrangements that looks very troublesome and seems illegal. But the truth is I know nothing about taxation. Can I ignore it or do I need to consult with others knowledgeable in tax laws?

The Commentary suggests that the rules establish a standard of a "prudent and competent attorney" with the "attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult."[18] In practical terms, that probably means that if you, acting prudently and competently, would not be expected to recognize a serious issue, then you will not be held liable. If, however, you recognize the issue, but cannot resolve it yourself (because of your limited

[18] 68 Fed. Reg. at 6302.

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knowledge and experience), you may be held liable if you have failed to utilize the opportunity to consult with a more knowledgeable colleague.

III. What Reporting Is Required?

36. I am attorney covered by the Reporting Requirements. I recently learned of evidence suggesting a possible material violation. I communicated this information to our chief executive officer. Have I complied with my initial reporting obligation?

No. In the absence of a report to a Qualified Legal Compliance Committee, § 205.3(b)(1) requires you to make a report to the company's Chief Legal Officer. At your option, you may report simultaneously to the CEO. However, the report to the CLO is mandatory, except under circumstances discussed in the next question.

37. I have recently learned of evidence of a material violation. Because the CLO and CEO appear to be involved in this material violation, I believe it would be futile to report this evidence to them. Can I report directly to the company's audit committee?

Yes. If you reasonably believe that it would be futile to report to the CLO and CEO, you may skip those two officers and go directly up the ladder. *See* § 205.3(b)(4).

38. I am attorney covered by the Reporting Requirements. I recently learned of evidence suggesting a possible material violation. I orally informed the CLO of this evidence. Is this sufficient to comply with my initial reporting obligation? Do I need to make a record of my report?

An oral report to the CLO is sufficient to meet the initial reporting obligation so long as it makes the evidence known to the CLO. The Reporting Requirements do *not* require you to document your report. Whether you choose to do so as a self-protective measure is another matter.

39. I recently reported evidence of a possible material violation to the CLO and he is conducting an investigation. However, I have my own sources that might shed light on the possible violation. May I conduct my own investigation?

Yes. While the Reporting Requirements do not require you to investigate, the commentary to the proposed rule that became Section 205.3(b)(1) indicated that "nothing in the proposed rule is intended to discourage" an investigation to determine whether there is a material violation.[19]

40. I reported evidence of a material violation to the CLO by e-mail (our company does not have a QLCC). The next day he e-mailed me back thanking me for

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[19] *Implementation of Standards of Professional Conduct for Attorneys*, 67 Fed. Reg. 71670, 71682 (Dec. 2, 2002).

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the report and told me not to worry about it any further. I do not expect to hear from him again on this topic. Do I have any further obligations under the Reporting Requirements?

Yes. You must continue to report "up-the-ladder," unless you receive an "appropriate response" from the CLO. An "appropriate response" is one which leads you reasonably to believe either (1) that no material violation occurred, (2) that the company has adopted appropriate remedial measures, or (3) that the company appropriately has retained an attorney to investigate and properly reacted to the investigative attorney's conclusions. *See* § 205.2(b). The response that you need not worry could not make you reasonably believe any of these three things.

41. I reported evidence of a material violation to the CLO (our company does not have a QLCC). A week later, he called and told me that he had looked into all the evidence and that the violation I suspected did not occur. He did not tell me anything else about his investigation. I have known the CLO for a long time and he is very conscientious and trustworthy. Do I need to take any further action?

It would be unwise to accept his statement although there is an argument you could do so. Based on this information it seems that you honestly (and maybe reasonably) believe that no material violation occurred. If so, then you do not have any further obligation. You must recognize that by accepting this assurance without more, you have placed yourself in a very vulnerable position if the CLO has not conducted his investigation properly. In any case, the CLO has not fulfilled his duty, because he has not given you the basis for his determination. *See* § 205.3(b)(2).

42. I reported evidence of a material violation to the CLO (our company does not have a QLCC). Several days later, the CLO told me that he had interviewed the relevant people, reviewed the relevant documents, and determined that no material violation occurred. I'm not certain, but I don't believe that he conducted any investigation at all. Do I need to take further action?

Based on your suspicion, it seems that the CLO's response has not made you believe that no violation occurred. Thus, the CLO's response is not an "appropriate response" under § 205.2(b), and you must report to the appropriate committee of the board of directors or to the board pursuant to § 205.3(b)(3).

43. I reported evidence of a material violation to the CLO (our company does not have a QLCC). The CLO conducted an investigation and reported back to me that he could find no evidence of a material violation. I believe that the issue requires more investigation and I have some sources that I believe the CLO should use. May I suggest that the CLO conduct further investigation before resorting to an "up-the-ladder" report to the audit committee?

Probably. The rules require you to report "up-the-ladder" if you have not received from the CLO "an appropriate response *within a reasonable time*." §

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205.3(b)(3) (emphasis supplied). The amount of time that is "reasonable" will depend on the circumstances. In this case, where the CLO has been investigating and you believe that further investigation will allow him to provide an appropriate response, it seems likely that giving the CLO more time to investigate the specific sources you suggest would be appropriate.

44. I reported evidence of a material violation to the CLO (our company does not have a QLCC). The CLO conducted an investigation and reported back to me that he could find no evidence of a material violation. I believe that the CLO did his best to conduct a thorough investigation, but I happen to know that he did not talk to a couple of company employees who I believe have relevant knowledge about the possible violation. Do I have any further obligation under the Reporting Requirements?

If you know that there are witnesses who may know of the possible material violation and these witnesses have not been interviewed, then you probably do not reasonably believe that no violation occurred. As a result, you must continue to report up the ladder.

45. I reported evidence of a material violation – significant ongoing insider trading by members of our company's sales force – to the CLO (our company does not have a QLCC). The CLO conducted an investigation and determined that a material violation was occurring. As a result, she privately reprimanded those involved. The CLO acted in good faith, but I don't think that the steps she took are sufficient. Do I have further obligations under the Reporting Requirements?

While the rules on this point are unclear, you probably do not have further reporting obligations. Section 205(b)(2) states that an "appropriate response" from a CLO includes a response that the company "has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing . . . ." Based on the literal text of the rule, the CLO's actions were an "appropriate response" because they were appropriate steps and they were taken to stop ongoing violations. Unless you can say that the response will not be effective or is not effective, you are not in a position to find it not appropriate.

46. I reported evidence of what I believe was a material violation of the securities law to the CLO (our company does not have a QLCC). The CLO, with the consent of the board of directors hired a well-regarded, aggressive, outside law firm to review the evidence that I reported. After conducting a thorough review, the firm reported that there was a good chance that the activity was a material violation, but because of ambiguity in the relevant regulations, there was a colorable legal argument that the activity did not, in fact, violate any law or duty. I agree that the firm's argument is colorable; it is not frivolous. However, I believe that it is more likely than not that this argument would be rejected by the SEC and by a court. Do I have any additional reporting obligation?

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No. If an investigative attorney retained with approval of the board of directors has determined that the company can assert a colorable defense in any investigation or judicial proceeding, this is an "adequate response" to your report pursuant to § 205.2(b)(3)(ii), and you do not have any further reporting obligation.

47. I reported a misstatement in a previous SEC disclosure to the CLO. The CLO reported back to me that the company has made a corrective disclosure with the SEC. Do I have any further obligation?

Probably not. You do not have any further reporting obligation if you have received "an appropriate response" from the CLO. § 205.3(b)(8). An "appropriate response" includes a response that the issuer has "adopted appropriate remedial measures." § 205.2(b). In most cases, correction of a misstatement would be an appropriate remedial measure. It is possible that in some circumstances further steps would be necessary. These further steps might include disciplining the person who made the misstatement, making restitution to those who were injured by the misstatement, and/or taking steps to prevent misstatements in future SEC disclosures.

48. I reported evidence of what I believe was a material violation of the securities law to the CLO. The CLO has refused to give me an adequate response. I know that I have a further reporting obligation. Can I fulfill this obligation by reporting this evidence to the full board of directors?

Not unless your company does not have an audit committee or another committee solely of independent directors. You must first report to the audit committee if there is one. If there is no audit committee, then you must report to a committee consisting entirely of independent directors. Only if there is no such committee, should your report go to the full board of directors. *See* § 205.3(b)(3).

49. After I did not receive an appropriate response to my report from the CLO, I reported evidence of a material violation to the audit committee. The audit committee responded, but I do not believe that their response was adequate. What do I need to do now?

You must explain the reasons for your belief that the response was not adequate to the CLO, CEO, and members of the audit committee. The SEC has proposed, but not implemented, regulations that would require your withdrawal. As of now, there is no such requirement.

50. I am the CLO of an issuer. We do not have a QLCC because I am generally able to handle all reports of evidence of material violations. However, an attorney has come to me and reported evidence of a possible material violation which is particularly sensitive and, in my view, warranting of special attention by independent board members. May I ask the board of directors to create a QLCC to deal with this report?

No. Under the Reporting Requirements, a QLCC may only be utilized if it was in existence prior to the initial report of evidence of a material violation.

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51. I reported evidence of a material violation to our company's QLCC. What more must I do?

Nothing. Under the Reporting Requirements, once you have submitted your report to the QLCC, you do not have any further obligations. *See* § 205.3(c)(1).

52. I am the chairman of our company's QLCC. I understand that the SEC eliminated the recordkeeping requirements from its final rules. Does this mean that the QLCC can dispose of written reports made pursuant to the Reporting Requirements as it sees fit on a case-by-case basis?

No. While reports to the QLCC are not required to be written, the QLCC is required to adopt written procedures for "the confidential receipt, *retention*, and consideration of any report of evidence of a material violation under § 205.3." § 205.2(k)(2) (emphasis supplied). Thus, at the very least, the QLCC must retain any reports that are prepared in accordance with consistent procedures and not as it sees fit on a case-by-case basis.

53. I am the Chairman and CEO of an issuer. I would like to set up a QLCC for the company, but I don't want the QLCC making any report to the SEC without first running it by me for a sanity check. Can I ensure this?

No. To be a valid QLCC under the Reporting Requirements, the committee must have "the authority and responsibility, acting by majority vote, to take all . . . appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the [QLCC] has recommended the issuer to take." § 205.2(k)(4).

54. Our company has a QLCC. I am an attorney covered by the Reporting Requirements and I have discovered evidence of a material violation. Do I have to report to the QLCC?

No, you can follow the standard up-the-ladder requirements, beginning with a report to the CLO or CLO and CEO, if you choose.

IV. The Obligations of Investigative Attorneys

55. Because of my knowledge of ERISA law, the CLO has directed me, an employed member of the corporate counsel's office, to undertake an investigation of a potential material violation of ERISA. To date, there has been no public disclosure of the issue. I have concluded that there are reasonable legal and factual arguments on both sides of the question as to whether the conduct breaches ERISA. Must I report this pursuant to the up-the-ladder regulations?

Here, you are acting as an investigative attorney. Section 205.3(b)(6)(i) is controlling. That section provides:

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An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

The attorney was retained or directed by the issuer's CLO to investigate such evidence and:

A) The attorney reports the results of such investigation to the CLO; and

B) Except where the attorney and the CLO each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the CLO reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a [QLCC].

Your reporting requirement in this case is to report the results of your investigation to the CLO. Here, it seems doubtful that you could "reasonably believe that no material violation has occurred," and thus you should ensure the CLO reports the evidence to the board of directors or appropriate committee thereof.

56. I was retained by the CLO to investigate evidence of a possible material violation reported to the CLO by another attorney. My investigation concluded that the suspected violation did not occur. However, during my investigation, I learned of evidence that suggests the likelihood of an entirely different and separate material violation. Am I subject to up-the-ladder reporting requirements?

Yes. The use of the phrase "such evidence" in § 205.3(b)(6)(i) (*see* previous answer) indicates that that special reporting provision for investigating attorneys applies only to the evidence that the attorney was assigned to investigate. Where the investigating attorney discovers different evidence of a different material violation, he is subject to the "normal" up-the-ladder reporting duty.

57. I was hired to investigate evidence of a material violation. I have determined that a material violation has occurred. There is no affirmative defense that the company could assert in a civil proceeding that I would consider "colorable." However, in a criminal proceeding, which I believe is likely to occur here, a defending attorney can require the prosecution to prove every element on which it has the burden of proof.[20] Does this position meet the "colorable defense" prong of § 205.3(b)(6)(ii)?

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[20] ABA Model Rule 3.1 states:

> A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith

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Answer

V. The Obligations of a CLO

58. I am the CLO of an issuer. However, I am not a securities lawyer and I have both inside and outside counsel who handle all securities advice and other securities work for the company. Am I subject to the Reporting Requirements?

Yes. A CLO is always subject to the Reporting Requirements because she is automatically a supervisory attorney. *See* § 205.4(a).

59. I am the CLO of an issuer and our company does not have a QLCC. I received a report from an attorney of evidence of a possible material violation. I investigated the evidence and determined that there is likely no violation. Do I need to do anything else?

Yes, you must communicate the result of your investigation and the basis for your conclusion that you believe that no material violation occurred to the attorney who made the report. Then you have no further obligation.

60. I am the CLO of an issuer and our company does not have a QLCC. I received a report from an attorney of evidence of a possible material violation. I investigated the evidence and determined that there was a past material violation. I told the CEO of the past violation and recommended that the company implement specific remedial measures. The CEO told me that he did not want the company to implement these measures. What else, if anything, must I do?

The Reporting Requirements require a CLO to "take *all* reasonable steps to cause the issuer to adopt an appropriate response." § 205.3(b)(2) (emphasis supplied). Now that the CEO has rejected your suggestion, you must evaluate whether, under the circumstances, there are any additional reasonable steps that you can take to cause the company to adopt an appropriate response. One such step might be to report the evidence, your suggestion, and the CEO's position to the board of directors. Whatever else you do, you are required to advise the attorney who reported to you of the steps that you have taken.

61. I am the CLO of an issuer that does not have a QLCC. I received a report of evidence of a material violation. I engaged an investigative attorney to look into this evidence. The investigative attorney concluded that a material violation did exist, and recommended certain remedial measures. However, the remedial measures that the attorney recommended are completely unrealistic

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argument for an extension, modification or reversal of existing law. A lawyer for the defendant in a criminal proceeding . . . may nevertheless so defend the proceeding as to require that every element of the case be established.

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from a business perspective, and there is no chance that the company would implement them. What can I do?

