Paul|Weiss

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SEC Proposes Rules Regarding the Implementation of Standards of Professional Conduct for Attorneys

The SEC has proposed new rules to establish standards of professional conduct for attorneys who appear and practice before the SEC on behalf of issuers. If adopted, the rules will significantly impact the role of attorneys representing issuers, increasing their responsibilities. The proposed rules would:

- require an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by an issuer or any agent of the issuer to the issuer's chief legal officer ("CLO") or the CLO and the chief executive officer ("CEO");
- if the CLO or CEO does not respond appropriately, require the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors; and
- if the issuer continues to fail to provide an appropriate response to the attorney, permit or require the attorney to effect a "noisy withdrawal" from his or her representation of the issuer, to notify the SEC that they have done so and to disaffirm any submission that they have participated in preparing that is tainted by the material violation, and permit attorneys to report material violations to the SEC.

The proposed rules are intended to implement Section 307 of the Sarbanes-Oxley Act (the "Act"), which directs the SEC to adopt rules setting forth minimum standards of professional conduct for attorneys. The proposed rules would apply to all attorneys, U.S. and foreign, whose practice involves advice to domestic and non-U.S. issuers.

The proposed rules are subject to a comment period ending on December 18, 2002. The Act requires the SEC to adopt final rules no later than January 26, 2003.

I. Mandate of the Sarbanes-Oxley Act

The Act requires the SEC to issue rules setting forth minimum standards of professional conduct for attorneys that require an attorney to: (i) report a material violation of securities laws or breach of fiduciary duty or similar violation by the company or its agent to the CLO or CEO, or equivalent, and then, if there is no appropriate response to the evidence, (ii) report the evidence to the audit committee, another committee of directors not employed directly or indirectly by the issuer or to the board of directors. The proposed rules go beyond the requirements of the Act. Among other things,

the Act does not direct the SEC to adopt rules covering foreign attorneys, nor does it require "up the ladder" reporting to the point of withdrawal from representation of a client with notification to the SEC and disaffirmation of SEC-filed documents. These provisions in the proposed rules place significant additional responsibilities on issuers' attorneys, as described below.

II. Who is Covered

The proposed rules would broadly apply to any attorney appearing and practicing before the SEC in the representation of an issuer. This would include:

- in-house counsel of the issuer and outside attorneys of the issuer, whether licensed or practicing in the United States or in a foreign jurisdiction; and
- any attorney acting in any way on behalf, or for the benefit of an issuer, whether or not employed or retained by the issuer.

Under the proposed rules, a person would be deemed to be an attorney if that person is qualified to practice law in any jurisdiction, or holds himself or herself out to be an attorney, including lawyers licensed in foreign jurisdictions, foreign law firms, multijurisdictional law firms and other foreign lawyers.

"Appearing and practicing" before the SEC would be broadly defined to include, without limitation, an attorney's:

- transacting any business with the SEC, including communication with SEC Commissioners, the SEC, or its staff;
- representing any party to, or the subject of, or a witness in an SEC administrative proceeding;
- representing any person in connection with any SEC investigation, inquiry, information request, or subpoena;
- preparing, or participating in the process of preparing, any statement, opinion or other writing which the attorney has reason to believe will be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the SEC Commissioners, the SEC, or its staff; or
- advising any party that:
    - a statement, opinion or other writing need not or should not be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the SEC Commissioners, the SEC, or its staff; or

- the party is not obligated to submit or file a registration statement, notification, application, report, communication or other document with the SEC or its staff.

Acting "in the representation of an issuer" would be defined as acting in any way on behalf of, at the behest of, or for the benefit of an issuer, whether or not employed or retained by the issuer.

III. What Must Be Reported – Material Violation

Under the proposed rules, an attorney who becomes aware of a material violation of securities laws, a material breach of fiduciary duty, or a similar material violation by the issuer or by any officer, director, employee or agent of the issuer, would be required to report the violation immediately, to the issuer's CLO or to both the issuer's CLO and its CEO.

The reporting obligation would be triggered only when an attorney becomes aware of information that would lead a reasonable attorney to believe a material violation has occurred, is occurring, or is about to occur. A breach of fiduciary duty would include any breach of fiduciary duty recognized at common law, including, but not limited to, misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of unlawful transactions. The SEC noted that the meaning of "similar violations" would be determined according to future SEC decisions.

It is significant to note, and the SEC emphasized, that the proposed rules are not intended to impose upon the attorney making an initial report, whether in-house counsel, or outside counsel, a duty to investigate evidence of a material violation or to determine whether there is a material violation. The SEC acknowledged that such inquiries are not discouraged, however.

