



## 603: Sarbanes-Oxley One Year Later: The Impact on Foreign Issuers

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### W. Randy Eaddy

Randy Eaddy is a partner in the corporate group and chair of the group's securities team of Kilpatrick Stockton LLP. Mr. Eaddy's corporate finance practice includes registered securities offerings, venture capital financings, mergers and acquisitions and other project transactions, and securities law disclosure and compliance matters for public companies. He is a counselor and advisor to executives and directors on myriad strategic decisions for managing their businesses to produce value for their internal and external constituents.

Mr. Eaddy has been principal counsel to issuers, underwriters, or investors in over 100 public or private offerings of equity or debt securities. He has been the lead attorney in over 150 M&A and other business combination or reorganization transactions. He has represented managements, boards of directors, and special committees in varied complex and sensitive corporate governance situations and has worked as counsel to select music and film industry participants.

In 1999, Mr. Eaddy received the Presidential Award from the Association of Social and Behavioral Scientists for services and contributions to the African-American community as an attorney, legal scholar, and civic leader. Mr. Eaddy has authored a chapter in a book, published articles in legal journals, served as a lecturer and panelist on various CLE programs, and participated as moderator or discussant for academic symposia. He is on the board of trustees of Furman University, board of directors and executive committee of Metropolitan Atlanta United Way, and is special advisor to the Atlanta Board of Education. He is a member of the ABA's Commission on Racial and Ethnic Diversity in the Profession and of the 2002 business advisory group to Representative James C. Greenwood, as Chairman of the Oversight & Investigations Subcommittee of the House Committee on Energy and Commerce.

Mr. Eaddy received a BA, Phi Beta Kappa, *summa cum laude* from Furman University and a JD from Harvard Law School. He was editor of the *Harvard Law Review*.

### Stephen Faciszewski

Stephen Faciszewski is vice president, managing director of Tyco International Holding AG, and oversees operations for global intangible asset (technology/brand/know-how) management subsidiaries of fortune 50 company, Tyco International Ltd. In this role, he is responsible for global portfolio acquisition, development, management, licensing, enforcement, and defense (litigation) functions across the fire & security, engineered products, and healthcare segments. He advises and counsels global executive operating managers in a wide range of strategic and operational business and legal matters.

Previously, Mr. Faciszewski was senior counsel, legal affairs, and assistant secretary for Cell Therapeutics, Inc., and secretary of CTI Technologies, Inc. In this capacity, he advised and counseled management in multifarious legal and technical matters, including commercial and technology licensing transactions, corporate, securities, employment, environmental, and U.S. drug laws, and U.S., PCT, and foreign-national intellectual property laws and regulations. Prior to joining Cell Therapeutics, Inc., Mr. Faciszewski was an associate with Oliff & Berridge, an intellectual property boutique law firm in Alexandria, Virginia, where he was responsible for assisting independent inventors and business entities in securing U.S. and foreign patents. Prior to

commencing the practice of law, Mr. Faciszewski was a senior manager with Accenture in Washington, DC, managing large software development projects in various industries.

Mr. Faciszewski obtained his BA from The Colorado College and JD from Georgetown University Law Center.

### **J. Daniel Fitz**

J. Daniel Fitz has been named the new general counsel and company secretary of Misys plc, a leading UK software firm with operation in a number of countries, including the US.

Most recently Mr. Fitz was the group general counsel of Cable & Wireless plc based in the London headquarters. Prior to joining Cable & Wireless, he worked at both Baring Brothers, the UK investment bank, and Pillsbury Winthrop, the US law firm.

Mr. Fitz has been active in ACCA since the founding of the European Chapter and has held a number of European Chapter offices, including president. At present, he serves on ACCA's board of directors. He also serves on the advisory board of Law Works for Community Groups, which seeks to promote pro bono work by in-house lawyers in the UK.

Mr. Fitz received his BA with honors from the University of North Carolina at Chapel Hill and has a Diploma in International & Comparative Politics from the London School of Economics. He received his JD with honors from the University of North Carolina at Chapel Hill.

### **Rhonda S. VanLowe**

Rhonda S. VanLowe has served as legal counsel since joining Rolls-Royce. Her responsibilities include aircraft finance transactions, treasury, and finance. She is based at the company's headquarters in Chantilly, Virginia.

Ms. VanLowe joined Rolls-Royce after serving as legal counsel for Reebok International Limited in Stoughton, Massachusetts. Her background also includes positions with the law firms of Ginsburg, Feldman & Bress, Chartered in Washington, DC and Swidler & Berlin, Chartered in Washington, DC. While in both corporate and private practice, she was involved in a variety of legal matters, including implementing the corporate antitrust compliance program and antitrust training at Reebok for senior management and the U.S. sales force, negotiating and supervising the completion of corporate finance transactions (synthetic lease financing for the Reebok world headquarters project), managing domestic litigation, drafting and negotiation of retail leases, and managing the company's diversity program. She also works with first year law students at American University, Washington College of Law providing academic support.

Ms. VanLowe is a member of the ABA and ACCA. Community activities include work with adult literacy programs in the District of Columbia and Northern Virginia and the Northern Virginia Therapeutic Riding Program.

She holds a BA from Cornell University and a JD from Georgetown University Law Center in Washington, DC.

**SARBANES-OXLEY ONE YEAR LATER: THE IMPACT  
ON FOREIGN ISSUERS—A Global Village of  
Corporate Governance Reforms**

by  
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*“I believe we need to be clear with respect to the area of foreign issuers and their coverage under the bill’s broad definitions . . . Foreign issuers are not part of the current problems being seen in the US capital markets, and I do not believe it was the intent of the conferees to export US standards, disregarding the sovereignty of other countries as well as their regulators.”*

*Remarks of U.S. Senator Michael Enzi  
(148 Cong. Rec. S7365 July 25, 2002).*

## I. INTRODUCTION

Since 1990, foreign companies have represented a rapidly growing percentage of issuers whose securities are traded in capital markets of the United States. Today, over 1,300 non-U.S. companies, from almost 60 countries, file disclosure reports with the Securities and Exchange Commission (the “SEC” or “Commission”) because they have such securities, as compared with approximately 400 companies, from less than 30 countries, in 1990. Most of these non-U.S. issuers are from Canada; the second largest number are from the United Kingdom; but an increasing number are from other European Union countries, Israel, Australia, Japan, Latin America and beyond.

When President Bush signed the Sarbanes-Oxley Act into law on July 30, 2002—formally known as the “Public Company Accounting Reform and Investor Protection Act of 2002”—he called it “the most far-reaching reform of American business practices since the time of Franklin Delano Roosevelt.” Sarbanes-Oxley is indeed far-reaching, and most would agree that the securities practice hasn’t

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\* I want to acknowledge and express my appreciation to my partners Neil D. Falis and Elizabeth (Betty) Wren, associates Alan T. Rosselot and David M. Eaton, and summer associate (until he returns full time next Fall) Nathan Headrick, for invaluable assistance on this Paper. I also plan to blame one or more of them for anything with which a reader may disagree, except for my arguably gratuitous and pedantic observations in Parts I and VII. It would be unseemly for me not to stand alone with respect to those.

seen such a dramatic legislative initiative since the seminal Securities Act of 1933 (the "1933 Act") and Securities Exchange Act of 1934 (the "Exchange Act" or "1934 Act"). However, the President's characterization of the Sarbanes-Oxley Act (affectionately known to many, and sometimes referred to here, as "SOX") both under-stated and over-stated the true scope and impact of SOX and the related corporate governance reforms that were to follow in its wake.

#### **A. Fundamental Principles and Effects**

In referring to SOX as a reform of "American business practices", the President unwittingly discounted the significant implications of SOX for business practices internationally, as the above data about foreign issuers should suggest. Senator Michael Enzi, whose comment during the Senate and House conference committee meetings on Sarbanes-Oxley is quoted above, also understates the matter. In addition, the understandable focus of most of the ensuing commentary on the impact of SOX and its progeny on domestic public companies may leave many observers insufficiently aware of the impact these initiatives are likely to have on foreign business practices. The effects of these corporate governance reforms extend to foreign as well as domestic issuers in significant ways, because the exceptions for foreign companies with U.S.-traded securities are, intentionally, far from comprehensive.

Sarbanes-Oxley is a mammoth piece of legislation, with myriad specific and general requirements and broad grants of rule-making authority and mandates to the Commission to promulgate implementing regulations. The SEC had been making such rules with considerable zeal, and most of them also extend to such foreign issuers with few general exceptions. In addition, the New York Stock Exchange ("NYSE") and Nasdaq Stock Market ("Nasdaq"), in part at the behest of directives in SOX<sup>1</sup>, have followed suit with reforms to many of their corporate governance requirements for issuers who list or trade their securities on or through those capital markets. While there are some exemptions from these for foreign issuers, they too are not comprehensive.

The sheer volume of these requirements, along with the inevitable ambiguities and incompleteness (and some latent inconsistencies) among some of them, contribute to the sense of Sarbanes-Oxley's historic far-reaching impact. However, when viewed with proper perspective, I believe it is an over-statement to compare Sarbanes-Oxley with the 1933 and 1934 Acts, as a matter of either substantive content or procedural and technical processes.

As a substantive matter, virtually all the requirements of Sarbanes-Oxley emanate from, or tie-back into, two fundamental principles and the objective of

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<sup>1</sup> Both the NYSE and Nasdaq had begun to propose such reforms in response to the corporate scandals that ultimately led to SOX. However, Sarbanes-Oxley contains indirect directives for these markets to make corporate governance reform amendments to their listing standards, which it achieved through several mandates to the Commission in its regulatory supervisor's role for these markets and other SEC-registered stock exchanges and securities quotation systems.

making them a reality for all public companies—foreign and domestic—who issue or trade securities in U.S. capital markets. These two principles are:

- achieving integrity and responsibility *by individuals* in the corporate governance context, and
- achieving accountable and transparent reporting, and disclosures generally, by public companies of the important financial and other information on which investors rely and the stability of our capital markets rest.

As a matter of procedural and technical processes, the case for fundamental simplicity is more difficult to make, because most of SOX is about technical structures, relationships and processes. And, admittedly, there are lots of those, and some contain ambiguities and occasional inconsistencies to which I alluded earlier. Even so, these technical requirements are finite and not so numerous as to defy diligent study. The subtleties of the varied factual situations to which they must be applied may be close to infinite—thus suggesting impenetrable complexity—but I believe these also become quite manageable, as a practical matter, when one views them from the perspective of their relationship to the above two fundamental substantive principles. I submit that—if one is not seeking to avoid the intended reach of one of those principles—then the intended reach (and likely enforcement) of some specific technical requirement that may initially appear confusing or difficult to gauge will become quite (if not completely) clear.

Of course, such an approach requires acceptance of the fact that Sarbanes-Oxley intended to revolutionize the way that corporate actors approach—and the attitude they bring to—corporate governance in the public company arena. Those are also readily apparent in the same two fundamental principles. As a result, I believe it is clear that there is no *sub rosa* agenda of complexity (or gratuitous burdens) that seek to ensnare the conscientious officer, director, accountant or even lawyer who approaches his or her duties with respect to corporate governance and public disclosures with a high level of integrity and individualized responsibility for doing the substantively correct thing.

That said, there are several new traps for the unrepentant or unwary, which require care and diligence to navigate. From the perspective of care and diligence, the implications for practices by foreign issuers of Sarbanes-Oxley and related U.S. corporate governance reforms can be significant, even though they will differ in several respects from the implications of these reforms for domestic issuers.

## **B. Organizational Approach**

The commentary on SOX and its progeny with respect to domestic issuers is voluminous, perhaps even excessive, and it continues to grow. I assume,

therefore, that the reader knows (or has ready access to) sufficient information about the application generally of the requirements of SOX, the related SEC rules, and the corporate governance reform proposals of the NYSE and Nasdaq (the latter being close to approval by the Commission for implementation as this Paper goes to press).<sup>2</sup> Accordingly, this Paper addresses the most significant implications for foreign issuers by focusing primarily on the ways that these reforms are different for foreign versus domestic issuers. Unless I consider it essential for context (or simply cannot resist talking about a particular matter), I do not explain in any detail the general application of the new requirements, but proceed fairly directly to whether (and if so, how) they apply to or impact foreign issuers differently.

To organize this discussion, I group the myriad SOX-related requirements into four categories that make conceptual sense to me, and I hope to the reader as well, in understanding the requirements in the context of the two fundamental principles. These are: (i) reporting and disclosure protocols, (ii) internal relationships and procedures, (iii) external relationships and protocols, and (iv) what I can only think to call “good citizenship” protocols. I begin, however, by tracking through the jurisdictional prerequisites for the application of SOX to foreign companies, because all foreign issuers are not equal under the Exchange Act or SOX.

## II. PREREQUISITES FOR APPLICATION

The jurisdictional reach of Sarbanes-Oxley is *not* territorial or geographic *per se*. As a general matter, SOX applies to each “issuer” of a class of securities that has a requisite level of contacts with U.S. capital markets and/or with U.S. citizens or residents as holders of the securities. For its purposes, SOX defines an “issuer” as an entity that (i) has registered securities under Section 12 of the 1934 Act, (ii) is required to file periodic reports under Section 15(d) of the 1933 Act (*i.e.*, because it has previously registered and sold securities under the 1933 Act and not registered them under Section 12 of the 1934 Act), or (iii) has filed (and not withdrawn) a registration statement under the 1933 Act that has not yet become effective. (The SOX definition is substantively the same as the basic definition used in the Exchange Act.) SOX then sets forth an array of required and prohibited actions for an issuer.

Other than an exemption for the very limited category of “foreign private issuers” who qualify under Rule 12g3-2(b) for exemption from the basic reporting and disclosure regime of the Exchange Act, there is no general exemption in SOX for “foreign private issuers” or any other category of foreign issuers. Such

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<sup>2</sup> Appendix A contains a comparison of the major provisions of the NYSE and Nasdaq proposals, which the Commission has had for many months. The Staff of the Commission is concerned about harmonizing some of the substantive differences between the two sets of proposals, which I believe is an appropriate concern. Substantive differences in corporate governance requirements should *not* be a basis for “forum shopping” by public companies in selecting a market on which to trade their securities within the United States.



companies become subject to SOX if they are (and by virtue of being) included in the general definition of issuer.

At the same time, however, it is also clear that Sarbanes-Oxley, as Senator Enzi's comment bears witness, acknowledges a distinction for some of its application between U.S. and non-U.S. issuers. Since the passage of Sarbanes-Oxley, the SEC has even hosted multiple interactive roundtables on the differential application of Sarbanes-Oxley to non-U.S. issuers.

#### **A. Foreign Private Issuers**

"Foreign private issuer" is a long-standing sub-classification within the general definition of "issuer" under U.S. securities laws. After excluding foreign governments, the classification is based on an issuer's organizational domicile *and* the jurisdictional profile of its voting equity ownership, management and operations. Specifically, it covers any foreign (not organized under U.S. law) company that meets the following two criteria:

- less than 50% of the company's outstanding voting securities are held of record, either directly or through voting trust certificates or depository receipts (ADRs), by residents of the United States, *and*
- any one of the following: (i) the minority of the company's executive officers or directors are U.S. citizens or residents, (ii) less than 50% of the company's assets are located in the United States or (iii) "the business of the issuer is not administered principally in the United States."

This classification alone does *not* remove the foreign private issuer from inclusion within the general universe of issuers that are subject to U.S. securities laws. However, it does set the stage for several specific exceptions to (or the differential application of) some provisions of those laws. If a foreign issuer (other than a government) does not qualify as a "foreign private issuer", it is subject to the same regimes for reporting and disclosures under U.S. securities laws as if it were a domestic U.S. issuer. Such is also the case with SOX.

Foreign *government* issuers are a different animal altogether, and historically have been so recognized by the Exchange Act, other U.S. securities laws, and the Commission.<sup>3</sup> There is no indication that Sarbanes-Oxley intended to do otherwise. Many to most of the SOX reforms clearly do not apply to

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<sup>3</sup> Starting with the fact that foreign government issuers have separate forms from non-government foreign issuers, for registration under both the 1933 Act and the Exchange Act, and for annual reports under the latter, foreign governments are in a completely separate category of issuers. As far as Sarbanes-Oxley is concerned, next to nothing is said about them in the legislation or the SEC's rulemaking.

foreign government issuers;<sup>4</sup> and, for those that may appear to apply upon a superficial or purposeless reading, the application would be so clumsy and/or nonsensical as to indicate that it is purely oversight on the part of Congress and the regulators. Accordingly, foreign government issuers are not a focus or concern here. And, while they otherwise are technically covered in the terms “issuer” and “foreign issuer”, they are not addressed by such usages here unless expressly indicated.

## **B. Rule 12g3-2 Exemptions**

Notwithstanding its threshold general application to all foreign issuers, including those who qualify as foreign private issuers, Sarbanes-Oxley does *not* apply to all foreign companies whose securities reach the shores of the United States. In addition to some specific exceptions that it makes, SOX effectively imports for its application the reporting exemptions that the Commission has previously established for certain foreign private issuers pursuant to its authority in Section 12(g)(3) of the Exchange Act. There are two categories of such exemptions, and the more significant is in Rule 12g3-2(b), because more companies may be eligible for it. Both categories, however, provide a complete exemption from Exchange Act report filing and from SOX.

As a threshold matter, it is important to note that no foreign private issuer with securities that are registered under Section 12(b) of the Exchange Act (which relates to NYSE and other U.S. stock exchange listing, but *not* to Nasdaq) is eligible for either exemption under Rule 12g3-2.

Rule 12g3-2(b) provides an Exchange Act reporting exemption for a foreign private issuer *if* it agrees to “furnish” the SEC with certain prescribed home country information, *and if* its securities (or securities represented by ADRs) are *not* quoted on Nasdaq (actually, on *any* automated inter-dealer quotation system). (Level I ADRs, which are discussed a bit further below, generally qualify for this exemption.) The prescribed home country information under Rule 12g3-2(b) consists of information that the issuer (i) is required to make public in its home country, (ii) is required to file with an exchange where those securities are listed, or (iii) otherwise distributes to its securityholders. The foreign private issuer must furnish this information to the SEC along with a list identifying the information and all recipients of it. Since the information is “furnished” to, rather than “filed” with, the SEC, the foreign private issuer is *not* thereby recaptured into the Exchange Act disclosure regime as a company subject generally to the basic periodic reporting and disclosure regime under that Act.

Rule 12g3-2(a), on the other hand, provides a simple and straight-forward, but very narrow category of exemption for foreign private issuers with fewer than

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<sup>4</sup> For example, Form 18-K on which foreign government issuers file their annual reports under the Exchange Act has not been the recipient of SOX-inspired form amendments, in contrast to Form 20-F and Form 40-F.

300 U.S. resident holders of any class of their securities (including ADRs with such an ownership profile that may represent underlying securities).

### C. ADR Program Levels

Most of the foreign companies potentially included within Sarbanes-Oxley's general application to all "issuers" are so as a result of one or more ADR programs. Depending upon the nature of a company's ADR program, however, it may nonetheless be exempt from Sarbanes-Oxley's general application as a result of the exemption provided for certain foreign private issuers by Rule 12g3-2(b) discussed above. The program pursuant to which a foreign issuer offers or trades ADRs in or on a U.S. capital market is assigned to one of three levels that have been established for ADR facilities (Levels I, II and III). These three levels have been tiered to permit companies different levels of access to U.S. capital markets depending upon the level of U.S. securities law disclosure requirements to which they submit.

In reverse order, a Level III ADR program involves an issuer who makes a public offering in the U.S. of securities that are being listed or traded on a U.S. exchange or through Nasdaq as part of the issuer's capital raising activities. A Level II ADR program also involves securities that are being listed or traded on a U.S. exchange or through Nasdaq, but they are not issued in connection with seeking to raise capital in U.S. capital markets. In both situations, however, the Rule 12g3-2(b) exemption is *not* available for such ADRs, and so the issuer *is* subject to the disclosure and periodic reporting requirements of the U.S. securities laws for foreign private issuers, and thus to Sarbanes-Oxley.