Assuming from the question that you cannot determine that no material violation has occurred, you must "take all reasonable steps to cause the issuer to adopt an appropriate response." § 205.3(b). Because the company is not going to "substantially implement[ ]" the remedial recommendations made by the investigatory attorney, you cannot use the investigation to satisfy the appropriate response requirement. *See* § 205.2(b)(3)(i). As a result, the burden falls on you to take all reasonable steps to cause the issuer to implement appropriate remedial measures, *see* § 205.2(b)(2), even if they will not be those suggested by the investigatory attorney.

62. I am the CLO of an issuer. I have four lawyers who report to me. They are the only other attorneys that our company has, and all five of us give securities advice. Do I have any responsibility to ensure that the four lawyers follow the Reporting Requirements?

The rules are ambiguous on this point. A "supervisory attorney" is required to "make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a), that he or she supervises or directs conforms to [the Reporting Regulations]." § 205.4(b). However, a "subordinate attorney" does *not* include an attorney who works "under the direct supervision or direction of the issuer's [CLO]." § 205.5(a). Further complicating things, a CLO is always a "supervisory attorney" under the rules. § 205.4(a). Read literally, the rules do not require you to take reasonable steps to ensure the compliance by the other lawyers because they are not "subordinate attorneys" under the rules. Peculiarly, read literally, the rules state that you are a "supervisory attorney" (pursuant to § 205.4(a)) even though there are no "subordinate attorneys" (pursuant to § 205.5(a)). Author's suggestion: Because of the probably unexpected manner in which this regulation applies to you, it would be wise to go beyond the literal reading of the text and take reasonable steps to ensure that the subordinate lawyers conform to the Reporting Requirements.

63. I am the CLO of an issuer. I received a report of evidence of a material violation from an outside attorney. I reported this evidence to the company's QLCC. Do I have any additional obligations under the Reporting Requirements?

No. If you report to the QLCC, then the QLCC is responsible for responding to the evidence of a material violation

VI. Sanctions Applicable to Violations of the Reporting Requirements

64. I am not primarily engaged in securities work for the company and, in fact, work in a wholly separate area. While it is possible that some reading of Part 205 might be deemed to reach my work for the company, I see no reason to worry about this provision as I have no interest in ever appearing before the Commission and would readily give up my right to do so. Am I safe in adopting this posture?

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No. It is a mistake to think of the right to appear and practice before the Commission as the equivalent of a voluntary bar association that one has the right to join or not. If an attorney performs certain functions for an issuer, that attorney is subject to the SEC's rules in Part 205 regardless of whether or not the attorney considers himself to be doing so. And the potential sanctions are far worse than exclusion from the SEC "bar." See below.

65. I am not concerned about the Commission taking away my "right" to appear and practice before the Commission. If I am prepared for the "sanction," of disbarment and suspension, can I stop worrying about Part 205?

No. The sanctions for violating the Reporting Requirements are not limited to disbarment or suspension of the right to practice before the Commission. An attorney who violates the Reporting Requirements could be subject to a host of possible sanctions including a civil action by the SEC for money damages or injunctive relief.

66. I did not realize that I was subject to the Reporting Regulations, and thus I did not report evidence of a material violation. Now the SEC is threatening to seek civil monetary penalties against me. What type of penalty could I receive?

The Reporting Regulations allow for the same monetary penalties as other securities law violations. For an inadvertent violation in which you did not receive any pecuniary gain, any monetary penalty should not exceed $5,000 per violation. *See* 15 U.S.C. § 78u(d)(3)(B)(i).

67. Although I am not a securities lawyer, I was aware that the Reporting Regulations apply to me. I think that the rules damage the attorney-client relationship so I decided not to follow them. Now the SEC is bringing a civil action against me. No one was injured as a result of my non-compliance. What type of penalty could I receive?

Because your violation appears to have been deliberate, you could receive a monetary penalty of up to $50,000. *See* 15 U.S.C. § 78u(d)(3)(B)(ii).

68. Because I am the CLO of an issuer, I was aware that the Reporting Regulations apply to me. Nevertheless, I ignored them because I was just too busy. Now the SEC is bringing a civil action against me, and it contends that my failure to follow the Reporting Requirements cost investors millions of dollars. What type of penalty could I receive?

For a deliberate violation that directly or indirectly resulted in substantial losses to other persons, you could receive a monetary penalty of up to $100,000. *See* 15 U.S.C. § 78u(d)(3)(B)(iii).

69. I am the CLO of an issuer and I also serve on the board of directors of several other issuers. Beyond imposing monetary penalties, what other tangible action

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could the SEC take against me for my failure to comply with the Reporting Requirements?

The SEC could bring administrative proceedings under SEC Rule of Practice 102(e). If the SEC determined in such a proceeding that you had willfully violated the Reporting Regulations, it could censure you or temporarily or permanently deny you the right to appear and practice before the SEC. This would mean that you could not continue as CLO, as a CLO of an issuer automatically appears and practices before the Commission. The SEC could also seek, in court, to have you temporarily or permanently prohibited from serving as an officer or director of an issuer. This would cost you your directorships. *See* 15 U.S.C. § 78u(d)(2). The SEC could also seek other equitable relief in such an action. *See* 15 U.S.C. § 78u(d)(5).

VII. Obligations of Supervisory and Subordinate Attorneys

70. I am an attorney who supervises more junior attorneys on certain projects. None of these projects involve "appearing and practicing" before the SEC. However, one of the attorneys whom I supervise also works on securities law projects. On these projects, she reports directly to the CLO, and I have nothing to do with them. Am I a "supervisory attorney" under the Reporting Requirement based on my supervision of this attorney?

    No. The Commentary clarifies that one "who supervises or directs a subordinate [attorney] on other matters unrelated to the subordinate's appearing and practicing before the Commission would not be a supervisory attorney" under the Reporting Requirements.[21]

71. I am a lawyer in a large general counsel's office in which a number of lawyers practice securities law on behalf of our company, an issuer. Our office is considering creating a committee to explain to attorneys the principles for complying with the Reporting Requirements. Would the members of this committee be considered "supervisory attorneys" under the Reporting Requirements?

The answer depends on the role that the committee undertakes. A "supervisory attorney" is one who "supervis[es] or direct[s] another attorney who is appearing and practicing before the Commission in the representation of an issuer." § 205.4(a). If the committee gives supervision or direction with regard to the practice of securities law, then its members likely would be considered "supervisor attorneys" under the Reporting Requirements. However, if the committee merely advises as to attorneys' obligations under the Reporting Regulations without supervising or directing the actual securities law practice, then its members would probably not be "supervisory attorneys."

72. I am the deputy general counsel of a German company that issues certain securities on the New York Stock Exchange and is thus an "issuer" under the

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[21] 68 Fed. Reg. at 6313.

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Reporting Requirements. I fit the definition of a "non-appearing attorney" under the Reporting Requirements and therefore do not consider myself to be "appearing and practicing before the Commission." However, as deputy general counsel, I have supervisory responsibility over some of our outside counsel and our New York-based inside counsel all of whom perform our U.S. securities work. Am I subject to the Reporting Requirements as a "supervisory attorney"?

Yes. The rules state that "[t]o the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission." § 205.4(b). Thus, to the extent the counsel that you supervise are appearing and practicing before the Commission, you are as well. You are thus subject to the rules.

73. I am an in-house attorney who reports to the CLO on all matters on which I work. These include securities law matters. Am I a "subordinate attorney" under the Reporting Requirements?

No. An attorney who reports directly to the CLO is not a subordinate attorney. *See* § 205.5(a).

74. I am an in-house attorney who practices securities law at the direction of the company's deputy general counsel. She reports to the CLO. I have discovered evidence of a material violation. I reported this evidence to the deputy general counsel. Do I have any further obligations under the Reporting Requirements?

No. Because you work at the direction of another attorney who is not the CLO, you are a "subordinate attorney," and your only reporting obligation is to your supervising attorney. *See* § 205.5(c). It is your supervisor's responsibility to report further. If you reasonably determine that she fails to comply with her obligation to report the evidence that you have presented to her, you may, but are not required to, report the evidence to the CLO as a non-subordinate attorney would. *See* § 205.5(d).

75. I am the deputy general counsel of an issuer. A subordinate attorney has reported to me what he believes to be evidence of a material violation. Based on his report, however, I am confident that what he has discovered does not suggest any likelihood of a material violation. What are my obligations under the Reporting Requirements?

Your question raises an issue of the interplay between § 205.4(c) and § 205.3. § 205.4(c) requires a supervisory attorney to comply with § 205.3 when a subordinate attorney has reported evidence of a material violation to her. § 205.3(b) requires an attorney who becomes aware of evidence of a material violation to report this evidence first to the CLO, and potentially up the ladder. "Evidence of a material violation" means evidence, "based upon which it would be unreasonable . . . for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation [exists]." § 205.2(e). Thus, if you

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reasonably believe that the evidence you have been presented does not suggest any likelihood of a material violation, then you are not required, under § 205.3(b), to report the evidence, even if your subordinate believes otherwise. Author's suggestion: Because of the possibility that the subordinate attorney will assume that you ignored her concern, it would be wise to explain to her the analysis you adopted. If that doesn't satisfy her, you should consider reporting it to the CLO and resolving the issue.

76. I practice securities law in-house at a large publicly traded company. I work under the supervision of the deputy general counsel. I also have several attorneys who work under my supervision, all practicing securities law. One of these subordinate attorneys recently reported to me evidence of a material violation. What are my obligations pursuant to the Reporting Requirements?

Because you supervise the work of another attorney and report to (yet) another attorney, you are both a supervisory and a subordinate attorney. As a supervisory attorney, you are responsible for complying with the Reporting Requirements when a subordinate employee has reported evidence of a material violation to you. *See* § 205.4(c). As a subordinate employee, however, you may discharge your reporting obligation by reporting the evidence of a material violation that you have become aware of to your supervisor. *See* § 205.5(c). As a result, you should report the evidence of a material violation to your supervisor, and this should discharge your obligations under the rules.

77. I am a supervisory attorney who reports directly to the CLO. A subordinate attorney reported to me evidence of a material violation. I then reported this evidence to the CLO pursuant to the Reporting Requirements. The CLO investigated and reported back to me the results of her investigation and explained to me how she determined that there was no material violation. I found her explanation convincing and satisfactory, but when I reported it to the subordinate attorney, he was dissatisfied and said he still believed that there was a likelihood of a material violation. What must I do to comply with the Reporting Requirements? What can my subordinate do?

By reporting the evidence to the CLO and receiving an appropriate response (i.e., a response as a result of which you reasonably believe that no material violation exists), you have discharged your duties. Your subordinate is permitted to report pursuant to § 205.3 *if* he "reasonably believes" that you have not complies with § 205.3. *See* § 205.5(d). In this case, although he does not accept the CLO's explanation, it does not appear that he could reasonably believe that you have failed to comply with § 205.3. Nevertheless, it might be wise for you to go beyond your duties under the rules and suggest that the CLO discuss the matter with the subordinate so that everyone can be satisfied that the company is acting properly.

VIII. When May a Reporting Attorney Disclose Issuer Confidences?

78. I have made several reports pursuant to the Reporting Regulations of evidence of material violations. Each time that I made a report to either the CLO or the audit

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committee, I wrote a memo to my file. I intended the memos, which reflect attorney-client correspondence, to be privileged and marked them as such. The SEC has begun an investigation of my compliance with the Reporting Regulations. Do the SEC rules permit me to use these memoranda to defend myself even if the company does not consent?

Yes. Section 205.3(d)(1) permits you to use contemporaneous records of reports made pursuant to the Reporting Requirements to defend yourself in any investigation, proceeding, or litigation in which your compliance with the Reporting Requirements is at issue.

79. I am an attorney covered by the Reporting Requirements. I am aware that the CEO and the board of directors are planning to issue misleading profit forecasts in order to increase the stock price so that the board members can cash in their stock options. All of this information was learned in my capacity as attorney to the company and is subject to attorney-client privilege. May I nevertheless reveal this information to the SEC?

Yes. Section 205.3(d)(2)(i) allows a covered attorney to disclose confidential information to the SEC to the extent that "the attorney reasonably believes necessary" "[t]o prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest . . . of . . . investors."

80. I am an attorney subject to the Reporting Requirements. Through my employment with Company X, I have learned that Company Y is planning to take a material violation that will likely cause substantial injury to investors. The information that I have learned is subject to an attorney-client privilege held by my employer, Company X, and it would not want me to reveal this information. Company X is not involved in any wrongdoing. I have never represented Company Y in any way. Do the Reporting Requirements give me permission to reveal the information about Company Y's plans to the SEC?

Probably not. The Reporting Requirements state that an attorney appearing and practicing in the "representation of an issuer" may reveal confidences to the SEC to "prevent *the issuer*" from committing a material violation that is likely to substantially injure investors. § 205.3(d)(2)(i) (emphasis supplied). It appears that the reference to "the issuer" means the issuer that the attorney is representing. Thus, because the issuer that you are representing is not about to commit a material violation, you are not permitted by this rule to disclose confidential information. Instead, you are subject to the applicable rules of professional responsibility.

81. I am an attorney covered by the Reporting Requirements. I have recently learned that the issuer that I represent committed a material violation of the securities laws that cost investors millions of dollars. I and my work had nothing to do with this violation which is entirely in the past. I believe that if the SEC became aware of this violation it would be able to rectify the consequences of the violation by recovering money for the victims. Do the

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Reporting Requirements give me permission to reveal confidential information about the past material violation to the SEC?

No. The Reporting Requirements allow a covered attorney to report confidential information to the SEC to the extent that the attorney reasonably believes necessary to rectify the consequences of a material violation that caused substantial injury *only if* the attorney's services were used in furtherance of the material violation. § 205.3(d)(2).

82. I am an attorney covered by the Reporting Requirements. I have recently learned that my legal work was used by the issuer that I represent in the commission of a material violation of the securities laws that cost investors millions of dollars. I believe that if the SEC became aware of this violation it would be able to rectify the consequences of the violation by recovering money for the victims. Do the Reporting Requirements give me permission to reveal confidential information about the past material violation to the SEC?

Yes. This question contains the one element that was missing in the previous question – that the attorney's work was used in furtherance of the past material violation.

IX. What if an Issuer Discharges a Reporting Attorney?

83. I am the CLO of an issuer. An attorney who worked under my supervision recently reported evidence of a material violation to me. The following week, I terminated her employment with the company. While her termination had nothing to do with the report, she believes that it did, and I can see how the coincidental timing would make her think this. She is now threatening to tell the board of directors that she believes that she was terminated for reporting evidence of a material violation. This would inform the board of the possible violation before I have had a chance to complete my investigation. Can she do this?

