RULES OF PROFESSIONAL CONDUCT FOR ATTORNEYS APPEARING AND PRACTICING BEFORE THE SEC

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On January 23, 2003, the Securities and Exchange Commission ("SEC") voted to adopt new standards of professional conduct for attorneys appearing and practicing before the SEC (the "Attorney Conduct Rule" or "Part 205").[1] The Attorney Conduct Rule is effective on August 5, 2003. The SEC adopted the Attorney Conduct Rule pursuant to Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act"), which directed the SEC to prescribe minimum standards of professional conduct, including a so-called "up the ladder" reporting obligation, for attorneys appearing and practicing before the SEC in the representation of issuers.

The SEC originally released a proposed version of the Attorney Conduct Rule for public comment on November 21, 2002 (the "Proposed Rule").[2] The Proposed Rule generated substantial controversy, particularly with respect to the so-called "noisy withdrawal" provision. Part 205 as adopted does not include any "noisy withdrawal" provision. In response to the numerous comments and objections generated by its original "noisy withdrawal" proposal, the SEC proposed a second, alternative version of the "noisy withdrawal" provision simultaneous with its adoption of the Attorney Conduct Rule. Both the original "noisy withdrawal" proposal (the "Original Proposal") and the revised, alternative proposal (the "Alternative Proposal"), remain under consideration by the SEC.

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[1] SEC Release Nos.: 33-8185; 34-47276; IC-25929; File No. S7-45-02 (the "Adopting Release"). The Attorney Conduct Rule is codified as a new Part 205 to Chapter 17 of the Code of Federal Regulations. A web cast of the January 23 Open Meeting at which the SEC voted to adopt the Attorney Conduct Rule may be heard at *www.sec.gov/news/openmeetings.shtml.* On February 6, 2003, the firm hosted a web cast providing an overview of the final Attorney Conduct Rule, which may be heard at our website: *www.simpsonthacher.com.*

[2] SEC Release Nos. 33-8150; 34-46868; IC-25829; 67 FR 71,670 (the "Proposing Release"). A web cast of the November 6, 2002 Open Meeting at which the SEC voted to propose the Attorney Conduct Rule may be heard at *www.sec.gov/news/openmeetings.shtml.*

This memorandum analyzes the most significant provisions of the Attorney Conduct Rule, focusing, where appropriate, on changes to Part 205 made in light of comments received on certain aspects of the Proposed Rule. Finally, the memorandum discusses both "noisy withdrawal" proposals, either of which the SEC may adopt at any time in the future.[3]

STATUTORY BACKGROUND

Section 307 of the Act directed the SEC to promulgate rules "setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers," including a rule that:

- an attorney must report evidence of a material violation of the securities laws or a breach of fiduciary duty or similar violation by the company or any of its agents to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

- if the chief legal counsel or chief executive officer does not appropriately respond to the evidence and adopt, as necessary, appropriate remedial measures or sanctions with respect to the violation, the attorney must report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

Section 307 thus expressly required the SEC to promulgate only one rule—an "up the ladder" reporting requirement applicable to attorneys appearing and practicing before the SEC. The Act, however, authorized the SEC to establish additional rules beyond the up the ladder reporting requirement provided such rules are (i) "in the public interest and for the protection of investors" and (ii) comprise "minimum standards of professional conduct for attorneys appearing before the Commission in any way in the representation of issuers." The Attorney Conduct Rule defines attorneys' up the ladder reporting obligations. The SEC is still considering whether to adopt either the original or the alternative "noisy withdrawal" provision.

THE ATTORNEY CONDUCT RULE

SUMMARY

[3] This memorandum supplements our prior memoranda regarding the Sarbanes-Oxley Act and related SEC rulemaking. These memoranda are available upon request or at our website: *www.simpsonthacher.com.*

The following is a summary of the most significant components of the Attorney Conduct Rule:

SCOPE OF THE ATTORNEY CONDUCT RULE

- The Attorney Conduct Rule applies to attorneys "appearing and practicing" before the SEC "in the representation of an issuer." In response to numerous comments, the definitions of these terms have been narrowed in the final Attorney Conduct Rule. For example, Part 205 makes clear that an employee of an issuer who possesses a law degree but works in a non-legal capacity is not "appearing and practicing" before the SEC.

