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SEC ISSUES FINAL ATTORNEY CONDUCT RULE

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On January 23, 2003, the SEC adopted its final Standards of Professional Conduct for Attorneys rule, implementing Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act") and imposing new ethical obligations on attorneys who "appear and practice" before the SEC. The rule is important not only for U.S.-based securities lawyers, but also for non-securities lawyers and even non-U.S. lawyers who do work for companies that file reports with the SEC.

Differences between the rule as proposed and as adopted include: (1) a narrower definition of "appearing and practicing" before the SEC, (2) a broader exclusion from coverage of non-U.S. attorneys, (3) an extension of the comment period on the "noisy withdrawal" provision, (4) adoption of an objective standard for evaluating whether a "material violation" has occurred, and (5) complete elimination of the documentation requirements proposed to be imposed on attorneys and issuers.

The final rule will become effective **August 5, 2003**. *(Click here to link to the full text of the SEC's final rule release.)*

Persons Covered by the Rule

Narrowing the scope of the definition "appearing and practicing" before the SEC, the final rule applies to attorneys who:

- Transact any business with the SEC, including communication (oral or written) with the SEC or its staff;
- Represent an issuer in an administrative proceeding or in connection with any SEC investigation, inquiry, information request or subpoena;
- Provide advice regarding U.S. securities laws or the SEC rules applicable to any document that the attorney has notice will be filed with the SEC, including participation in the preparation of such documents; or

- Advise an issuer as to whether information or documentation is required to be filed or incorporated in a filing with the SEC under U.S. securities laws or SEC rules.

Foreign Lawyers

In a significant departure from the proposed rule, and in response to comments from law firms, foreign lawyers, international regulators and professional associations, the definition of "appearing and practicing" in the final rule excludes "non-appearing foreign attorneys." While the proposed rule would have raised multi-jurisdictional and extraterritorial issues as a result of subjecting foreign attorneys to regulations and ethical obligations that may have been inconsistent with the obligations imposed in their home countries, the final rule alleviates that situation. It excludes from coverage attorneys admitted to practice law in a jurisdiction outside the U.S. who

- Do not advise or hold themselves out as advising on U.S. securities or other laws; and

- Appear and practice before the SEC only incidentally to their practice outside the U.S. or in consultation with a U.S. attorney.

"Up the Ladder" Reporting Requirement; Definition of "Material Violation"

The final rule requires an attorney to report evidence of a material violation "up the ladder" to the issuer's chief legal officer (or the equivalent thereof) (CLO), or to both the CLO and the issuer's chief executive officer (CEO). Alternatively, the attorney may report this evidence to the issuer's qualified legal compliance committee (QLCC) if one has been established. Unlike the proposed rule,[1] the final rule adopts the more objective standard of a "prudent and competent attorney" for evaluating whether there exists "evidence of a material violation."

Replete with double negatives, the reporting requirement is triggered when there is "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."

[1] Under the proposed rule, "evidence of a material violation" was defined as information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur.

The final rule defines a "material violation" as a material violation of U.S. federal or state securities law, a material breach of fiduciary duty arising under U.S. federal or state law, or a material violation of any other U.S. federal or state law; as expressly noted by the SEC in its final rule release, the term does not include violations of foreign laws.

Once the report has been made, the CLO must conduct an inquiry into the reported evidence of a material violation. Alternatively, the CLO must inform the reporting attorney that the report has been referred to the issuer's QLCC, if one has been established.

A CLO who concludes, after reasonable inquiry, that no material violation has occurred, is ongoing or is about to occur, must provide notice of this conclusion to the reporting attorney. Unless the CLO reaches that conclusion, however, the CLO must take all reasonable steps to ensure that the issuer adopts an "appropriate response" and to notify the reporting attorney. An "appropriate response" is one as a result of which the reporting attorney reasonably believes that:

- No material violation has occurred, is ongoing, or is about to occur;
- The issuer has adopted proper remedial measures to stop, prevent and remedy any material violation that has occurred and to minimize the likelihood of its recurrence; or
- The issuer has retained an attorney to review the reported evidence and either (i) has substantially implemented any remedial recommendations made by such attorney; or (ii) has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense[2] on behalf of the issuer in proceedings relating to the material violation.

[2] By providing that an "appropriate response" includes an issuer's CLO directing defense counsel to assert either a "colorable defense" or a colorable basis for contending that the SEC should not prevail, the final rule broadened the scope of "appropriate response." The SEC's discussion in the final rule release states that, while "colorable defense" does not encompass all defenses, with regard to SEC administrative proceedings, it encompasses situations where an attorney by signing a filing 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."

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On the other hand, a reporting attorney who does not reasonably believe that the CLO provided an "appropriate response" within a reasonable time or reasonably believes it would be futile to report to the CLO, must report the evidence of a material violation "up the ladder" to the issuer's audit committee, other committee of independent directors or to the full board. Alternatively, a CLO may refer the report to the issuer's QLCC, if one has been established.

The final rule eliminates the documentation requirement provided for in the proposed rule. It also changes the language requiring the CLO to take steps in the event of a material violation, from "any necessary steps to ensure that the issuer adopts an appropriate response" to "all reasonable steps to cause the issuer to adopt an appropriate response."

Qualified Legal Compliance Committee

As noted above, the final rule permits the establishment of a QLCC, or qualified legal compliance committee, and permits the issuer to use an existing committee for that purpose so long as it meets all of the requirements for a QLCC, such as the requisite number of independent directors, and agrees to function as a QLCC.