A Level I ADR program, however, allows a foreign company to trade ADRs only in the over-the-counter, or "pink sheet", market. By only utilizing such a limited U.S. trading market for its ADRs, the foreign company can avoid the full registration and reporting requirements of the Exchange Act if it satisfies *any one* of the following conditions: (i) the issue has less than 500 total holders, or the foreign company has less than \$10 million in total assets; (ii) the issue has less than 300 holders who are residents of the United States; or (iii) the issuer is otherwise eligible for a Rule 12g3-2(b) exemption.

## III. REPORTING AND DISCLOSURE PROTOCOLS

Neither Sarbanes-Oxley nor the SEC (or anyone else for that matter) has recognized "reporting and disclosure protocols" as a descriptive category for any of the new corporate governance requirements. The same non-recognition applies for the other three conceptual categories I use to organize the discussions in this Paper. We are breaking new ground here. Again, my general approach assumes a familiarity with the basics of these respective requirements.

In this particular category, I include the two sets of SOX certification requirements for CEOs and CFOs; the special or enhanced requirements for off-balance sheet or MD&A disclosures; the non-GAAP financial measures rules; the rules for disclosures about a code of ethics covering certain senior executives; and the “real time” disclosure obligations.

## **A. CEO and CFO Certifications**

Both the Section 906 and Section 302 certification requirements for CEOs and CFOs apply to persons who hold those positions (or their functional equivalents) with foreign private issuers who file reports with the SEC that are covered by those Sections.

### **1. Section 906 Certification**

As you undoubtedly know, Section 906 of Sarbanes-Oxley requires an issuer's CEO and CFO—under sanction of criminal penalties for knowing or willful non-compliance—to accompany any periodic report the issuer *files* with the SEC that contains financial statements with a certification that the financials contained therein (a) fully comply with the applicable requirements of the Exchange Act, and (b) contain information that fairly presents, in all material respects, the financial condition and results of operations of the issuer.

While the Section 906 certification requirement applies to foreign private issuers that file financial statements as part of an annual report on Form 20-F or Form 40-F, it does not apply to the interim reports such issuers may make on Form 6-K. This is because Section 906 applies only to “filed” periodic reports, and reports on Form 6-K (while some of them may be required at periodic intervals, as a practical matter, because of the issuer's reporting obligations in its home country or to a foreign exchange on which it trades the securities) are not treated as “filed” with the SEC pursuant to Section 12 of the Exchange Act or Section 15(d) of the 1933 Act. Rather, unlike interim periodic reports on Form 10-Q by domestic issuers, reports on Form 6-K are only required to be “submitted” to the SEC. Such *submission* is *not* deemed to be equivalent to the “filed” status that triggers the certification obligation.

However, in a delayed post-enactment development, considerable doubt has been introduced concerning whether reports on Form 6-K are not covered by Section 906 because of the filed versus submitted distinction. On April 11, 2003, U.S. Senator Joseph R. Biden introduced a statement into the Congressional Record asserting that the Section 906 certification “is intended to apply to any financial statement filed by a publicly-traded company, upon which the investing public will rely to gauge the financial health of the company,” and that it therefore includes financial statements that are a part of current reports on Form 6-K (for foreign private issuers) as well as Form 8-K (for domestic issuers). Senator Biden acknowledged, and did not challenge, the historic distinction the SEC has made between “periodic” reports and

“current” reports under the Exchange Act for purposes of interim reporting and disclosure generally. However, he emphasized that the key for Section 906 is the inclusion of such financial statements, and that Section 906 intends (and effects) a broader coverage to include all interim reports that contain such financial statements, whether they are called periodic or current, and whether they are considered to be filed or merely submitted.

It should be apparent that Senator Biden’s position is perfectly consistent with the fundamental principles and objective of Sarbanes-Oxley that I discussed early, notwithstanding the logic of a literal reading of Sarbanes-Oxley to reach the opposite conclusion based on the historic filed/submitted distinction. This represents an instance of both the ambiguities and apparent inconsistencies of certain Sarbanes-Oxley provisions to which I alluded, although even I did not initially see through to this one. There is no indication that the SEC or the Department of Justice is preparing to heed Senator Biden’s request for regulatory action that reflects his position. But, no one should be too surprised if Senator Biden’s position becomes the prevailing view and enforcement position, without formal Congressional action to amend Section 906.

A different issue, from the opposite perspective, arises from a literal reading of Section 906 to conclude that it requires CEO and CFO certifications in connection with the annual reports of foreign government issuers on Form 18-K, because these reports do contain financial statements of sorts and are filed with the SEC under the Exchange Act. However, in releases discussing the Section 906 certifications, the SEC has not listed Form 18-K as among the report forms subject to the requirement, and even Senator Biden’s more expansive view of Section 906’s coverage does not purport to encompass it. In any event, it does not appear feasible to apply the requirement to a foreign government. For example, who signs the certification? The President and Finance Minister of the foreign government?

I digressed here to talk about foreign government issuers in connection with this requirement (even though they are not otherwise my concern here, for the reasons discussed in Part II.A), because it is an ideal illustration of a point that is implicit in my threshold observations—*i.e.*, that one not create complexity or confusion by making too much of the ambiguities or obviously unintended inconsistencies in some SOX provisions. While it is good sport sometimes to identify latent issues such provisions could raise if they were purposeful, it makes no practical sense to dwell upon them in receiving or giving legal advice. To do so is *not* a touchstone for the care and diligence that are required for corporate governance analyses in this new era.

So, notwithstanding the apparent application of the Section 906 certification requirement to foreign government issuers, that would not be a purposeful reading of Section 906 in light of any principle or objective articulated in or underlying Sarbanes-Oxley or its progeny.

## 2. *Section 302 Certification*

The separate Section 302 certification obligation also applies only to annual reports on Form 20-F or Form 40-F, and not to Form 6-K (or to annual reports of foreign government issuers on Form 18-K). Pursuant to SEC rules implementing the Section 302 requirements, the issuer's CEO and CFO must certify with respect to several specific items, in addition to the overall compliance of the report with Exchange Act requirements and the fair presentation of financial statements. These include an evaluation of the effectiveness of the issuer's disclosure controls and procedures (which includes internal financial controls), and the conclusions of management about such effectiveness as of the end of the period covered by the report. These obligations are identical to those applicable to domestic issuers in their annual reports.

It may be important to note that the Section 302 certification requirement does *not* apply to the narrow category of foreign private issuers that are exempt from SEC filing requirements under Rule 12g3-2(b) of the Exchange Act and only "furnish" reports to the SEC.

### **B. Enhanced MD&A Disclosures**

In its SOX-related rulemaking, the SEC took the opportunity to elaborate upon or extend certain requirements, which it had begun to articulate pre-SOX, for enhanced disclosures in the management's discussion and analysis of financial condition and operating results section ("MD&A") of periodic reports and registration statements. The principal such requirements apply to foreign private issuers along with all other issuers that are subject to SOX.

These requirements include that issuers disclose all material off-balance sheet transactions, including contingent obligations, as well as relationships between the issuer and its unconsolidated entities or other persons that have more than a remote likelihood of having a material current or future effect on the issuer. As with other covered issuers, foreign private issuers must provide this new disclosure in a separately captioned section in their covered annual reports.

Additional new requirements include that issuers provide (i) an overview (in tabular format) of the issuer's material contractual obligations as of the date of the latest balance sheet date included in a covered report, and (ii) an overview (which may be in either narrative or tabular form) of the issuer's material contractual obligations that are payable, or its other contingent liabilities and commitments that are expected to materialize (or, as the case may be, to remain as a contingency) during specified periods.

### C. Non-GAAP Financial Measures

A principal concern of the SEC in implementing Sarbanes-Oxley's transparency objective for financial disclosures has been the use by issuers—in a variety of media and public situations—of pro forma or non-GAAP financial data that are derived from GAAP financial information (or calculated based thereon) in ways that could distort or compromise the presentation or comprehension of the required GAAP information. Issuers and their advisors have been quite creative in fashioning financial measures to tell a preferred version of their operating story. Many of these are useful and even desired by investors and financial analysts, but some are less so and have led to an amusing acronym to characterize the more aggressively creative instances—*i.e.*, “EBBS”, which stands for “everything but the bad stuff”.

To address that concern, the SEC promulgated two sets of rules:

- New Regulation G—which applies to all public disclosures by issuers—to define, and to impose a general proscription on the misleading use of, non-GAAP financial measures, and to require the inclusion along with any such use of additional disclosures that reconcile each such measure to the most directly comparable U.S. GAAP financial measure.
- Amendments to Item 10 of Regulation S-K—which apply only to reports and other disclosures that are *filed* with the SEC—to impose a requirement (beyond Regulation G's requirements) that the issuer discuss its purpose for using each non-GAAP financial measure, as well as the issuer's reason for believing the non-GAAP financial measure is useful to investors.

Foreign private issuers, as a general matter under the Exchange Act, are not subject to the disclosure requirements of Regulation S-K in connection with their reports on Form 20-F, Form 40-F or Form 6-K. Accordingly, they would not be subject to the new amendments to Item 10 of Regulation S-K that address non-GAAP financial measures, *unless* those requirements were added to those Forms. They were so added to Form 20-F (although not to Form 40-F or Form 6-K), and thus foreign private issuers who file annual reports on Form 20-F are effectively subject to those new Item 10 requirements. However, in applying the requirements, a foreign private issuer must also refer to the generally accepted accounting principles under which its primary financial statements are prepared, if they are not U.S. GAAP, in its analysis of compliance with the non-GAAP financial measures requirements.

New Regulation G, on the other hand, applies directly to foreign private issuers along with all other issuers, except for a very limited exception to the U.S. GAAP reconciliation requirement contained in Rule 100(c) of Regulation G. This exception, however, only applies where each of the following conditions are met:

- the company's securities are listed outside the U.S.;
- the non-GAAP financial measure is not derived from a measure calculated in accordance with U.S. GAAP; and
- the disclosure is made by or on behalf of the foreign issuer outside the U.S., or is included in a written communication that is released only outside the U.S. *unless*, if also released in the U.S., (i) the U.S. release is not made before the foreign release (and the release is not otherwise targeted at persons located in the U.S.), (ii) U.S. journalists have access to it, and (iii) the disclosure is submitted to the SEC under cover of a report on Form 6-K.

The absolute prohibition on using certain types of non-GAAP financial measure in reports or other disclosures required to be filed with the SEC—such as “OIBITDA”, which is operating income before interest, taxes, depreciation and amortization—apply to foreign private issuers, as a general matter. However, a foreign private issuer may include in its annual report on Form 20-F a non-GAAP financial measure that would otherwise be prohibited *if* (i) the measure is allowed under the accounting principles governing that company's primary financial statements, and (ii) the measure was included in the company's annual report or financial statements used in or for its home country jurisdiction or market.<sup>5</sup>

#### **D. Codes of Ethics**

Foreign private issuers are subject to the requirement of Section 406 of Sarbanes-Oxley, and the SEC's related rules, that issuers disclose whether or not they have adopted a written code of ethics for their CEO and senior financial officers. The disclosure must be made in their annual reports on Form 20-F or Form 40-F, and the code of ethics (if the issuer has one) must be filed as an exhibit to such reports. In lieu of filing the code of ethics as an exhibit to the report, the issuer may include it on the issuer's website if the issuer so indicates in its annual report, or the issuer may offer in its annual report to provide it without charge upon request by an investor.

The SEC rules extended SOX's express requirement beyond senior financial officers to include CEOs, reasoning that investors have an interest in knowing if a company also holds its CEO to explicit written ethical standards. The same definition that the SEC provided for “code of ethics”, lieu of express guidance for the content of such a code, applies for foreign private issuers.

Unlike all other issuers who are required to file interim reports on Form 10-Q, however, a foreign private issuer need only disclose a change to (or waiver

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<sup>5</sup> I have included as Appendix B a Securities Legal Alert of my firm that provides a more detailed discussion of the generally applicable requirements of Regulation G and the amendments to Item 10 of Regulation S-K.



of) its code of ethics in its next annual report on Form 20-F or Form 40-F, rather than in an intervening interim report on Form 6-K. A Foreign private issuer may voluntarily disclose such a change or waiver, however, in a report on Form 6-K or on its website.

#### **E. "Real Time" Disclosures**

Foreign private issuers are not required to file current reports on Form 8-K, although a few companies have chosen, as a matter of market practice, to voluntarily file on Form 6-K information about material or significant interim developments. Sarbanes-Oxley did not change that historical exception from Exchange Act reporting obligations of foreign private issuers.

However, Section 409 of Sarbanes-Oxley requires disclosure on "a rapid and current basis" of such additional information as the SEC determines appropriate and requires, regarding material changes (including known trends) in the financial condition or operations of an issuer. The requirement expressly applies to each "issuer" who files reports pursuant to Section 13(a) of the Exchange Act or Section 15(d) of the 1933 Act, and thus on its face would reach foreign private issuers on the same terms as domestic reporting issuers (the latter being subject, in the normal course, to ongoing current reporting on Form 8-K under the Exchange Act). Until the SEC adopts implementing rules, it is unclear whether (and if so, to what extent) it may seek to use Section 409 to change the historically circumscribed interim period disclosure regime that is now available to foreign private issuers.

Section 409 could become the instrument for radical change in reporting by foreign private issuers if the SEC were to interpret Section 409 as a mandate to all issuers, without exception, to provide such "real time" disclosure of certain types of information in interim reports, rather than allowing foreign private issuers to rely on their home country law and principal trading market practices for reporting outside the current regime of Forms 20-F, 40-F and 6-K. There is no indication (at least not explicit) that Sarbanes-Oxley intends for this requirement to be applied in such a manner with respect to foreign private issuers.

#### **IV. INTERNAL RELATIONSHIPS AND PROCEDURES**

In this category, I include the Sarbanes-Oxley provisions and SEC rules that impose requirements concerning audit committees, financial experts, disclosure controls and procedures, and auditor attestation of management reports on internal controls. I also discuss the principal corporate governance reforms proposed by the NYSE and Nasdaq that relate to audit and other committees, overall board structure, and other infrastructure features of listed companies. The rationale for this category is that—while an effect of complying with several other reform requirements will lead to changes in how an issuer may organize, staff or approach many of its internal processes or systems—these new requirements relate directly to such matters.

## A. Audit Committees

Apart from establishment of the Public Company Accounting Oversight Board and the requirements directly relating to practices by auditing firms, the focus on the composition and responsibilities of an issuer's audit committee is the single most striking feature of Sarbanes-Oxley and most of its progeny. That is understandable, of course, in light of the origins of the scandals that ignited the reform movement leading to Sarbanes-Oxley. Only time will tell whether too much has been laden upon the audit committee, which one of my colleagues has referred to as the "pack mule" of recent corporate governance reforms.

Be that as it may, all of the requirements in Section 301 of Sarbanes-Oxley and the SEC's related rules concerning audit committees apply, as a threshold matter, to all issuers. They raise some significant problems for most foreign issuers, precisely because they deal with structure, relationships and processes, rather than with ultimate results (as do most of the disclosure requirements) that might be derived via any number of different structures or processes. These begin with the per se requirement that issuers have an audit committee (or else an issuer's entire board must serve as such, and must meet the qualitative standards that are imposed on the audit committee) and extend to the "independence" and specific responsibilities mandates.

It would be a stretch to say that Sarbanes-Oxley (or even the SEC in its subsequent rulemaking) considered circumspectly the ramifications of these requirements for all foreign issuers. But, while there is no general exception for foreign private issuers from the myriad audit committee-related requirements, there are several specific exceptions for (or differential applications of certain requirements to) foreign private issuers that seek to address (if not alleviate completely) the major points of tension created by these requirements.

As an initial matter, foreign private issuers are not subject to Sarbanes-Oxley's audit committee requirements until July 31, 2005, whereas other issuers will likely be subject to them as early as the time of their annual shareholders meetings in 2004. More importantly, foreign private issuers can qualify for exemptions from certain of the "independent" members requirements in the situations described later below. First, however, a summary review of those requirements is essential for context.<sup>6</sup>

Under Section 301 of Sarbanes-Oxley, a member of an audit committee is not independent if he or she (i) accepts, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer, other than in his or her capacity as a member of the board or a board committee, or (ii) is an "affiliated person" of the issuer. The SEC's rules establish that the prohibition against accepting any compensatory fee includes the acceptance of such a fee by an entity

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<sup>6</sup> I have also included as Appendix C to this Paper a Securities Legal Alert of my firm that provides a more detailed discussion of the SEC's rules on audit committee standards.

(i) in which the director is a partner or member or occupies a similar position (other than where the director has no active role in providing services to the entity), and (ii) that provides accounting, consulting, legal, investment banking, financial or other advisory services to the issuer. It also generally precludes the acceptance of such a fee by a spouse or minor children of a director. The rules do not contain either a *de minimis* exception or an exception for “limited and exceptional circumstances”.

The prohibition on compensatory fees do not, however, preclude other ordinary course commercial relationships between an issuer and an entity with which a director has a relationship; these were left to the stock exchanges' and stock markets' listing standards for possible reform consideration. In addition, the prohibitions only apply to current relationships and do not include a “look back” period. The prohibition on compensatory fees also do not include fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the issuer, provided that such compensation is not contingent in any way on continued or future service.

An “affiliated person” is defined consistent with the definition of “affiliate” under existing U.S. securities laws—*i.e.*, as a person who directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the issuer. “Control” is defined as the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise. The rules include a safe harbor for the absence of “control”, which basically is a person who is not the beneficial owner, directly or indirectly, of more than 10% of any class of equity securities of the subject company and is not an executive officer of the company. Outside the safe harbor, an issuer may still establish that an audit committee member is not an affiliated person of the issuer based on a facts and circumstances analysis. However, executive officers, directors who are also employees of an affiliate, and general partners and managing members of an affiliate, will automatically be deemed to be affiliates.

These basic cut-backs on (and safe harbor protection from) the independence criteria do not address nearly all the concerns raised by some foreign private issuers however; and, neither do the following important, but narrowly tailored, specific exemptions that are available for foreign private issuers in the SEC's rules.<sup>7</sup>

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<sup>7</sup> For some of the discussion in the remainder of this Part IV.A, I borrow from the useful distillation prepared by M. Ridgway Barker and Randi-Jean G. Hardin that is included in II METROPOLITAN CORPORATE COUNSEL, No. 6 (June 2003).

### **1. *Controlling Shareholder Representation***

SEC Rule 10A-3(b)(1)(iv)(D) provides an exemption from the no-affiliation prohibition for an audit committee member of a foreign private issuer who is an affiliate because of a controlling share ownership position (or who is the representative of such an affiliate) *if* (a) the member satisfies the no-fee prohibition and has only observer status on, and is not the chair or a voting member of, the committee, and (b) neither the member nor its affiliate is an executive officer of the issuer. The SEC designed this exemption to address the greater prevalence among foreign issuers of controlling shareholders who have traditionally played a prominent governance role, but while still maintaining the SEC's exclusion of executive management personnel from the audit committee.

### **2. *Foreign Government Representation***

SEC Rule 10A-3(b)(1)(iv)(E) provides an exemption from the no-affiliation prohibition for an audit committee member of a foreign private issuer who is a representative of a foreign government or governmental entity that is an affiliate of the issuer, *if* the member satisfies the no-fee prohibition and is not an executive officer of the issuer. The SEC designed this exemption to accommodate the fact that foreign governments may have significant shareholdings in some foreign issuers (or may own special shares that give rights relating to such issuers), which holdings (or rights) may constitute affiliate status under U.S. securities law and thus would preclude the representative's independence.