Yes. The Reporting Regulations allow an attorney who reasonably believes that she has been terminated for reporting evidence of a material violation to the CLO to notify the board of directors or any committee thereof that she believes that she was terminated for that reason. § 205.3(b)(10).

X. The SEC Regulations vs. State Ethical Rules: What To Follow When There Is Conflict

84. I regularly advise the corporation on matters of securities law and, for that reason, I am assisting outside counsel in the defense of contentious securities litigation against the company. In the course of the defense, I have appeared at depositions where I have stated on the record that I represented an officer of the corporation. In preparation for the deposition, this officer advises me that he has engaged in insider trading by "tipping" third parties who sold short the corporation's stock. Does my Sarbanes-Oxley obligation override my state law ethical duty of confidentiality?

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Yes. A literal reading of Section 205.1 of the regulations suggests you must make a report notwithstanding contrary state ethics rules. That section provides, in part, "[t]his part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. . . . Where the standards of a state . . . where an attorney is admitted or practices conflict with this part, this part shall govern." The Commentary advises that the Commission's "rules shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdiction in which an attorney is admitted or practices."[22]

85. I am an attorney covered by the Reporting Requirements. I am aware of certain information that (1) under the Reporting Regulations, I would have the option of reporting to the SEC, but (2) under the ethics rules in the state in which I am admitted and practice, I would be required to disclose. Which rule should I follow?

The state requirements. The Reporting Requirements do not preempt stricter state requirements. § 205.1. Here, the state requirements requiring disclosure are considered stricter than the SEC rule permitting disclosure. Moreover, there is no conflict between the standards because by following the state rule you are not violating the permissive federal rule.

86. I violated state ethics rules because I thought such violation was required by the SEC Reporting Regulations. I acted entirely in good faith and tried my best to follow the law, but I now realize I was mistaken. Do I have a federal defense to state ethics disciplinary procedures?

Unfortunately, you do not. The federal defense only applies to an "attorney who complies in good faith" with the Reporting Regulations. § 205.6(c). Although you acted in good faith, you did not comply with the Reporting Regulations.

87. I am a lawyer practicing in a foreign jurisdiction who is nevertheless subject to the Reporting Requirements. Do I have to follow the Reporting Requirements to the extent that they conflict with ethical canons, professional disciplinary rules, and court rules in my home jurisdiction?

If the foreign obligations are forms of "law," then you are not required to follow the Reporting Requirements to the extent they conflict with that "foreign law." § 205.6(d). Court rules, for example, would probably be a form of "law." Ethical canons, depending on the law in your home jurisdiction, might not rise to the level of "law," and thus might not excuse you from compliance with contradictory provisions in the Reporting Requirements.

[22] 68 Fed. Reg. at 6297.

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ETHICS & PRIVILEGE

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Supervisory Attorney Liability under § 307 of Sarbanes-Oxley: Another Sand Trap for the Unwary

You are just beginning to absorb your own responsibilities under the SEC's new up-the-corporate-ladder rules implementing § 307 of the Sarbanes-Oxley Act when your colleagues remind you that, as general counsel, you have potential liability for those whom you supervise. Great Scott. Will it never end? Who is a supervisory counsel, and what is supervisory counsel's liability under the new regulations anyway? As it turns out, the answer, for once, is that it could be worse—thanks to those who pointed out to the SEC the degree to which the proposed rules deviated from the ABA's model rules. But there are still risks.

By John K. Villa
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As every corporate lawyer now knows, the U.S. Securities and Exchange Commission ("SEC") has followed the mandate of § 307 of the Sarbanes-Oxley Act[1] and promulgated an initial set of rules of professional conduct for attorneys who appear and practice before it on behalf of an issuer.[2] Given the confusion over responsibilities imposed by these rules, an important question that has been largely ignored is to ascertain which attorneys within a general counsel's office or a law firm may be held responsible for ensuring compliance with these rules. And to what extent do these rules depart from the standards under the *Model Rules of Professional Conduct* in imposing liability on supervisory attorneys for the unethical conduct of their subordinates? *(Got you there: I bet many of you did not even know that a supervisory attorney could be held responsible for the unethical conduct of subordinates!)*

Let's begin with Model Rule 5.1 to ensure that we all remember the ethical requirements imposed on supervisory lawyers:

Responsibilities of Partners, Managers, and Supervisory Lawyers

(a) A partner in a law firm, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.

(b) A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.

(c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if:

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(1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or
(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

One can view the mandates of Model Rule 5.1 as threefold, proceeding from the most general to the most specific. Model Rule 5.1(a) imposes on lawyers with managerial authority the obligation to make reasonable efforts to ensure that the firm has in effect procedures giving reasonable assurance of compliance with ethical rules. "Firm," for these purposes would include the legal department of a corporation.[3] Model Rule 5.1(b) imposes obligations on a lawyer who has "direct supervisory authority over another lawyer [to] make reasonable efforts to ensure that the other lawyer" conforms to the ethical rules. Finally, Model Rule 5.1(c) describes the circumstances in which a lawyer will have sufficient knowledge of or involvement in the unethical conduct of another (either by ratifying the conduct or by failing to take remedial steps) to be held ethically responsible for the misconduct of another lawyer. Subsections (a) and (b), thus, provide that it is unprofessional conduct not to properly supervise. Subsection (c) makes a lawyer individually liable for more than inadequate supervision: the supervisory lawyer is individually liable for another lawyer's misconduct. Liability under Model Rule 5.1(c) is thus much more severe than (a) or (b) because the supervisor is liable for the acts of the subordinate.

With that background, let us turn to the SEC rule. The responsibility of supervisory attorneys with respect to the up-the-ladder reporting requirements of the SEC's new rules of professional conduct is set forth in § 205.4, the final version of which provides as follows:

§ 205.4 Responsibilities of supervisory attorneys.

(a) An attorney supervising or directing another attorney who is appearing and practicing[4] before the Commission in the representation of an issuer is a supervisory attorney. **An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.**
(b) A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a),[5] that he or she supervises or directs conforms to this part. **To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.**
(c) A supervisory attorney is responsible for complying with the reporting requirements in § 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.
(d) A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under § 205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.[6]

In tracking the evolution of the final rules, we will see that the comments of the ABA and others clearly reshaped the rule to make it similar albeit not identi-

Do Not Miss John K. Villa's

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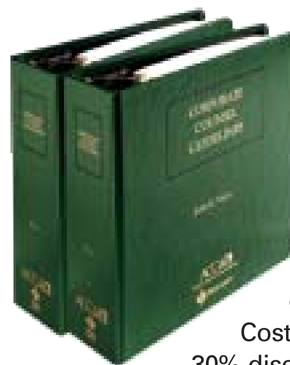

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cal to the Model Rules. The proposed rules defined "supervisory attorney" in § 205.4(a) to include any attorney "supervising, directing, or having supervisory authority over another attorney."[7] In its comments to the proposed rule, the ABA criticized this definition: the ABA observed that it exceeded the obligations imposed on supervisory attorneys under Rule 5.1 of the *Model Rules of Professional Responsibility* "by including any attorney with supervisory authority over another attorney," such as partners or senior associates, even if such authority is unrelated to the particular matter involving the SEC.[8] The ABA contrasted the SEC proposal with Model Rule 5.1, which provides that a "lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct."[9]

The ABA also criticized § 205.4(b) of the proposed rule, which provided that a supervisory attorney was responsible for ensuring compliance with the new rules and "with the statutes and other rules administered by the Commission," as well as the provision that a supervisory attorney will be deemed to be appearing and practicing before the SEC to the extent that a subordinate attorney appears and practices before the SEC.[10] By expanding a supervisory attorney's obligation to ensure compliance with all federal securities laws and by treating a subordinate attorney's appearance and practice before the SEC as that of the supervisory attorney, "without regard to whether the supervision relates to the matter involving appearing and practicing before the Commission or whether the supervisory attorney is even aware the subordinate attorney is so practicing," the ABA argued that the proposed rule placed "extraordinary burdens" on attorneys that "go well beyond the obligations imposed by Rule 5.1(c).[11] Under the Model Rule, the ABA pointed out, a supervisory attorney is responsible for a violation of an ethical rule by another attorney only "if he orders or knowingly ratifies the conduct or knows of the conduct and fails to take reasonable remedial action."[12]

In response to these objections,[13] the final SEC rules modified 205.4(a) to provide "that only a senior attorney who actually directs or supervises the actions of a subordinate attorney appearing and practicing before the Commission" will be considered a supervisory attorney subject to the rule.[14] According to the SEC, in cases in which the supervision or direction of a subordinate attorney concerns matters unrelated to the latter's appearing and practicing before the SEC, the senior attorney will not be considered a supervisory attorney under the rule.[15] With respect to § 205.4(b), the SEC eliminated the proposed requirement that a supervisory attorney ensure a subordinate attorney's compliance with the federal securities laws—only compliance with the new up-the-ladder rules must be ensured.

Do the modifications in the final rule defang § 205.4? Hardly.

Although it now resembles Model Rule 5.1,[16] § 205.4(b) still equates a subordinate attorney's appearance and practice before the SEC with that of the supervisory attorney. This provision means that every corporate chief legal officer or any other attorney who supervises another attorney practicing before the Commission is subject to the SEC rules and sanctions. Can a supervisory attorney be disciplined for failure to report up-the-ladder by the subordinate if the issue was not known to the supervisor? It would not seem that § 205.4(c) and (d) appear to impose duties on the supervisor if the supervisor is informed of the necessity to report by the subordinate. Can a supervisor be subject to SEC discipline under § 205 for failure to "make reasonable efforts to ensure that a subordinate attorney . . . conforms to [these rules]"? Very likely—although it may be that the supervisory lawyer would not be held individually liable for the misconduct of the subordinate attorney if the only sin were failure to supervise. That distinction, as we have observed, is the one drawn between Model Rules 5.1(a) and (b) on the one hand and 5.1(c) on the other. What is the extent of the duty on chief legal officers? In other words, what constitutes "reasonable efforts" under § 205.4(b)? Model Rule 5.1(b)—from which the "reasonable efforts" standard was derived—and the SEC commentary provide some direction. Here are some suggestions derived from the commentary to the Model Rules and the SEC's comments:[17]

- The general counsel should mandate the imposition of clear, mandatory, and specific procedures designed by lawyers schooled in the principles of § 205. ACCA may be able to assist in this regard. See generally ACCA's corporate responsibility page on ACCA Online℠ at www.acca.com/legres/corpresponsibility/index.php.
- The office should have periodic meetings to explain and review the SEC rules and to impress on subordinate attorneys the obligation to observe them. Records that such meetings were held should be maintained.
- The office should have a knowledgeable advisor available to consult on the obligations under Rule 205 and should strongly encourage subordinate attorneys to consult orally with that advisor with any questions.[18]

ACCA's second round of comments to the SEC address the issue raised in this column and are available on ACCA Online℠ at www.acca.com/advocacy/307comments2.pdf. ◘

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NOTES

1. Pub. L. No. 107-204, 116 Stat. 745, 784 (2002).
2. Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6320 (2003) (to be codified at 17 C.F.R. pt. 205). Briefly stated, these rules require an attorney that appears and practices before the SEC on behalf of a company to report up the ladder within the company whenever the attorney becomes aware of evidence of a material violation of the securities laws or a breach of fiduciary duty. The SEC had also proposed a rule that would require the attorney to withdraw from representation and notify the SEC if the attorney reasonably believed that the organization's directors either had made no response or had made an inappropriate response to the attorney's up-the-ladder report. *See* Proposed Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71705–71706 (proposed Dec. 2, 2002). Because of numerous comments received in response to this proposal, known as the "noisy withdrawal" provision, however, the SEC has extended the comment period on this proposed rule and has also proposed an alternative approach. *See* Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324 (proposed Feb. 6, 2003).
3. *See* the definition of "firm" in Model Rule 1.0.
4. The phrase "appearing and practicing before the Commission" has its own definition, which can be summarized as the provision of legal services to an in issuer that includes any of the following: the transacting of any business with the SEC; representing the issuer in SEC administrative proceedings or in connection with any SEC investigation, inquiry, information request, or subpoena; providing advice concerning the securities law or the SEC's regulations with respect to any document to be filed in any manner with the SEC; or advising as to whether certain information is required to be filed in any manner with the SEC. Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6320 (to be codified at 17 C.F.R. § 205.2(a)).
5. Section 205.5(a) defines a subordinate attorney as any "attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)." Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6323 (to be codified at 17 C.F.R § 205.4).
6. Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6323 (to be codified at 17 C.F.R § 205.4). (Emphasis supplied.)
7. Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71706.
8. Comments of the American Bar Association, dated Dec. 18, 2002, at 23 (emphasis in original) (available at www.abanet.org/poladv/letters/other/comment_letter.pdf).
9. *ABA Model Rules of Professional Conduct*, Rule 5.1(b) (2003). (Emphasis supplied.) Subsection (a) of the rule imposes upon partners, as well as other lawyers with comparable management authority in the firm, the obligation "to make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct." Under subsection (c), partners, managerial lawyers, and supervisory attorneys will be held responsible for ethical violations committed by other attorneys if they knew of the conduct at a time when its consequences could have been avoided or mitigated but failed to take reasonable remedial action.
10. Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71706.
11. Comments of the American Bar Association, *supra* note 8, at 23.
12. *Id. See supra* note 6.
13. Similar objections were raised by several commenters. *See* Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6313.
14. *See supra* note 2.
15. "Conversely, an attorney who typically does not exercise authority over a subordinate attorney but who does direct the subordinate attorney in the specific matter involving the subordinate's appearance and practice before the Commission is a supervisory attorney under the final rule." *See supra* note 2.
16. Section 205.4(a)'s classification of an issuer's chief legal officer as a supervisory attorney subject to the requirements of the rule is also analogous to Model Rule 5.1(a)'s imposition of compliance obligations on law firm partners and/or managers. Under Model Rule 5.1(a), however, the obligation imposed on partners and managerial lawyers is directed to the firm as a whole, requiring them to "make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct." Unlike the SEC rule, moreover, under which an issuer's chief legal officer "cannot avoid responsibility . . . by claiming a lack of knowledge of, or supervision over, the actions of subordinate attorneys," Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71695, responsibility for specific misconduct by an attorney cannot be imposed on a partner or managerial attorney unless the partner or managerial lawyer had had knowledge of the misconduct and had either ratified it or failed to take reasonable remedial action when able to do so. *ABA Model Rules of Professional Conduct*, Rule 5.1(c).
17. *ABA Model Rules of Professional Conduct*, Rule 5.1, cmt. 6. According to the SEC, § 205.4(b) requires the supervisory attorney to take "affirmative steps" to ensure compliance with the rules, but "leaves to the professional judgment of the supervisory attorney how best to accomplish this goal." The SEC, however, "would expect that these steps would include the creation of procedures for subordinate attorneys to report evidence of material misconduct they learn about and, perhaps, periodic meetings for the purpose of discussing how to address such matters." Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71695. As to how the courts have variously construed the term "reasonable efforts" under Model Rule 5.1, *see Supervisory and Subordinate Lawyers*, LAW. MAN. ON PROF. CONDUCT 91:101 (ABA/BNA).
18. *See* Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, n. 17.

