Q & A
NEW RULES GOVERNING STANDARDS OF PROFESSIONAL CONDUCT
FOR ATTORNEYS


Who is covered by the new rules?

The rules cover “attorneys” who are “appearing and practicing” before the Commission “in the representation of an issuer.” The Commission initially proposed broad definitions for these terms that encompassed a wide range of persons and activities. Based on comments received, the Commission has narrowed the rule, with respect to the nature of the services provided and non-U.S. attorneys. Attorneys who have an attorney-client relationship with the issuer and provide legal services to it are appearing and practicing before the Commission in the representation of the issuer when they

- transact business or communicate with the Commission with respect to the issuer;
- represent the issuer in an administrative proceeding;
- provide advice with respect to U.S. securities laws or the Commission’s rules or regulations 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 advice regarding or participation in the preparation of the document; or
- provide advice as to whether information is required to be filed with or submitted to, or incorporated into any document to be filed with or submitted to, the Commission.

The rules generally do not cover non-U.S. attorneys unless they provide legal advice to the issuer regarding U.S. laws.

What triggers an attorney’s responsibilities under the new rules?

If an attorney covered by the rules becomes aware of evidence of a material violation by the issuer or any officer, director, employee or agent of the issuer, the attorney must report it to the issuer’s Chief Legal Officer (or an equivalent officer) or to both the CLO and the CEO forthwith. A “material violation” means a material violation of applicable U.S. securities laws (federal or state), a material breach of a fiduciary duty arising under U.S. law, or a similar material violation of any U.S. law.

Evidence of a material violation is an objective standard that is triggered when an attorney has 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. Some commentators have already criticized this part of the new rules as difficult to enforce. In the view of these commentators, this standard is convoluted and contains a double negative.
The rules do not impose a separate duty on the attorney to investigate the evidence of a material obligation. If the attorney reasonably believes that the CLO has provided an “appropriate and timely” response, he or she has satisfied the obligations imposed by the rules. An “appropriate response” means a response as a result of which an attorney reasonably believes (1) that there is no material violation; (2) that the issuer has adopted appropriate remedial measures to stop ongoing violations, prevent future violations and remedy or otherwise appropriately address past violations or (3) that the issuer has retained or directed an attorney to review the evidence of a material violation and has either (a) substantially implemented any remedial recommendations or (b) been advised that the reviewing attorney may assert a colorable defense on behalf of the issuer in any investigation or proceeding relating to the evidence of a material violation.

According to the Commission, the standard of “reasonable belief” allows the attorney to take into account, and the Commission to weigh, all attendant circumstances, including 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.

What must the CLO do once he receives the report?

Upon receiving a report from the attorney, the CLO is obligated to conduct a reasonable inquiry to determine whether, in fact, a material violation has occurred, is occurring, or is about to occur. If, following the conclusion of the inquiry, the CLO reasonably believes that no material violation has occurred, he or she must advise the attorney of this conclusion and the basis for the determination. If, on the other hand, the CLO reasonably believes that a material violation has occurred, is occurring, or is about to occur, he or she must take all reasonable steps to cause the issuer to adopt appropriate remedial measures, which may include disclosure and sanctions to stop the material violation, prevent it from occurring, or rectify any material violation that has already occurred. In this instances, the CLO is required to promptly report the remedial measures adopted and sanctions imposed to the (1) CEO; (2) the audit committee or the full board of directors and (3) the reporting attorney.

What happens if the attorney does not get an appropriate response?

If the attorney does not receive an appropriate and timely response from the CLO, or if the attorney reasonably believes that it would be futile to report the evidence of a material violation to the CLO and the CEO, the attorney is obligated to report the evidence of a material violation “up the ladder” at the issuer. The attorney may fulfill this obligation by informing the audit committee (or if there is no audit committee, another committee of independent directors) or if there is no audit committee or equivalent independent committee, the full board of directors of the issuer, of the evidence of a material violation. The attorney shall explain the reasons for believing that any response received was not appropriate or timely to the parties to which he or she has reported the evidence of a material violation.

