

THE SARBANES-OXLEY ACT
The Attorney Conduct Rules
(Section 307)

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C O U N S E L O R S A T L A W

OVERVIEW

Section 307 of Sarbanes-Oxley:

- Requires the SEC to issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in the representation of an issuer.
- Mandates that the rules require that attorneys report evidence of material violations of securities law, or breaches of fiduciary duty or similar violations, to the chief legal officer or the chief executive officer.
- Specifies that the rules require that, if the reporting attorney does not believe the response is appropriate, he or she must “report up” to the board of directors, to the audit committee, or to another board committee comprised solely of outside directors.

On November 21, 2002, the SEC issued proposed rules implementing Section 307 but going well beyond these requirements. The Commission adopted final rules on January 23, 2003.

OVERVIEW OF THE FINAL RULES:

The SEC:

- Mandated a “reporting up” provision, but with a higher triggering standard than proposed originally.
- Established a *permissive* “noisy withdrawal” mechanism.
- Did *not adopt mandatory* “noisy withdrawal,” *but . . .*
- Is likely to adopt a reporting obligation for public companies that is the functional equivalent of “noisy withdrawal” by a company’s attorneys.

Revised ABA Model Rules of Professional Conduct

Rule 1.6: Confidentiality of Information

- (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).

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- (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;

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- (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;
- (42) to secure legal device about the lawyer's compliance with these Rules;
- (53) 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
- (64) to comply with other law or a court order.

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Rule 1.13: Organization as Client

- (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 facts from which a reasonable lawyer, under the circumstances, would conclude 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

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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:~~

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- ~~(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.

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(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.

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- (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.

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(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.



FIRST QUESTION:

WHO IS SUBJECT TO THE RULES?

DEFINITION OF “ATTORNEY”:

- A person who provides legal services and who is in an attorney-client relationship with the company.

DEFINITION OF “APPEARING AND PRACTICING”:

- There must be a nexus between the attorney’s activities and the SEC.
- For example, an attorney must have notice that a document as to which he or she is providing legal advice will be filed with the SEC.



THESE TWO DEFINITIONS COMBINE TO TIGHTEN THE SCOPE OF THE FINAL RULES:

- Business people who happen to be lawyers are not covered.
- Non-U.S. attorneys are not covered unless they are counseling clients about U.S. law and they are not consulting with a U.S. attorney in so doing.

Attorneys Who are Representing a Company in an SEC Investigation

The Problem:

Under the proposed rules, an attorney representing an issuer in an SEC investigation would be “appearing and practicing” before the Commission and would have a reporting obligation if he or she learned of evidence of a material violation.

The Solution:

- (1) Under the final rules, the absence of a “reporting out” obligation makes the initial “reporting up” obligation less problematic.
- (2) There is no reporting obligation if the attorney was retained to assert a “colorable defense” and he or she reports the progress of the proceeding periodically to the board.*

* The advantage is that, in such a scenario, the CLO and the board do not have an obligation to investigate and respond.



SECOND QUESTION:

**WHAT IS THE TRIGGERING STANDARD?
(WHEN ARE ATTORNEYS OBLIGATED TO ACT?)**

THE STANDARD

“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 to both the issuer’s [CLO] and its chief executive officer . . . Forthwith.” (§ 205.3(b))

The background of the slide features a stylized globe on the left side, overlaid with a network of glowing fiber optic cables that create a sense of global connectivity and data flow. The overall color palette is a gradient of blues, from light to dark.