IV. "Up the Ladder" Reporting Procedure

A. Initial Report to CLO

Under the proposed rules, an attorney must make an initial report to the issuer's CLO or to both the issuer's CLO and its CEO, of a material violation, as soon as the attorney becomes aware of such a violation.

B. Maintaining a Contemporaneous Record

The attorney reporting evidence of a material violation would be required to take steps reasonable under the circumstances to document the report and any responses to it received from the CLO, CEO or others, and would be required to retain such documentation for a reasonable time. A subordinate attorney who reports evidence of a material violation to his or her supervising attorney is also required to take these steps. The SEC gave the following additional guidance on the preparation and maintenance of contemporaneous records:

- Such contemporaneous records would typically include the date, time, location, manner and substance of the report, the response and the identity of witnesses to the report and the

response. The records would also include the report or the response itself, if in written form.

- A reasonable time to retain the required report under the proposed rules will depend on the circumstances, but this time period should probably not be shorter than the statute of limitations applicable to the material violation at issue.

- The proposed rules do not establish any requirement for documentation of an attorney's decision that information does *not* constitute evidence of a material violation (except with respect to supervisory/subordinate attorney relationships). However, the SEC acknowledged that in close cases, it would be prudent for an attorney to document this determination.

C. Chief Legal Officer's Duty to Investigate

Once a report of a material violation is received, the CLO would be required to conduct or cause an inquiry into the evidence of the material violation that he or she reasonably believes is necessary to determine whether the material violation described in the initial report has occurred, is occurring, or is about to occur. If the CLO reasonably believes no material violation has occurred, is occurring, or is about to occur, he or she is required to so advise the reporting attorney.

Alternatively, the CLO may refer a report of evidence of a material violation to a qualified legal compliance committee (a "QLCC," as described below). If the CLO does not refer the report to a QLCC, or the issuer does not have a QLCC, the CLO is responsible for review of the report of a material violation, if he or she reasonably believes it necessary to review. The proposed rules set forth the following procedures that the CLO should follow after receipt of a report of a material violation:

- If the CLO reasonably believes that a material violation has occurred, is occurring, or is about to occur, he or she shall take any necessary steps to ensure that the issuer adopts appropriate remedial measures, including appropriate disclosures, and/or imposes appropriate sanctions to stop any material violation that is occurring, prevent any material violation that is about to occur, and/or to rectify any material violation that has already occurred.

- The CLO shall promptly report the remedial measures adopted and/or sanctions imposed "up the ladder," to the CEO, to the audit committee of the issuer's board of directors, or to the issuer's board of directors, and advise the reporting attorney of these actions.

- The CLO shall take reasonable steps to document his or her inquiry and to retain such documentation for a reasonable time.

D. Appropriate Response to the Report

Under the proposed rules, a reporting attorney who receives an appropriate response within a reasonable time and has taken reasonable steps to document his or her report and the response to it, has satisfied his or her reporting obligations.

An "appropriate response" would be defined as one that provides a basis for an attorney reasonably to believe:

- that no material violation is occurring, has occurred, or is about to occur; or
- that the issuer has, as necessary, adopted remedial measures, including appropriate disclosures, and/or imposed sanctions that can be expected to stop any material violation that is occurring, prevent any material violation that has yet to occur, and/or rectify any material violation that has already occurred.

E. Reporting a Material Violation "Up the Ladder"

If an attorney who has made a report reasonably believes that the CLO or the CEO of the issuer has not provided an appropriate response, or has not responded within a reasonable time, the attorney would be required to report the evidence of a material violation to:

- the audit committee of the issuer's board of directors;
- another committee of independent directors (if the issuer's board of directors has no audit committee); or
- the issuer's full board of directors (if the issuer does not have another committee of independent directors).

Under the proposed rules, 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 the full board.

A reporting attorney who has reported a matter all the way "up the ladder" within the issuer and who reasonably believes that the issuer has not responded appropriately must explain his or her reasons for so believing to the CLO, CEO, or directors to whom the attorney reported the evidence of a material violation and must take reasonable steps to document the response, or absence thereof, and retain such documentation for a reasonable period of time.

F. "Noisy Withdrawal" Provisions

The proposed rules provide that attorneys who have made a report all the way "up the ladder" (that is, an initial report to the CLO or CLO and CEO and a second report to the board, audit or other independent committee), and have not received an appropriate response in a reasonable time, and reasonably believe that the reported material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest of the issuer or of investors, are required to:

- withdraw from the representation;
- notify the SEC, within one business day after withdrawing, indicating that the withdrawal was for "professional considerations;" and

- promptly disaffirm to the SEC any submission that the attorney has prepared or assisted in preparing that the attorney reasonably believes is, or may be, materially false or misleading.