### **3. *Dual Holding Companies***

SEC Rule 10A-3(b)(1)(i) contains a special accommodation to deal with the no-affiliation prohibition in a situation where the foreign private issuer is part of a "dual holding companies" structure. (The dual holding companies structure is not uncommon in the United Kingdom, Germany, Australia and some Latin American countries.) Such a structure involves two foreign companies, organized in different national jurisdictions, that collectively own and supervise the management of businesses that are conducted as a single economic enterprise. If a foreign private issuer is one of the dual holding companies, it may designate one audit committee for both companies, so long as each committee member is a board member of at least one of the companies. For the rule's purposes, dual holding companies are not deemed to be affiliates of each other by virtue of their dual holding companies structure or arrangements.

#### 4. *Designated Employee Representation*

SEC Rule 10A-3(b)(1)(iv)(C) provides an exemption from both the no-affiliation and no-fee prohibitions for an employee of a foreign private issuer who is not an executive officer, *if* the employee serves on the board or audit committee in order to comply with the issuer's governing law or documents, a collective bargaining or similar agreement, or other home country requirements. The SEC thus sought to accommodate the practice in some foreign countries that requires one or more non-management employees to serve on the supervisory board or audit committee of their companies, which the SEC reasoned may provide its own check on management that accomplishes the objectives of Sarbanes-Oxley.

#### 5. *Two-Tiered Boards and Board of Auditors*

As indicated above, prefatory to the issue of audit committee composition, SOX prescribes certain functions that must be administered by the audit committee or by the full board qualified and acting as such a committee. That prescription, of course, is tantamount to requiring that all issuers have an audit committee. Similarly, and prefatory to the issue of audit committee member independence, is the requirement that all audit committee members be members of the issuer's board of directors (or its equivalent body).

These threshold requirements can also be problematic for some foreign companies, which led the SEC to promulgate other exemptions, including one focused on issues created for foreign companies with a two-tiered board—which tends to consist of a “lower level”, management board that is composed entirely of inside executives (and thus would not satisfy independence requirements), and an “upper level”, supervisory board composed in part of labor representatives and non-executive employees. In the case of foreign private issuers with such a two-tier board structure, SEC Rule 10A-3(e)(2) has defined “board of directors” as the supervisory, non-management board.

The requirement of an audit committee per se—with its membership criteria and prescribed responsibilities—do not apply to a foreign private issuer that has a board of auditors (or similar body) or statutory auditors (in any such case, referred to here as a “board of auditors”) (i) that is established, and its members selected, pursuant to home country provisions that require or expressly permit the board of auditors and require it to be separate from the board of directors (or to be composed of one or more board and one or more non-board members), and (ii) whose members are not elected by management, and on which no executive officer is a member.

However, the foreign private issuer must nonetheless comply with the Rule's remaining provisions for certain responsibilities or conduct of audit committees—*i.e.*, the handling of complaints, engagement of its own advisors, and funding by the issuer therefor (which I refer to as the “core Rule 10A-3(b) responsibilities”)—to the extent permitted by the issuer's home country governing law. The board of auditors also must be responsible for the appointment, retention and oversight of the work of any accounting firm performing services for the issuer, to the extent permitted by law (and in accordance with) applicable home country requirements or governing documents.

In providing these accommodations, the SEC acknowledged that several foreign jurisdictions (*e.g.*, Japan, Italy and Brazil) provide for auditor oversight through such a board of auditors, which can provide a meaningful measure of independent oversight. While that oversight might not meet all of its requirements, the SEC determined that requiring an additional audit committee that meets SOX-related requirements would involve duplicative functions, could generate possible conflicts, and would be costly and inefficient.

## 6. *Some Residual Matters*

Notwithstanding the above accommodations, many foreign private issuers remain extremely dissatisfied with SOX's requirement of an independent audit committee. This is particularly acute in countries such as Germany that require many companies to have two-tiered governing boards. Many foreign issuers in such situations fear that establishing an audit committee drawn from non-management, supervisory boards could give excessive leverage to labor organizations. Whether or not further exemptions will be made to address these or other residual concerns remains to be seen. It is significant, in any event, that the instructions to SEC Rule 10A-3(b) clarify that its requirements do not conflict with (or affect the application of) any requirement or ability under an issuer's governing law or documents, or other home country provisions, that:

- require or permit shareholders of a foreign private issuer to vote on, approve or ratify such requirements, but instead relate to the assignment of responsibility as between the audit committee and management (*provided that*, if the issuer provides a recommendation or nomination regarding such responsibilities to shareholders, then the audit committee or comparable body must make the recommendation or nomination);
- prohibit the full board of a foreign private issuer from delegating any of the core Rule 10A-3(b) responsibilities to the audit committee, or that limit the degree of delegation (*provided that*, the audit committee or comparable body must have such responsibilities with respect to such matters, to the extent permitted by law); or

- vest any of the core Rule 10A-3(b) responsibilities with a government entity (*provided that*, the audit committee or comparable body must have such responsibilities with respect to such matters, to the extent permitted by law).

A foreign private issuer that utilizes any of the controlling shareholder, foreign government or designated employee representation exemptions or the board of auditors exemption discussed above, must disclose both its reliance on the exemption and its assessment of whether (and if so, how) such reliance would materially adversely affect the audit committee's ability to act independently and satisfy the Rule's other requirements.

## **B. Financial Experts**

The "financial expert" requirement threatens the integrity of this organizational category, because it is technically a disclosure requirement. Foreign private issuers are required to disclose in their annual reports and certain other documents filed with the SEC whether their board has a financial expert on its audit committee; and if not, why not. However, the practical impact of the audit committee financial expert requirement is that issuers are under considerable pressure to have at least one such financial expert in order to avoid explaining why they do not.<sup>8</sup>

While foreign private issuers are subject to the basic disclosure requirement, the SEC rules provide two significant differential applications that seek to accommodate special situations many of them may face with greater frequency than domestic issuers.

First, the "board" to which the requirement relates, in the case of a foreign private issuer with a two-tiered board as discussed above in Part III.A.5, above, is the non-management, supervisory board. And, for foreign private issuers with a board of auditors as also discussed in Part III. A.5, the applicable "board" for this requirement is that body.

Second, in applying the criterion that the financial expert possess an understanding of GAAP and financial statements, a foreign private issuer can assess qualification of its members by referring to GAAP as used in its primary financial statements filed with SEC, rather than to U.S. GAAP. The SEC provided this differentiation, even though the SEC continues to believe an understanding of reconciliation to U.S. GAAP of as foreign private issuer's financial statements prepared in accordance with non-U.S. GAAP—which reconciliation is required in all reports filed with the SEC in which the foreign

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<sup>8</sup> But, one might say, isn't the same true with respect to the "code of ethics" disclosure requirement, which is grouped in Part III with other disclosure requirements and protocols? Yes, but I believe to lesser extent that warrants differential treatment. In any event, it's my system, and I *deem* it to be internally consistent.

private issuer chooses not to include full U.S. GAAP financial statements—would be helpful.

### **C. Other Board Committees**

Neither Sarbanes-Oxley nor the SEC (directly) imposed any significant new requirements covering other board committees as part of their reform initiatives. However, both the NYSE and Nasdaq include in their respective corporate governance reform proposals new listing standards that relate to compensation committees, nominating committees, as well as audit committees. Appendix A to this Paper contains a summary of those requirements. In each case, however, the proposed requirements contain (or permit the grant of) fairly generous exceptions to accommodate special situations that may be more prevalent for foreign companies than for U.S. companies.

#### **1. NYSE Listing Standards**

With the exception of the matters listed in the next paragraph, the proposed corporate governance reform rules of the NYSE would allow a foreign private issuer to follow home country practice in lieu of NYSE corporate governance standards, if the issuer complies with each of the following conditions:

- the issuer's CEO must promptly notify the NYSE if any executive officer of the issuer becomes aware of material non-compliance with any of the NYSE rules to which the issuer remains subject as a condition of the exception; and
- the issuer must disclose to its U.S. investors (in a brief, general summary) any significant ways in which its home country corporate governance practices differ from those followed by domestic issuers under NYSE listing standards.

No detailed, item-by-item analysis of differences is required, and the NYSE has made clear that this requirement is not intended to suggest that one country's corporate governance practices are better or more effective than those of another country. Even so, the preparation of such differential disclosure should be approached with some care, so that no reasonable investor will be able to assert credibly that unawareness of some such difference was a material factor in an investment decision with which the investor has become disappointed.

A foreign private issuer may provide the above differential disclosure on its web site (provided it is in English and accessible from the U.S.) and/or in its English-language annual report distributed to shareholders in the U.S. If the disclosure is only made available on a web site, the annual report must so state that fact and provide the web address.



The specific NYSE listing standards from which *no* exception (or deference to home country practice) exists or is proposed are: (a) the NYSE's proposed expanded definition of "independence" for audit committee members; (b) the NYSE's proposed minimum size and composition requirement for audit committees; and (c) the SEC's required responsibilities (contained in Rule 10A-3(b)(2)-(5) of the Exchange Act) for audit committees to perform. These responsibilities relate to:

- appointing, retaining, compensating, evaluating and terminating auditors;
- establishing procedures for the confidential receipt and disposition of complaints or concerns from employees about accounting, internal controls or auditing matters;
- obtaining advice from outside legal, accounting or other advisors as it deems necessary; and
- having access to appropriate funding from the issuer to pay for such outside advisors as it determines necessary.

The NYSE's new standards are currently proposed to be effective within six months of SEC approval of them for implementation. All foreign listed companies will likely have to comply upon such effectiveness.

## **2. *Nasdaq Listing Standards***

Nasdaq has taken a somewhat different approach from the NYSE to accommodate foreign issuers with respect to its corporate governance requirements. Rather than establishing a general home-country practice exception, the Nasdaq's proposed rules expressly allow it to create exemptions as necessary or appropriate, on a case-by-case basis. They do make clear, however, that a foreign issuer will not be required to take any act that is contrary to laws of public authorities exercising jurisdiction over the issuer, or that is in opposition to generally accepted business practices in the issuer's country of domicile.

The proposed Nasdaq rules require a foreign issuer who is granted an exemption to disclose initially and annually each requirement from which it is exempted and the alternative practice (if any) that it follows in lieu thereof.

## **D. Disclosure Controls and Procedures**

Foreign private issuers are fully subject to the requirements imposed by the SEC's new concept of "disclosure controls and procedures" in Rule 13a-15 and Rule 15d-15. In adopting these rules, the SEC expanded significantly upon Sarbanes-Oxley's mandate in Section 404 that the SEC require issuers to include in their annual reports a statement of management as to its responsibility for the

issuers “internal control structure and procedures . . . for financial reporting” and its assessment of such structure and procedures as of the end of the last fiscal year.

The SEC created the broader concept in order to extend beyond the traditional conception of internal control procedures that related to financial information, and to reach procedures for the generation of virtually all material data and information for which disclosure may be required in an SEC-filed report or other document. The SEC even recommended, but did not require, that issuers form an internal “SEC Disclosure Committee” (with several recommended personnel positions as members) to be responsible for the timely generation of complete and accurate information for inclusion in required filings. The impact of these requirements is achieved through the Section 302 certification requirements discussed earlier—which were also expanded by the SEC’s rules—where the contents of the Section 404-mandated statements are listed among the items to which an issuer’s CEO and CFO must certify.

These requirements do *not* impose any specific set of systems or procedures upon an issuer, but the issuer’s systems and processes must be such as to permit its CEO and CFO to make a good faith Section 302 certification. As a practical result, therefore, they require foreign private issuers to do whatever is necessary for that purpose.

A potentially significant differential application to foreign private issuers is that they are only required to make the Section 302 certification covering these matters in their annual reports filed with the SEC, whereas other issuers subject to the rules must certify (and thus make the corresponding assessments prerequisite thereto) in interim periodic reports on Form 10-Q.

Like all other issuers, however, a foreign private issuer is subject to the requirement that its auditor must attest to and report on the annual assessment made by the issuer’s management. Foreign private issuers must report on their internal control and disclosure processes beginning with reports for their respective fiscal years ending on or after April 15, 2005.

## **V. EXTERNAL RELATIONSHIPS AND PROTOCOLS**

### **A. Auditor Independence**

Sarbanes-Oxley and related SEC rules contain extensive requirements focused on creating or enhancing the independence of auditors from the issuers whose financial statements they audit. Other requirements for auditors focus on their internal processes and the like, and are not my principal concern here. However, I have included as Appendix D a discussion of the principal requirements of those rules.

Sarbanes-Oxley amended several of the principal SEC rules that focus on independence in the relationship between auditors and their audit clients, which

rules previously applied (and now continue to apply) to foreign private issuers to substantially the same extent as to domestic issuers.

The general rule, unchanged by Sarbanes-Oxley, is that an accountant's independence is impaired if the accountant is not capable—or would appear incapable to a reasonable, informed investor—of exercising objective and impartial judgment on all issues encompassed within the engagement. In addition, there are several specific disqualifying relationships, such as financial, employment or business relationships with the audit client. For example, auditors cannot have a contingent fee arrangement with their clients, and no audit partner can earn or receive compensation based on the audit partner procuring engagements with the client to provide any products or services other than audit, review or attestation services.

Sarbanes-Oxley added the requirement that all audit and non-audit services be pre-approved by the issuer's audit committee—either before each engagement by the audit committee or a delegate from among its members—or pursuant to an audit committee-approved, pre-approval policy that is sufficiently detailed as to the engagements covered so that the policy does not constitute a delegation of approval authority to management. Of interest to foreign private issuers without audit committees, the rules indicate that the responsibility lies with the audit committee or an “equivalent body”, and in the absence of such a body, the entire board of directors.

Sarbanes-Oxley also added a one-year “time-out” before former auditors can be employed in certain positions with their former clients. Specifically, a former audit engagement team member who accepts a financial reporting oversight role at an issuer would cause the accounting firm with which that person was formerly employed not to be independent with respect to that issuer, if the person was a member of the audit engagement team within one year prior to the commencement of procedures by the firm for a current audit engagement.

The SEC's initial proposal of this rule would have applied the prohibition to the entire audit client—*i.e.*, the consolidated entity, not just the parent-level issuer as was effected in the final rules. This change was made in response to comments from, among other concerned observers, the international community. They may have been motivated by a concern expressed with respect to the audit partner rotation requirement—that is, a smaller pool of accounting talent in some jurisdictions, particularly developing countries. It was also pointed out that, in certain jurisdictions, labor laws or policies would prohibit foreign accounting firms from imposing restrictions on the future employment opportunities of their personnel. In the rule as adopted, members of the audit engagement team will be able to take positions with the subsidiaries or affiliates of an issuer.

One of the areas most affected by Sarbanes-Oxley-based reforms is the list of non-audit services that impair auditor independence:

- bookkeeping or other services related to the accounting records or financial statements of the audit client;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions;
- human resources;
- broker-dealer, investment adviser, or investment banking services;
- legal services; and
- expert services unrelated to the audit.

While only the last item above is a truly “new” prohibited service, most of the other items on the list have been changed in substantive ways. Three of the proscribed non-audit services—*i.e.*, appraisal and valuation services, legal services and bookkeeping services—are of some particular interest to foreign private issuers.

Taking them in order, laws and regulations in certain foreign countries require auditors to provide contribution-in-kind reports or valuation services. The SEC has previously afforded relief from this proscription where, among other things, the auditor and issuer were able to demonstrate that the auditor was not providing an opinion on the fairness of a given transaction. The SEC declined to provide blanket relief for these situations in the new rules, but stated that it will continue to consider individual requests for exemptive relief on a case-by-case basis.

Regarding legal services, several foreign commentators noted that a prohibition on legal services could amount to a prohibition on the provision of tax services by foreign accounting firms from particular jurisdictions. In certain jurisdictions, tax services are defined as legal services and can only be rendered by persons licensed to practice law in the subject jurisdiction. The SEC made clear in its adopting release that foreign accounting firms can provide tax services, as appropriate, despite their local definition and local licensing requirements as legal services.

The pre-Sarbanes-Oxley prohibition on bookkeeping services contained an exception for such services provided by the auditor for a foreign affiliate or subsidiary of the issuer. That exception has been eliminated in the new rules.

Another new requirement is mandatory audit partner rotation. The lead partners on domestic audit engagements have previously been subject to rotation requirements under professional standards, while foreign auditors generally have not. To accommodate this historical differential in part, the transition or phase-in arrangements for the partner rotation rules provide the following temporal relief for foreign auditors.

- U.S. lead partners are only permitted to conclude an audit for fiscal year 2003 (assuming for this example a calendar fiscal year) before their previous service time with the client as lead partner counts towards the five-year limit. Consequently, if, after completion of the fiscal year 2003 audit, the lead partner has served in that capacity for five or more years, he or she must begin the required 5-year time-out from service on the firm's engagement team for the issuer. U.S. concurring partners are also allowed to complete the fiscal year 2004 audit before their previous service time likewise counts towards their five-year limit.
- For foreign accountants, however, lead and concurring partners are not only allowed to complete the fiscal year 2003 and 2004 audit, respectively, but also they need not count prior service towards the five-year limit as lead or concurring partner, as the case may be—that is, fiscal year 2004 and 2005, respectively, would count as the first year of their five-year limit as lead or concurring partner.

There are no other transition breaks for foreign accountants. Other partners of a firm who are subject to rotation (*e.g.*, any other level partner on the engagement for the issuer, and the lead partners for over-20% subsidiaries of the issuer) may complete the fiscal year 2003 audit and need not count prior service—that is, fiscal year 2004 would be the first year of their seven-year limit.

In closing this summary of a fairly detailed topic, I note that accountants are sometimes asked to prepare statutory financial statements for foreign companies, and these are not filed with the SEC. The SEC has made clear that an accountant's independence would be impaired where the accountant prepared such statutory financial statements if those statements form the basis of the financial statements that are required to be filed with the SEC. Under these circumstances, the SEC reasoned that the accountant is in the position of auditing its own work, and thus is not independent with respect to the preparation of the financial statements being filed with the SEC.

## B. Attorney Conduct

As a general matter, the SEC's attorney conduct rules, promulgated pursuant to the mandate in Section 307 of Sarbanes-Oxley, applies to attorneys who represent or work for foreign issuers, *if* they fit within the definition of "appearing and practicing" before the Commission. It is within that definition that space is provided to accommodate special situations that are more prevalent for foreign issuers relative to domestic issuers.

For U.S. attorneys, or foreign attorneys who are also admitted to practice in the United States, the provisions of the definition apply without differentiation, whether the issuer involved is foreign or domestic. Foreign attorneys who provide legal advice regarding U.S. law—whether or not admitted to practice in the United States (which could raise a different set of concerns, of course)—are covered by the attorney conduct rules to the extent they are appearing and practicing before the Commission, unless they provide such advice in consultation with U.S. counsel. Foreign attorneys who are not admitted in the United States, and who do not advise clients regarding U.S. law, are not covered by the attorney conduct rules.

Foreign lawyers who primarily practice abroad, and deal only indirectly or "incidentally" with the Commission, would not likely come within the definition, and so would be exempt from the substantive requirements of the attorney conduct rules.

A detailed discussion of the attorney conduct rules is beyond the scope of this Paper, and is addressed by at least one other presenter for this program. However, the singular importance of the implications of these rules to lawyers warrants some summary here for general contextual purposes, which I provide below. Also, for the truly gluttonous, I have included as Appendix E a more fulsome summary of the principal requirements of these rules.

The SEC rules implementing Section 307 of Sarbanes-Oxley require an attorney—appearing and practicing before the Commission in the representation of an issuer—who becomes aware of evidence of a material violation of law by the issuer, or by any officer, director, employee or agent of the issuer, to promptly report the evidence to the issuer's CLO or to both its CLO and CEO.