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ABA Presidential Task Force on Corporate Responsibility

- Recommendation to amend Rule 1.13 of the ABA Model Rules of Professional Conduct and to amend the related comments;
- Recommendation to amend Rule 1.6(b) of the ABA Model Rules of Professional Conduct and to amend the related comments; and
- Recommendation to adopt corporate governance policies and related governance practices

ABA Corporate Responsibility Task Force Releases Final Report

Task Force Urges New Corporate Governance Policies and Lawyer Ethics Rules

Addresses Practices and Attitudes that Contributed to Failures

The final report of the American Bar Association Task Force on Corporate Responsibility urges changes in corporate governance policies to create a new culture of corporate responsibility stressing constructive skepticism and active independent oversight of corporate executives.

The task force's recommended corporate governance policies also are designed to enhance the role of corporate lawyers in the system of checks and balances needed to ensure corporate compliance with law. The report also makes recommendations for amendments to the ABA Model Rules of Professional Conduct to sharpen existing duties of the corporate lawyer to the corporate client and to act in the best interests of that client when faced with illegal conduct by executive officers.

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*The in-house bar association*SM

August 15, 2003

ABA Adopts New Model Rules Affecting In-House Practice

At the American Bar Association Annual Meeting in San Francisco (on August 11 and 12), the ABA House of Delegates approved the recommendations of the ABA's Corporate Responsibility Task Force, otherwise known as the "Cheek Commission." ACCA supported these changes and worked hard for their passage. The floor debate was intense and the voting highly contentious, but the resolutions carried. What's the practical impact that the passage of these recommendations on you and your department, as well as on your client relationship? Here are a few thoughts from ACCA:

(Please see http://www.acca.com/public/newmodelrules.pdf for the full text of the new model rules referenced below. Remember – we're only hitting the highlights!)

1. The ABA Task Force on Corporate Responsibility, after over a year of assessing how to improve the role of corporate lawyers post-Enron, issued a report from which three recommendations were presented to the ABA House for passage. The full report, information on the Task Force, the testimony of those who presented comments, and more are available at http://www.abanet.org/buslaw/corporateresponsibility/home.html.

   The three recommendations before the House were an amendment to ABA Model Rule of Professional Conduct 1.6, an amendment to ABA Model Rule of Professional Conduct 1.13, and a series of best practices recommendations to improve the role of lawyers in governance matters important to the responsible functioning of the board and senior management. ACCA supported all three recommendations (http://www.acca.com/public/accapolicy/aba_corpresp.pdf), and all three passed the House, although through a series of close and highly contested votes. While the governance best practices are laudable, it is the changes to the Model Rules that have been the focus of most of the attention.

2. The Model Rules of Professional Conduct are highly influential in shaping states' rules of professional conduct, especially over time. But remember that amending the Model Rules is relatively meaningless in terms of immediate impact on you. A "model" rule regulates no one – the rules of professional conduct that regulate you must be adopted by the states in which you practice law (which may include states in which you are not admitted).

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3. The ABA model rule changes create new a Model Rule 1.6 and a new Model Rule 1.13; these rules set lawyer conduct standards for confidentiality and reporting up the ladder within an organizational client, respectively. The amendments allow additional "reporting out" opportunities for lawyers in certain closely defined situations involving client malfeasance that cannot be corrected. For a fuller explanation, see Footnote 1, at the end of this summary.

4. The primary concerns raised in opposition to these new rules are that they will further erode client confidentiality (any exceptions to which some believe to be inappropriate on their face) and potentially increase lawyer liability. We do not agree. See Footnote 2 for more on why.

5. It is important to separate the confidentiality exceptions of the Model Rules of Conduct from changes to the evidentiary standards of the attorney-client privilege They are two separate, and – for purposes of these rules – unrelated things.

6. ACCA made its decision to support the Task Force reforms to the Model Rules based on a number of reasons. Two important ones are: We believe that taking this action voluntarily sends the message that the bars are willing to regulate themselves in a manner that is responsive to questions raised about the appropriate role of lawyers (and their absence) in preventing a number of recent corporate failures. Thus, we hope that this action will forestall the perceived need for additional attorney conduct regulation by federal authorities such as Congress, the FTC, and the SEC. Second, we believe that these changes are consistent with what we understand from ACCA members and others about what clients really want. (See footnote 3 below for more information.)

7. There is obvious interplay and a number of parallels between the content and passage of these rules, and the content and passage of new rules by the SEC governing the conduct of attorneys for issuers who are "appearing and practicing" before the Commission. One important thing to remember is that while the SEC's Sarbox Section 307 rules (codified as Part 205 in the CFR) only apply to certain lawyers for issuers, these new Model Rules, if adopted by states, will apply to all lawyers, regardless of their practice and regardless of whether the client is public, private, a partnership, a non-profit, and so on.

8. You might take advantage of the adoption of these new model rules to raise the issue of client confidentiality for re-examination with both lawyers you work with and clients you serve: perhaps this might be an agenda item at a future ethics program for the department retreat, or the subject of a discussion with senior management and the board in the form of a report reiterating your department's policies and procedures in protecting client confidentiality and the realistic limits of its application. Sometimes client expectations regarding confidentiality are erroneously shaped to a greater degree by TV dramas than by a clear understanding of realistic expectations, especially given the number of new and ongoing government initiatives to violate confidentiality or seek waiver of the privilege in the course of the investigation of alleged corporate

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wrongdoing. Need help developing a program or policy on confidentiality? Call us! (202/293-4103, ext 318, or email hackett@acca.com)

9. These new Model Rule amendments will be added to the pile of rule amendments under consideration by the states. As you know, ACCA has been pushing for states to adopt Model Rule 5.5, which is a new rule (as of August of 2002) authorizing multijurisdictional practices (MJP). Some states have already taken action on the new 5.5 and other rule changes proposed a year ago by the ABA's Ethics 2000 Commission (and they may not jump to open the rule amendment process again immediately); other states are in process and will probably add these changes to the line-up under consideration; still others may ignore the process altogether until they come to these issues in their own good time. You can check out your state's MJP progress to date on our "state scorecard" and related charts at http://www.acca.com/practice/mjp.php.

For more information on these rules and how they impact in-house practice, call Susan Hackett, ACCA's General Counsel, at 202/293-4103, ext. 318 or email hackett@acca.com.

FOOTNOTES

Footnote 1.

Model Rule 1.6 is the "Confidentiality" Rule. It generally notes that lawyers have a duty of confidentiality to clients and then sets out the exceptions to that duty. Depending on your state, your state's version of 1.6 might include a mix of exceptions from the general duty of confidentiality, including mandatory reporting requirements, or "permissive" (optional to the lawyer in her discretion) reporting opportunities. Every state has an exception for the lawyer to report and thus help prevent client acts which would result in an imminent bodily harm. There are also a few exceptions in every state for lawyers to use confidential information to the extent necessary to provide their own defense if sued by the client or to collect a fee if the client does not pay. Some states allow or mandate lawyers to report additional kinds of client wrongdoing of one sort or another. Thus, the state equivalents of Model Rule 1.6 are probably the least consistent in their application from state to state of all the rules of professional conduct.

The new ABA Model Rule adds an exception to the Model which already exists in 42 states' rules in some form or another. (Thus, in a sense, the change in the ABA Model Rule just passed simply makes the ABA Model consistent with the majority of state rules already on the books.) The new exception permits (but does not mandate) a lawyer to report client confidences to (unspecified) outsiders, if and only if: the fraud is reasonably likely to have a significant financial impact on innocent third parties; and if the lawyer's services have been abused by the client so as to have been used in the commission of the fraud.

The classic situation in which this rule applies is when the lawyer working on a client matter discovers new information about the matter that was withheld from him

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previously. He realizes that his services are thus unwittingly assisting the client in the commission of a fraud. He confronts the client and the client says it's not interested in changing course or correcting the underlying illegalities. The lawyer now has a permissive, not mandatory, option, to report that the client has used the lawyer's services in the commission of a fraud. (Most lawyers, when confronted with this unfortunate situation, find that the client, upon learning that the lawyer may disclose the illegal conduct to a regulator or court or other parties, will change course and conform. Thus, the disclosure option is often used not to disclose, but to carrot and stick the client into conformity with the law. This permissive disclosure and prohibition against lawyers aiding client wrongdoing is consistent with other portions of the model rules which prohibit lawyers from allowing clients to use their services to commit crimes.

The language of the amended rules is very conservative in that many of the 42 states with some kind of mandatory or permissive disclosure rule in response to client crimes or frauds are triggered more easily. Because we have the long-time experience of so many states with this rule on the books, we think it unlikely that the adoption of this rule in jurisdictions where it currently does not exist will not have a deleterious impact on you or your client relationships since it has not had such an impact in those states where it has been the rule for many years.

Model Rule 1.13 is the "Organization as Client" Rule – otherwise colloquially known as the "reporting up the ladder" rule. It generally reminds us that the client is the entity and not any one of its officers or agents. The previous Model Rule which is codified verbatim in most states suggests that lawyers who discover allegations of wrongdoing should report up the ladder, all the way to the board if necessary; in the event of client intransigence, the lawyer may need to resign. The old rule was not very helpful in providing practical guidance on how or when these responsibilities should be fulfilled.

The new model rule is significant in its changes. It not only clarifies and mandates stronger responses to allegations which must be reported up the ladder within the organization, but then offers lawyers the option (permissive, not mandatory) to report client wrongdoing outside of the company, but if and only if: the lawyer has exhausted all possible attempts to get the client (including the board) to remedy the wrongdoing, and the client refuses; and the harm to the *client* (and not to innocent third parties, as in new Model Rule 1.6) by not reporting would be substantial. This rule's optional reporting out amendment is thus consistent with the rule's first message: that the client represented by the lawyer is the entity and its best interests; when the agents of the client show that they are not appropriately fulfilling their fiduciary duties, the lawyer may act in a reasonable fashion to protect the entity client's best interests.

Footnote 2.

First, the confidentiality standards proposed by the amended rules are consistent with standards already applicable in 42 states; there has been no reported diminution of the attorney-client relationship in those states (where many of you already practice!), and many other portions of the Model Rules also prohibit the willing use of the lawyer's

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services in the commission of a client fraud (sometimes offering permissive reporting as a remedy, as well), again without any reported chill on the health of the lawyer-client relationship or any sign that this reporting out option is being exercised in an abusive fashion.

Second, while it is possible that lawyers who could have reported under these rules but did not could be held up to ridicule if their decision to not report "contributes" to the next major corporate financial debacle, such a decision, if reasonable, is not grounds for a finding of negligence or other liability. If there is an attempt to show that a lawyer's decision to not report was "unreasonable" in light of subsequent disaster, you can be sure that the fact that there was a permissive option to report or not will have little to do with shielding such a lawyer from warranted or unwarranted scrutiny. Times have simply changed. Any lawyer at the center of the next major corporate investigation will receive harsh scrutiny if regulatory agencies, the courts, shareholders or the public believe that the lawyer could have done something that she didn't to prevent a corporate collapse . . . unfortunately, 20/20 hindsight and outraged morality alone will be dispositive in such cases.

Footnote 3.

See ACCA's recent survey of corporate directors, conducted in cooperation with the National Association of Corporate Directors (NACD), a summary of which is online at http://www.acca.com/practice/stats.php (click open the NACD/ACCA survey link on this survey page). The hands down top response of board members when asked "what is the most valuable service offered by lawyers" was "Warning the board of significant legal risks to the company." We believe the amendment of these rules works to that purpose most directly by firmly focusing a lawyer's attention on reporting up and exhausting all possible remedial actions. The fact that so few lawyers ever choose to report out under permissive disclosure systems suggests to us that such an option is used more as a carrot/stick to convince clients to correct illegal behaviors and is only exercised with an understanding that the lawyer who discloses but has not considered and sought out all possible remedial measures to avoid divulging client confidences will be judged most harshly for his rash actions and poor discretion.

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The in-house bar association[SM]

August 20, 2003

AMERICAN BAR ASSOCIATION'S REVISED MODEL RULES OF PROFESSIONAL CONDUCT 1.6 & 1.13

RULE 1.6: CONFIDENTIALITY OF INFORMATION (AS REVISED ON 8/11/2003)[1]

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4~~2~~) to secure legal advice about the lawyer's compliance with these Rules;

(5~~3~~) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(6~~4~~) to comply with other law or a court order.

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[1] Additions are underlined; stricken text indicates deletions.

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Comment

[1] This Rule governs the disclosure by a lawyer of information relating to the representation of a client during the lawyer's representation of the client. See Rule 1.18 for the lawyer's duties with respect to information provided to the lawyer by a prospective client, Rule 1.9(c)(2) for the lawyer's duty not to reveal information relating to the lawyer's prior representation of a former client and Rules 1.8(b) and 1.9(c)(1) for the lawyer's duties with respect to the use of such information to the disadvantage of clients and former clients.

[2] A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation. See Rule 1.0(e) for the definition of informed consent. This contributes to the trust that is the hallmark of the client-lawyer relationship. The client is thereby encouraged to seek legal assistance and to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter. The lawyer needs this information to represent the client effectively and, if necessary, to advise the client to refrain from wrongful conduct. Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct. Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.

[3] The principle of client-lawyer confidentiality is given effect by related bodies of law: the attorney-client privilege, the work product doctrine and the rule of confidentiality established in professional ethics. The attorney-client privilege and work-product doctrine apply in judicial and other proceedings in which a lawyer may be called as a witness or otherwise required to produce evidence concerning a client. The rule of client-lawyer confidentiality applies in situations other than those where evidence is sought from the lawyer through compulsion of law. The confidentiality rule, for example, applies not only to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source. A lawyer may not disclose such information except as authorized or required by the Rules of Professional Conduct or other law. See also Scope.

[4] Paragraph (a) prohibits a lawyer from revealing information relating to the representation of a client. This prohibition also applies to disclosures by a lawyer that do not in themselves reveal protected information but could reasonably lead to the discovery of such information by a third person. A lawyer's use of a hypothetical to discuss issues relating to the representation is permissible so long as there is no reasonable likelihood that the listener will be able to ascertain the identity of the client or the situation involved.