Are there any exceptions to the attorney’s obligation to report “up the ladder”?

An attorney does not have any obligation to report evidence of a material violation “up the ladder” if he or she is retained by the CLO to investigate a report of a material violation or to assert a colorable defense on behalf of the issuer (or the issuer’s director, officer, employee or agent) in an investigation or proceeding relating to evidence of a material violation, reports the results of the investigation to the CLO and (i) either both the attorney and the CLO reasonably believe no material violation has occurred, is ongoing, or is about to occur or (ii) the CLO reports the results of the investigation (or in the case of litigation, provides reasonable and timely reports) “up the ladder” to the issuer’s board of directors, audit committee (or equivalent independent committee) or a QLCC. An attorney who is retained or directed by a QLCC to investigate evidence of a material violation or to assert
a colorable defense does not have any obligation to report evidence of a material violation “up the ladder.”

The existence of a QLCC may also relieve an attorney of the obligation to report evidence of a material violation “up the ladder.”

What is a QLCC?

By creating a “qualified legal compliance committee,” an issuer can provide for an alternative method of addressing evidence of a material violation. An attorney who becomes aware of such evidence can fully satisfy his or her obligations under the rules by reporting the information to the QLCC. In addition, a CLO who receives a report of evidence of a material violation from an attorney may refer the report to the QLCC in lieu of conducting his or her own inquiry.

A QLCC (which may also be the audit committee or other committee) will consist of at least one member of the issuer’s audit committee (or an equivalent committee of independent directors if there is no audit committee) and two or more independent board members. In order to constitute a QLCC, the committee must adopt written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation and must have been duly established by the board of directors with the authority and responsibility to determine whether an investigation is necessary, conduct inquiries (including retention of experts), inform the CLO, CEO and the board of directors of the results of investigations, and recommend (by majority vote) that the issuer implement an appropriate response to evidence of a material violation. The QLCC will have the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response recommended by the QLCC.

What can an attorney do if the issuer does not take appropriate remedial actions?

An attorney may, without the client’s consent, provide to the Commission confidential information related to the representation of the client, if the attorney reasonably believes it necessary (1) 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; (2) to prevent the issuer, in a Commission investigation or administrative proceeding, from committing perjury, suborning perjury or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission or (3) to rectify the consequences of the issuer’s material violation 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. In addition, an attorney may use the documentation in connection with a report to defend against charges against that the attorney has failed to comply with the rules.

The proposed rules provided that if an issuer, through its attorney, shared with the Commission information related to a material violation, pursuant to a confidentiality agreement, the sharing of information would not constitute a waiver of the attorney-client privilege or any otherwise applicable privilege or protection with respect to third parties. In response to comments asserting that Sarbanes-Oxley did not grant the Commission any authority to preempt state law regarding attorney-client privilege, the Commission removed this provision from the final rules. In the adopting release, however, the Commission states that it will continue to follow its policy of entering into confidentiality agreements when 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 agreements when litigants (usually class action plaintiffs) argue that such disclosure of information to the Commission has waived any privilege or protection.
In addition, an attorney who reported evidence of a material violation and reasonably believes that he or she has been discharged for making such a report may notify the issuer’s board of directors or any committee that he or she believes that the reason for the discharge was the reporting of evidence of a material violation under these rules. This provision is designed to ensure that the CLO may not block the issuer’s board (or appropriate committee) from receiving a report merely by discharging the attorney.

**What happened to the “noisy withdrawal” requirement?**

As adopted, the rules do not currently do not require either an attorney or an issuer to report evidence of a material violation, or the response to such evidence, outside of the issuer. The rules as proposed were to have set forth the obligations of an attorney who has not received an appropriate response in a reasonable time to an “up the ladder” reporting of evidence of a material violation. Instead, the Commission has extended the comment period for the “noisy withdrawal” requirements and proposed a possible alternative.