### 1. *Attorney*

The rules define an "attorney" as anyone licensed or otherwise qualified to practice law in any foreign or domestic jurisdiction, or who holds himself or herself out as licensed or otherwise qualified to practice law. However, the rules expressly exempt "non-appearing foreign attorneys", which they define as attorneys who:

- are licensed to practice law outside the United States;

- do not hold themselves out as licensed or qualified to practice U.S. federal or state securities law, and do not give legal advice regarding those laws; and
- either “appear and practice” before the Commission only incidentally to, and in the ordinary course of, the practice of law outside the United States, or “appear and practice” before the Commission only in consultation with counsel (other than another non-appearing foreign attorney) who is licensed in the United States.

Some commentators had been concerned that the definition of “attorney” would include individuals who do not hold legal positions or perform legal services, simply because they are licensed or qualified to practice law. However, the definition of “appearing and practicing” discussed below, while quite broad, nonetheless should avoid entangling those individuals.

## 2. *Appearing and Practicing*

The rules define “appearing and practicing” before the SEC quite broadly as:

- conducting business with the SEC, including communications in any form;
- representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation;
- advising an issuer regarding U.S. securities laws or the SEC’s rules or regulations with respect to any document that the attorney has notice will be filed with or submitted to the SEC; or
- advising an issuer regarding whether U.S. securities laws or the SEC’s rules or regulations require information or a statement, opinion or writing to be filed with or submitted to the SEC.

On the other hand, the rules make clear that “appearing and practicing” specifically *excludes* any attorney who:

- conducts any or all of the foregoing activities outside the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship (in other words, the existence of an attorney-client relationship with the issuer is a prerequisite); or
- is a “non-appearing foreign attorney” as described earlier.

Based on the above exclusion, an attorney who is employed by an issuer as a financial officer (and who does not provide legal services to the issuer), for example, would not be covered by the rules. Attorneys should be mindful,

however, that an attorney-client relationship may exist without an attorney-client engagement letter, and also may exist in some situations where the attorney-client privilege would not govern communications between the attorney and the issuer. The expectations and understandings between the attorney and the issuer may not be totally dispositive of the issue, but they will be important factors in determining the existence or absence of the requisite attorney-client relationship.

The SEC emphasized that for an attorney to be covered by the rule, he or she “must have notice that the document that he or she is preparing or assisting in preparing will be submitted” to the SEC. While that provision operates to exclude an attorney who prepares a document that he or she does not have reason to believe will be submitted to the SEC, it does not exclude an attorney simply because he or she practices in a non-securities or non-corporate law area. Regardless of one’s practice area, the rules will extend to an attorney who reviews or prepares discrete portions of an issuer’s periodic reports, for example. Also, the above focus on “documents” should *not* be viewed as a limitation of the rules’ coverage to matters that involve actual documentation work.

### **3. Broader Scope of “Issuer”**

The SEC has also emphasized that an “issuer”, for these purposes, includes entities controlled by the issuer, such as wholly-owned subsidiaries, when the attorney provides legal services to such an entity for the benefit or on behalf of the issuer. Accordingly, attorneys who work for a non-public subsidiary at the direction of the parent company issuer, where the work-product will be submitted to the SEC, or who discover evidence of a material violation while working for such a subsidiary at the direction of the parent issuer, would be deemed to be “representing” the issuer.

## **VI. “GOOD CITIZENSHIP” PROTOCOLS**

This category is somewhat of a “catch-all” for the few remaining important SOX-related reform matters I want to highlight. They are not necessarily less significant in their impact (or exemption) on foreign issuers, and they are not after-thoughts. And, of course, at some level, all that I have discussed earlier could fit within a concept of “good corporate citizenship”. They are each a bit *sui generis* relative to the rest of Sarbanes-Oxley, and to each other.

### **A. Prohibition of Personal Loans**

As everyone now knows, loans to directors and executive officers (so-called “personal loans”) are prohibited as a result of Section 402 of the Sarbanes-Oxley Act—affectionately called by many the “Bernie Ebbers provision.” It applies to all issuers, foreign and domestic, and has had a fairly sweeping impact in the United States. On the other hand, most foreign private issuers are located in countries that already prohibited or heavily regulated loans to most insiders, although most such countries do *not* prohibit all such loans to both all directors



and all executive officers. As a result, foreign private issuers in countries without a total prohibition on such loans should consider specifically the degree to which the Sarbanes-Oxley prohibitions differ from their home country laws, and whether or not any practices permitted under their home country laws are prohibited by Sarbanes-Oxley.

The personal loan prohibition raised immediate and numerous concerns, here and abroad, regarding a host of practices that arguably *could* be deemed to constitute a personal loan to an insider under the very broad and lax language of Section 402. These include typical arrangements such as split-dollar life insurance; advances of anticipatory bonuses, indemnification expense and relocation expenses; and even routine “cashless” exercises of stock options. These concerns led a group of 25 domestic law firms to prepare a unique document (a *de facto* consensus paper) setting forth presumed and preferred interpretations with respect to 17 types of arrangements that the prohibition theoretically might reach. The consensus paper also concluded generally that Section 402 should be interpreted narrowly.

The SEC has not expressed a disagreement with the specific positions taken, or the desired and presumed narrow interpretation for Section 402 set forth, in the consensus paper, and it has had an opportunity to do so. In fact, members of the Staff have indicated informally that the SEC does not intend to give any guidance on the matter. While care is certainly warranted in considering possible *de facto* loan arrangements, fear seems unwarranted in situations that involve prudent and reasonable business practices and rationales, where the loan element is theoretical and the transaction does not expose the company to financial risk for the benefit of the executive.

## **B. Pension Blackout Periods**

The provisions of Sarbanes-Oxley (and Regulation BTR) that prohibit directors and executive officers of issuers from certain stock trading during pension plan “blackout periods” apply for certain foreign private issuers in the same manner as for domestic issuers, and all covered issuers must give blackout notices to directors and executive officers. The threshold for application to foreign private issuers is that (i) the subject pension plan has 50% or more of its participants or beneficiaries located in the United States who are subject to a temporary trading suspension, and (ii) such affected participants and beneficiaries represent more than 15% of the worldwide employees of the issuer and consolidated subsidiaries, or number 50,000 or more persons.

## **C. Accelerated Section 16 Filings**

The “insiders” of foreign private issuers have historically been exempt from compliance with the reporting requirements of Section 16 of the Exchange Act. They remain exempt, and so are not subject to the SEC’s new SOX-related rules that require Section 16(a) filers to electronically file their Form 4 beneficial

ownership reports within two business days following the transaction resulting in a change in ownership. Foreign private issuers are also exempt, therefore, from the requirement to post such reports on their Web sites.

## VII. CONCLUDING OBSERVATIONS

Traditionally, foreign private issuers have been exempted from much of the Exchange Act's regime for reporting and other disclosure-related corporate governance requirements that apply generally to domestic and other foreign non-governmental issuers. It is possible to read certain provisions of Sarbanes-Oxley as having changed this more dramatically than it intended. As I indicated in the introductory discussion in Part I, however, Sarbanes-Oxley was passed very quickly for such a massive legislative initiative. Many of its provisions were added without full hearings by essentially last-minute floor amendments. Accordingly, some of its provisions contain ambiguities and can be read to have unintended consequences for foreign issuers and as well others.

Until the SEC or Congress acts specifically to address such matters, some confusion will continue to exist, and so careful and thoughtful positions should be the norm for all issuers and their directors and managements. However, as also discussed above, the fundamental principles and objective of Sarbanes-Oxley are quite clear, and much of the ambiguity or seeming uncertainty about the intent or reach of specific provisions can be resolved by faithful and purposeful analyses of issues consistent with the spirit of those principles and objective.

For foreign private issuers concerned about an ambiguity or the uncertainty of an apparent application to them of a questionable provision, there is some guarded comfort in the comment by Senator Michael Enzi during the Congressional conference committee meetings to approve the final version of the Sarbanes-Oxley Act. I again highlight Senator Enzi's statement, observing that the legislation should not apply equally to domestic and foreign private issuers, Senator Enzi stated:

"I believe we need to be clear with respect to the area of foreign issuers and their coverage under the bill's broad definitions . . . Foreign issuers are not part of the current problems being seen in the US capital markets, and I do not believe it was the intent of the conferees to export US standard, disregarding the sovereignty of other countries as well as their regulators."

While the statement is overly broad as to Congress' intended impact, if read literally rather than purposefully, its basic sentiment is accurate. The SEC has echoed that sentiment in much of its rulemaking.

That said, foreign private issuers, like everyone else, should make no mistake about it. Sarbanes-Oxley intended to initiate a new era of corporate governance—extending into the "global village" of modern business—for public

companies who access U.S. capital markets. In this new era, any issuer must take a much keener and aggressive interest in its public disclosures (especially about financial matters and arrangements that affect financial condition or results), and in the relationships and behavior of its corporate actors that could sublimate the interest of public investors to the personal interests of such corporate actors. Reasonable procedures and practices that would facilitate such efforts, if they appear to be required by some corporate governance rule, should probably be followed (as if they are clearly required), rather than ignored or avoided in the close-call situation.

**W. Randy Eddy**  
**Kilpatrick Stockton LLP**  
**August 15, 2003**

**APPENDIX A**

**Summary of Comparison of NYSE  
and NASDAQ Corporate Governance Proposals**

**Alan T. Rosselot**  
**Corporate Group, Securities Team**

**KILPATRICK STOCKTON LLP**

## Summary Comparison of NYSE and NASDAQ Corporate Governance Proposals As of August 12, 2003

The following summarizes and compares the most significant corporate governance proposals of the New York Stock Exchange and The Nasdaq Stock Market. This summary discusses only proposed revisions to the listing standard, and therefore does not address standards that are not proposed to be changed. This comparison is only a summary, and is not legal advice and does not address specific factual situations.

The summary of the NYSE proposal is based on the April 4, 2003 amended rule filing by the NYSE with the SEC. The filing is subject to review and approval by the SEC. The summary of the NASDAQ proposal is based on the February 26, 2003 Summary of Nasdaq Corporate Governance Proposals. These proposals may be revised in some respects as the result of the SEC's attempts to harmonize certain of the NYSE and NASDAQ proposals prior to final adoption. This summary does not address listing standards relating to shareholder approval of equity compensation plans, which were approved on June 30, 2003.

New York Stock Exchange Proposals	The Nasdaq Stock Market Proposals
<b>Independence of Directors</b>	
<ul style="list-style-type: none"> <li>• Listed companies would be required to have a board consisting of a majority of independent directors.</li> <li>• A controlled company (a company of which more than 50% of voting power is held by an individual, group or another company) would be able to choose not to have a majority of independent directors, but would be required to disclose that choice in its annual meeting proxy statement, and would be required to have a three person audit committee composed entirely of independent directors.</li> </ul>	<ul style="list-style-type: none"> <li>• Listed companies would be required to have a board consisting of a majority of independent directors.</li> <li>• A controlled company exception would apply.</li> </ul>
<b>Definition of Independence</b>	
<ul style="list-style-type: none"> <li>• For a director to be "independent," the board would be required to determine affirmatively that the director has no "material relationship" with the company and to disclose those determinations in its annual meeting proxy statement. <ul style="list-style-type: none"> <li>• A director who receives, or whose immediate family member receives, more than \$100,000 per year in direct compensation from the company, other than director or committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is presumed not to be independent until five years after he or she ceases to receive more than \$100,000 per year in such compensation.</li> <li>• A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company is not "independent" until five years after the end of either the affiliation or the auditing relationship.</li> <li>• A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serves on that compensation committee is not "independent" until five years after the end of such service or the employment relationship.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Independent director would be prohibited from receiving any payments (including political contributions) in excess of \$60,000 other than for board service, including payments to a family member of the director.</li> <li>• A director would not be considered independent if the company makes payments to a charity where the director is an executive officer, and such payments exceed the greater of \$200,000 or 5% percent of either the company's or the charity's gross revenues.</li> <li>• A shareholder owning or controlling 20% or more of the company's voting securities would not be considered independent.</li> <li>• Any relative of an executive officer of a company or its parent or subsidiaries would not be considered independent.</li> <li>• Former partners or employees of outside auditors who worked on a company's audit engagement would not be deemed independent.</li> <li>• A three-year "cooling off" period would be imposed in the case of (1) interlocking compensation committees; (2) the receipt by the director or a family member of the director of any payments in excess of \$60,000, other than for board service; or (3) persons who worked on the company's audit engagement,</li> </ul>

<b>New York Stock Exchange Proposals</b>	<b>The Nasdaq Stock Market Proposals</b>
<ul style="list-style-type: none"> <li>A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of another company (1) that accounts for at least 2% or \$1 million, whichever is greater, of the company's gross revenues, or (2) for which the company accounts for at least 2% or \$1 million, whichever is greater, of the other company's consolidated gross revenues, in each case is not "independent" until five years after falling below the applicable threshold.</li> </ul>	<p>during which such persons would not be deemed independent.</p>
<b>Meetings of Non-Management/Independent Directors</b>	
<p>Non-management directors would be required to meet in regular executive sessions without management.</p>	<ul style="list-style-type: none"> <li>Independent directors would be required to meet in regular sessions without non-independent members.</li> </ul>
<b>Nominating/Corporate Governance Committee</b>	
<ul style="list-style-type: none"> <li>Listed companies would be required to have a nominating/corporate governance committee (or equivalent) comprised solely of independent directors.</li> <li>The committee would be required to have a written charter that addresses: <ul style="list-style-type: none"> <li>the committee's purpose;</li> <li>the committee's goals and responsibilities; and</li> <li>an annual performance evaluation of the committee.</li> </ul> </li> <li>The NYSE recommends that the committee's charter address: <ul style="list-style-type: none"> <li>committee member qualifications;</li> <li>committee member appointment and removal;</li> <li>committee structure and operations; and</li> <li>committee reporting to the Board.</li> </ul> </li> </ul> <p>The controlled company exception would apply.</p>	<ul style="list-style-type: none"> <li>Listed companies would be required to obtain independent director approval of director nominations, either by an independent nominating committee or by a majority of independent directors.</li> <li>A single non-independent director would be permitted to serve on this committee (1) if the individual is an officer who owns or controls more than 20% of the issuer's voting securities or (2) pursuant to an "exceptional and limited circumstances" exception.</li> <li>A controlled company exception would apply.</li> </ul>
<b>Compensation Committee</b>	
<ul style="list-style-type: none"> <li>Listed companies would be required to have a compensation committee (or equivalent) comprised solely of independent directors.</li> <li>The committee would be required to have a written charter that addresses: <ul style="list-style-type: none"> <li>the committee's purpose;</li> <li>the committee's goals and responsibilities, which must include <ul style="list-style-type: none"> <li>the review and approval of goals and objectives relevant to CEO compensation, CEO's performance, and compensation level; and</li> <li>recommendations regarding incentive-compensation plans and equity-based plans; and</li> </ul> </li> <li>an annual performance evaluation of the committee.</li> </ul> </li> <li>The NYSE recommends that the committee's charter address: <ul style="list-style-type: none"> <li>committee member qualifications;</li> <li>committee member appointment and removal;</li> <li>committee structure and operations; and</li> <li>committee reporting to the Board.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Listed companies would be required to obtain independent director approval of CEO compensation, either by an independent compensation committee or by a majority of independent directors meeting in executive session.</li> <li>Listed companies would be required to obtain independent director approval of other executive officer compensation, either by an independent compensation committee or by a majority of independent directors.</li> <li>A single non-independent director, who is not an officer, would be permitted to serve on this committee, for up to two years, pursuant to an "exceptional and limited circumstances" exception.</li> <li>A controlled company exception would apply.</li> </ul>

New York Stock Exchange Proposals	The Nasdaq Stock Market Proposals
<ul style="list-style-type: none"> <li>The committee would have the authority to retain and terminate a consulting firm to assist in evaluating and determining compensation.</li> <li>The controlled company exception would apply.</li> </ul>	
<p><b>Independence and Qualifications of Audit Committee Members</b></p>	
<ul style="list-style-type: none"> <li>The independence requirements of Rule 10A-3(b)(1) under the Exchange Act apply, subject to the exceptions in Rule 10A-3(c).</li> <li>Director fees would be the sole compensation that could be received from the company, but audit committee members can receive additional compensation for their committee work.</li> <li>Each member of the committee must be financially literate or become financially literate within a reasonable time after his or her appointment. At least one member of the committee must have accounting or related financial management expertise (satisfaction of the "audit committee financial expert" standard under Item 401(e) of Regulation S-K will satisfy this standard).</li> <li>The board would be required to evaluate whether simultaneous service on the audit committees of multiple companies would impair ability of a member to serve.</li> </ul>	<ul style="list-style-type: none"> <li>Audit committee members could not receive any payment from the company other than payment for board or committee service.</li> <li>Audit committee members can not be an affiliated person of the issuer or any subsidiary. In this regard, an audit committee member cannot own or control 20% or more of the issuer's voting securities.</li> <li>All audit committee members would need be able to read and understand financial statements at the time of their appointment rather than "within a reasonable period of time" thereafter.</li> <li>The listing standards would limit the time that a non-independent director may serve on the audit committee pursuant to "exceptional and limited circumstances" to two years, and prohibit that person from serving as the chair of the audit committee.</li> </ul> <p>Issuers will continue to be required to have at least one member of the audit committee that has past employment experience in finance or accounting, requisite professional certification in accounting or comparable experience which results in the individual's financial sophistication.</p>
<p><b>Responsibility and Authority of Audit Committee</b></p>	
<ul style="list-style-type: none"> <li>The company must have a minimum three person committee composed solely of independent directors.</li> <li>The committee would be required to have a written charter that addresses:                         <ul style="list-style-type: none"> <li>the committee's purpose;</li> <li>the committee's duties and responsibilities; and</li> <li>an annual performance evaluation of the committee.</li> </ul> </li> <li>The NYSE recommends that the committee's charter address:                         <ul style="list-style-type: none"> <li>committee member qualifications;</li> <li>committee member appointment and removal;</li> <li>committee structure and operations; and</li> <li>committee reporting to the Board.</li> </ul> </li> <li>The duties of the committee must include:                         <ul style="list-style-type: none"> <li>directly appointing, retaining, compensating, evaluating, and terminating the company's independent auditors;</li> <li>establishing procedures for the receipt, retention and treatment of complaints from employees on accounting, internal accounting controls or auditing matters;</li> <li>obtaining advice and assistance from outside legal, accounting or other advisors as the committee deems necessary;</li> <li>receiving appropriate funding for payment of</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>The committee would have the sole authority to appoint, determine funding for, and oversee the outside auditors.</li> <li>The committee would have to approve, in advance, the provision by the auditor of all permissible non-audit services.</li> <li>The committee would have the authority to engage and determine funding for independent counsel and other advisors.</li> <li>The committee would have to establish procedures for the receipt, retention and treatment of complaints regarding accounting, international accounting controls or auditing matters.</li> </ul>

