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Frequently Asked Questions Concerning the SEC's Standards of Professional Conduct for Attorneys

The SEC's final rules establishing standards of professional conduct for attorneys who appear and practice before the SEC on behalf of issuers became effective on August 5, 2003. We are taking this opportunity to provide a general overview of some of the practical implications of the new rules in a question and answer format. A more detailed discussion of the rules is available in our February 12, 2003 memorandum entitled "SEC Adopts Standards of Professional Conduct for Attorneys."

I. Overview

What do the rules require?

The rules require an attorney practicing or appearing before the SEC in representing an issuer to report evidence of a material violation of U.S. federal or state law or a material breach of fiduciary duty or similar violation of law by an issuer or an officer, director, employee or agent of the issuer. Violations of foreign laws are not covered by the rules.

To whom should reports be directed?

Attorneys are to report evidence of a material violation to:

- the issuer's chief legal officer ("CLO"); or
- the CLO and the chief executive officer ("CEO").

Unless the attorney reasonably believes the CLO or CEO has responded appropriately within a reasonable time, the attorney must report the evidence further "up the ladder" to:

- the audit committee;
- another committee of independent directors; or
- the full board of directors.

If the reporting attorney reasonably believes that it would be futile to report evidence of a material violation to the CLO and CEO, the attorney may report the evidence of a material violation directly to the audit committee, another committee of independent directors or the full board.

If the issuer has a qualified legal compliance committee ("QLCC"), an attorney may report evidence of a material violation to the QLCC instead of the CLO or CEO.

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Does the CLO have to be an attorney?

Yes, the CLO must be an attorney. If a company does not have an in-house CLO they must designate an outside counsel as CLO.

What constitutes "evidence of a material violation"?

The rules define "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".

There is no requirement that the source of the evidence of a material violation arise in the context of representing the issuer. If a lawyer is appearing and practicing before the SEC in the representation of an issuer and learns of a material violation by the issuer or any agent of the issuer, no matter what the source, he or she has a duty to report it in accordance with the rules.

What does the SEC mean by "reasonably likely" that a material violation has occurred, is ongoing, or is about to occur?

In order to be "reasonably likely," a material violation must be more than a mere possibility, although it does not have to be "more likely than not." Under the rules, attorneys are required to make a report if they conclude that a material violation is reasonably likely to occur, is ongoing or has occurred.

Who is covered by the rule?

Generally, both in-house and outside attorneys who appear and practice before the SEC in the representation of an issuer are covered by the rules. Attorneys who work in-house, but no longer act in any legal capacity (*e.g.*, they serve in a purely business function) are not covered.

Although the rules apply to foreign attorneys, there is a broad exclusion for "non-appearing foreign attorneys." Non-appearing foreign attorneys are attorneys who are (i) not U.S. counsel, (ii) do not hold themselves out as U.S. law advisors, (iii) do not advise on U.S. law and who:

- either conduct activities that would constitute appearing and practicing before the SEC only incidentally and only in the ordinary course of their practice outside the United States; or
- engage in activities that qualify as appearing and practicing before the SEC but only in consultation with U.S. counsel.

What does "appear and practice before the SEC" mean?

"Appearing and practicing" before the SEC means:

- transacting any business with the SEC, including communications in any form;
- representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request, or subpoena;
- providing advice with respect to U.S. securities laws or any SEC rule or regulation regarding any document that the attorney has notice will be filed with, submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, including any advice with respect to the preparation, or participation in the preparation, of any document to be filed with the SEC; or
- advising an issuer as to whether information or a statement, opinion, or other writing is required under the U.S. securities laws or the SEC's rules or regulations to be filed with or

submitted to, or incorporated into any document that will be filed with or submitted to, the SEC.

Are there circumstances where an attorney is excluded from the reporting obligations?

Yes. An attorney retained or directed by the issuer or the QLCC in connection with an investigation regarding evidence of a material violation is excluded from reporting obligations.

In addition, an attorney practicing outside the U.S. is not required to comply with the rules to the extent that such compliance is prohibited by applicable foreign law.