Authorized Disclosure

[5] Except to the extent that the client's instructions or special circumstances limit that authority, a lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation. In some situations, for example, a lawyer may be impliedly authorized to admit a fact that cannot properly be disputed or to make a disclosure that facilitates a satisfactory conclusion to a matter. Lawyers in a firm may, in the course of the firm's practice,

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disclose to each other information relating to a client of the firm, unless the client has instructed that particular information be confined to specified lawyers.

Disclosure Adverse to Client

[6] Although the public interest is usually best served by a strict rule requiring lawyers to preserve the confidentiality of information relating to the representation of their clients, the confidentiality rule is subject to limited exceptions. Paragraph (b)(1) recognizes the overriding value of life and physical integrity and permits disclosure reasonably necessary to prevent reasonably certain death or substantial bodily harm. Such harm is reasonably certain to occur if it will be suffered imminently or if there is a present and substantial threat that a person will suffer such harm at a later date if the lawyer fails to take action necessary to eliminate the threat. Thus, a lawyer who knows that a client has accidentally discharged toxic waste into a town's water supply may reveal this information to the authorities if there is a present and substantial risk that a person who drinks the water will contract a life-threatening or debilitating disease and the lawyer's disclosure is necessary to eliminate the threat or reduce the number of victims.

[7] Paragraph (b)(2) is a limited exception to the rule of confidentiality that permits the lawyer to reveal information to the extent necessary to enable affected persons or appropriate authorities to prevent the client from committing a crime or fraud, as defined in Rule 1.0(d), that is reasonably certain to result in substantial injury to the financial or property interests of another and in furtherance of which the client has used or is using the lawyer's services. Such a serious abuse of the client-lawyer relationship by the client forfeits the protection of this Rule. The client can, of course, prevent such disclosure by refraining from the wrongful conduct. Although paragraph (b)(2) does not require the lawyer to reveal the client's misconduct, the lawyer may not counsel or assist the client in conduct the lawyer knows is criminal or fraudulent. See Rule 1.2(d). See also Rule 1.16 with respect to the lawyer's obligation or right to withdraw from the representation of the client in such circumstances, and Rule 1.13(c) which permits the lawyer, where the client is an organization, to reveal information relating to the representation in limited circumstances.

[8] Paragraph (b)(3) addresses the situation in which the lawyer does not learn of the client's crime or fraud until after it has been consummated. Although the client no longer has the option of preventing disclosure by refraining from the wrongful conduct, there will be situations in which the loss suffered by the affected person can be prevented, rectified or mitigated. In such situations, the lawyer may disclose information relating to the representation to the extent necessary to enable the affected persons to prevent or mitigate reasonably certain losses or to attempt to recoup their losses. Paragraph (b)(3) does not apply when a person who has committed a crime or fraud thereafter employs a lawyer for representation concerning that offense.

[9~~7~~] A lawyer's confidentiality obligations do not preclude a lawyer from securing confidential legal advice about the lawyer's personal responsibility to comply with these Rules. In most situations, disclosing information to secure such advice will be impliedly authorized for the lawyer to carry out the representation. Even when the disclosure is not impliedly authorized,

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paragraph (b)(4) permits such disclosure because of the importance of a lawyer's compliance with the Rules of Professional Conduct.

[10~~8~~] Where a legal claim or disciplinary charge alleges complicity of the lawyer in a client's conduct or other misconduct of the lawyer involving representation of the client, the lawyer may respond to the extent the lawyer reasonably believes necessary to establish a defense. The same is true with respect to a claim involving the conduct or representation of a former client. Such a charge can arise in a civil, criminal, disciplinary or other proceeding and can be based on a wrong allegedly committed by the lawyer against the client or on a wrong alleged by a third person, for example, a person claiming to have been defrauded by the lawyer and client acting together. The lawyer's right to respond arises when an assertion of such complicity has been made. Paragraph (b)(5~~3~~) does not require the lawyer to await the commencement of an action or proceeding that charges such complicity, so that the defense may be established by responding directly to a third party who has made such an assertion. The right to defend also applies, of course, where a proceeding has been commenced.

[11~~9~~] A lawyer entitled to a fee is permitted by paragraph (b)(5~~3~~) to prove the services rendered in an action to collect it. This aspect of the rule expresses the principle that the beneficiary of a fiduciary relationship may not exploit it to the detriment of the fiduciary.

[12~~10~~] Other law may require that a lawyer disclose information about a client. Whether such a law supersedes Rule 1.6 is a question of law beyond the scope of these Rules. When disclosure of information relating to the representation appears to be required by other law, the lawyer must discuss the matter with the client to the extent required by Rule 1.4. If, however, the other law supersedes this Rule and requires disclosure, paragraph (b)(6~~4~~) permits the lawyer to make such disclosures as are necessary to comply with the law.

[13~~11~~] A lawyer may be ordered to reveal information relating to the representation of a client by a court or by another tribunal or governmental entity claiming authority pursuant to other law to compel the disclosure. Absent informed consent of the client to do otherwise, the lawyer should assert on behalf of the client all nonfrivolous claims that the order is not authorized by other law or that the information sought is protected against disclosure by the attorney-client privilege or other applicable law. In the event of an adverse ruling, the lawyer must consult with the client about the possibility of appeal to the extent required by Rule 1.4. Unless review is sought, however, paragraph (b)(6~~4~~) permits the lawyer to comply with the court's order.

[14~~12~~] Paragraph (b) permits disclosure only to the extent the lawyer reasonably believes the disclosure is necessary to accomplish one of the purposes specified. Where practicable, the lawyer should first seek to persuade the client to take suitable action to obviate the need for disclosure. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes necessary to accomplish the purpose. If the disclosure will be made in connection with a judicial proceeding, the disclosure should be made in a manner that limits access to the information to the tribunal or other persons having a need to know it and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.

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[15~~13~~] Paragraph (b) permits but does not require the disclosure of information relating to a client's representation to accomplish the purposes specified in paragraphs (b)(1) through (b)(6~~4~~). In exercising the discretion conferred by this Rule, the lawyer may consider such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction and factors that may extenuate the conduct in question. A lawyer's decision not to disclose as permitted by paragraph (b) does not violate this Rule. Disclosure may be required, however, by other Rules. Some Rules require disclosure only if such disclosure would be permitted by paragraph (b). See Rules 1.2(d), 4.1(b), 8.1 and 8.3. Rule 3.3, on the other hand, requires disclosure in some circumstances regardless of whether such disclosure is permitted by this Rule. See Rule 3.3(c).

~~Withdrawal~~

~~[14] If the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, the lawyer must withdraw, as stated in Rule 1.16(a)(1). After withdrawal the lawyer is required to refrain from making disclosure of the client's confidences, except as otherwise permitted by Rule 1.6. Neither this Rule nor Rule 1.8(b) nor Rule 1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like. Where the client is an organization, the lawyer may be in doubt whether contemplated conduct will actually be carried out by the organization. Where necessary to guide conduct in connection with this Rule, the lawyer may make inquiry within the organization as indicated in Rule 1.13(b).~~

Acting Competently to Preserve Confidentiality

[16~~15~~] A lawyer must act competently to safeguard information relating to the representation of a client against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are subject to the lawyer's supervision. See Rules 1.1, 5.1 and 5.3.

[17~~16~~] When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy. Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to the use of a means of communication that would otherwise be prohibited by this Rule.

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Former Client

[18~~17~~] The duty of confidentiality continues after the client-lawyer relationship has terminated. See Rule 1.9(c)(2). See Rule 1.9(c)(1) for the prohibition against using such information to the disadvantage of the former client.

RULE 1.13: ORGANIZATION AS CLIENT (AS REVISED ON 8/12/2003)

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. ~~In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations.~~
~~Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include among others:~~
~~(1) asking for reconsideration of the matter;~~
~~(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and~~
~~(3) referring~~

Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, ~~seriousness of the matter, referral~~ to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if~~,~~

(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action or a refusal to act, that is clearly a violation of law ~~and is likely to result in substantial injury to the organization~~, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may~~: resign in accordance with Rule 1.16,~~ reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but

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only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

~~(d)~~ (f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

~~(e)~~ (g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Comment

The Entity as the Client

[1] An organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders and other constituents. Officers, directors, employees and shareholders are the constituents of the corporate organizational client. The duties defined in this Comment apply equally to unincorporated associations. "Other constituents" as used in this Comment means the positions equivalent to officers, directors, employees and shareholders held by persons acting for organizational clients that are not corporations.

[2] When one of the constituents of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 1.6. Thus, by way of example, if an organizational client requests its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client's employees or other constituents are covered by Rule 1.6. This does not mean, however, that constituents of an organizational client are the clients of the lawyer. The lawyer may not disclose to such constituents information relating to the representation except for disclosures explicitly or impliedly authorized by the organizational client in order to carry out the representation or as otherwise permitted by Rule 1.6.

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[3] When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. ~~However, different considerations arise~~ Paragraph (b) makes clear, however, that when the lawyer knows that the organization ~~may~~ is likely to be substantially injured by action of ~~a~~ an officer or other constituent that violates a legal obligation to the organization or is in violation of law ~~In such a circumstance, it may be reasonably necessary for the lawyer to ask the constituent to reconsider the matter. If that fails, or if the matter is of sufficient seriousness and importance to the organization, it may be reasonably necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. Clear justification should exist for seeking review over the head of the constituent normally responsible for it. The stated policy of the organization may define circumstances and prescribe channels for such review, and a lawyer should encourage the formulation of such a policy. Even in the absence of organization policy, however, the lawyer may have an obligation to refer a matter to higher authority, depending on the seriousness of the matter and whether the constituent in question has apparent motives to act at variance with the organization's interest. Review by the chief executive officer or by the board of directors may be required when the matter is of importance commensurate with their authority. At some point it may be useful or essential to obtain an independent legal opinion.~~ that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. As defined in Rule 1.0(f), knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious. The terms "reasonable" and "reasonably" imply a range within which the lawyer's conduct will satisfy the requirements of Rule 1.13. In determining what is reasonable in the best interest of the organization the circumstances at the time of determination are relevant. Such circumstances may include, among others, the lawyer's area of expertise, the time constraints under which the lawyer is acting, and the lawyer's previous experience and familiarity with the client. For example, the facts suggesting a violation may be part of a large volume of information that the lawyer has insufficient time to comprehend fully. Or the facts known to the lawyer may be sufficient to signal the likely existence of a violation to an expert in a particular field of law but not to a lawyer who works in another specialty. Under such circumstances the lawyer would not have an obligation to proceed under Paragraph (b).

[4] In determining how to proceed under Paragraph (b), the lawyer should give due consideration to the seriousness of the violation and its consequences, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations. Ordinarily, referral to a higher authority would be necessary. In some circumstances, however, it may be appropriate for the lawyer to ask the constituent to reconsider the matter; for example, if the circumstances involve a constituent's innocent misunderstanding of law and subsequent acceptance of the lawyer's advice, the lawyer may reasonably conclude that the best interest of the organization does not require that the matter be referred to higher authority. If a constituent persists in conduct contrary to the lawyer's advice, it will be necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization. If the matter is of sufficient seriousness and importance or urgency to the organization, referral to higher authority in the organization may be necessary even if the lawyer has not communicated with the constituent. Any measures taken should, to the extent practicable, minimize the risk of revealing information relating to the representation to persons outside the organization. Even in circumstances where a lawyer is not

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obligated by Rule 1.13 to proceed, a lawyer may bring to the attention of an organizational client, including its highest authority, matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization.

[4] [5] Paragraph (b) also makes clear that when it is reasonably necessary to enable the organization to address the matter in a timely and appropriate manner, the lawyer must refer the matter to higher authority, including, if warranted by the circumstances, the highest authority that can act on behalf of the organization under applicable law. The organization's highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority repose elsewhere, for example, in the independent directors of a corporation.

Relation to Other Rules

[5] [6] The authority and responsibility provided in this Rule are concurrent with the authority and responsibility provided in other Rules. In particular, this Rule does not limit or expand the lawyer's responsibility under Rules 1.6, 1.8, 1.16, 3.3 or 4.1. Paragraph (c) of this Rule supplements Rule 1.6(b) by providing an additional basis upon which the lawyer may reveal information relating to the representation, but does not modify, restrict, or limit the provisions of Rule 1.6(b)(1) – (6). Under Paragraph (c) the lawyer may reveal such information only when the organization's highest authority insists upon or fails to address threatened or ongoing action that is clearly a violation of law, and then only to the extent the lawyer reasonably believes necessary to prevent reasonably certain substantial injury to the organization. It is not necessary that the lawyer's services be used in furtherance of the violation, but it is required that the matter be related to the lawyer's representation of the organization. If the lawyer's services are being used by an organization to further a crime or fraud by the organization, Rules 1.6(b)(2) and 1.6(b)(3) may permit the lawyer to disclose confidential information. In such circumstances Rule 1.2(d) can may also be applicable, in which event,
withdrawal from the representation under Rule 1.16(a)(1) may be required.

[7] Paragraph (d) makes clear that the authority of a lawyer to disclose information relating to a representation in circumstances described in Paragraph (c) does not apply with respect to information
relating to a lawyer's engagement by an organization to investigate an alleged violation of law or to defend the organization or an officer, employee or other person associated with the organization against a claim
arising out of an alleged violation of law. This is necessary in order to enable organizational clients to enjoy the full benefits of legal counsel in conducting an investigation or defending against a claim.

[8] A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to Paragraph (b) or (c), or who withdraws in circumstances that require or permit the
lawyer to take action under either of these Paragraphs, must proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's

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discharge or withdrawal, and that the lawyer reasonably believes to be the basis for his or her discharge or withdrawal.

Government Agency

~~[6]~~ [9] The duty defined in this Rule applies to governmental organizations. Defining precisely the identity of the client and prescribing the resulting obligations of such lawyers may be more difficult in the government context and is a matter beyond the scope of these Rules. See Scope [18]. Although in some circumstances the client may be a specific agency, it may also be a branch of government, such as the executive branch, or the government as a whole. For example, if the action or failure to act involves the head of a bureau, either the department of which the bureau is a part or the relevant branch of government may be the client for purposes of this Rule. Moreover, in a matter involving the conduct o government officials, a government lawyer may have authority under applicable law to question such conduct more extensively than that of a lawyer for a private organization in similar circumstances. Thus, when the client is a governmental organization, a different balance may be appropriate between maintaining confidentiality and assuring that the wrongful act is prevented or rectified, for public business is involved. In addition, duties of lawyers employed by the government or lawyers in military service may be defined by statutes and regulation. This Rule does not limit that authority. See Scope.