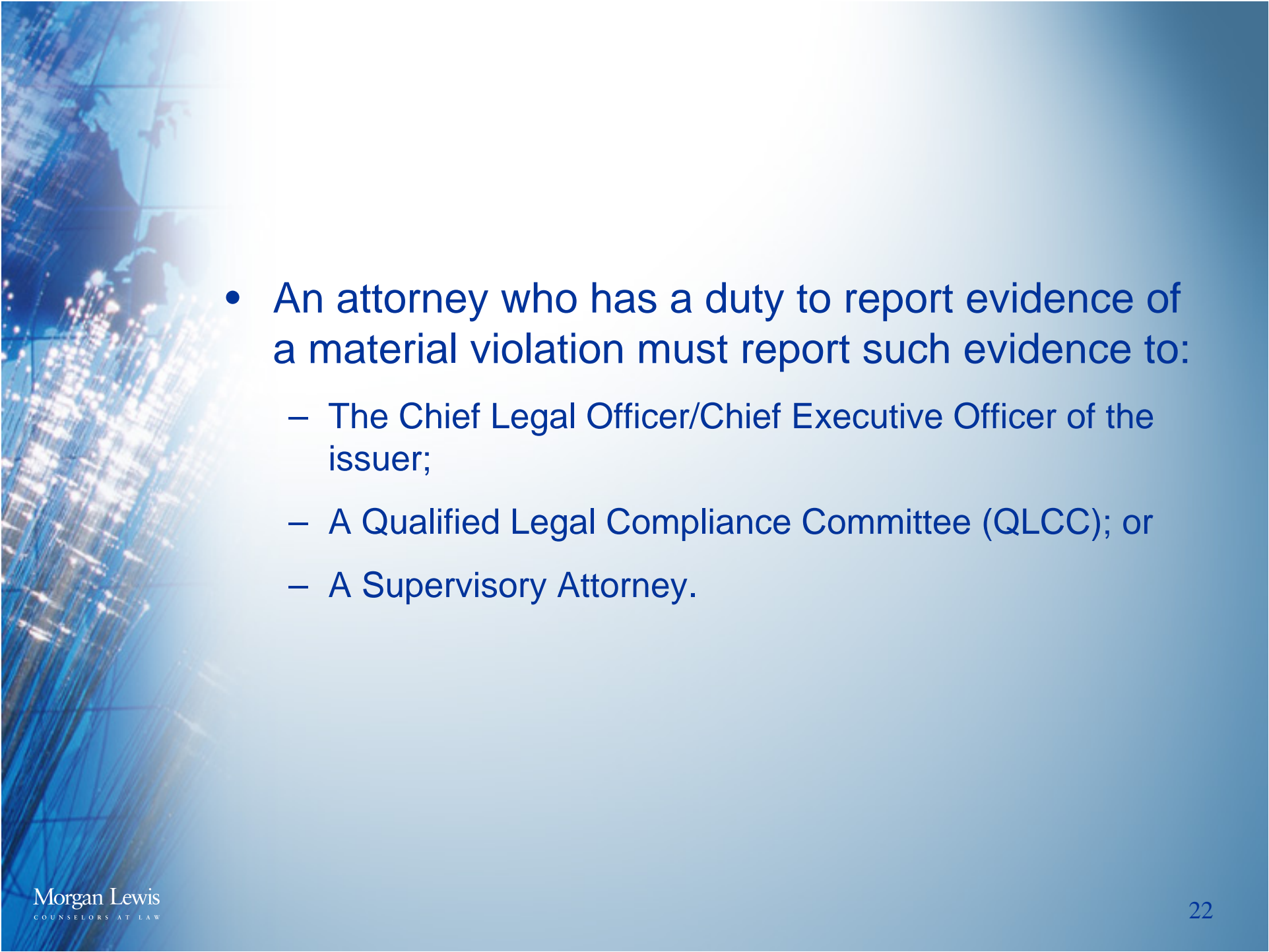
DEFINITION OF “EVIDENCE OF A MATERIAL VIOLATION”:

“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.” (§ 205.2(e))



THIRD QUESTION:

**WHAT ARE THE OBLIGATIONS IMPOSED
ON ATTORNEYS?**

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- An attorney who has a duty to report evidence of a material violation must report such evidence to:
 - The Chief Legal Officer/Chief Executive Officer of the issuer;
 - A Qualified Legal Compliance Committee (QLCC); or
 - A Supervisory Attorney.

- If an attorney who has decided to report to the CLO/CEO believes that the response of the CLO/CEO is not appropriate, the reporting attorney must present the evidence of a material violation to the Audit Committee, a QLCC, or the full board of directors.