As proposed by the Commission, “noisy withdrawal” would have forced an attorney who had not received an appropriate response in a reasonable time and who believed that the reported material violation was either ongoing or was about to occur and was likely to result in substantial injury to the issuer or investors to (1) withdraw from representation (but in-house lawyers need not resign); (2) notify the SEC, within one business day, that the withdrawal was based on professional considerations, and (3) disaffirm any false or misleading submission to the SEC that he or she had participated in preparing. If a violation had previously occurred, but had no ongoing effect, an attorney would have been permitted, but not required to take those actions. An attorney who believed he or she was discharged because of a report would be permitted, but not required, to take those actions. The CLO would have had to inform any attorney replacing the resigning attorney that the withdrawal was based on professional considerations.

The Commission has put forth an alternative proposal for comment. This proposal would require an attorney who has reported evidence of a material violation (other than to a QLCC) and has not received an appropriate and timely response after reporting the matter “up the ladder” and reasonably concludes that there is substantial evidence of a material violation that is ongoing or about to occur and is likely to cause substantial injury to the financial interest or property of the issuer or of investors to withdraw from representation and notify the issuer in writing that the withdrawal is based upon professional considerations (or in the case of in-house counsel, to cease any participation or assistance in any matter concerning the violation and notify the issuer in writing that he or she believes that the issuer has not provided an appropriate and timely response). The issuer’s CLO would be required to notify any replacement attorney that the previous attorney had withdrawn, ceased to participate or been discharged pursuant to these provisions.

The second part of this alternative proposal provides that where an attorney had provided the issuer with such a written notice, the issuer would be required to report such notice and “the circumstances related thereto” on a Form 8-K (or Form 20-F or 40-F, as applicable) within two business days of receipt of the written notice. Among other things, the Commission has specifically requested comment on whether any circumstances exist under which an issuer should not be required to disclose an attorney’s written notice.

Finally, the alternative proposal would permit an attorney, if the issuer had not complied with the Form 8-K requirement, to inform the Commission that he or she had provided the issuer with such a written notice.
What are the consequences if an attorney does not comply with the new rules?

A violation by an attorney appearing and practicing before the Commission in the representation of an issuer will subject the attorney to the civil penalties and remedies for a violation of the federal securities laws. Such attorneys are also subject to the disciplinary authority of the Commission, which may censure the attorney or the attorney, temporarily or permanently, from appearing or practicing before the Commission.

However, an attorney who complies in good faith with the rules will not be subject to discipline or otherwise liable for violations of inconsistent standards imposed by a state or federal jurisdiction. Also, an attorney practicing outside the U.S. will not be required to comply with the rules to the extent that such compliance is prohibited by applicable foreign law.

The rules make clear that the rules do not create a private right of action against any attorney, law firm or issuer and exclusive enforcement authority lies with the Commission. In the event of conflicts with state law, the rules govern. However, the rules do not preempt the ability of a state to impose more rigorous obligations on attorneys if the state rules are not otherwise inconsistent with the rules.

How do the new rules affect attorneys in their different roles?

How do the new rules apply from the chief legal officer’s perspective?

The CLO must bear a substantial portion of the burden under the new rules. While the reporting attorney’s role is one of notification, the CLO’s role is one investigation and enforcement (although the CLO can be in the position of reporting attorney as well).

Once a CLO receives a report of evidence of a material violation from the attorney, the CLO is obligated to conduct a reasonable inquiry to determine whether a material violation has occurred, is occurring or is about to occur. Then, unless the CLO reasonably believes that a material violation has not occurred, he or she must take all reasonable steps to cause the issuer to undertake appropriate remedial measures. Further, if the reporting attorney does not reasonably believe that the CLO has provided an appropriate and timely response to matter, the attorney must report the matter “up the ladder” to the Board of Directors or audit or other independent committee.

Therefore, not only is the CLO charged with investigating evidence of a material violation and causing the issuer to take any remedial measures necessary, he or she must do so to the satisfaction of the reporting attorney and possibly of the Board of Directors or independent directors.