New York Stock Exchange Proposals	The Nasdaq Stock Market Proposals
<p>compensation to outside legal, accounting or other advisors;</p> <ul style="list-style-type: none"> <li>○ obtaining and reviewing, at least annually, a report by the independent auditor, describing the auditor's policies and procedures;</li> <li>○ discussing the annual audited financial statements and quarterly financial statements with management and the independent auditor;</li> <li>○ discussing earnings press releases;</li> <li>○ discussing policies with respect to risk management and risk assessment;</li> <li>○ meeting separately, with management, with internal auditors and with independent auditors at periodic intervals;</li> <li>○ reviewing with the independent auditor any audit problems or difficulties with management's response;</li> <li>○ setting clear hiring policies for employees or former employees of the independent auditors; and</li> <li>○ reporting regularly to the board.</li> </ul> <ul style="list-style-type: none"> <li>● Each company would be required to have an internal audit function.</li> </ul>	
<b>Adoption and Disclosure of Corporate Governance Guidelines</b>	
<ul style="list-style-type: none"> <li>● Listed companies would be required to adopt and disclose corporate governance guidelines.</li> <li>● The NYSE recommends that the guidelines address the following subjects: <ul style="list-style-type: none"> <li>○ director qualification standards;</li> <li>○ director responsibilities;</li> <li>○ director access to management and, as necessary and appropriate, independent advisors;</li> <li>○ director compensation;</li> <li>○ director orientation and continuing education;</li> <li>○ management succession; and</li> <li>○ annual performance evaluation of the board.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>● Listed companies would be required to provide continuing education for all directors, pursuant to rules to be developed by the Nasdaq Listing and Hearing Review Council and to be approved by the Nasdaq Board. (This proposal is under consideration and has not been filed with the SEC.)</li> </ul>
<b>Adoption and Disclosure of Code of Business Conduct and Ethics</b>	
<ul style="list-style-type: none"> <li>● Listed companies would be required to adopt and disclose a code of business conduct and ethics for directors, officers, and employees, and promptly disclose any waivers of the code for executive officers and directors.</li> <li>● The NYSE recommends that the code address the following subjects: <ul style="list-style-type: none"> <li>○ conflicts of interest;</li> <li>○ corporate opportunities;</li> <li>○ confidentiality;</li> <li>○ fair dealing;</li> <li>○ protection and proper use of company assets;</li> <li>○ compliance with laws, rules and regulations (including insider trading laws); and</li> <li>○ encouraging the reporting of any illegal or unethical behavior.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>● Listed companies would be required to adopt a code of conduct addressing, at a minimum, issues necessary to comply with rules promulgated by the SEC. Waivers could only be granted by independent directors. The code of conduct would be required to be publicly available.</li> </ul>



New York Stock Exchange Proposals	The Nasdaq Stock Market Proposals
<b>CEO Certification of Compliance with Listing Standards</b>	
<ul style="list-style-type: none"> <li>Each listed company CEO would be required to certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards.</li> </ul>	<i>No comparable proposal.</i>
<b>Public Reprimand Letters</b>	
<ul style="list-style-type: none"> <li>The NYSE would be allowed to issue a public reprimand letter to any listed company that violates an NYSE listing standard (as opposed to necessarily suspending trading or delisting the company's stock).</li> </ul>	<i>No comparable proposal.</i>

## **APPENDIX B**

# SEC Issues Final Rules on Use of Non-GAAP Financial Measures and Furnishings Earnings Releases on Form 8-K

## **SECURITIES LEGAL ALERT**



## SECURITIES LEGAL ALERT

March 11, 2003

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

### SEC Issues Final Rules on Use of Non-GAAP Financial Measures and Furnishing Earnings Releases on Form 8-K

In our *Securities Legal Alert* dated December 3, 2002, we discussed the SEC's proposed rules to implement Section 401(b) of the Sarbanes-Oxley Act of 2002. The SEC has adopted final rules setting forth the following principal requirements:

- Public disclosure of non-GAAP financial measures must be accompanied by the most directly comparable GAAP measures.
- Non-GAAP financial measures must be reconciled to the most directly comparable GAAP measures.
- Issuers must furnish earnings releases and similar public disclosures about historical financial performances (oral as well as written) to the SEC on Form 8-K.

In addition to these affirmative items, the final rules contain a number of significant prohibitions, as discussed below.

These rules are first effective for disclosures made as of March 28, 2003; however, the special portion of the new rules that is applicable only to disclosures made in SEC filings is effective only for filings covering periods ending after March 28. The requirement to furnish disclosures containing non-GAAP financial measures on Form 8-K is effective for disclosures made after March 28.

The rules apply to any SEC reporting company, other than investment companies. Their application to foreign issuers differs in some important respects from their application to domestic issuers—we do not cover these distinctions here.

#### SEC Filing vs. Other Public Disclosure

The new rules regarding non-GAAP financial measures are contained in two places:

- New Regulation G, which applies to any public disclosure—not only SEC filings, but also press releases and website and oral disclosures.
- New Item 10 of Regulation S-K (and Regulation S-B for small issuers), which provides additional rules for SEC filings only.

Under the final rules, earnings releases (and certain similar public disclosures) must be “furnished” to the SEC pursuant to new Item 12 of Form 8-K, but they do not need to be “filed”, as the SEC had initially proposed to require. Consequently, these releases furnished on Form 8-K will not be subject to Item 10 of Regulation S-K, which applies only to SEC filings.

Although the Regulation S-K requirements that apply only to SEC filings cover some additional, more stringent matters, companies should be wary of over-reliance on these distinctions in assessing compliance with Regulation G. For example, if an issuer would be prohibited by Item 10 of Regulation S-K from adjusting a measure for a “non-recurring” charge in an SEC filing, the issuer should think twice before disclosing the same adjustment in a press release or in another non-filed format, even though Regulation G might not expressly forbid it in that context. It is possible that Regulation G's general prohibition against misleading uses of non-GAAP financial measures in any type of public disclosure may be interpreted in some situations in light of the additional specific matters contained in Item 10 of Regulation S-K.

#### What is a Non-GAAP Measure?

**General.** The basic definition of non-GAAP financial measure is a numerical measure of a company's historical or future financial performance, financial position or cash flows that:



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- excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable GAAP measure in the financial statements; or
- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP measure.

**What's Included in the Definition:** Non-GAAP financial measures include any item that has the effect of depicting either:

- a measure of performance that is different from net income or similar performance measures in the financial statements, or
- a measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP.

Consequently, a measure of operating income that excludes one or more expenses, or a revenue item that is characterized as "non-recurring," is a non-GAAP financial measure. And, of course, EBIT or EBITDA are such measures that are subject to the rules.

**What's Not Included:** Non-GAAP financial measures do not include:

- operating and other statistical measures that are not derived from a GAAP-required item in the issuer's financial statements (such as unit sales, numbers of employees, numbers of subscribers, or numbers of advertisers); and
- ratios or statistical measures that are calculated using exclusively one or both of (a) GAAP measures and (b) operating measures or other measures that are not non-GAAP measures.

Permissible ratios and measures include sales per square foot and same store sales (assuming in both cases that the sales figure is derived from GAAP), and operating margin calculated by dividing revenues into operating income, where

both revenue and operating income are GAAP figures.

Non-GAAP financial measures also do not include numerical measures that do not provide information different from the comparable GAAP measure, including:

- disclosure of amounts of expected indebtedness;
- disclosure of amounts of repayments that have been planned or decided upon but not yet made;
- disclosure of estimated revenues or expenses of a new product line, so long as such amounts were estimated according to GAAP; and
- GAAP-required segment information.

Finally, the definition does not include:

- non-GAAP disclosure required by regulators;
- non-GAAP per share information; and
- non-GAAP information about a business combination transaction that is presented in a business combination communication subject to SEC rules.

#### Common Elements of Both Sets of Rules

Regulation G and Item 10 of Regulation S-K both require that, whenever a company or person acting on its behalf publicly discloses material information that includes a non-GAAP financial measure, the non-GAAP measure must be accompanied by:

- a presentation of the most directly comparable financial measure as calculated and presented in accordance with GAAP; and
- a quantitative reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP measure and such most directly comparable GAAP measure.

In addition to the above common affirmative disclosure requirements, all non-GAAP financial measures are subject to the following condition. Neither a company nor a person acting on its



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behalf can disclose publicly a non-GAAP financial measure that, taken together with the material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP measure, in light of the circumstances under which it is presented, not misleading.

**Forward-Looking Information.** If the non-GAAP financial measure is forward-looking, the quantitative reconciliation to the most directly comparable GAAP measure must be provided “to the extent available without unreasonable efforts”. If the forward-looking GAAP measure is not available, companies must disclose that fact, disclose the probable significance of its unavailability, and provide whatever reconciling information is available without unreasonable efforts.

### **Additional Requirements of Regulation S-K Applicable to SEC Filings**

As previously noted, Item 10 of Regulation S-K, applicable only to SEC-filed documents, contains express requirements beyond those applicable to public disclosures generally pursuant to Regulation G.

All SEC filings containing non-GAAP financial measures must disclose:

- the reasons why management believes the non-GAAP financial measure provides useful information to investors; and
- to the extent material, any additional reasons why management uses the non-GAAP financial measure.

The fact that analysts use the particular measure will not be considered a sufficient reason. To the extent management’s reasons have not changed at the time of a particular filing, companies can rely on complying statements in their most recent Form 10-K (or a more recent filing), provided the statements are updated as necessary.

information and discussion accompanying the measure, contains an untrue statement of a By virtue of requirements included in new Item 12 of Form 8-K (which is discussed below), the requirement for these statements also applies to non-filed public disclosures (that are otherwise only subject to Regulation G) in connection with “furnishing” those disclosures to the SEC on Form 8-K. But, the prohibitions of Regulation S-K described next do not apply to non-filed disclosures.

Under new Item 10 of Regulation S-K, a company must not, in an SEC filing:

- exclude charges or liabilities that require cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures (EBIT and EBITDA are excepted from this prohibition);
- adjust a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent, or unusual, when (a) it is reasonably likely that the item will recur within two years, or (b) there was a similar item within the prior two years;
- present non-GAAP financial measures on the face of GAAP financial statements or notes thereto;
- present non-GAAP financial measures on the face of any pro forma historical financial information related to business combinations or significant asset sales or dispositions that is required pursuant to Article 11 of Regulation S-X; or
- use titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP measures.

### **Oral Disclosures**

If a non-GAAP financial measure is used in a public disclosure that is transmitted orally—including telephonically, by webcast or by broadcast—companies may provide the



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required Regulation G information by posting it on the company's website and disclosing the location and availability of the required information during the presentation. As discussed below, such oral and similar disclosures are subject to the Form 8-K furnishing requirement, unless the disclosure is covered under the exception applicable to the typical earnings conference call.

### **Furnishing Earnings Releases, Etc. on Form 8-K**

**General.** The SEC has added new Item 12 to Form 8-K to require companies to "furnish" to the SEC, within five business days of the disclosure, any written or oral public announcement or release, or update of the foregoing, disclosing material non-public information regarding the company's results of operations or financial condition for completed quarterly or annual fiscal periods.

While the requirement covers disclosures relating to the historical financial performance of a company, such as the typical earnings release, it does not apply to disclosures that are solely forward-looking, such as earnings estimates.

The new rules do not require that companies disseminate earnings information prior to filing the SEC report for the most recently completed fiscal period. But, if a company does so, the new furnishing requirement comes into play.

**Furnishing vs. Filing.** Pursuant to the new disclosure item, information is "furnished" to the SEC, rather than filed, even though a Form 8-K is used. The differences between furnishing and filing information is that, in the case of the former:

- furnished information that contains non-GAAP financial measures are not subject to Item 10 of Regulation S-K;
- furnished information does not become part of the issuer's reported information and, therefore, does not create liability exposure under Section 18 of the Securities Exchange Act of 1934; and

- for the above reason, furnished information is not automatically incorporated by reference into previously-filed registration statements on Form S-3 or S-8, and consequently does not subject the issuer to liability under Section 11 of the Securities Act of 1933.

It should be noted, however, that any materially deficient non-GAAP financial measure or other disclosure in the underlying material being furnished would be subject, in any case, to the ubiquitous antifraud remedies under Section 10(b) and Rule 10b-5 of the Securities Exchange Act. It is only that the "furnishing" per se on Form 8-K does not create an additional liability exposure to a private action.

**Reasons for Use.** It is also important to note that new Item 12 of Form 8-K incorporates the portion of the Regulation S-K requirements for statements about the company's belief in the utility of non-GAAP financial measures it uses and its reasons for their use. Accordingly, as discussed above, that information must be included with the "furnished" document (unless adequately disclosed in an earlier annual or quarterly report), even though it is not required in the public disclosure as initially made.

**Earnings Conference Calls.** The furnishing requirements apply to oral as well as written disclosure, but the rules contain an exception that should cover a typical earnings conference call. Companies are not required to furnish on a new Form 8-K material non-public information that is disclosed orally, telephonically, by webcast, by broadcast, or by similar means if:

- the information is provided as part of a presentation that is complementary to, and initially occurs within 48 hours after, a related, written announcement or release that has been furnished on Form 8-K prior to the presentation;
- the presentation is broadly accessible to the public by dial-in conference call, by webcast, by broadcast, or by similar means;



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- the financial and other statistical information contained in the presentation is provided on the company's web site, together with any required Regulation G disclosure; and
- the presentation was announced in advance by a widely disseminated press release that included instructions as to when and how to access the presentation, and the location on the company's website where the information would be available.

Most companies that release periodic earnings data prior to filing the related SEC report for the fiscal period already follow substantially similar procedures to comply with Regulation FD (discussed below). The principal addition to these procedures is that the earnings release, in addition to dissemination via the news wire services, must be furnished on Form 8-K pursuant to new Item 12 prior to the call.

An important question is to what extent can company personnel venture outside the subject matter of the furnished earnings release in the subsequent conference call and still be covered by the exception. The SEC has stated that it does not intend to change "current practices where presentations include information that, although not already included in the related, written release or announcement, is complementary thereto." However, the SEC also does not want to encourage a shift in the disclosure emphasis from the release to the oral presentation. This approach seems largely consistent with Regulation FD, which permits a company to go outside of its earnings release in the conference call, provided that the company follows procedures similar to those described above.

### Regulation FD and the New Rules

Companies should be cognizant of the relationship (and differences) between new Item 12 of Form 8-K and Regulation FD, the SEC's rule prohibiting selective disclosure of material non-public information to certain prohibited persons, such as analysts and other investment professionals.

Regulation FD requires simultaneous disclosure to the public, via press release or similar means such as a Form 8-K, of any material non-public information disclosed to one of the prohibited recipients. If a company is required to publicly disclose material non-public historical financial information because of Regulation FD, the company will now be required to "furnish" such information on Form 8-K pursuant to new Item 12 as well. Moreover, to the extent such information contains non-GAAP financial measures, the disclosure rules of Regulation G also will apply.

Regulation FD requires simultaneous public disclosure if a selective private disclosure is made, while the new rules allow a company five business days to furnish subject information on Form 8-K, and even provides an exception if the company can meet the criteria previously described that should cover earnings conference calls. Moreover, the new Form 8-K requirement is only triggered if the information relates to historical financial performance, whereas Regulation FD is triggered by any material non-public disclosure.

Accordingly, compliance with the new rules does not ensure compliance with Regulation FD. Companies necessarily will need to focus attention to both sets of requirements.

*The information contained in this Legal Alert is not intended as legal advice or as an opinion on specific facts. For more information about these issues, please contact the author(s) of this Legal Alert, Ben Barkley, Randy Eaddy, Neil Falis, Rey Pascual, David Stockton, Mike Trotter or Betty Wren, or your existing firm contact at (404) 815-6500. The invitation to contact the author is not to be construed as a solicitation for legal work in any jurisdiction in which the author is not admitted to practice. There will be no charge for the initial contact. Any attorney/client relationship will be confirmed in writing. You can also contact us through our Web site at [www.KilpatrickStockton.com](http://www.KilpatrickStockton.com).*

## **APPENDIX C**

# **SEC Issue Final Rules on Audit Committee Standards**

## **SECURITIES LEGAL ALERT**





# SECURITIES LEGAL ALERT

April 28, 2003

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

## SEC Issues Final Rules on Audit Committee Standards

### Overview

Section 301 of the Sarbanes-Oxley Act of 2002 prohibits national securities exchanges and national securities associations from listing companies that are not in compliance with the following requirements:

- each member of the audit committee must be “independent”, as defined pursuant to the Act;
- the audit committee must be directly responsible for the appointment, compensation, retention and oversight of the work of the listed company’s auditor, and the auditor must report directly to the audit committee;
- the audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the listed company of concerns regarding questionable accounting or auditing matters;
- the audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- the listed company must provide appropriate funding for the audit committee.

The SEC has now issued final rules implementing these provisions, and which also clarify and expand upon the requirements of Section 301. The rules will apply to issuers that have any securities (not only voting equity securities) listed on any national securities exchange or through a national securities association.

### Independence

Under Section 301 of the Act, a member of a listed company’s audit committee is not independent if he or she (a) accepts, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company, other than in his or her capacity as a member of the board of directors or a board

committee; or (b) is an “affiliated person” of the listed company.

Under the SEC’s final rules, the prohibition against accepting any compensatory fee includes the acceptance of such a fee by an entity (a) in which the director is a partner or member or occupies a similar position, (other than where the director has no active role in providing services to the entity), and (b) that provides accounting, consulting, legal, investment banking, financial or other advisory services to the listed company. It also generally precludes the acceptance of such a fee by a spouse or minor children of a director. The rules do not contain either a de minimus exception or an exception for “limited and exceptional circumstances”, as currently provided under existing Nasdaq rules.

The prohibition on compensatory fees will not, however, preclude other ordinary course commercial relationships between a listed company and an entity with which a director has a relationship, although certain such relationships may be prohibited under rules proposed by the various stock exchanges. In addition, the prohibitions only apply to current relationships and do not include a “look back” period, as is contemplated under separate rules proposed by the various stock exchanges.

The prohibition on compensatory fees will not include fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed company, provided that such compensation is not contingent in any way on continued service.

Under the rules, an “affiliated person” is defined consistent with the definition of “affiliate” under existing federal securities laws -- i.e., as a person who directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the listed company. “Control” as used in the rules is defined as the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a


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person, whether through the ownership of voting securities, by contract or otherwise.

The rules include a safe harbor for the absence of "control". A person will be deemed not to "control" a company if the person is not the beneficial owner, directly or indirectly, of more than 10% of any class of equity securities of the company and is not an executive officer of the company. Outside the safe harbor, a listed company may still establish that an audit committee member is not an affiliated person based on a facts and circumstances analysis.

However, under the rules, executive officers, directors who are also employees of an affiliate, and general partners and managing members of an affiliate will automatically be deemed to be affiliates.

### **Exemptions from Independence Requirement**

The final rules contain two exemptions from the independence rules:

- newly listed companies will not immediately be required to comply with the independence requirements; instead, a newly public company's audit committee must have one fully independent member at the time of the company's initial listing, a majority of independent members within 90 days of initial listing, and a fully independent audit committee within one year of initial listing.
- an audit committee member may sit on the board of directors of a listed company and any affiliate of that company so long as, except for serving on such boards, the member otherwise meets the independence requirements for each such entity, including the receipt of only ordinary course compensation for serving as a member of the board of directors, audit committee or other board committee of each such entity.

A listed company availing itself of one of these exemptions must disclose that fact in its annual report and proxy statement, and provide the company's assessment of how, if at all, such reliance materially and adversely affects the ability of the

audit committee to act independently and perform its duties.

The rules also provide a limited exception for audit committee members who cease to be independent for reasons outside the member's reasonable control. The SEC referenced one such potential situation as where an audit committee member is a partner in a law firm that provides no services to the listed company on which the member sits, but the listed company later acquires another company that is a client of the member's law firm. In these types of limited circumstances, the audit committee member, with notice by the listed company to the applicable national securities exchange or association, could remain an audit committee member of the listed company until the earlier of the next annual meeting of the listed company or one year from the occurrence of the event that caused the member to lose his or her independence.

### **Responsibility for Independent Auditors**

The final rule regarding the authority of audit committees with respect to independent auditors provides that the audit committee of each listed company, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of the listed company's auditors (including resolution of disagreements between management and the auditor regarding financial reporting), and the auditors must report directly to the audit committee.

The SEC indicated that this requirement does not conflict with, and will not be affected by, any requirement that a listed company's shareholders elect, approve or ratify the selection of the listed company's auditor. If the listed company provides a recommendation or nomination for an auditor to its shareholders, the audit committee of the listed company will be responsible for making such recommendation or nomination.