Definition of “Appropriate Response”:

- Appropriate response means a response to a reporting attorney as a result of which she or he reasonably believes:
 - (1) That there is no violation;
 - (2) That the company has adopted appropriate remedial measures; or
 - (3) That the company has been informed by an attorney that a colorable defense exists. (§ 205.2(b))

REPORTING TO A QLCC OR A SUPERVISORY ATTORNEY

- An attorney who has decided to report to a QLCC or to his or her supervisory attorney has fulfilled his or her obligation and need not evaluate the response.
- Thus, a subordinate attorney is protected by reporting up to a supervisory attorney. (This is consistent with ABA Model Rule of Professional Conduct 5.2(b), Responsibilities of a Subordinate Lawyer.)

Permissive Noisy Withdrawal

- An attorney may reveal confidential information “(i) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interests of investors; (ii) to prevent the issuer . . . from committing perjury [or an act] that is likely to perpetuate a fraud upon the Commission; or (iii) to rectify the consequences of a material violation by the issuer . . . in furtherance of which the attorney’s services were used.” (§ 205.3(d)(2))

QUALIFIED LEGAL COMPLIANCE COMMITTEE (QLCC)

- The issuer may establish a QLCC consisting of at least one member of the audit committee and at least two other independent directors.
- The QLCC must:
 - Have written procedures.
 - Be authorized by the Board to initiate an investigation conducted by the CLO or outside counsel.
 - Be authorized to recommend that the issuer implement responsive actions.
 - Have the authority and responsibility to take other appropriate action, including notifying the SEC in the event that the issuer fails to implement a recommended response.

OBLIGATIONS OF THE CHIEF LEGAL OFFICER (CLO)

- Determine whether the material violation has occurred, is occurring, or is about to occur.
- If the CLO determines that there is no material violation, she or he must notify the reporting attorney and advise the reporting attorney about the basis for her or his decision.
- Unless the CLO reasonably believes that no material violation has occurred, is occurring or is about to occur, she or he must take reasonable steps to cause the issuer to adopt an appropriate response and must advise the reporting attorney of that response.
- As an alternative, the CLO may report to a Qualified Legal Compliance Committee (QLCC).

SUPERVISORY ATTORNEY

- An attorney supervising, directing, or having supervisory authority over another attorney is a supervisory attorney.
- The definition applies to ongoing supervisory relationships and to supervisory relationships in the context of a particular project.
- The CLO is a supervisory attorney.
- Supervisory attorneys must take steps to ensure that subordinate attorneys comply with the Section 307 rules.
- A subordinate attorney may report to a supervisory attorney evidence of a material violation and satisfy her/his obligation to report up.
- A supervisory attorney who has received a report from a subordinate attorney “steps into the reporting attorney’s shoes” for subsequent obligations.

“NOISY WITHDRAWAL” STILL IS ON THE TABLE

- The possibility of a noisy withdrawal (even if remote) inhibits the free flow of communication between client and attorney.
- A noisy withdrawal provision may conflict with state court rules governing attorney conduct.

NOISY WITHDRAWAL (ALTERNATIVE PROPOSAL):

- If an attorney identifies evidence of a material violation and the issuer, in the attorney's judgment, refuses to respond appropriately, the attorney would be required to resign, but would not need to either notify the Commission or disavow any filings, but . . .
- The issuer would be required to report the facts and circumstances of the attorney's resignation on Form 8-K (or similar form) within two days of the attorney's resignation.

NOTE: The Commission will allow a 60-day comment period on the alternative proposal.

OTHER ISSUES -- THE FINAL RULES:

- Do not include a documentation requirement.
- Clarify that Section 307 does not create a private cause of action.
- Provide that a violation is punishable as a violation of the Exchange Act (*i.e.*, the attorney is subject to civil monetary penalties, not just to suspension from appearing or practicing before the Commission, as under Rule 102(e)).

NEAR TERM IMPLICATIONS OF THE FINAL RULES

- Companies must develop procedures for dealing with reports of evidence of material violations.
- Companies must decide if they want to avail themselves of the QLCC and, if so, identify members, provide training, and develop written procedures.
- The final rules will require substantial training of attorneys both employed and retained. Supervisory attorneys now have heightened responsibilities.
- Companies should ask their law firms about the procedures the firms have adopted and what mechanism will be used to transmit reports.