The above provisions apply to both in-house and outside counsel, however, unlike outside counsel, in-house counsel may, but are *not required*, to resign.

If the past material violation at issue has already occurred, and is not ongoing and is likely to have resulted in substantial financial injury to the issuer, the reporting attorney may, but is not required, to withdraw, notify the SEC, and disaffirm false or misleading submissions the attorney has prepared or assisted in preparing. Under the proposed rules, an ongoing violation includes an inaccurate disclosure in a submission to the SEC that has not been corrected and may be relied on by investors.

In addition, the SEC stated that the use of the phrase "professional considerations" to explain the withdrawal keeps confidential the particular facts underlying the withdrawal while signaling that the withdrawal reflects substantially more than a disagreement about the best legal strategy or a dispute over the cost of representation. A purely silent withdrawal, the SEC also noted, would be likely to assist an issuer in carrying out an ongoing or intended violation.

The proposed rules further require the CLO to notify any attorneys retained or employed to replace the attorney who has withdrawn, that the previous attorney withdrew based on professional considerations. In the case of withdrawal for professional considerations in connection with evidence of an issuer's past material violation, the same disclosure obligation would be imposed on the CLO.

G. Alternative Reporting to a Qualified Legal Compliance Committee

The proposed rules would also provide an alternative system for reporting evidence of material violations to a qualified legal compliance committee ("QLCC"). If an attorney 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 making a report to the CLO or the other channels described above, report such evidence of a material violation to a QLCC, if the issuer has duly formed such a committee. In addition, as noted earlier, in lieu of conducting his or her own inquiry, a CLO who receives a report of a material violation may refer the report to a QLCC.

An issuer may, but is not required to, establish a QLCC. The proposed rules provide that if established, a QLCC must:

- consist of at least one member of the issuer's audit committee and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer;

- be duly established by the issuer's board of directors and be authorized to investigate any report of evidence of a material violation by the issuer, its officers, directors, employees or agents;

- establish written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation; and
- have the authority and responsibility:
  - to inform the issuer's CLO and CEO 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 decide whether an investigation is necessary to determine whether the material violation described in the report has occurred, is occurring, or is about to occur and, if so, to:
    - 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; and
  - at the conclusion of any such investigation regarding a material violation, to:
    - direct the issuer to adopt appropriate remedial measures, including appropriate disclosures, and/or to impose appropriate sanctions to stop any material violation that is occurring, prevent any material violation that is about to occur, and/or to rectify any material violation that has already occurred; and
    - inform the CLO and the CEO and the board of directors of the results of any such investigation and the appropriate remedial measures to be adopted.

In addition, each member of a QLCC, together with the issuer's CLO and CEO, must individually have the authority and responsibility, in the event the issuer fails in any material respect to take any of the remedial measures that the QLCC has directed the issuer to take, to notify the SEC that a material violation has occurred, is occurring or is about to occur and to disaffirm in writing any document submitted to or filed with the SEC by the issuer that the individual member of the QLCC or the CLO or the CEO reasonably believes is false or materially misleading.

If an attorney reports a material violation to a QLCC, he or she would be deemed to satisfy his obligation to report and would not be required to assess the issuer's response to the reported evidence of a material violation. The SEC indicated that this type of provision may encourage attorneys to report

evidence of a material violation more promptly, since the reporting attorney would not have to worry that he or she might ultimately be obliged to decide whether the issuer's response was "appropriate."

H. Issuer Confidentiality/Attorney-Client Privilege Issues

The proposed rules provide that a report of a material violation or any response thereto (or any contemporaneous records of the report and responses) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with the proposed rules are in issue.

The proposed rules also provide that 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 is necessary, in the following circumstances:

- 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;
- to prevent the issuer from committing an illegal act that the attorney reasonably believes is likely to perpetrate a fraud on the SEC; or
- to rectify the consequences of the issuer's illegal act in the furtherance of which the attorney's services had been used.

The SEC further indicated that it does not intend to inhibit the consultative process between an issuer and its attorney or chill zealous advocacy by an issuer's defense counsel by adopting these proposed rules. However, the SEC noted that such provisions facilitate investigations by the SEC and protect investors by maintaining the privileged or protected status of internal reports shared with the SEC. The proposed rules also provide that the attorney client privilege is not violated by the reporting of a material violation by an attorney, notice to the SEC following up the ladder procedure or disclosure to the SEC under the discharge provisions of the proposed rules (described below).