### **Receipt of Complaints**



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The final rule regarding the establishment of procedures for complaints provides that an audit committee of a listed company must establish procedures for:

- the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters; and
- the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

The rules do not establish specific procedures for audit committees to follow; instead, the SEC emphasized that each company should have the flexibility to establish procedures that are most appropriate for the company's individual circumstances.

### Advisors and Funding

Under the final rules, an audit committee of a listed company must have the authority to engage independent counsel and other advisors as it determines necessary to carry out its duties. The SEC emphasized that such outside advisors can help educate audit committees on standards employed by audit committees of other comparable public companies.

The rules also mandate that each listed company must provide appropriate funding, as determined by the audit committee, for payment of compensation to the listed company's auditors and to any advisors employed by the audit committee. A listed company must also provide appropriate funding for the ordinary administrative expenses of the audit committee that are necessary or appropriate for carrying out its duties.

### Compliance with Standards

Under the final rules, each listed company will be required to promptly notify the national securities exchange or association when any executive officer of the listed company becomes aware of a material noncompliance with the audit committee

requirements. The rule contemplates, however, that listed companies will have an opportunity, presumably in accordance with existing delisting procedures of each national securities exchange or association, to cure any defects before delisting would be mandated.

### Timing

Each national securities exchange and association must provide to the SEC no later than July 15, 2003 proposed rules or rule amendments that comply with the requirements of the final rules. The final rules must be approved by the SEC no later than December 1, 2003. Each listed company (other than small business issuers) must be in compliance with the new listing rules by the earlier of (a) its first annual shareholders meeting after January 15, 2004, or (b) October 31, 2004. Listed companies that are small business issuers will have until July 31, 2005 to comply with the new listing rules.

The New York Stock Exchange, Nasdaq and the American Stock Exchange all have proposals for changes in their listing criteria pending before the SEC that purport to address the requirements of the rules, although all were submitted before the SEC rules became final.

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**APPENDIX D**

**SEC Proposes Rules  
on Auditor Independence**

**SECURITIES LEGAL ALERT**



## SECURITIES LEGAL ALERT

December 23, 2002

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

### SEC Proposes Rules on Auditor Independence

One of the most significant aspects of the Sarbanes-Oxley Act of 2002 is the series of new and enhanced "independence" requirements to which accounting firms that audit issuer financial statements are subject. Section 201 of the Act sets forth several prohibitions to sustaining an auditor's independence, and the Act directed the SEC to issue rules to implement these and other aspects of its independence initiatives. The SEC has now proposed those rules.

#### General Prohibitions and Related Requirements

Section 201 of the Act itself prohibits an accounting firm that audits an issuer's financial statements from providing to that issuer, contemporaneously with the audit, any of the following non-audit services:

- bookkeeping or other services related to the accounting records or financial statements of the issuer;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser, or investment banking services;
- legal services and expert services unrelated to the audit; and
- any other service that the Public Company Accounting Oversight Board (PCAOB) determines, by regulation, to be impermissible.

Other provisions of the Act (a) require an issuer's audit committee to pre-approve all audit and non-

audit services provided by the issuer's auditor that are not otherwise prohibited; (b) prohibit partners on an audit engagement team from providing audit services to an issuer for more than five consecutive years; (c) prohibit an accounting firm from auditing an issuer's financial statements if certain members of the issuer's management had been members of the accounting firm's audit engagement team within the one-year period preceding commencement of the audit; and (d) require auditors to report certain matters to an issuer's audit committee.

Many of the items covered under the Act already were prohibited under existing SEC rules. However, as proposed, the new rules expand on or clarify many of the existing standards.

#### Four Principles Underlying Prohibitions

In compiling the list of prohibited items, Congress sought to limit situations which could create a fundamental conflict of interest for the accounting firm. Accordingly, the list of prohibited items is based on four guiding principles:

- an auditor should not audit its own work
- an auditor should not function as part of management or as an employee of the audit client
- an auditor should not act as an advocate for the audit client
- an auditor should not be a promoter of the audit client's stock or other financial interests

These principles are especially important to decision-making about several types of non-audit services that are not categorically prohibited – such as legal services, expert services and tax services – but would be prohibited if they involved certain factors that compromise or tend to compromise



independence. Of particular note in the SEC proposed rules are their application of these principles to implement standards for these three types of conditionally prohibited services.

### **Certain Conditionally Prohibited Services**

Neither the Act nor the SEC proposed rules uses the term “conditionally prohibited,” but that concept aptly describes the treatment afforded to certain types of services that had become common for accounting firms to offer to clients, including legal, expert and tax services.

*Legal Services.* The proposed rule on legal services provides that an auditor would not be deemed independent if the firm provides any service to the audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided.

The SEC expressed the view that an auditor cannot be an advocate for a client while at the same time remain objective and impartial in performing its audit services. So, for example, auditors would be prohibited from representing an audit client in Tax Court. However, the SEC indicated that auditor representation of a client during the examination phase of an IRS audit would be permitted, even though such work might be considered to involve advocacy.

*Expert Services.* The proposed rule on expert services provides that an auditor would not be considered independent if the firm provides expert opinions for the audit client in connection with legal, administrative or regulatory proceedings, or acts as an advocate for an audit client in such proceedings.

The prohibition would extend to situations where the auditor is engaged by the audit client’s legal counsel to provide expert witness or other services, including accounting advice, opinions or forensic accounting services, in connection with the client’s participation in a legal, administrative or regulatory proceeding.

However, an auditor would remain able to assist a client’s audit committee in fulfilling its responsibilities in connection with the financial reporting process. For example, an auditor would not be impaired if it assisted an audit committee in conducting an investigation into an accounting impropriety, so long as the auditor did not assume the role of an advocate in the investigation.

*Tax Services.* Tax services, like any other non-prohibited, non-audit service, may be provided by an auditor to an audit client if the services are pre-approved by the audit committee. However, the SEC noted that classifying a service as a “tax service” would not necessarily mean that such service would be permitted.

To determine if a service is prohibited, the SEC recommended that the accounting firm and the audit committee evaluate whether the service falls under one of the prohibited categories, based on the four principles described above. For example, the SEC indicated that auditors would be prohibited from performing “tax shelter” strategy work for an audit client, because that work might require the auditor to audit his or her own work, to assume a management function, or to become a client’s advocate on a particular tax issue. Likewise, the SEC indicated that tax opinions may be prohibited in situations where the auditor may be serving as an advocate for the client.



## Cooling-Off Periods

The Act prohibits a registered accounting firm from performing an audit for an issuer if the chief executive officer, controller, chief financial officer or chief accounting officer of the issuer was employed by that accounting firm and participated in any capacity in the audit of that issuer during the one-year period preceding the date of initiation of the audit.

Under rules implementing that provision, an accounting firm would not be permitted to audit an issuer if an audit engagement team member of the accounting firm was employed in a “financial reporting oversight role” by the issuer within the specified one-year period. The term “financial reporting oversight role” refers to a person who has direct responsibility for oversight over those who prepare the issuer’s financial statements and related information that is included in filings with the SEC.

As proposed, the one-year prohibition would begin when the accountant began the current fiscal year’s audit or, if earlier, when the accountant began review procedures necessary to conduct a timely review of the issuer’s quarterly financial information associated with the current fiscal year.

## Partner Rotation

Section 203 of the Act prohibits an accounting firm from providing audit services to an issuer if the lead or coordinating audit partner, or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the five previous fiscal years of that issuer.

The proposed rules would expand this provision of the Act to cover all partners who provide audit services to the issuer. The coverage would include the lead partner, the concurring review partner, the

client service partner and other “line” partners directly involved in the performance of the audit. Coverage also could include tax partners, to the extent that they provide services related to the audit engagement. Partners assigned to “national office” duties would not be subject to the rotation requirement.

The proposed rules also prohibit any covered partner from returning to the engagement for five years, although the SEC indicated that all partners on an audit engagement would not be required to rotate at the same time.

## Audit Committee Approval of Services

The proposed rules would require each issuer’s audit committee to pre-approve all engagements for audit, review or attest services. The rules also would generally require approval of all permissible non-audit services, either by the full audit committee or through detailed policies and procedures established by the audit committee.

## Prohibited Compensation

The proposed rules provide that an accountant would not be considered independent if, at any point during the engagement period, any partner, principal or shareholder of the accounting firm who is a member of the audit engagement team earns or receives compensation based on the performance, or procuring, of engagements with that audit client to perform non-audit services. This rule is intended to reduce an accounting firm’s incentive to compromise its accounting judgments to avoid losing the prospect for future non-audit business from the client.

## Communications with Audit Committees



The SEC proposes to require each accounting firm that audits an issuer's financial statements to report to the issuer's audit committee, prior to the filing of an audit report with the SEC, the following:

- all critical accounting policies and practices used by the issuer;
- all alternative accounting treatments of financial information under generally accepted accounting principles (GAAP) that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm; and
- other material written communications between the accounting firm and management.

The SEC expects that these discussions would occur annually at a minimum, but permits and encourages more frequent communication.

### **New Disclosure Requirements**

The SEC proposes to expand required disclosure of professional fees paid to auditors for audit and non-audit services. The expanded proxy disclosure would require a specific breakdown of (a) audit fees, (b) audit-related fees, (c) tax fees, and (d) all other fees. The new rules would require such disclosure for each of the two most recent fiscal years, rather than the present requirement of

only the most recent fiscal year. Issuers also would be required to describe the nature of the services provided under audit-related fees and all other fees.

As proposed, the rules also require each issuer to disclose in its proxy statement the policies and procedures of its audit committee in engaging an auditor to perform non-audit services, as well as the percentage of fees that were pre-approved.

### **Timing**

The Act requires the SEC to issue final rules by January 26, 2003. However, the SEC is considering a transition period for certain of its proposals, including the rules relating to audit partner rotation, audit partner compensation, audit committee communications and disclosure of auditor fees.

*The information contained in this Legal Alert is not intended as legal advice or as an opinion on specific facts. For more information about these issues, please contact the author(s), Ben Barkley, Randy Eaddy, Neil Falis, Rey Pascual, David Stockton, Mike Trotter or Betty Wren at (404) 815-6500, of this Legal Alert or your existing firm contact. The invitation to contact the author is not to be construed as a solicitation for legal work in any jurisdiction in which the author is not admitted to practice. There will be no charge for the initial contact. Any attorney/client relationship will be confirmed in writing. You can also contact us through our Web site at [www.KilpatrickStockton.com](http://www.KilpatrickStockton.com).*



**APPENDIX E**

**SEC Issues (near) Final Rules on  
Standards of Professional Conduct for Attorneys**

**SECURITIES LEGAL ALERT**



## SECURITIES LEGAL ALERT

March 10, 2003

### SEC Issues (near) Final Rules on Standards of Professional Conduct for Attorneys

Section 307 of the Sarbanes-Oxley Act of 2002 directed the SEC to issue rules that require an attorney to report evidence of a material violation of securities laws or a breach of a fiduciary duty "up the ladder" within an issuer to the issuer's chief legal counsel (CLO) or chief executive officer (CEO) and, if that person fails to appropriately respond, to the issuer's audit committee, another committee of independent directors or the full board of directors. The SEC has now issued final rules implementing those provisions, although it indicated an intention to issue additional rules on the matter of an attorney's withdrawal from representing an issuer when the issuer does not appropriately respond in such a situation.

#### Attorneys Covered by the Rules

The new rules require an attorney -- appearing and practicing before the SEC in the representation of an issuer -- who becomes aware of evidence of a material violation by the issuer, or by any officer, director, employee or agent of the issuer, to promptly report the evidence to the issuer's CLO or to both its CLO and CEO.

*Attorney.* The rules define an "attorney" as anyone licensed or otherwise qualified to practice law in any foreign or domestic jurisdiction, or holding oneself out as licensed or otherwise qualified to practice law. The rules nonetheless exempt "non-appearing foreign attorneys".

Non-appearing foreign attorneys are attorneys who:

- are licensed to practice law outside the United States;
- do not hold themselves out as licensed or qualified to practice U.S. federal or state securities laws, and do not give legal advice regarding these laws; and
- either "appear and practice" before the SEC only incidentally to, and in the ordinary course of, the practice of law outside the United States, or "appear and practice" before

the SEC only in consultation with counsel (other than another non-appearing foreign attorney) licensed in the United States.

Some commentators had been concerned that the definition of "attorney" would include individuals who do not hold legal positions or perform legal services, simply because they are licensed or qualified to practice law. However, the definition of "appearing and practicing" discussed below should avoid entangling those individuals.

*Appearing and Practicing before the SEC.* The rules define "appearing and practicing" before the SEC as:

- conducting business with the SEC, including communications in any form;
  - representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation;
  - advising an issuer regarding U.S. securities laws or the SEC's rules or regulations with respect to any document that the attorney has notice will be filed with or submitted to the SEC; or
  - advising an issuer regarding whether U.S. securities laws or the SEC's rules or regulations require information or a statement, opinion or writing to be filed with or submitted to the SEC.
- On the other hand, the rules make clear that "appearing and practicing" specifically excludes any attorney who:
- conducts the foregoing activities outside the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship (in other words, the existence of an attorney-client relationship with the issuer is a prerequisite); or
  - is a "non-appearing foreign attorney".

Based on the above exclusion, an attorney who is employed by an issuer as a financial officer (and who does not provide legal services to the issuer), for example, would not be covered by the rules. In addition, attorneys



representing third parties, such as underwriters in a public offering, would not be covered with respect to their conduct in relationship to the issuer.

Attorneys should be mindful, however, that an attorney-client relationship may exist without an attorney-client engagement letter, and also may exist in some situations where the attorney-client privilege would not govern communications between the attorney and the issuer. The expectations and understandings between the attorney and the issuer may not be totally dispositive of the issue, but will be important factors in determining the existence or absence of the requisite attorney-client relationship.

The SEC emphasized that for an attorney to be covered by the rule, he or she “must have notice that the document that he or she is preparing or assisting in preparing will be submitted” to the SEC. While that provision operates to exclude an attorney who prepares a document that he or she does not have reason to believe will be submitted to the SEC, it does not exclude an attorney simply because he or she practices in a non-securities or non-corporate law area. Regardless of one’s practice area, the rules will extend to an attorney who reviews or prepares discrete portions of an issuer’s periodic reports, for example.

Also, the above focus on “documents” should not be viewed as a limitation of the rules’ coverage to matters that involve actual documentation work.

*Representation of an Issuer.* The SEC’s release emphasizes that an “issuer” includes entities controlled by the issuer, such as wholly-owned subsidiaries, when the attorney provides legal services to such an entity for the benefit or on behalf of the issuer. Accordingly, attorneys who work for a non-public subsidiary at the direction of the parent company issuer where the work will be submitted to the SEC, or who discover evidence of a material violation while working at the direction of the parent, would be deemed to be “representing” the issuer.

## The Reporting Obligation

The rules trigger an obligation to report “up-the-ladder” only when the attorney becomes aware of evidence of a “material violation” of an applicable U.S. federal or state securities law, a “material breach of fiduciary duty” arising under U.S. federal or state law, or a “similar material violation” of any U.S. federal or state law.

*Evidence of a Material Violation.* The release defines “evidence of a material violation” as credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur. The SEC attempted to formulate an objective standard, rather than a subjective one. The attorney may consider the circumstances known when assessing the issue, including the attorney’s professional abilities and experience, applicable time constraints, and prior experience and familiarity with the client. The rules do not define “evidence of a material violation” to include gossip or circumstances that, when assessed with the benefit of hindsight, could have led the attorney to different conclusions. The release emphasizes, however, that the attorney does not need to “know” of a material violation to trigger the obligation to report evidence “up-the-ladder”.

*Breach of Fiduciary Duty.* The definition of “breach of fiduciary duty” is expansive, and includes any breach of a fiduciary or other duty recognized under applicable federal or state statutory or regulatory law or at common law. A breach of fiduciary duty includes, among other things, abdication of duty, abuse of trust and approval of unlawful transactions, and may be based on nonfeasance as well as misfeasance.

*Material Violation.* The SEC did not define materiality in the rules, but stated that materiality will have the same meaning for these purposes as under existing federal securities laws. Under existing standards, information is “material” if there is a substantial likelihood that a reasonable shareholder or investor would consider it important in making an investment decision, or if there is a substantial



likelihood that a fact would have been viewed by a reasonable investor or shareholder as significantly altering the “total mix” of information otherwise available. Under the rules, a material violation will not include a violation of foreign laws.

### Reporting “Up-the-Ladder”

As noted above, the Act required the SEC to prescribe standards that require an attorney to report evidence of a material violation or a breach of a fiduciary duty “up-the-ladder” within the issuer to the issuer’s CLO or CEO and, if that person fails to respond, to report the matter to the issuer’s audit committee, another committee of independent directors or to the full board of directors.

Under the SEC’s rules, once the attorney’s duty to report evidence of a material violation is triggered, the attorney must promptly report the evidence to the issuer’s CLO or to both its CLO and CEO. If an issuer does not have an inside CLO, then obviously the report must be made to its CEO. If an issuer does have an inside CLO, he or she must receive the report, regardless of whether the CEO is informed, unless the attorney uses the QLCC alternative discussed below, or makes a determination of futility as also discussed below.

The rules do not dictate the form that the report must take, but generally require the report to include sufficient information to evaluate the matter, including dates, times, locations and witnesses, as well as the substance of the evidence. Once the CLO/CEO receives the attorney’s report, the CLO/CEO must investigate the evidence that the CLO/CEO reasonably believes is appropriate to determine whether the reported material violation has occurred, is ongoing or is about to occur. If the CLO/CEO determines that no material violation has occurred, is ongoing or is about to occur, the CLO/CEO must notify the reporting attorney of the basis for reaching that conclusion. If the CLO/CEO does not determine that no material violation has occurred, is ongoing or is about to occur, then the CLO/CEO must take reasonable steps to cause the issuer to adopt an “appropriate response”.

Alternatively, the CLO/CEO could refer the report of the evidence of a material violation to the issuer’s qualified legal compliance committee (QLCC) for further action, as explained below.

The rules define an “appropriate response” as a response that causes the reporting attorney to reasonably believe that:

- no material violation has occurred, is ongoing or is about to occur;
- appropriate remedial measures have been adopted to stop any ongoing material violation, prevent any material violation that has not occurred, or remedy any material violation that has occurred; or
- the issuer -- with the consent of the issuer’s board of directors, a committee of the board of directors composed entirely of directors who are not employed by the issuer, or the issuer’s QLCC -- has retained or directed another attorney to review the reported evidence, and either (i) has substantially implemented any recommendations from such other attorney after reasonable investigation, or (ii) has been advised by such other attorney that the issuer can assert a colorable defense in the context of any investigation or judicial proceeding relating to the material violation.

It is fair to say that the rules effectively require a reporting attorney to use his or her professional judgment to assess whether the reporting attorney has received an appropriate response.

Unless a reporting attorney reasonably believes that the CLO/CEO has provided an appropriate response within a reasonable period of time, the reporting attorney must report the evidence to the audit committee, another committee of the issuer’s board of directors composed entirely of directors who are not employed by the issuer, or (if no such committee exists), the issuer’s board of directors as a whole. In addition, the reporting attorney must explain the attorney’s reasons for concluding that he or she has not received an appropriate response within a reasonable period of time.



If the reporting attorney receives an appropriate response within a reasonable period of time, then the reporting attorney would have no further obligations.

### The QLCC Alternative

The rules permit an attorney with evidence of a material violation to report that evidence to a “qualified legal compliance committee” in lieu of following the “up the ladder” requirements discussed above. A QLCC is defined as a committee established by the issuer’s board of directors that:

- consists of at least one member of the issuer’s audit committee (or an equivalent committee, if the issuer does not have an audit committee), and two or more other directors who are not employed by the issuer;
- adopts written procedures for the confidential receipt of evidence of a material violation; and
- has authority to notify the CLO or CEO of a report, to assess whether an investigation is warranted (and conduct one, if necessary), and to direct the issuer to take appropriate remedial measures, including any necessary disclosures or sanctions to stop ongoing violations, prevent future violations or remedy past violations.