Is the report required to be in writing or documented in a specific manner?

No. A report may be made in person, by telephone, by e-mail or other writing.
Although the rules do not mandate documentation of a report or how companies should respond to a report, the SEC recommends that companies adopt compliance procedures for recording and tracking all such reports.

What should a CLO do upon receipt of a report?

Once a report of evidence of a material violation is received, the CLO (or the equivalent) is required to conduct or cause an inquiry into the report of 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 CLO determines no material violation has occurred, is ongoing, or is about to occur, he or she is required to notify the reporting attorney and advise the reporting attorney of the basis for this determination.

Alternatively, in lieu of causing an inquiry by the CLO and CEO, a CLO may refer a report of evidence of a material violation to a QLCC, if the issuer has duly established a QLCC prior to the report of evidence of a material violation. If the CLO refers the report to a QLCC, the CLO is to inform the reporting attorney of this fact and thereafter, the QLCC is responsible for responding to the evidence and the reporting attorney is not required to assess the issuer's response to the reported evidence of a material violation.

What is an "appropriate response" to a report?

Unless the CLO reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she is to take all reasonable steps to cause the issuer to adopt an appropriate response to the report and advise the reporting attorney of such response.

An "appropriate response" is a response as a result of which the reporting attorney reasonably believes:

- that no material violation has occurred, is ongoing, or is about to occur;
- 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
- that the issuer, with the consent of the board of directors, a board committee to whom a report of a material violation could be made or a QLCC, has retained or directed an attorney to review the reported evidence of a material violation and either:

- has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or
- 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.

If the reporting attorney does not reasonably believe that the issuer has made an appropriate response within a reasonable time, the attorney is to explain to the CLO or the CEO why he or she believes that the response was not appropriate.

How does an attorney satisfy his or her obligations under the rule?

A reporting attorney who receives an appropriate and timely response to a report he or she has made, has satisfied his or her reporting obligations. The SEC's stated intent is to allow attorneys to exercise their judgment so long as it is reasonable and it has said that will consider attendant circumstances in determining whether an attorney could reasonably believe that an issuer's response is appropriate.

May a reporting attorney reveal confidential information about an issuer to the SEC?

Yes. An attorney may reveal to the SEC, without the issuer's consent, confidential information related to the representation of the issuer, to the extent the attorney reasonably believes necessary:

- 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;
- to prevent the issuer, in a SEC investigation or administrative proceeding from committing perjury, suborning perjury, or committing any act that is likely to perpetrate a fraud upon the SEC; or
- to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

We note that in some jurisdictions this may conflict with state rules regarding attorney conduct and that the SEC rule provides that the SEC rules of conduct preempt inconsistent state rules.

II. Supervisory and Subordinate Attorneys

Who is a supervisory attorney under the rules?

An attorney supervising or directing another attorney who is appearing and practicing before the SEC in the representation of an issuer is a supervisory attorney. The CLO (or the equivalent) is a supervisory attorney under the rules.

An attorney who supervises or directs a subordinate on matters unrelated to the subordinate's "appearing and practicing" before the SEC is not a supervisory attorney. 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 SEC is a supervisory attorney.

Who is a subordinate attorney under the rules?

An attorney who appears and practices before the SEC 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 CLO) is a subordinate attorney. An attorney who acts directly under the CLO is a supervisory attorney under the rules.

What are the responsibilities of a supervisory attorney?

A supervisory attorney is to make reasonable efforts to ensure that a subordinate attorney that he or she supervises or directs complies with the rules. To the extent a subordinate attorney appears and practices before the SEC in the representation of an issuer, the supervisory attorneys of such subordinate are also deemed to appear and practice before the SEC.

A supervisory attorney is to comply with the reporting requirements in the rules when a subordinate attorney has reported evidence of a material violation to the supervisory attorney.

What are the responsibilities of a subordinate attorney?

A subordinate attorney is required to comply with the rules notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

A subordinate attorney is to report to his or her supervising attorney evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the SEC.

A subordinate attorney may but is not required to take the steps permitted or required by the rules if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation has failed to comply with the rules.