Clarifying the Lawyer's Role

~~[7]~~ [10] There are times when the organization's interest may be or become adverse to those of one or more of its constituents. In such circumstances the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care must be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged.

~~[8]~~ [11] Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case.

Dual Representation

~~[9]~~ [12] Paragraph (g) recognizes that a lawyer for an organization may also represent a principal officer or major shareholder.

Derivative Actions

[~~10~~][13] Under generally prevailing law, the shareholders or members of a corporation may bring suit to compel the directors to perform their legal obligations in the supervision of the organization. Members of unincorporated associations have essentially the same right. Such an

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action may be brought nominally by the organization, but usually is, in fact, a legal controversy over management of the organization.

[~~11~~] [14] The question can arise whether counsel for the organization may defend such an action. The proposition that the organization is the lawyer's client does not alone resolve the issue. Most derivative actions are a normal incident of an organization's affairs, to be defended by the organization's lawyer like any other suit. However, if the claim involves serious charges of wrongdoing by those in control of the organization, a conflict may arise between the lawyer's duty to the organization and the lawyer's relationship with the board. In those circumstances, Rule 1.7 governs who should represent the directors and the organization.

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HellerEhrman

QUALIFIED LEGAL COMPLIANCE COMMITTEE: POLICIES AND PROCEDURES

April 2003

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I. INTRODUCTION

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 ("the Act") that provides for various measures to improve the accuracy and reliability of corporate disclosures. On January 29, 2003, the Securities and Exchange Commission (the "Commission") acted pursuant to Section 307 of the Act and issued a release (the "Final Release") entitled, "Final Rule: Implementation of Standards of Professional Conduct for Attorneys" (the "Final Rules") that adopted rules establishing the standards of professional conduct for attorneys appearing and practicing before the Commission on behalf of issuers.[1] The Final Rules require, among other things, that an attorney who is "appearing and practicing"[2] before the Commission in the representation of issuers to report "up-the-ladder" "evidence of a material violation"[3] of U.S. Federal or state securities laws, a material breach

[1] The adopting release is available at http://www.sec.gov/rules/final/33-8185.htm, and is attached hereto as Exhibit A.

[2] The Final Rules provide that an attorney will not be deemed to be "appearing and practicing" before the Commission unless the attorney is providing legal services to an issuer with whom the attorney has an attorney-client relationship. See, Final Rules, Section 205.2(a). Appearing and practicing before the Commission:

(1) Means:
- (i) Transacting any business with the Commission, including communications in any form;
- (ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;
- (iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or
- (iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2) Does not include any attorney who:
- (i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or
- (ii) Is a non-appearing foreign attorney.

[3] The Final Rules define "evidence of a material violation" to mean "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." See, Final Rules, Section 205.2(e).

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of fiduciary duty arising under U.S. Federal or state laws, or a similar violation of any U.S. Federal or state laws.

"Up-the-ladder" reporting requires an attorney to report evidence of a material violation to a supervisory attorney[4] or the issuer's chief legal counsel or chief executive officer, as the case may be.[5] When an attorney reports evidence of a material violation directly to the issuer's chief legal or executive officer and the reporting attorney reasonably believes that he or she did not receive an appropriate response from such officers, the reporting attorney must report the violation up to the issuer's audit committee, another committee of independent directors or the full board of directors.[6]

In instances where a subordinate attorney[7] reports evidence of a material violation to a supervisory attorney, however, the supervisory attorney must report such evidence "up-the-ladder" to the issuer's chief legal or executive officer if the supervisory attorney reasonably believes that a material violation has occurred, is ongoing or is about to occur.[8] Furthermore, the supervisory attorney must evaluate the response from the issuer's chief legal or executive officer and, if the supervisory attorney reasonably believes that such officers do not respond appropriately, the supervisory attorney must report the evidence up to the issuer's audit committee, another committee of independent directors or the full board of directors.[9] If the supervisory attorney does not reasonably believe that a material violation has occurred, is ongoing or is about to occur, the supervisory attorney must notify the subordinate attorney of such a determination.[10] At this point, if the subordinate attorney reasonably believes that the supervisory attorney failed to comply with the "up-the-ladder" reporting requirements by not reporting the evidence of a material violation, the subordinate attorney may, but is not required to, report the evidence to the issuer's chief legal or

[4] The Final Rules define a "supervisory attorney" to include attorneys who are "supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer." Final Rules, Section 205.4(a).

[5] Final Rules, Section 205.3(b)(1) and 205.5(c).

[6] Final Rules, Section 205.3(b)(3).

[7] The Final Rules define a "subordinate attorney" to include attorneys who "appear and practice before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof))." Final Rules, Section 205.5(a).

[8] Final Rules, Section 205.4(c) and 205.3(b).

[9] Id.

[10] Id.

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executive officer or to the issuer's audit committee, another committee of independent directors or the full board of directors.[11]

However, if the issuer has established a Qualified Legal Compliance Committee (the "QLCC"), an attorney who is "appearing and practicing" before the Commission in the representation of an issuer may satisfy all of his or her "up the ladder" reporting obligations by disclosing the violation directly to the QLCC.[12]

The QLCC, therefore, allows an attorney to by-pass several steps of reporting "up-the-ladder," and instead allows the attorney to report evidence of a material violation directly to a single entity within the issuer. While the Commission's Final Rules do not require an issuer to adopt a QLCC, the Commission "encourages issuers to do so as a means of effective corporate governance."[13] In fact, the Commission noted that the "QLCC institutionalizes the process of reviewing reported evidence of a material violation," and suggests that the QLCC "may also produce broader synergistic benefits, such as heightened awareness of the importance of early reporting of possible material violations so that they can be prevented or stopped."[14]

In order to explain how the QLCC can function as an effective means of corporate governance, this presentation will: (1) set forth the basic structure of a QLCC; (2) analyze the mechanics of reporting to a QLCC; (3) suggest policies and procedures for implementing a QLCC; and (4) discuss the advantages and disadvantages of creating a QLCC.

II. STRUCTURE OF A QLCC

The Final Rules provide that an issuer need not form a QLCC as a new corporate structure if another committee of the issuer meets all the criteria required of a QLCC and agrees to function as such in addition to performing its other duties and responsibilities.[15] The requisite criteria for a QLCC are set forth below.

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[11] Final Rule, Section 205.5(d) and 205.3(b).

[12] Final Rules, Section 205.3(c)(1).

[13] Final Release, Part II, Section-by-Section Discussion of the Final Rules, at 205.2(k).

[14] Final Release, Part II, Section-by-Section Discussion of the Final Rules, at 205.3(c).

[15] Final Release, Part II, Section-by-Section Discussion of the Final Rules, at 205.2(k).

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A. Composition

In order to qualify as a QLCC under the Final Rules, a committee must consist of:

1. at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors); and

2. two or more members of the issuer's full board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in Section 2(a)(19) of the Investment Company Act of 1940.[16]

B. Powers and Procedures

In addition to requiring QLCC's to meet certain membership standards, the Final Rules also require a QLCC to adopt and retain certain powers and procedures in order to qualify for QLCC status. Namely, the Commission requires a QLCC to:

1. adopt written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation under Section 205.3; and

2. be duly established by the issuer's board of directors, with the authority and responsibility to:

    a. determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

        i. notify the audit committee or the full board of directors; and

        ii. initiate an investigation, which may be conducted either by the chief legal counsel (or the equivalent thereof) or by outside counsel; and

[16] Final Rules, 205.2(k)(1). The "Commission considers it appropriate and consistent with the mandate in the Act to ensure a high degree of independence in QLCC members and members of committees to whom reports are made under Section 205.3(b)(3). Accordingly, the Commission anticipates that these provisions will be amended to conform to final rules defining who is an 'independent' director under Section 301 of the Act, upon adoption of those rules." Final Release, Part II, Section-by-Section Discussion of the Final Rules, at 205.2(k).

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iii. retain such additional expert personnel as the committee deems necessary; and

b. at the conclusion of any such investigation to:

i. recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

ii. inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

3. have the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.[17]

In order to fully understand how the QLCC's powers and procedures actually work, it is helpful to clarify a few points.

- The QLCC has the authority and the responsibility to recommend that an issuer take appropriate remedial action in response to evidence of a material violation, but the QLCC cannot direct the issuer to take such action. The Commission specifically designed the Final Rules this way because a QLCC's power to compel the full board of directors to take action would conflict with established corporate governance models.[18]
- Decisions and actions of the QLCC must be made by majority vote; unanimity is not required.[19]
- If the issuer fails in any material respect to implement an appropriate response that the QLCC has recommended, the QLCC has authority and responsibility, acting by majority vote, to notify the Commission of such failure.[20]

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[17] Final Rules, 205.2(k)(2)-(4).

[18] Final Release, Part II, Section-by-Section Discussion of the Final Rules, at 205.2(k).

[19] Id.

[20] Final Rules, Section 205.2(k)(4).

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C. QLCC Member Liability

As explained above, the Final Rules impose great responsibility and stringent requirements on the QLCC. Members who serve on the QLCC will be charged with making the ultimate decision with respect to deciding what qualifies as a material violation, what remedial measures to take and whether to notify the Commission if the issuer fails to adequately respond to the QLCC's recommended course of action. However, in light of the burden placed upon QLCC members, the Commission expressly stated in the Final Release that it "does not intend service on a QLCC to increase the liability of any member of a board of directors under state law, and, indeed, expressly finds that it would be inconsistent with the public interest for a court to so conclude."[21] It is important to note, however, that neither Section 307 of the Act nor the Final Rules contain any provision with respect to the liability of directors who serve on the QLCC.

III. REPORTING MECHANICS

A. Reporting Obligations of Attorneys

As noted earlier, the QLCC offers attorneys an alternative to the traditional "up-the-ladder" reporting whereby the attorney first reports evidence of a material violation to a supervisory attorney or the chief legal or executive officer, as warranted, and then to the board or one of its committees if the attorney does not receive a satisfactory response from the chief legal or executive officer.

Given the complexities of "up-the-ladder" reporting when a supervisory and subordinate attorney are involved, issuers will want to create standardized systems for reporting evidence of a material violation. One way to establish a routine practice would be for an issuer to require a subordinate attorney to report evidence of a material violation to the appropriate supervisory attorney. Once the supervisory attorney receives notice of such a material violation, the supervisory attorney may want to draft a memorandum describing the alleged material violation and the supervisory attorney's determination as to whether the evidence needs to be reported "up-the-ladder." Furthermore, the supervisory attorney may want to ask the subordinate attorney who reported the evidence to sign the memorandum acknowledging his or her agreement with the determination to report, or not report, further "up-the-ladder" the alleged material violation. In so doing, the supervisory attorney preserves a record as to the facts of the case and the subordinate attorney's decision to accept the determination of the supervisory attorney. If the reporting attorney and the supervisory attorney do not agree on the outcome, the supervisory attorney may well want to document in greater detail his or her reasons for the decision.

[21] Final Release, Part II, Section-by-Section Discussion of the Final Rules, at 205.2(k).

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If the issuer has a pre-existing QLCC, however, an attorney who reports evidence of a material violation directly to that QLCC:

1. satisfies his or her reporting obligation to report such violation; and
2. is not required to assess the issuer's response to the reported evidence of the material violation.[22]

Thus, if an attorney reports evidence of a material violation to the QLCC he or she satisfies all reporting obligations and is not required to determine whether or not the issuer takes appropriate remedial measures. The job of assessing the appropriateness of the issuer's response falls upon the QLCC and not the attorney. This shift in responsibility from the attorney to the QLCC frees the attorney from having to act as a "watch-dog" and allows the issuer to deal directly with the reported violation itself.

It is important to understand that in order to take advantage of the QLCC reporting paradigm, the issuer must have a QLCC in place before a reported material violation has occurred.[23] The issuer will not be able to use a QLCC if it establishes such a committee in response to a specific incident.

B. Reporting Obligations of the Chief Legal Officer

The issuer's chief legal officer, or the equivalent thereof, may also take advantage of the benefits of reporting to a QLCC. The chief legal officer may report evidence of a material violation directly to a previously established QLCC in lieu of causing an inquiry to be made as would otherwise be required by the Final Rules.[24] Once the chief legal officer has reported the evidence of a material violation to the QLCC, he or she must notify the reporting attorney that the report has been referred and, thereafter, the QLCC is responsible for responding to the evidence presented to it.[25]

C. Reporting Obligations When Retained by the QLCC to Investigate or Litigate a Reported Violation

The Final Rules also remove an attorney's reporting obligations if he or she has been retained or directed by a QLCC to investigate or litigate reported evidence of a material violation. Specifically, an attorney will not have any obligation to report evidence of a material violation if the attorney was retained or directed by a QLCC to:

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[22] Final Rules, Section 205.3(c)(1).

[23] Final Release, Part II, Section-by-Section Discussion of the Final Rules, at 205.3(c).

[24] Final Rules, Section 205.3(c)(2).

[25] Id.

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1. investigate such evidence of a material violation; or
2. assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.[26]

While the Final Rules also remove an attorney's reporting obligations if he or she was retained or directed by the issuer's chief legal counsel to investigate or litigate evidence of a material violation, the attorney and the chief legal counsel must go through a series of steps.[27] First, the attorney must report the results of the investigation to the issuer's chief legal officer. Then, the attorney and the chief legal officer must both reasonably believe that no material violation has occurred, is ongoing or is about to occur. If both do not agree, the chief legal officer must report the results of the investigation to the issuer's board of directors.

The QLCC, however, offers a much simpler and more efficient method of investigating or litigating evidence of a material violation. If an attorney is retained or directed by the QLCC to investigate or litigate evidence of a material violation, neither the attorney nor the issuer's chief legal counsel will be required to report "up-the-ladder" such evidence of a material violation because the QLCC has the responsibility of determining whether disclosure is necessary.

IV. POLICIES AND PROCEDURES

While the Final Rules set forth the basic requirements for a QLCC, they do not offer guidelines as to how a QLCC should be implemented or administered. First, in order to create a QLCC, an issuer's board of directors must approve the QLCC's charter, a sample copy of which is attached hereto as Exhibit B. Second, because the Final Rules were published so recently, one can only speculate as to how "best practices" will evolve with respect to the administration of a QLCC. It may be instructive, however, to look to other special committees that boards often rely upon in managing the business of an issuer. The special litigation committee[28] and the audit committee are two such examples of board

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[26] Final Rules, Section 205.3(b)(7).