On the other hand, if the issuer has a QLCC in place, it may assume these responsibilities of investigation and enforcement that would otherwise fall to the CLO.

How do the new rules apply from the outside counsel’s perspective?

Outside counsel must now always be mindful of its own duties and obligations should it become aware of facts that might constitute evidence of a material violation. The standard, while an objective one, does not provide much in the way of clear guidance. Evidence of a material violation exists when an attorney has 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. Some commentators have already criticized this somewhat cumbersome standard as unworkable and unenforceable.
While the use of the term “evidence” implies information for which an attorney search, in reality, for an outside counsel such evidence will usually involve fragmentary information to which the attorney is exposed while performing legal services for the issuer. Without the benefit of hindsight, outside counsel will have difficulty determining whether information rises to the level of “evidence of a material violation.” Outside counsel will likely have even greater difficulty determining: (a) whether the response of CLO is appropriate and timely, (b) whether up the ladder reporting is necessary; and (c) assuming no satisfactory response occurs, what further steps are necessary. Even apart from uncertainties and difficulties with compliance, the standard will likely raise a host of client-relationship considerations for outside counsel.

Although the Commission eliminated the proposed documentation requirement in the final rule, outside counsel should consider implementing policies and procedures in that regard in light of these new obligations. It should be noted that the Commission may still implement “noisy withdrawal” or an alternative which involves withdrawal from representation of the issuer by the attorney and possibly notification regarding the matter to the Commission. Any such requirements which are imposed will create additional issues for the outside attorney.

How do the new rules apply from the junior in-house attorney’s perspective?

On the face of the new rules, a subordinate in-house attorney has perhaps the least cause for concern. A junior in-house attorney fulfills his or her responsibility by reporting evidence of a material violation to a supervisory attorney. The subordinate attorney has the authority, but not the obligation, to report the evidence of a material violation up the ladder if he or she believes that the supervisory attorney has failed to comply with the requirements. In reality, of course, the in-house attorney’s “supervisory attorney” may be the CLO, and the issuer is the in-house attorney’s employer. While the Commission has attempted to take these employment issues into consideration in shaping the rules, it remains true that complying with the rules may result in difficult and awkward situations, possibly even job-threatening situations, for junior in-house attorneys.

How do the new rules apply from the board’s perspective?

The Board of Directors, or an independent committee of the Board, is ultimately responsible for ensuring that the issuer takes the necessary remedial measures in the event of a material violation. The Board already has such duties generally, so the rules do not appear to increase significantly the Board’s obligations. The Board must consider, however, the possibility that a reporting attorney will determine that the Board has failed to take appropriate remedial steps. Under certain circumstances, the new rules permit the reporting attorney to provide the Commission with information that would otherwise be confidential. In addition, depending on the Commission’s ultimate decision on whether to require a “noisy withdrawal” or a Form 8-K filing, the Board will have to consider the consequences of public disclosure if the Board fails to satisfy the reporting attorney that it has taken appropriate remedial actions.

With the possibility of the audit committee or other committee of independent directors being designated a QLCC, the responsibilities of independent directors will continue to mount under the new rules, as they have under other aspects of the Sarbanes-Oxley Act and other associated rules the Commission has already promulgated.

How do the new rules apply from the plaintiffs bar’s perspective?

The new rules expressly state that they do not establish a private right of action. Given the ingenuity of the plaintiffs’ bar, purported violations of the new rules will surely find their way into class action complaints alleging securities fraud. The convoluted nature of the definition of “evidence of a
material violation,” among other things, almost guarantees that the plaintiffs’ bar can routinely make such allegations, with only limited proof, if any, and without reasonable fear of sanctions. Assuming, as seems likely, the new rules cause more disclosures of apparent violations, either by the Board or inside or outside counsel, such disclosures will certainly provide fodder for the plaintiffs’ bar to file more class action lawsuits.