III. QLCC Alternative

What is a QLCC?

A qualified legal compliance committee, or QLCC, is a board committee that an issuer may, but is not required to, establish. A QLCC may be the same as the audit committee or another committee of the issuer. An audit committee can function as a QLCC, as can a Nominating/Corporate Governance Committee if it has among its members a member of the Audit Committee.

If established, a QLCC must:

- consist of at least one member of the issuer's audit committee (or, if no audit committee, an equivalent committee of independent directors) and two or more members of the board who are not employed, directly or indirectly, by the issuer;
- adopt written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation;
- be duly established by the board, with the authority and responsibility:
    - to inform the issuer's CLO and CEO (or the equivalents) of any report of evidence of a material violation (except when such a report would be futile, in which case a report is made directly to the audit committee, another committee of independent directors, or to the full board);
    - 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 that an investigation is necessary or appropriate, to:
        - notify the audit committee or the full board of directors;
        - initiate an investigation, which may be conducted either by the CLO or by outside attorneys; and
        - retain such additional expert personnel as the committee deems necessary.

- at the conclusion of any such investigation regarding a material violation, to:
  - recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and
  - inform the CLO and CEO and the board of directors of the results of any such investigation and the appropriate remedial measures to be adopted; and
- acting by majority vote, to take all other appropriate action, including the authority to notify the SEC in the event that the issuer fails in any material respect to implement an appropriate response that the QLCC has recommended the issuer to take.

What is the role of the QLCC?

If a company has established a QLCC, an attorney may, instead of reporting a material violation to the CLO or other channels described above, make a report to the QLCC.

In addition, in lieu of conducting his or her own inquiry, a CLO who receives a report of evidence of a material violation may refer the report to a previously established QLCC. The CLO shall inform the reporting attorney that the report has been referred to a QLCC and thereafter, the QLCC shall be responsible for responding to the evidence of a material violation reported to it.

If an attorney reports a material violation to a QLCC, he or she is deemed to satisfy his or her obligation to report and would not be required to assess the issuer's response to the reported evidence of a material violation.

What are the advantages of establishing a QLCC?

The primary benefit of establishing a QLCC is that once a reporting lawyer reports to the QLCC, his or her obligations are satisfied. If a report is made to the CLO and/or CEO, the reporting attorney may have continuing up-the-ladder reporting obligations if he or she does not believe that the CLO or CEO responded appropriately to the report.

If the SEC adopts the "noisy withdrawal" requirements which are under consideration, the QLCC would be of greater benefit as a lawyer would be able to satisfy his or her reporting out or noisy withdrawal obligations by reporting directly to the QLCC. Under the proposed noisy withdrawal rules, attorneys who have made a report all of the way "up the ladder" and have not received an appropriate response would be required to withdraw from the representation, notify the SEC that the withdrawal was for "professional considerations" and disaffirm to the SEC any submission that the attorney has prepared that the attorney reasonably believes is, or may be, materially false or misleading.

What are the disadvantages of establishing a QLCC?

A disadvantage of having a QLCC is that it takes any inquiry out of the hands of the CLO, who may be better suited to investigate and filter reports in the first instance.

In addition, post-Sarbanes-Oxley, boards already have greater duties and the establishment of another committee may add to that burden. Directors may also be concerned about increased liability, although the SEC has specifically stated that service on a QLCC is not intended to increase liability under state law.

IV. Sanctions & Discipline

What are the consequences of a violation?

Violators of the rules will be subject to SEC enforcement action for civil violations of the federal securities laws.

Can an individual sue an attorney for violation of the rules?

The rules state that only the SEC can enforce the rules, provide a safe harbor for attorneys that comply with the rules from private civil suits and specifically negate any private right of action. However, this may not prevent individual investors from attempting to enforce the rules through private litigation.

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The questions and answers set forth herein are intended to be general in nature and are not intended to provide legal advice with respect to any particular situation. No legal or business decision should be based solely on the content of this memorandum. Questions concerning issues addressed in this memorandum should be directed to any of the following:

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