The QLCC may be used both by the attorney who is reporting "evidence of a material violation" and by the CLO who has received such a report. Once the reporting attorney reports to the QLCC, the attorney need make no further reports about the violation or make any evaluations regarding the issuer's response. Once a CLO who has received a report has referred it to the QLCC, he need not cause an inquiry to be conducted and need only inform the reporting attorney that the report has been referred to the QLCC. Thereafter, the QLCC is responsible for responding to the evidence of the material violation.

A QLCC must:

- Consist of at least one member of the audit committee and two other independent directors;
- Adopt written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation;
- Have the authority and responsibility:

- To inform the issuer's CLO and CEO of any report of evidence of a material violation;

- To determine whether an investigation is necessary and, if such investigation is warranted, to: (i) notify the audit committee or the full board; (ii) initiate an investigation; and (iii) retain expert personnel; and

- At the conclusion of the investigation, to (i) recommend implementation of an "appropriate response;" and (ii) inform the CLO, CEO and board of directors of the results of the investigation and the measures to be adopted; and

- Have the authority and responsibility, acting by majority vote, to take all other appropriate action, including authority to notify the SEC in the event the issuer fails to implement an "appropriate response."

"*Noisy Withdrawal" Provision*

Under the "noisy withdrawal" provision, as included in the proposed rule, an attorney could be required, in certain circumstances, to withdraw from representation of an issuer and report his or her withdrawal to the SEC. The SEC did not implement this provision in the final rule, but voted to extend the comment period on the provision for 60 days. The SEC also voted to propose an alternative to this provision under which attorney action would be required only where the attorney reasonably concludes that there is substantial evidence that a material violation is ongoing or about to occur and is likely to cause substantial injury to the issuer. Under the alternative proposal:

- The issuer, rather than the attorney, would be required to publicly disclose the attorney's withdrawal or written notice that the attorney did not receive an "appropriate response;"

- Such disclosure would have to be made within two business days of receiving the attorney's notice, on Form 8-K, 20-F, or 40-F, as applicable; and

- Where the issuer fails to comply with these notice obligations, the proposal would permit the attorney to inform the SEC that the attorney has withdrawn from representing the issuer.

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Disclosure of Company Confidences

The rule allows, but does not require, attorneys to reveal confidential information related to their "appearing and practicing" before the SEC. An attorney may, without consent of the issuer client, disclose confidential information to the extent the attorney reasonably believes it is necessary to:

- Prevent the issuer from committing a material violation likely to cause substantial injury to the financial interests of the company or investors;
- Prevent the issuer from committing perjury, inducing perjury or committing any act likely to perpetrate a fraud upon the SEC; or
- Rectify the consequences of a material violation by the issuer that caused or may cause substantial injury to the financial interests of the company or investors in the furtherance of which the attorney's services were used.

The SEC specified in its final release that the disclosure provisions are intended to supplement, rather than preempt, existing state ethics rules, and in no way limit the ability of any jurisdiction to impose more stringent obligations on attorneys, provided they are not inconsistent with the SEC's final rule. Consistent with practice under the Model Rules of Professional Conduct, attorneys under the final rule may use any records created in the course of fulfilling their reporting obligations under the final rule to defend themselves against charges of misconduct.

Supervisory and Subordinate Attorneys

A supervisory attorney is required to make reasonable efforts to ensure that a subordinate attorney who is "appearing and practicing" before the SEC in the representation of an issuer complies with the reporting requirements of the final rule. "Supervisory attorney" is narrowly defined as an attorney who supervises or directs another attorney in the representation of an issuer. Where a subordinate attorney "appears and practices" before the SEC, the supervisory attorney is deemed to be "appearing and practicing" before the SEC. In addition, where an attorney does not routinely exercise authority over a subordinate attorney but directs the subordinate attorney in a specific matter involving the subordinate's "appearance and practice" before the SEC, he or she is a supervisory attorney for purposes of the rule.

However, where an attorney supervises or directs a subordinate attorney on matters unrelated to the subordinate's "appearing and practicing" before the SEC, he or she is not deemed to be a supervisory attorney. Additionally, an attorney under the direct supervision or direction of the issuer's CLO is deemed not to be a subordinate attorney, is not relieved of the rule's reporting requirements and must report "up the ladder" within the issuer if that attorney does not receive an "appropriate response" from the CLO. In contrast, once a subordinate attorney makes a report to his or her supervisory attorney, the subordinate attorney need do nothing further to fulfill his or her obligations under the rule.

Sanctions and Discipline

Under Section 3(b) of the Act, a violation of any rule issued by the SEC under the Act constitutes a violation of the Securities Exchange Act of 1934. The SEC thus intends to proceed against individuals violating Section 307 of the Act as it would against other violators of the federal securities laws and can initiate proceedings seeking appropriate disciplinary sanctions.

The SEC's final rule does not create a private right of action against an attorney, law firm or issuer based upon compliance or non-compliance with the rule; only the SEC can bring such an action. In addition, attorneys who comply in good faith with the rule shall not be subject to discipline for violations of inconsistent lower standards imposed by a state jurisdiction.

Attorneys practicing outside the U.S. must comply with the SEC's final rule to the maximum extent allowed by the regulations and laws to which they are subject, and are not obligated to comply to the extent such compliance is prohibited by applicable foreign law.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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