[27] Final Rules, Section 205.3(b)(6).

[28] A special litigation committee is "an independent committee appointed by a majority of the directors of a corporation, which is charged with the task of determining the propriety of the corporation's pursuit of a derivative action." James L. Rudolph & Gustavo A. del Puerto, The Special Litigation Committee: Origin, Development and Adoption Under Massachusetts Law, 83 Mass. L. Rev. 47, 47 (1998). Further, a special litigation committee, like the QLCC, is (1) comprised of independent directors, (2) vested with the full authority to act on behalf of the board to perform a thorough investigation; (3) able to access outside counsel and other experts; and (4) able to access adequate information.

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committees that provide guidance as to how an issuer may manage the operations of a QLCC.

How Does the QLCC Relate to Corporate Governance Principles?

In its composition and the limited scope of its function, the QLCC resembles other committees of the Board of Directors, including the audit committee or special litigation committee. Unlike a special litigation committee, to be effective a QLCC must be created prior to any issue arising that would be appropriate for QLCC consideration. As in the operation of other committees, the likelihood of proper functioning will be improved by careful advance attention to appropriate committee membership. QLCC members should be independent. They should enjoy freedom from potential conflict of interest and other grounds for having the quality and objectivity of their judgment subject to question.

It is also recommended that the Board adopt a charter reflecting the principles governing the QLCC's composition, responsibilities, authority and operation. Such a charter can be for a stand alone committee that would serve as the QLCC, or for an amendment to the charter of an existing committee that could so serve. A draft charter is attached to illustrate some of these considerations. We would expect that such charters would be subject to refinement and revision over time as experience and best practices evolve. It seems likely that QLCC's will serve an important compliance role, and would frequently be the body responsible for initiating investigations to explore, address, and resolve issues relating to possible material violations.

How Often Should the QLCC Meet?

At the very least, the QLCC should meet at the first instance of a reported violation and thereafter as deemed appropriate to conduct or supervise a thorough and exhaustive investigation. However, the question arises as to whether the QLCC should meet on a regular basis. While the special litigation committee does not provide much guidance on this issue since it is usually formed after a claim is brought, the audit committee does offer some insight into how often the QLCC should meet. The New York Stock Exchange proposed new rules relating to audit committees whereby the audit committee would be required to meet at least quarterly.[29] While the QLCC, unlike the audit committee, would not be charged with reviewing the quarterly financial statements, it would be helpful for the QLCC to meet at least once a quarter to discuss any alleged evidence of a material violation in connection with the issuer's accounting, internal accounting controls or audit functions that occurred during the preparation of the quarterly financial statements. Query: Is there routine information that the QLCC should review periodically (e.g., loss contingencies or the management letter from the outside auditors)?

[29] Section 7(b)(ii)(C) of proposed NYSE rules.

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Should the QLCC Hire Outside Counsel?

In deciding whether to hire outside counsel, it is helpful to look at the procedures used by special litigation committees. Many commentators on the issue of a special litigation committee have opined that a "corporation should hire 'special counsel' to advise and assist" a special committee of the board.[30] Typically, that outside counsel would not customarily be the principal outside counsel for the issuer. And, generally, outside counsel would be preferable to inside counsel acting alone, since outside lawyers assist the QLCC to "avoid the appearance of a conflict of interest."[31] Furthermore, since the attorney-client privilege only protects communications of a legal nature and does not apply to business advice given by an attorney, it would be preferable to involve outside counsel since in-house counsel often dispenses advice of both a business and legal nature and such mixed advice may not be privileged.

Should the QLCC Keep Minutes of Meetings?

The decision as to whether to keep minutes of QLCC meetings is a difficult one. The QLCC's main task is to investigate, or supervise the investigation of, evidence of a material violation. The key to these investigations, in addition to determining the facts, is preserving the attorney-client privilege and work product doctrine from the beginning of the investigation. On the one hand, if the QLCC keeps minutes of its meetings, the QLCC runs the risk that those minutes, or portions thereof, may not be protected by the attorney-client privilege or the work product doctrine and may be discoverable in subsequent civil or regulatory proceedings. On the other hand, without minutes it may be difficult for the QLCC members to reconstruct their deliberations years after the events occurred. If the QLCC keeps minutes of its meetings, it is advisable for the QLCC to include only the most basic information and to have counsel review the minutes in order to preserve the attorney-client privilege or work product doctrine.

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[30] Alice A. Seebach, Special Litigation Committees: A Practioner's Guide, 24 L.A. L. Rev. 1, 24 (1990); see also, Paul H. Dawes & Mary E. Kostel, The Treatment of the Demand Requirement and the Use of the Special Litigation Committee in Delaware Law and in the American Law Institute's "Principles of Corporate Governance: Analysis and Recommendations," 444 PLI/LIT 383, at *401 (1992); Carlton Investments v. TLC Beatrice International Holdings, Inc., No. Civ. A. 13950, 1997 WL 305829, at *11 (Del. Ch. May 30, 1997) (noting that the special litigation committee's use of highly reputable outside counsel was "efficient").

[31] Seth Aronson & Sharon L. Tomkins, Recent Developments in Shareholder Derivative Actions, 1269 PLI/CORP 791, at *820 (2001); see also, Strougo ex. rel. The Brazil Fund, Inc. v. Padeges, 27 F. Supp. 2d 442, 451 (S.D.N.Y. 1998) (noting that several courts have relied upon the appointment of independent outside counsel as a factor in making a finding of independence for a special litigation committee).

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How Should the QLCC Conduct the Investigation?

The investigation should last for as long as necessary to perform a thorough and complete examination.[32] In order to understand what constitutes a "thorough and complete" investigation, it is helpful to examine investigations conducted by special litigation committees. First, the QLCC may not be deemed to have conducted a reasonable good faith investigation if it fails to interview the most important witnesses regardless of how many interviews it conducts.[33] If the QLCC interviews the important witnesses, it does not seem to matter what type of interview format the QLCC uses whether it be in person, or by telephone or written questionnaire.[34] Furthermore, the QLCC should be careful of who is present during interviews of corporate employees since at least one court has cautioned against having in-house counsel present during such times.[35] Finally, the QLCC should thoroughly review all relevant documents in order to conduct a reasonable investigation.[36]

V. ADVANTAGES AND DISADVANTAGES OF THE QLCC

Each issuer must decide on its own whether to create a QLCC to investigate evidence of material violations. While the list of pros and cons of creating a QLCC is likely to grow as the law becomes more developed, listed below are some initial impressions on the advantages and disadvantages of using a QLCC as the primary investigatory tool for suspected material violations.

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[32] See, Lewis v. Fuqua, 502 A.2d 962, 936 (Del. Ch. 1985) (holding that an investigation was "reasonable" in light of thorough examination).

[33] See, Seebach, supra note 27, at 29; see also, Hasan v. CleveTrust Realty Investors, 729 F.2d 372, 379-80 (6th Cir. 1984) (holding the investigation was not thorough because the committee failed to interview two companies that could have provided crucial information).

[34] Seebach, at 29.; see also, Auerbach v. Bennett, 47 N.Y.2d 619, 635, 393 N.E.2d 994, 1003, 419 N.Y.S.2d 920, 930 (1979) (holding that investigation by the special litigation committee was sufficient where the committee interviewed witnesses in person and sent written questionnaires to non-management directors); In re General Tire & Rubber Co., 726 F.2d 1075, 1085 (6th Cir. 1984) (holding that the investigation was thorough because the special committee distributed questionnaires, performed personal interviews and telephoned contacts).

[35] Seebach, at 29; see also, Kaplan v. Wyatt, 499 A.2d 1184, 1190 (Del. 1985) (stating that while the presence of in-house counsel during employee interviews was not fatal, such a practice is not recommended).

[36] Seebach, at 29; See also, Kaplan, 499 A.2d at 1188 (holding that the investigation was thorough because the committee, among other things, reviewed the relevant documents); Rosengarten v. International Tel. & Tel. Corp., 466 F. Supp. 817, 824 (S.D.N.Y. 1979) (holding that because the committee studied reams and reams of paper and interviewed witnesses, the investigation was thorough).

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A. Advantages

Privileges

If the QLCC retains outside counsel at the outset of an investigation into evidence of a material violation, the QLCC increases its ability to use effectively the attorney-client privilege and work product doctrine to protect information gained during the course of the investigation. Without the protection afforded by these doctrines, the issuer may face increased liability due to the disclosure to civil litigants of potentially damaging information.

Sentencing Guidelines

In theory, the Federal Sentencing Guidelines should substantially reward companies which have effective QLCC's. There are significant reductions built into the guidelines when an offense occurs "despite an effective program to prevent and detect violation of law" -- as long as high level personnel did not participate in the fraud.[37] Similarly, there are even greater reductions for organizations that self report and cooperate with the government.[38] We would not be surprised if the guidelines were ultimately amended to include specific reference to QLCC's.

The most important advantage though, of a QLCC in terms of interaction with criminal authorities, is the potential to convince the prosecutor not to charge the company in the first place. First of all, the theory behind the guideline reductions applies equally well in the context of charging decisions -- why penalize a good corporate citizen? How can the government encourage self reporting if there is no way out of a crippling corporate indictment? Second, many prosecutors and scholars already question the utility of criminally charging an inanimate organization. The existence of a substantial and respected QLCC might sway the ultimate decision of a prosecutor or her supervisor. Finally, the government will be dealing with a group of people -- the QLCC members and their outside attorneys -- significantly removed from the company, which may bring down tensions on both sides and comfort the government when making its final decision.

Director and Officer Liability Insurance

In the post-Enron era of skyrocketing insurance rates for directors and officers, establishing a QLCC may present a unique opportunity for an issuer to negotiate for lower premiums. The existence of a properly constituted and functioning QLCC should demonstrate an issuer's commitment to corporate ethics and its resolve to deal quickly and effectively with any material violations. The QLCC will address, and if necessary, correct,

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[37] U.S.S.G. § 8C2.5(f).

[38] U.S.S.G. § 8C2.5(g).

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undisclosed material violations that otherwise may subject the issuer to substantial, incremental liability. Furthermore, the Commission has expressly stated in the Final Release that membership on a QLCC is not intended to increase the liability of any of its members. As a result, issuers that have QLCC's in place may be able to negotiate for lower insurance premiums for their directors' and officers' coverage.

B. Disadvantages

Standard of Review for a QLCC's Decision Not to Act

The Final Rules do not provide any standard by which to judge a QLCC's decision not to take action after investigating evidence of a material violation. Thus, a QLCC will have no clear guidance as to when to recommend remedial action and/or when to disclose that a material violation has occurred. In light of this uncertainty, there is potential for liability for members of the QLCC and the issuer if a QLCC fails to take action with respect to evidence of a material violation.

Reporting to the Commission

At present, it is unclear whether the QLCC will be required to report its findings to the Commission.[39] The Final Rules only provide that the QLCC has the "authority and responsibility, acting by majority vote" to notify the Commission if the issuer fails to follow the QLCC's recommended course of action.[40] Thus, it is not clear whether the QLCC must report to the Commission or whether it has discretion to disclose its findings. Given the uncertainty, QLCC members may face a greater risk of liability if they choose not to disclose their findings to the Commission.

Increased Legal and Financial Expertise

While the Commission has stated that it does not expect directors who serve on the QLCC to face increased liability, the fact remains that QLCC members will need to have some legal and financial expertise in order to investigate effectively evidence of material violations. However, directors who serve on audit committees are already concerned with the existing level of "financial literacy" that is required of them to serve on such committees[41] and of the new "financial expert" qualifications under Section 407 of the Act. Notwithstanding the Commission's words to the contrary, directors may be hesitant to serve on the QLCC because they may fear additional exposure to liability for their perceived lack of legal and/or financial expertise.[42] One may argue, however, that QLCC members will

[39] See, Susan Hackett, The Road to Compliance, Texas Lawyer, March 3, 2003.

[40] Final Rules, 205.2(k)(2)-(4).

[41] Section 303.01(B)(2)(b) of the NYSE Listed Company Manual.

[42] See, Hackett, supra, note 33.

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presumably be covered by insurance and the issuer's indemnity and, as a result, need not concern themselves with the potential for incremental liability. While this argument may be true in most circumstances, it is less persuasive if the issuer files for bankruptcy because the indemnity is lost and it is unclear what value the insurance will have if it also applies to the issuer.

VI. CONCLUSION

Each issuer must decide whether to create a QLCC to investigate evidence of a material violation. If the issuer decides to create a QLCC, it must first chose whether to create an entirely new committee or whether to use a pre-existing committee such as an audit committee to serve both roles. The issuer must then ensure that it vests the QLCC with the appropriate authority required by the Commission's Final Rules. Even if the issuer complies with such rules, however, it is not entirely clear how the QLCC will actually function. Due to the lack of guidance regarding the administration of a QLCC, we are left to examine the management of other board committees such as an audit committee or a special litigation committee as examples. While instructive, these board committees do not provide definitive answers. In fact, the Commission or the courts may interpret the proper functioning of a QLCC in a different manner. Furthermore, as of yet, there is no clear standard by which to judge a QLCC's decision not to act after investigating evidence of a material violation. This lack of clarity may lead to increased exposure if the QLCC decides not to take action with respect to a material violation that, in hindsight, should have been acted on. Despite the uncertainty surrounding the QLCC, however, it appears that the QLCC may be used as an effective tool to manage an issuer's legal risk, especially if the QLCC follows traditional standards applicable to board committees such as an audit committee or a special litigation committee. As the Commission has noted, the QLCC provides an institutionalized method of reporting evidence of material violations and in so doing, allows the issuer to respond promptly to violations that, if left untreated, could lead to increased civil, regulatory and potentially, criminal exposure.

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FORM OF CHARTER FOR QUALIFIED LEGAL COMPLIANCE COMMITTEE (QLCC)

Adopted by the Board of Directors of ________________

Purpose

The purpose of the Qualified Legal Compliance Committee (the "QLCC") of the Board of Directors (the "Board") of __________________ (the "Company") is to determine the appropriate response of the Company to reported evidence of material violations of United States federal or state securities law, a material breach of fiduciary duty, or similar material violation of a United States federal or state law. These reports may include, but need not be limited to, reports from counsel pursuant to the standards adopted under Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act").

Composition

The QLCC shall be comprised of 3 or more independent, non-employee directors,[1] as determined by the Board, at least one of whom also serves on the Audit Committee.