If an attorney reports evidence of a material violation to the QLCC, the attorney would have no further reporting obligation, and no obligation to assess the issuer’s response to the report.

### The “Futility” Exception; Other Options

If the attorney reasonably believes that it would be futile to report the evidence of a material violation to the CLO and CEO, the reporting attorney may bypass the CLO and CEO and directly report the evidence to one of the three board of directors options discussed above. Of course, if the issuer has a QLCC, that alternative can be used without a determination of futility in reporting to the CLO and CEO.

It is also important to note that the SEC rules do not prohibit the attorney from discussing the matter, at

any time, with other appropriate persons within the issuer whom the attorney might believe could act to produce a salutary result. Any such discussion simply would need to be in addition to, and not in lieu of, the reporting prescribed by the rules.

### Sanctions and Discipline for Non-Compliance

Attorneys who fail to comply with the rules will be subject to the remedies and sanctions available to the SEC under the Securities and Exchange Act of 1934, including civil injunctions, monetary penalties and bars from appearing or practicing before the SEC. The rules include an express safe harbor provision that the rules do not create a private cause of action against an attorney, a law firm or an issuer, based solely on failure to comply with the rules.

### Effect on Attorney-Client Privilege and Confidentiality

The rules provide that attorneys may use any report of evidence of a material violation, and the issuer’s response to the report, in connection with any investigation or proceeding relating to the attorney’s compliance with the rules. In short, the attorney may use records that he or she maintains in “self-defense”. The SEC intends these provisions to be substantially similar to existing exceptions to the client confidentiality rules under state law.

The rules also permit, but do not require, an attorney to reveal confidential information to the SEC, without the issuer’s consent, to the extent necessary to prevent an illegal act by the issuer that the attorney reasonably believes is likely to cause substantial injury to the financial interests of the issuer or investors. The attorney also may, but is not required to, disclose confidential information to remedy the issuer’s illegal acts, when those illegal acts have been advanced by the issuer’s use of the attorney’s services.

The rules do not preempt ethical rules under state law that establish more stringent obligations. However,



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the SEC emphasized that the rules will prevail over conflicting or inconsistent provisions under state law.

### Timing

The rules discussed above become effective on August 5, 2003.

### Additional Consideration for a “Noisy Withdrawal”

Although the rules as proposed by the SEC in November 2002 would have required an attorney to effect a “noisy withdrawal” if an issuer failed to deliver an appropriate response after receipt of evidence of a material violation, the SEC took no final action on that matter in releasing the above rules. Instead, the SEC extended the comment period on those aspects of its earlier proposals to April 7, 2003.

Under those proposed rules, a reporting attorney who did not receive an appropriate response, and who reasonably believed that a material violation is ongoing or about to occur and is likely to result in substantial injury to the financial interests of the issuer or its investors, would be required (a) in the case of outside counsel, to withdraw from representing the issuer and notify the SEC that the attorney withdrew for “professional considerations”, and (b) in all cases, to disaffirm any SEC submissions prepared by the attorney that the attorney believed may be materially false or

misleading. In addition to seeking further comment on these proposed “noisy withdrawal” rules, the SEC also proposed an alternative provision that would require the issuer, as opposed to the attorney, to publicly disclose on Form 8-K the withdrawal of an attorney under the circumstances discussed above, within two business days of the withdrawal.

At the meeting approving the rules that were released as final, four of the five SEC Commissioners spoke in favor of a “reporting out” requirement. Several commentators have renewed earlier objections to such a requirement. We believe, in light of the overall thrust of recent corporate governance reform initiatives, that it is likely that the SEC will adopt some form of reporting out requirement when it revisits the issue this spring.

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## Association of Corporate Counsel – Europe 603 Sarbanes-Oxley One Year Later: The Impact on Foreign Issuers

### Stephen Faciszewski, Esq.

*One year later, Sarbanes-Oxley has reshaped the landscape of corporate governance for publicly held U.S. companies. But what effect has the act had on the corporate governance practices of foreign issuers? Do you need to alter these practices within your company? Find out what your colleagues are doing to insure compliance. Panel members will engage in an interactive discussion to review the new rules for Form 20-F and 40-F reports, loans to directors and executive officers, audit committee organization, effects on domestic and international ethics rules, and much more.*

### **INTRODUCTION:**

There is no question of the American capital market's significant global influence, and any foreign entity intending to participate in the U.S. capital markets realizes it must (ultimately) abide by all relevant Sarbanes-Oxley (synonymously, the "Act") provisions. Too, foreign equity- and debt holders have not escaped the fallout from the pre-Sarbanes-Oxley environment.

For practical purposes, my panel colleagues and I have divided this broad topic into several sub-topics. Each panel member chose a different sub-topic to address within the context of the broader framework. Thus, these written materials summarize the effect(s) the Act has had on foreign entities that are not necessarily, because their shares are not publicly issued on a U.S. exchange for which trading companies are Sarbanes-Oxley regulated, compelled to comply with its statutory provisions.

Too, we find no surprise that the reactions of foreign issuers and that of equity- and debt-holders differ considerably. The former oft find it far too complicating (and arguably egregious) a factor (so much so as to dictate remarkably altered business outcomes<sup>1</sup>). In contrast, the latter, having seen fortunes vaporize, applaud its enactment. And because some institutions may be issuers, as well as equity- and debt-holders, the respective interests of such institutions compete, on one hand, objecting to the Act's enactment, and on the other, favouring it.

This sub-topic will only examine the perceived impact that the Act has had on a foreign issuer that is: i) neither, itself, governed directly by Sarbanes-Oxley; nor 2) tangentially affected by the Act, because the foreign issuer holds equity or debt or other interests in a Sarbanes-Oxley regulated entity.

### **EUROPEAN PERSPECTIVE:**

As a U.S.-licensed attorney, residing in Europe, and actively engaged in a global law practice, I impose some geographic parameters around this present inquiry. Europe being within my greatest "sphere of influence", the substantive scope of this summary provides a Euro-centric, foreign-issuer reaction to the Sarbanes-Oxley legislation. However, excepting cultural and regional nuances, I expect other mature and reasonably well-developed global capital markets in

Australasia, Latin America, and to some extent, Canada and Mexico, might share in some of the reactions expressed across a nationally and culturally diverse European Community.

In the first instance, it would be shortsighted to discount the cultural differences between Europeans and United States citizens and the impact that the U.S. culture has had in shaping the basis for the Act. For example, most European corporate cultures discourage disparate executive compensation programs such as those that evolved primarily in the U.S. during the 1990's, as compared with non-executive employees. Although preferential perquisites for European employees exist at certain levels in many organizations, these tend to apply to a broader segment of the employee workforce.<sup>ii</sup> Generally, as a result of these corporate cultural differences, Europeans don't have the same emotional sense of "betrayal" exhibited by the U.S. public. And where such executive abuses have occurred, Europeans are swift to take action to address the problem. Personal, criminal liability among corporate executives is not a new concept to Europeans.<sup>iii</sup>

The varied cultural influences in Europe warrant a brief introductory characterization. Together, Germany, France and Italy, make up approximately 75% of the Euro-Zone's economy, the largest of which is Germany. The United Kingdom (including Great Britain, Ireland and Scotland) has a market economy arguably more closely aligned (certainly from a cultural perspective) with the U.S., than with the more proximate (geographically) national and regional market economies of Continental Europe.

The balance of Continental Europe and Scandinavia comprise populations creating markets that do not share a unifying identity, cultural or lingual. Therefore, most of the discussion in response to the U.S. Sarbanes-Oxley legislation has been distributed among these few, national "economic powerhouses", with the broader regional European Union voice overshadowing commentary put forth on behalf of the smaller, national economies.

Despite the incremental successes of the European Union in unifying a market economy that, in May 2004, will approach one half billion consumers, there has not been a uniform, consistent foreign-issuer response to the Act across the whole of Europe. One factor that could be seen as restraining the candidness of commentary from European companies and governments is the mistaken perception that pointing out issues in applying the U.S. Act in a framework of national and European legislation may be interpreted as European companies have something to hide. In acknowledging any European response to the impact that the U.S. Sarbanes-Oxley legislation has had on foreign issuers, this factor shouldn't be discounted.

In the year since Sarbanes-Oxley was enacted, the European response has evolved from a stark, "knee-jerk", rejection of the legislation as inappropriately reaching beyond the scope of the U.S. jurisdiction to mutual recognition that within the broader framework of SEC legislation, application of the Act may require a slightly modified approach.<sup>iv</sup>

With that said, there are some fundamental, common themes in Europeans' responses that are useful to set out here for purposes of the present discussion. Those taking up the subject of a European response to the Act fall into one of three groups:



- a. Some foreign issuers have taken the present situation as an opportunity to examine existing company practices, identify inconsistencies between corporate practices and the Act's requirements, and develop and implement an action plan to reach absolute (or at least partial) compliance with Sarbanes-Oxley;
- b. At a broader, regional level, the European Community has objected to the Act's reach beyond the U.S. territorial boundaries, suggesting that any such regulation should be: i) in the form of mutually-negotiated and developed regional counterpart legislation; ii) left to the national governments of the European Member States; or iii) some combination of the two; or
- c. Continued rebuke of Sarbanes-Oxley as an Act that is inconsistent and conflicting with the national laws of the European Member states.

### **LEGISLATIVE FRAMEWORK:**

Any analysis of the impact of Sarbanes-Oxley beyond U.S. borders requires a basic understanding of the underlying Act. Although our purpose here is not to provide an in-depth, comprehensive analysis into the practical application and operation of Sarbanes-Oxley in a broader, U.S. practice, Appendix 1 to these written materials is a sectional summary of the Sarbanes-Oxley Act of 2002,<sup>v</sup> and useful reference. In addition, the law firm of Weil, Gotshal & Manges LLP has assembled a very useful, colour-coded implementation chart, providing an organized, fairly comprehensive, analysis of those sections of the Act that are subject to rulemaking (including: i) identification of adopting releases and new and amended rules and regulations; ii) the effective date of the relevant rule/section, along with a brief summary of its effect; and iii) links/references to other firm or third party materials).<sup>vi</sup> For further information, consult the Weil, Gotshal & Manges LLP website (URL in footnote), or their office in London:

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In reviewing the substantive text of Act, when compared against selected relevant regional and national laws governing foreign issuers of European Member States, several, more significant inconsistencies stand out.

First, Sarbanes-Oxley requires chief executive and chief financial officers to certify that financial statements are truthful and do not omit material facts. By contrast, in some jurisdictions, management boards, by law, collectively (not individual members of management boards), have responsibility for truthfulness and accuracy in financial statements.

Second, Sarbanes-Oxley establishes a new Oversight Board, charged with regulating accounting firms, and thereby provides the Oversight Board with access to sometimes privileged and often-confidential accounting records and other internal corporate documents. This, from a European perspective, essentially equates to double regulation of European Union audit firms, and any such access by the Oversight Board to privileged or confidential records would indeed breach professional secrecy laws and clearly raises concerns about confidentiality.

Third, the Act sets out that a corporate board audit committee will appoint auditors, not management. However, in several European jurisdictions, shareholders already appoint auditors.

And fourth, because, according to many national laws (specifically those of Germany, Netherlands, Denmark and Austria), employee representation on boards is mandatory, Sarbanes-Oxley, requiring that a corporate audit committee be entirely comprised of totally independent (*i.e.*, non-employee) directors, is incompatible with any such national laws.

Finally, although not specifically in conflict with regional or national laws of a jurisdiction, it is worth clarifying a common misconception about Sarbanes-Oxley. First, Sarbanes-Oxley, and any resulting, enacted rules are, according to Sarbanes-Oxley (for the Act, itself does not make exceptions to foreign, but U.S.-listed companies), imposed without regard to the nationality of the issuer. But, the Act and rules will have to fit within the existing scheme of U.S. securities regulation, which generally affords the SEC some latitude in making exceptions to foreign issuers. U.S. practitioners have broadly shared, without specificity, that the SEC is likely to grant foreign-issuer exceptions under a number of the new rules. For other rules, the SEC may make no exceptions. Again, the Act only directly applies to those foreign issuers who seek access to U.S. capital markets.<sup>vii</sup>

### **PRACTICAL IMPLICATIONS:**

Jaap Winter, partner at De Brauw Blackstone and Westbroek (Amsterdam), law professor at Rotterdam's Erasmus University, and Chair of the High Level Group of Company Law Experts (established by and providing counsel to the European Commission), had a concise observation of the European response to Sarbanes-Oxley:

“In many aspects of public and economic life Americans radiate a natural self confidence that we Europeans sometimes (and some of us often) find annoying, but at the same time envy. We criticise their views and arguments, often by saying they are too single-minded and that other factors have to be taken into account as well. Nonetheless, many times we are forced to follow the directions they take because they are embedded in what is overall an effective and powerful system which is difficult to resist, but also because we are usually not able to come to a determined view of what could present a better alternative, or an alternative that would work at least as well in our particular circumstances. Without our own view on the way forward we lose the right to speak.

Corporate governance is a good example. In response to the corporate frauds of Enron, Worldcom and others, the United States presented its regulatory response in a flash in the form of the Sarbanes-Oxley Act, introducing a host of detailed new corporate governance

rules. The Act does not make exceptions for foreign companies which are listed in the US, and probably not much thought went into assessing whether the new rules could and should be applied to them. But that isn't what the Act is about in the first place. The Act is focused on curbing the particular failures in the US corporate governance system.

...The new rules must be seen against the particular American corporate governance and company law background... The new rules seek to shift the balance of power and put more power into the hands of non-executive directors. A closer look at the new corporate governance rules shows that important elements of them are already part of company law and corporate governance codes and practice in many European Member States.

The Sarbanes-Oxley rules do differ in some details, and introduce certain rules that we may not be familiar with... Overall, however, they cover familiar ground for us in Europe and certainly do not have an exclusively American nature.

...By not focusing on the content of the corporate governance debate but on the way the US proceeds, we deny ourselves the self confidence we could have in appreciating where our rules and systems are appropriate and up to standard. But at the same time we forget to be as self critical as we should be in recognising where they are not, and assessing if we could benefit from (elements of) the US approach. Europe should first of all self confidently and self critically review its own corporate governance systems and rules. Only on that basis can it have a beneficial discussion with the US legislator and the SEC as its main regulator.”<sup>viii</sup>

Although Mr. Winter's comments summarize one perspective on the broader European response to Sarbanes-Oxley, it is clear the debate (or a mutually-satisfactory response) is far from reaching any near-term or comprehensive conclusion.<sup>ix</sup>

For those foreign issuers that have taken the present situation as an opportunity to examine existing company practices, in the case of European companies, the complexity of the task will depend upon the number of jurisdictions whose legislative authority influences the European company's corporate governance function. But those organizations that pursue this proactive approach will no doubt find any ultimate compliance with Sarbanes-Oxley (or any resulting regional/national legislation) well worth the effort and cost expended.

One particularly successful approach has been Novartis AG's (although Novartis AG ultimately falls under the reach of Sarbanes-Oxley, as a foreign-issuer of instruments in the U.S. capital markets) swift restructuring of its corporate governance infrastructure in response to Sarbanes-Oxley, specifically taking into account the “best practices” of both Europe and the US.<sup>x</sup> Too, many private law practitioners, servicing national and regional market, are developing materials, including guides and recommendations for navigating the dynamic corporate governance landscape.<sup>xi,xii</sup>

For those standing behind the position that the European Union (or the national governments of the Member States) should independently (or collectively with the U.S.) negotiate and develop

counterpart governance legislation (either at a regional, European, or national level or some combination of regional and national), there is historical support for Europe's ability to do so.

Since the mid-1990's, in response to pressures of an ever-increasing global market, European Member States have markedly improved their "corporate practices" legislation. According to a study released early in 2002 and conducted by Weil, Gotshal & Manges LLP, on behalf of the European Commission, there were only 10 such codes of corporate governance in Member States in 1997, six of which Britain had issued. By the time of the study's completion, there were already 35.<sup>xiii</sup>

Indeed, even the U.K., its economy much closer in structure to the aggressive U.S. capitalistic model than its Continental counterparts across the Channel, is not entirely supportive of the attempted cross-border reach of the Sarbanes-Oxley legislation, maintaining that regulation of audit and corporate governance is for the European Union or individual Member States to decide.<sup>xiv</sup>

But, the legislation and practices of each of the Member States is arguably as disparate as the underlying national cultures and languages. Issuers in Europe (and very-well other, non-U.S. jurisdictions globally) are well advised to consult experienced, local counsel in the specific requirements of the jurisdiction in which the organization intends to issue.

Those foreign issuers who don't intend to take advantage of the U.S. capital markets may continue, if they so choose, in their staunch opposition to Sarbanes-Oxley, specifically, that its extra-territorial reach does not extend to non-U.S. issuers of the European Member states. But they may also want to heed the signals emanating from the European Commission, that a convergence of corporate governance codes into a set of uniformly adopted set of accounting and auditing rules may not be so remote, but a nearer term reality.<sup>xv</sup> Many will, no doubt, take a wait and see approach.

How this all affects the day-to-day practice of in-house professionals remains a "practice guide" work-in-progress, particularly as it relates to foreign issuers. The bulk of the legislative rules resulting from the Act remain largely either unsettled, or pending enactment. For the immediate future, the implementing rules will continue to result in changes to reporting legislation, forms and requirements. The Act's maturing infrastructure, itself, will no doubt identify deficiencies, thus prompting further changes in the legislation.

### **LOOKING FORWARD:**

The present situation remains unresolved for a majority of foreign issuers, primarily because their own national and regional jurisdictions have not settled on a best approach to addressing the corporate governance dilemma on a broader global and regional level, particularly, rationalizing their own national codes in view of the U.S. legislative response, and a prospective pan-European approach (see below).

In the absence of achieving further progress in finding a mutually acceptable resolution to the Act's "extra-territorial" issues, or obtaining a specific waiver from application of Sarbanes-

Oxley, at present, any foreign issuer intending to access the U.S. capital markets will need to comply with the Act. However, the deadline by which foreign issuers must comply with Sarbanes-Oxley has been once extended, now set at 15 April 2005.<sup>xvi</sup> In view of the dialog already initiated, albeit without substantive results, between the European Commission, the SEC and the Oversight Board, the compliance deadline for foreign issuers may still yet be extended.

But, foreign issuers should take note: the European Commission (21 May 2003) presented an action plan for improving corporate governance and statutory audit in the European Union, and specifically designed to establish governance norms that are consistent with current international expectations. Indirectly, the European Commission seeks further market integration while maintaining control over corporate governance and audit standards—a direct response to the perceived extra-territorial reach of the U.S. Act and rules already promulgated and yet to follow.

The European Commission's Communications to the European Parliament propose a European plan that contemplates a lengthy implementation period, stretching, for some reforms, to this decade's end. As a result, foreign issuers shouldn't expect any immediate regulatory consequences—certainly not along the Act's timeline. The proposals require further development, resulting in implementation through: i) non-binding recommendations; or ii) directives to each Member State to achieve the regulatory result, allowing for empowered national authorities to choose specific forms and methods.