In addition, although this may trigger conflicts with state law, the proposed rules also provide that where an issuer, through its attorney, shares information related to a material violation with the SEC pursuant to a confidentiality agreement, this sharing of information does not constitute a waiver of any privilege or protection as to other persons. The SEC acknowledged that the proposed rules which permit disclosure in this instance would appear to preempt a state's rules which would forbid disclosure in this case.

Accordingly, the SEC noted that an attorney who is admitted in a jurisdiction that forbids disclosure of confidential information under circumstances where the proposed rules would permit disclosure, may disclose the information to the SEC, notwithstanding the contrary state rule. The SEC has invited comments on whether an attorney is required to disclose information to the SEC in this type of case.

V. Discharge

Under the proposed rules, an attorney formerly employed or retained by an issuer who reasonably believes that he or she has been discharged because he or she fulfilled the reporting obligation imposed by the proposed rules may, but is not required, to notify the SEC that he or she was discharged for reporting evidence of a material violation. In addition, that attorney may, but is not required, to disaffirm in writing any opinion, document, affirmation, representation, characterization or the like in any submissions the attorney has prepared or assisted in preparing that the attorney reasonably believes is or may be materially false or misleading.

VI. Responsibilities of Supervisory and Subordinate Attorneys

The proposed rules detail the respective responsibilities of supervisory and subordinate attorneys, employed in-house for the issuer and those serving as outside counsel retained by the issuer. The provisions in the proposed rules broadly define "supervisory attorney," specifically providing that an individual serving as the CLO of an issuer (or who serves in an equivalent role) is a supervisory attorney and that individuals who may exercise authority over subordinate attorneys for a particular matter, but who do not routinely supervise that attorney, are also supervisory attorneys. The proposed rules provide that an attorney under the supervision, direction, or supervisory authority of another attorney is a subordinate attorney.

The responsibility for compliance with the proposed rules' reporting requirements and documentation obligations are placed upon the supervisory attorney after he or she has been informed of evidence of a material violation by a subordinate. Subordinate attorneys would not be exempt from the proposed rules, although they would be deemed to have complied with it where they report evidence of material violations they learn about to their supervisory attorney.

In addition, the SEC indicated that a subordinate attorney who has reported evidence of a material violation to a supervisory attorney, and who believes that the supervisory attorney has failed to comply with the reporting requirement under the proposed rules would be permitted, but not obligated, to report the evidence "up the ladder" within the issuer.

The proposed rules further state that if a subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a possible material violation has failed to comply with the reporting requirements of the proposed rules, he or she may report the evidence to appropriate officers and directors of the issuer and the issuer's QLCC, if the issuer has established such a committee, and may carry out a "noisy withdrawal."

VII. Sanctions

Under the proposed rules, violations will be addressed by the SEC and will be treated as violations of the Exchange Act and subject the violator to all the remedies and sanctions available under the Exchange Act, including injunctions, civil money penalties and cease and desist orders. The SEC has acknowledged that violations of the proposed rules would not, without more, meet the standards prescribed in the Exchange Act which provide for the imposition of criminal penalties.

An attorney who violates a provision of the proposed rules will be deemed to have engaged in improper professional conduct and may also be subject to administrative disciplinary proceedings that can result in a censure, or a suspension or bar from practicing before the SEC. The types of conduct that an attorney would be subject to discipline for under the proposed rules include the following:

- intentional or knowing conduct, including reckless conduct, and
- negligent conduct in the form of a single instance of highly unreasonable conduct or repeated instances of unreasonable conduct, in each case which results in a violation of the proposed rules.

The SEC noted that under the proposed rules it would be able to sanction an attorney even when the attorney is also subject to discipline for violation of a state ethical rule in the state where he or she practices or is admitted. The SEC indicated that it is considering, among other things, whether Congress intended for the proposed rules to preempt state regulation governing an attorney's internal reporting evidence of a material violation and has asked for comments on this issue.

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These proposed rules are creating a significant amount of controversy. A discussion of the objections and debate generated by the proposals is beyond the scope of this summary. It remains to be seen how the SEC will respond to the many comments that it will likely receive on this proposal.

The descriptions set forth herein are intended to be general in nature. This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

Mark S. Bergman	(44 20) 7367-1601	John C. Kennedy	(212) 373-3025
Richard S. Borisoff	(212) 373-3153	Edwin S. Maynard	(212) 373-3034
Andrew J. Foley	(212) 373-3078	Raphael M. Russo	(212) 373-3309
Paul D. Ginsberg	(212) 373-3131	Valerie A. Bruce	(212) 373-3188

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