Responsibilities

The QLCC is charged by the Board with establishing and maintaining the appropriate procedures to address reported evidence of material violations of United States federal or state securities law, a material breach of fiduciary duty, or similar material violation of a United States federal or state law received from attorneys complying with the reporting requirements mandated by Section 307 of the Act,[2] and to take all appropriate action to address such evidence.[3] Accordingly:

1. The QLCC shall meet as necessary to develop its procedures and discharge its responsibilities.

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[1] The QLCC may have no less than 3 directors.

[2] May possibly include other sources.

[3] The Company may want to consider the possible merits of institutionalizing a formal supervisory and "up-the-ladder" reporting mechanism that would address the obligation to report evidence of material violations.

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2. The QLCC shall establish written procedures to confidentially receive, consider and retain Section 307 reports, as contemplated by the Act.

3. The QLCC shall inform the issuer's chief legal officer ("CLO") and chief executive officer ("CEO") of any report of evidence of a material violation.[4]

4. The QLCC shall decide whether an investigation is necessary to determine whether the material violation described in the report has occurred, is occurring, or is about to occur and, if so, to:

(a) notify either the Audit Committee or the full Board of Directors;[5]

(b) initiate an investigation, which may be conducted either by the CLO or by outside attorneys; and

(c) retain such additional expert personnel as the QLCC deems necessary.

5. The QLCC shall at the conclusion of any such investigation:

(a) recommend that the issuer implement an "appropriate response," which may include appropriate remedial measures, such as

(i) appropriate disclosures, and/or the imposition of appropriate sanctions or steps to stop any material violation that occurs, prevent any material violation that is yet to occur, and/or to rectify or address any material violation that has already occurred and minimize the likelihood of its recurrence; and

(ii) inform the CLO and CEO and the Board of the results of any such investigation and the appropriate remedial measures to be adopted; and

(b) take all appropriate action to implement an appropriate response, including, in the event the Company fails in any material respect to implement an appropriate response that the QLCC has recommended, consider exercising, and if appropriate, exercising

[4] Except in appropriate circumstances.

[5] Note that the QLCC has a choice to notify either the Audit Committee or the full Board of Directors.

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the QLCC's authority to notify the Securities and Exchange Commission.

6. The QLCC shall have the authority to engage such professional advisors, including independent counsel and such other advisors or consultants as the QLCC determines are appropriate to discharge its responsibilities.

7. The QLCC shall have the authority to develop and maintain appropriate corporate training programs to facilitate familiarity with and foster the development of expertise in the operation of the QLCC.

Authority

By adopting this Charter, the Board delegates to the QLCC full authority in its sole discretion to:

1. Perform each of the responsibilities of the QLCC described above.

2. Appoint a chair of the QLCC, unless a chair is designated by the Board.

3. Engage independent counsel and other advisers as the QLCC determines necessary to carry out its responsibilities.

4. Cause the officers of the Company to provide such funding as the QLCC shall determine to be appropriate for payment of compensation to the QLCC's independent counsel or other advisers or consultants engaged by the QLCC.

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August 18, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Via e-mail: rule-comments@sec.gov

Re: File No. S7-45-02

Ladies and Gentlemen:

The Commission's recently adopted regulations regarding professional conduct of attorneys, and the current proposed extension of those rules, raise significant issues of law and policy. These issues are not confined to the administration of the securities laws, but have important implications for the evolution of our legal system and the way in which society shapes the role of lawyers within that system.

The Rulemaking Environment and the Need for New Rules

The Commission confronts those issues in a hothouse political environment, warmed by loss of confidence in corporate governance, fertilized by business scandals, and irrigated by a disastrous stock market. In the wake of any major scandal there is an inevitable tendency toward legislative and regulatory overreaction. This is no exception. While it may be that some changes in regulation are called for to reduce the likelihood of another Enron, or WorldCom, or Tyco, it is essential that the Commission not rush into adopting complex new rules when the enforcement of simple old ones is a perfectly satisfactory remedy. Most, if not all, of the misconduct in these cases violated at least one, and often several, existing legal proscriptions. And it should not be forgotten that the overwhelming majority of corporations in this country are, and remain, conscientious and scrupulous about complying with their legal and ethical obligations.

This is not to say that there is not room for changes in law and practice whose purpose is to alter institutional practices in order to discourage misconduct and encourage healthy behavior. Much of the Sarbanes-Oxley Act is directed at those ends. In attempting to use regulation to alter behavior, however, we must take care that we not impose new compliance burdens whose costs outweigh their benefits. I believe that the attorney conduct rules recently

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adopted by the Commission may already have gotten that balance wrong; and I am certain that adoption of the proposed additional rules would be a mistake.

"Hyperlexis" and Legal Rules in a Healthy Society

A quarter of a century ago, Bayless Manning, a distinguished scholar and corporate lawyer, published a prescient article, which he called "Hyperlexis: Our National Disease." (71 Nw. U.L. Rev. 767 (1977)). In that article, he argued persuasively that the nation is suffering from "the pathological condition" of an "exploding" volume of laws and regulations. A few years later, Dean Manning further developed that theme in an elegant and often-cited short piece, "Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385," 36 Tax Law. 9 (1982). In it he observed that lawyers, like experts in any field, when confronted by ambiguity are typically "seized by an urge to elaborate" in an effort to reduce it. The result is a burgeoning complexity of laws and regulations that grow ever more difficult to navigate, ultimately posing grave threats to respect for and compliance with the law. And the tragedy of it all is that the elaboration of rules seldom results in truly reducing ambiguity, it merely transfers the ambiguity to some other place in the rules. It is worth contemplating the recently-adopted Part 205 in the light of this sage counsel.

The primary immediate purpose of Part 205 is to define "minimum standards of professional conduct" for securities lawyers faced with evidence that their client, or its officers, directors or employees, has violated, or is about to violate, the law or a fiduciary duty. For decades – at least – attorneys in the United States thought they could go about the ethical practice of the law in these situations guided by three or four short paragraphs in their relevant codes of professional responsibility. The American Bar Association Model Rules of Professional Conduct ("ABA Model Rules"), for example, includes only three rules relevant to the issue: Rule 1.4, "Communications," Rule 1.6, "Confidentiality," and Rule 1.13 "Organization as Client." Together, these were thought by generations of serious, thoughtful attorneys to provide sufficient standards of professional conduct, without further elaboration other than that which naturally grows out of a body of precedent and commentary interpreting and applying the simple rules. Even if one were to refer to one or two of the other rules that might help to determine an appropriate course of action in a particular situation, the entirety of the body of relevant rules is short, simple, and generally relatively easy to interpret.

Contrast the elegant simplicity of the ABA Model Rules and their state derivatives with the new Part 205, which goes on for over 3,500 words and, in the version I have before me, occupies nine pages of small print. Even conceding that some changes in the previous substantive rules regarding lawyers' duties when they learn their clients are engaged in a violation of the law, it can fairly be asked whether these changes could not have been accomplished with greater economy. The goal of this letter is not, however, to urge the repeal of rules that have already been adopted. The foregoing observations are intended only to suggest that the Commission should heed Dean Manning's caution in approaching the current proposal, lest in its efforts to reduce ambiguity the Commission add further complexity to a set of rules that neither require nor can easily support it.

Ultimately, the health of a society depends largely on voluntary adherence to *private* codes of ethics and morality. The principal role of the *public* codes of conduct we call law is to

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establish a floor, a minimum standard for violations so serious that they merit formal sanctions. In any healthy society, most of the citizenry is guided in most of its conduct by higher standards derived from private codes. Indeed, it has been observed that one could develop a measure of a society's health over time by plotting two lines, one representing the informal private standards of conduct required by ethics, morality and general norms of civilized behavior and the other representing the formal standards required by the law. The distance between these two metaphorical lines would serve as a fair gauge of how well the society is doing at governing itself. They would converge only if the society is experiencing one or the other of two adverse trends: either private standards of conduct are in decline; or adherence to private standards has so weakened that the society has been forced to rely more heavily on the law to enforce acceptable standards of behavior.

Interaction of the Proposed Rules with Private Standards of Conduct

Sadly, in the area of conduct to which Part 205 applies, these two metaphorical lines have now converged, and there is no longer much, if any, distance between them. The Commission's detailed rules have now effectively displaced the private standards embodied in the profession's codes of professional responsibility; and, if one accepts the proposition above, one must conclude that society is less healthy for it.

The Commission's proposed extension of these rules is subject to the same objections, but in amplified form. Were the proposed rules to be adopted, the two metaphorical lines would not only converge, but they would cross. For, as proposed, the rules would *require* attorneys in some jurisdictions to take actions that existing codes of professional responsibility would *prohibit*.

Rule 1.6 of the ABA Model Rules forbids lawyers to divulge client confidences with certain narrow exceptions, none of which would be applicable. Whatever one might think of Rule 1.6, it, and the analogous rules in all of the states, were drafted by serious, thoughtful, and presumably ethical people. In formulating the private standards of conduct embodied in these rules, they chose to strike the balance between conflicting interests in a way different from the balance proposed by the Commission. One might disagree with the balance struck by the various state bar associations (and there is considerable variety among them in how they deal with the issue), but one cannot dismiss the rules they formulated as clearly erroneous or ill-founded. The Commission should pause and ponder deeply the potential consequences of legalizing standards of conduct that have heretofore been left (largely successfully) to privately developed bodies of ethical rules.

The problems with the proposed extensions of Part 205 do not stop there, however. Because of the particular nature of the relevant private standards of conduct implicated in this discussion, their interaction with the proposed public rules is more complex than usual. In most cases, the standards of conduct required by legal rules underlie and support the standards required by private norms of behavior. Even if the two sets of standards do converge to the point that they are identical, they remain mutually reinforcing, and not in conflict with each other.

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In some situations, however, the private norm is intended to serve a goal different from the public one, and there arises the potential of conflict between them. Such is the case with lawyers' duties when confronted with evidence of wrongdoing by their clients. Lawyers in such situations are subject to not one, but two, standards of behavior, one that may prohibit disclosure and another that may require it. The prohibition against disclosure (e.g., ABA Model Rule 1.6(a)) is intended to protect the nature of the attorney-client relationship. But lawyers may – and in some states must – disclose such confidences when necessary to protect the interests of victims or potential victims of wrongdoing (*compare,* ABA Model Rule 1.6(b)(1) *with* Virginia Rules of Professional Conduct, Rule 1.6(c)(1), *and* Texas Disciplinary Rules of Professional Conduct, Rule 1.05(e)).

While there is considerable variation from state to state as to the exceptions from the general duty to maintain client confidences, most codes of professional responsibility have been careful to leave a space between situations in which disclosure is prohibited and those in which it is required. Thus under ABA Rule 1.6(b)(1) a lawyer "*may*" disclose a confidence "to prevent reasonably certain death or substantial bodily harm." While informal private norms of conduct would generally incline a responsible lawyer towards disclosure in such circumstances, the formal rules leave the lawyer latitude to exercise judgment and to be wrong in that judgment.

The existence of some area of discretion between two otherwise conflicting requirements is essential to the health of any system of rules of behavior. The application of ethical rules, however clear, to the ambiguities and uncertainties of real life is often difficult enough. Where there is a potential conflict between two rules arising from the differing interests they serve, it is essential that those who are bound by the rules be allowed some latitude to exercise judgment – indeed even to err innocently. Otherwise those subject to the rules would be forced to walk a careful tightrope, knowing that a foot set down on either side of the line would put them in violation of one rule or the other.

The Operation of the Proposed Rules in the Real World

This is precisely the situation that would obtain if the Commission were to adopt the "noisy withdrawal" proposal. Consider the following situation: A securities attorney (who could be outside counsel or the chief legal officer) is advising the chief executive officer of a public company in a situation in which there is considerable time pressure. Both are responsible, ethical professionals. The company proposes to take a certain course of action and the CEO asks the attorney whether it would be lawful. The attorney researches the issue as thoroughly as time allows, concludes that the law is unclear on the point, and so advises the CEO, adding that, while the attorney does not believe the course of action would clearly be unlawful, there is a risk that a tribunal might find it so in the future. The attorney recommends, therefore, that the company not pursue the proposed course. The CEO thanks the attorney for the thoughtful advice and informs him or her that, balancing the legal risks against serious adverse business consequences of not taking the proposed action, he has decided to go ahead.

Until today, at that point most lawyers would have believed they had fully discharged their professional responsibilities, it being ultimately the client's right to decide whether to take the "legal risk" in such a situation. Most lawyers would also have believed that they were

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ethically and legally free to continue to represent the client in taking the action in question, indeed perhaps even under some obligation to continue with the engagement and, through sound advice, attempt to minimize or even eventually eliminate the legal risk.

If the Commission adopts the proposed rules, the attorney would be in an entirely different situation, faced with a new and harsh dilemma. If the course of action is in fact lawful (as the attorney believes it may well be), the private system of rules to which he or she is subject as a lawyer (not to mention his or her professional instincts and training) would flatly prohibit divulging client confidences through a "noisy withdrawal." On the other hand, the attorney must now worry that the situation might turn sour, and it might later be determined that the client's actions were in fact unlawful and taken in the face of counsel's advice that they may be unlawful. Were that to come to pass, the attorney would be exposed to a risk of an enforcement action by the Commission – which would, of course, be proceeding with the benefit of hindsight, extensive discovery, lengthy reflection and lots of time for legal research – charging him or her with having failed to withdraw from the representation and notify the Commission.

In short, the situation that would be created by the proposed rules would force the attorney to make the call whether the client's proposed course of action is lawful. And there would no latitude for error. From an erroneous call as to what the law requires would follow an erroneous conclusion as to the conduct required. If the attorney concludes, wrongly, that the client's proposed action is lawful, he or she must keep the client's confidence and risk being found to have violated a duty to "withdraw noisily." Conversely, if the attorney concludes, wrongly, that the client is about to violate the law, he or she will feel compelled to notify the Commission, and thus will violate a sworn duty to maintain client confidences.

If the Commission goes forward with this proposal, cases like the one described above, while perhaps uncommon, will occur. And their occurrence, as well as their potential to occur, will do great harm, both directly to lawyers who find themselves trapped in an unreasonable ethical bind, and indirectly to the relationship between attorney and client that is so essential to the health of our legal system.

Conclusion

It is enough that, in Part 205 as already adopted, the Commission has converged the line drawn by the requirements of the law with the line drawn by the well-developed system of private standards of conduct embodied in the rules of professional ethics. If the argument above is correct, the long-term consequences for the legal profession and the rule of law will not be beneficial. Whether or not that is so, it would certainly be a mistake for the Commission to extend the rules of Part 205 to set up a situation in which attorneys may be faced with walking a narrow line between their duty to their clients and their obligations under the securities laws. The Commission should not make this mistake.

Sincerely,

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