And, of course, uncertainty will remain, but the plan does provide insight into Europe's broader (and independent) regulatory response to Sarbanes-Oxley in the near term.<sup>xvii</sup>

More specific detail of the European action plan can be found in the substantive Commission's Communications to Parliament.<sup>xviii</sup>

***Appendix I<sup>5</sup>***  
***Title/Section Summary***  
***Sarbanes-Oxley Act of 2002***

<b><i>TITLE I</i></b>	<b><i>The Oversight Board</i></b>
<u>Sec. 101.</u>	Establishment of Board; administrative provisions.
<u>Sec. 102.</u>	Registration with the Board for public accounting firms is 180 days after SEC makes determination.
<u>Sec. 103.</u>	Auditing, quality control, and independence standards and rules, including outside auditor statements on internal controls.
<u>Sec. 104.</u>	Board's Inspections of registered public accounting firms.
<u>Sec. 105.</u>	Board's Investigations and disciplinary proceedings.
<u>Sec. 106.</u>	Foreign public accounting firms.
<u>Sec. 107.</u>	Commission oversight of the Board rulemaking, which is subject to notice and comment.
<u>Sec. 108.</u>	Accounting standards.
<u>Sec. 109.</u>	Funding.
<b><i>TITLE II</i></b>	<b><i>AUDITOR INDEPENDENCE</i></b>
<u>Sec. 201.</u>	Services outside the scope of practice of auditors, and specific prohibition on specified non-audit services (does not apply until registration with Oversight Board).
<u>Sec. 202.</u>	Preapproval requirements and audit committee approval process.
<u>Sec. 203.</u>	Audit partner rotation (does not apply until registration with Oversight Board).
<u>Sec. 204.</u>	Reports by auditors (accounting firms) to board audit committees (does not apply until registration with Oversight Board).
<u>Sec. 205.</u>	Conforming amendments.
<u>Sec. 206.</u>	Conflicts of interest.
<u>Sec. 207.</u>	Commission oversight of the Board rulemaking, which is subject to notice and comment.
<u>Sec. 208.</u>	Commission authority and loss of rights for violations.
<u>Sec. 209.</u>	Considerations by appropriate State regulatory authorities.
<b><i>TITLE III</i></b>	<b><i>CORPORATE RESPONSIBILITY</i></b>
<u>Sec. 301.</u>	Independent, public company audit committees.
<u>Sec. 302.</u>	Corporate responsibility (certification) for financial reports ( <i>e.g.</i> , annual and quarterly), specifically subject to SEC rule.
<u>Sec. 303.</u>	Prohibition on improper influence on conduct of audits.
<u>Sec. 304.</u>	Disgorgement of certain bonuses and profits following restatement of financial statements.
<u>Sec. 305.</u>	Bars and penalties against certain persons serving as officers and directors enforceable by SEC and the federal courts, and ability to obtain equitable relief.
<u>Sec. 306.</u>	Trading restrictions during pension fund blackout periods.
<u>Sec. 307.</u>	Rules of professional responsibility for attorneys.
<u>Sec. 308.</u>	Fair funds for investors.

***TITLE IV ENHANCED FINANCIAL DISCLOSURES***

- Sec. 401. Disclosures in periodic reports (including off balance sheet transactions and pro forma financial information) to reflect all material correcting adjustments.
- Sec. 402. Enhanced conflict of interest provisions, particularly prohibition on loans to executive officers and directors.
- Sec. 403. Disclosure of transactions involving management and principal stockholders (specifically, reporting trades by executive officers and directors).
- Sec. 404. Management assessment of internal controls (specifically, management report on internal controls in audit report).
- Sec. 405. Exemptions.
- Sec. 406. Codes of ethics for senior financial officers and disclosure requirements.
- Sec. 407. Disclosure of audit committee financial expert.
- Sec. 408. Enhanced review of period disclosures by issuers, and no less than regular and systematic review by the SEC.
- Sec. 409. "Real-time" disclosures (SEC).

***TITLE V ANALYST CONFLICTS OF INTEREST***

- Sec. 501. Treatment of securities analysts by registered securities associations and national securities exchanges.

***TITLE VI COMMISSION RESOURCES AND AUTHORITY***

- Sec. 601. Authorization of appropriations.
- Sec. 602. Appearance and practice before the Commission, and barring firms and persons from SEC practice.
- Sec. 603. Federal court authority to impose penny stock bars.
- Sec. 604. Qualifications of associated persons of brokers and dealers, and restrictions thereon.

***TITLE VII STUDIES AND REPORTS***

- Sec. 701. GAO study and report regarding consolidation of public accounting firms.
- Sec. 702. Commission study and report regarding credit rating agencies.
- Sec. 703. Study and report on violators and violations.
- Sec. 704. Study of enforcement actions.
- Sec. 705. Study of investment banks.

***TITLE VIII CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY***

- Sec. 801. Short title.
- Sec. 802. Compulsory retention of documents and criminal penalties for altering documents (destruction/alteration/falsification of records, including corporate audit records, in federal investigations and bankruptcy cases).
- Sec. 803. Debts nondischargeable in bankruptcy if incurred in violation of securities fraud laws.
- Sec. 804. Extension of statute of limitations for private action in securities fraud.
- Sec. 805. Review of Federal Sentencing Guidelines for obstruction of justice and extensive criminal fraud.

Sec. 806. Protection for employees of publicly traded companies from retaliation who provide evidence of fraud (whistle blower protection).

Sec. 807. Criminal penalties for defrauding shareholder of publicly traded companies.

***TITLE IX WHITE-COLLAR CRIME PENALTY ENHANCEMENTS***

Sec. 901. Short title.

Sec. 902. Attempts and conspiracies to commit criminal fraud offenses.

Sec. 903. Criminal penalties for mail and wire fraud.

Sec. 904. Criminal penalties for violations of the Employee Retirement Income Security Act of 1974.

Sec. 905. Amendment to sentencing guidelines relating to certain white-collar offenses.

Sec. 906. Corporate responsibility for certification of periodic (specifically financial) reports, and failure of corporate officer to certify.

***TITLE X CORPORATE TAX RETURNS***

Sec. 1001. Sense of the Senate regarding the signing of corporate tax returns by chief executive officers.

***TITLE XI CORPORATE FRAUD AND ACCOUNTABILITY***

Sec. 1101. Short title.

Sec. 1102. Tampering with a record or otherwise impeding an official proceeding.

Sec. 1103. SEC authority to freeze extraordinary payments to directors and officers.

Sec. 1104. Amendment to the Federal Sentencing Guidelines.

Sec. 1105. Authority of the Commission to prohibit persons from serving as officers or directors.

Sec. 1106. Increased criminal penalties under Securities Exchange Act of 1934.

Sec. 1107. Retaliation against informants (whistle blowers).



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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.<sup>1</sup> 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.



# Standards



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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.<sup>2</sup> In response to a storm of criticism from foreign lawyers, the SEC excluded "non-appearing foreign attorneys" in the final rules.<sup>3</sup>

### 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."<sup>4</sup>

### Definition of "Appearing and Practicing before the SEC"

The new standards set forth a two-part definition of "appearing and practicing before the SEC."<sup>5</sup> 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

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."<sup>6</sup> 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.<sup>7</sup>

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 mat-

ters 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

## 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 evi-

dence 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.<sup>8</sup> 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 sub-

stantial 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.

law.”<sup>9</sup> The adopting release states that “material” should be interpreted in accordance with its well-established meaning under the federal securities laws.<sup>10</sup>

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.’”<sup>11</sup> 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.”<sup>12</sup> 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.



### 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").<sup>15</sup> The final rules do not regulate the nature of the report, so it can be made orally, in writing, or electronically.<sup>14</sup> We refer to this approach as the "CLO approach."

Under the new standards, this report must be made "forthwith." The SEC did not, however, pro-

vide 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.<sup>15</sup>

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,

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.<sup>16</sup> If the CLO refers the matter to the QLCC, the QLCC then becomes responsible for responding to the report.<sup>17</sup>

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.<sup>18</sup>

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.<sup>19</sup> 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.<sup>20</sup> 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

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.<sup>21</sup>

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.<sup>22</sup>

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.

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.<sup>25</sup> 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.<sup>24</sup>

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—itsself 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.<sup>25</sup>

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.<sup>26</sup> 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.<sup>27</sup> 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.<sup>28</sup> 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-

*From this point on . . .*

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#### ONLINE:

- ACCA's comment letters to the SEC, available on ACCA Online<sup>SM</sup> at [www.acca.com/advocacy/307comments.pdf](http://www.acca.com/advocacy/307comments.pdf) and [www.acca.com/advocacy/307comments2.pdf](http://www.acca.com/advocacy/307comments2.pdf).
- 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](mailto:windley@acca.com), or visit ACCA Online<sup>SM</sup> at [www.acca.com/networks/ecommerce.php](http://www.acca.com/networks/ecommerce.php).
- ACCA's Corporate Responsibility page, which features timely post-Enron reform information, available on ACCA Online<sup>SM</sup> at [www.acca.com/legres/corpresponsibility/index.php](http://www.acca.com/legres/corpresponsibility/index.php).
- ACCA's executive summary of the rule and its provisions, available on ACCA Online<sup>SM</sup> at [www.acca.com/legres/corpresponsibility/307/summary.pdf](http://www.acca.com/legres/corpresponsibility/307/summary.pdf).
- ACCA's § 307 "Questions and Answers," available on ACCA Online<sup>SM</sup> at [www.acca.com/legres/corpresponsibility/qa.php](http://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](http://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](http://www.practicallaw.com/A27020).
- *Corporate Governance and Directors' Duties*, GLOBAL COUNSEL HANDBOOK, 2003, available on *PLC Law Department* at [www.practicallaw.com/T2214](http://www.practicallaw.com/T2214).
- Ethics Officers Association, at [www.eoa.org](http://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](http://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](http://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<sup>SM</sup> at [www.acca.com/protected/pubs/docket/nd02/sarbanes1.php](http://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](http://www.sec.gov/rules/final/33-8185.htm).
- SEC proposed rule on noisy withdrawals, at [www.sec.gov/rules/proposed/33-8186.htm](http://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<sup>SM</sup> at [www.acca.com/protected/pubs/docket/am03/ethics1.php](http://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<sup>SM</sup> at [www.acca.com/protected/pubs/docket/nd02/codeblue1.php](http://www.acca.com/protected/pubs/docket/nd02/codeblue1.php).

#### ON PAPER:

- JOHN K. VILLA, CORPORATE COUNSEL GUIDELINES (ACCA and West 1999, with annual updates).

*If you like the resources listed here, visit ACCA's Virtual Library<sup>SM</sup> on ACCA Online<sup>SM</sup> at [www.acca.com/resources/vl.php](http://www.acca.com/resources/vl.php). Our library is stocked with information provided by ACCA members and others. If you have questions or need assistance in accessing this information, please contact Staff Attorney and Legal Resources Manager Karen Palmer at 202.293.4103, ext. 342, or [palmer@acca.com](mailto:palmer@acca.com). If you have resources, including redacted documents, that you are willing to share, email electronic documents to Managing Attorney Jim Merklinger at [merklinger@acca.com](mailto:merklinger@acca.com).*

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.<sup>29</sup> 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 question-

able 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](http://www.sec.gov/rules/final/33-8185.htm) ("Adopting Release"). The SEC repropose the noisy withdrawal provision in SEC Rel. 33-8186 (Jan. 29, 2003) at [www.sec.gov/rules/proposed/33-8186.htm](http://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](http://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 non-appearing 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.

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<sup>1</sup> (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.<sup>2</sup>

### **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.

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.

\*\*\*\*\*

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 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.

## **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 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.

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.

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.<sup>3</sup> 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 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,<sup>4</sup> issues sufficiently "material" to trigger reporting under this provision will probably be shared knowledge within the department. In-house 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 a 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 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 disagree 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.<sup>5</sup> 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 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.<sup>6</sup>

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, CLOs 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.

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:

\* 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.

On Behalf of the Board of Directors of the American Corporate Counsel Association:

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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](http://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.

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.

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 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.

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.

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.

**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)<sup>1</sup> 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.<sup>2</sup>

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 release<sup>3</sup> 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



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.<sup>4</sup>

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.<sup>5</sup> 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.<sup>6</sup> Finally, several commenters questioned why the Commission would seek to supplant state ethical rules which impose a higher obligation upon attorneys.<sup>7</sup>

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.

## 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:

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.<sup>8</sup>

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."<sup>9</sup>

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.<sup>10</sup>

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

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,<sup>11</sup> or that the Commission adopt the ABA's Model Rules' definition of "reasonably believes."<sup>12</sup> 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.<sup>13</sup> Others opined that the standard should be modified to require

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

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."<sup>16</sup> 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."<sup>17</sup> Some comments questioned whether reporting attorneys would be able to judge whether discipline or corrective measures were sufficient to constitute an appropriate response.<sup>18</sup> 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.<sup>19</sup> Some commenters found the term "and/or" in subparagraph (b)(2) of the proposed paragraph confusing.<sup>20</sup> 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,<sup>21</sup> 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.<sup>22</sup> 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.<sup>23</sup>

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.<sup>24</sup> 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."<sup>25</sup>

Several commenters suggested that the proposed rule should exempt internal investigations of reported evidence of a material violation.<sup>26</sup> 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.<sup>27</sup> 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."<sup>28</sup> Some commenters stated that "counsel conducting an internal investigation" should not be subject to the rule's reporting and disclosure requirements.<sup>29</sup>

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."<sup>30</sup> Several commenters were concerned over a possible chilling effect on an

attorney's representation of an issuer in a Commission investigation or administrative proceeding if the attorney were subject to reporting and disclosure requirements.<sup>31</sup> 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.<sup>32</sup> 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."<sup>33</sup> 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.<sup>34</sup> 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.<sup>35</sup>

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

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."<sup>36</sup> 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.<sup>37</sup> 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."<sup>38</sup> 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

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.<sup>39</sup> 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.<sup>40</sup> 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.<sup>41</sup> 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.<sup>42</sup> 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.<sup>43</sup> 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.<sup>44</sup> The revised definition incorporates suggested changes into an objective standard that is designed to



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.<sup>45</sup> 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.<sup>46</sup> 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."<sup>47</sup> 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 occurred<sup>48</sup> or when the attorney "conclude[s] there has been a violation, and no reasonable fact finder could conclude otherwise."<sup>49</sup> 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."<sup>50</sup> 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."<sup>51</sup> The substitution of the term "providing legal services" responds to these concerns. We

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.<sup>52</sup>

For the reasons explained in the proposing release,<sup>53</sup> 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,"<sup>54</sup> 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.<sup>55</sup> 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.<sup>56</sup>

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. 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.

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.<sup>57</sup>

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

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 laws<sup>59</sup> 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.

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

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

(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.<sup>60</sup>

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.<sup>61</sup>

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.<sup>62</sup>

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,<sup>63</sup> 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

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,<sup>64</sup> 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.<sup>65</sup> 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.

### 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.<sup>66</sup> 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;<sup>67</sup> 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."<sup>68</sup> 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.<sup>69</sup> 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.<sup>70</sup> 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.



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

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.<sup>72</sup>

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."<sup>73</sup> 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."<sup>74</sup> Indeed, it was pointed out, there may be occasions where the preparation of documentation is not in the best interests of the client.<sup>75</sup>

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"<sup>76</sup> 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.<sup>77</sup>

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.<sup>78</sup> 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.

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.<sup>79</sup> 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.<sup>80</sup> 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.<sup>81</sup>

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.<sup>82</sup>

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.<sup>83</sup> 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

(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:

(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.<sup>84</sup>

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.

(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.<sup>85</sup> 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.<sup>86</sup> 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.<sup>87</sup> This comment has been addressed in Section 205.3(c), which authorizes referral only to a QLCC that has been previously formed.

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.<sup>88</sup> 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.<sup>89</sup> 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.<sup>90</sup> 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.



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,<sup>91</sup> and as adopted in the vast majority of states.<sup>92</sup> 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.<sup>93</sup> 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.<sup>94</sup> 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."<sup>95</sup>

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,<sup>96</sup> or to ongoing criminal or fraudulent conduct by the issuer,<sup>97</sup> while others suggest that attorneys should only be permitted to

disclose information where there is a risk of death or bodily harm, and not where only "monetary interests" are involved.<sup>98</sup> Many of the commenters voicing objections to this paragraph suggested that the Commission defer its promulgation until after further developments by state supreme courts<sup>99</sup> or further discussion.<sup>100</sup> 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.<sup>101</sup>

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,<sup>102</sup> 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."<sup>103</sup> 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,<sup>104</sup> and urged the Commission to make clear that this paragraph does not override state ethics rules that make such disclosures mandatory.<sup>105</sup> Many commenters also stated that it was proper for this paragraph to preempt any state ethics rule that does not permit disclosure.<sup>106</sup> 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.<sup>107</sup> Others generally supported the provision as injecting vitality into existing ethics rules, and stated that the Commission should not delay action on this provision.<sup>108</sup> One commenter emphasized the need to protect from retaliation attorneys who engage in the reporting mandated by Part 205.<sup>109</sup>

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.<sup>110</sup> 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,<sup>111</sup> and the Commission has seen no evidence that those already-existing disclosure obligations have undermined the attorney-client

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,<sup>112</sup> 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,<sup>113</sup> and a few suggested that the proposed paragraph would conflict with Federal Rule of Evidence 501.<sup>114</sup> 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.<sup>115</sup> A few also noted that proposed legislation before

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.<sup>116</sup> 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.<sup>117</sup>

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.

(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.<sup>118</sup> 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.<sup>119</sup>

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.

### 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.<sup>120</sup> 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.

## 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.<sup>121</sup> 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.<sup>122</sup> 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.<sup>123</sup>

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

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."<sup>124</sup> Nevertheless, the Commission requested comments on whether it should provide in the final rule "a 'safe harbor' from civil suits" for



attorneys who comply with the rule.<sup>125</sup> 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.<sup>126</sup> 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 . . . ." <sup>127</sup> 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."<sup>128</sup> 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.<sup>129</sup>

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")<sup>130</sup> 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

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.<sup>131</sup>

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.<sup>132</sup> 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.<sup>133</sup> 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.<sup>134</sup> 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 QLCCs<sup>135</sup> and, on the other hand, many companies would use QLCCs.<sup>136</sup> 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.

#### 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.

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

\$300 per hour,<sup>137</sup> and inside counsel accounts for the other half at \$110 per hour,<sup>138</sup> 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.<sup>139</sup> 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%.<sup>140</sup> 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 counsel<sup>141</sup> and four comments indicating that the rule would result in more matters referred to outside counsel.<sup>142</sup> 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.<sup>143</sup> 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.<sup>144</sup> 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

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.<sup>145</sup> 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.<sup>146</sup> We estimate that there are 211 small investment

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.<sup>147</sup> 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



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

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,<sup>148</sup> Section 19 of the Securities Act of 1933,<sup>149</sup> Sections 3(b), 4C, 13, and 23 of the Securities Exchange Act of 1934,<sup>150</sup> Sections 38 and 39 of the Investment Company Act of 1940,<sup>151</sup> and Section 211 of the Investment Advisers Act of 1940.<sup>152</sup>

### 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

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

(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;

(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

(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.

(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

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



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.

(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:

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)).

"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.

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

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

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.

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.



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.

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

(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 material 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.

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

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.*

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.

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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September 14, 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)<sup>1</sup>**

(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)~~ to secure legal advice about the lawyer's compliance with these Rules;

~~(5)~~ 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)~~ to comply with other law or a court order.

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<sup>1</sup> Additions are underlined; stricken text indicates deletions.



## 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,

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.

[97] 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,

paragraph (b)(4) permits such disclosure because of the importance of a lawyer's compliance with the Rules of Professional Conduct.

[108] 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)(53) 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.

[119] A lawyer entitled to a fee is permitted by paragraph (b)(53) 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.

[1210] 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)(64) permits the lawyer to make such disclosures as are necessary to comply with the law.

[1311] 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)(64) permits the lawyer to comply with the court's order.

[1412] 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.

[1513] 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)(64). 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

[1615] 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.

[1716] 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.

## Former Client

[1817] 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

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.

[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

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



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 of 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**

[40] [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

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.