TRIGGER FOR "UP THE LADDER" REPORTING REQUIREMENT

- "Up the ladder" reporting obligations are triggered when an attorney "becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer." "Evidence of a material violation" is defined 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."

"UP THE LADDER" REPORTING REQUIREMENT

- The Attorney Conduct Rule provides that an attorney who becomes aware of evidence of a material violation of federal or state securities laws, material breach of fiduciary duty, or similar material violation, must report such evidence to the issuer's chief legal officer or to both that officer and the chief executive officer.

- Upon receiving a report of evidence of a material violation, the chief legal officer must conduct an inquiry, as he or she reasonably believes is necessary, into the evidence of a material violation, and, if necessary, take steps to ensure that the issuer adopts appropriate remedial measures.

- If the reporting attorney reasonably believes that the chief legal officer or chief executive officer has not provided an "appropriate response," the reporting attorney must go "up the ladder" and report the evidence of the material violation to the issuer's audit committee, another committee of the board consisting solely of independent directors, or the entire board of directors.

THE "QUALIFIED LEGAL COMPLIANCE COMMITTEE" ALTERNATIVE

- The Attorney Conduct Rule provides that an issuer may establish a "qualified legal compliance committee" ("QLCC"). A QLCC must consist of at least one member of the issuer's audit committee and two or more independent directors. If an issuer has established a QLCC, an attorney that becomes aware of evidence of a material violation may report such violation directly to the QLCC. The QLCC must then ensure that an appropriate response is made. An attorney who reports evidence of a material violation to a duly appointed QLCC has no further reporting obligations.

SUPERVISORY OBLIGATIONS UNDER THE ATTORNEY CONDUCT RULE

- The Attorney Conduct Rule delineates the duties and obligations of both supervisory and subordinate attorneys. An attorney "supervising or directing another attorney" is a "supervisory attorney." A supervisory attorney must make "reasonable efforts" to ensure that attorneys practicing under his or her supervision comply with the rules. For in-house counsel, the chief legal officer and his or her direct reports are considered supervisory attorneys.

- With respect to the up the ladder reporting requirement, a subordinate attorney satisfies his or her obligations under the Attorney Conduct Rule by reporting evidence of a material violation to a supervising attorney.

- Once the supervisory attorney receives a report from a subordinate, that supervisor becomes responsible for complying with the reporting requirements of the rules. If the subordinate attorney reasonably believes that the supervising attorney failed to subsequently comply with the Attorney Conduct Rule, the subordinate could, but would not be required to, report further "up the ladder."

"NOISY WITHDRAWAL" REQUIREMENT UNDER CONSIDERATION

- The most controversial provision of the Proposed Rule was the "noisy withdrawal" requirement. If a reporting attorney did not receive an "appropriate response" after reporting evidence of a material violation to the issuer's board of directors (or to the audit or other independent committee)—and the attorney reasonably believed that a material violation was "ongoing" or "about to occur" and "is likely to result in substantial injury to the financial interest or property of the issuer or of investors"—the Proposed Rule required that the attorney:

    - withdraw from the representation[4];

    - notify the SEC that the withdrawal is due to "professional considerations;" and

[4] The withdrawal requirement would apply only to outside counsel. An attorney employed by the issuer would be required to disaffirm any tainted filings and notify the SEC of such disaffirmance, but would not be required to resign his or her employment.

- disaffirm any documents (or portions thereof) filed with the SEC tainted by the material violation.

- The Attorney Conduct Rule as adopted does not include a "noisy withdrawal" requirement. Instead, the SEC requested an additional 60-day comment period on the Original Proposal, and in addition, proposed an alternative, narrower noisy withdrawal provision.

  - The Alternative Proposal provides that if an attorney reports evidence of a material violation all the way "up the ladder" and does not receive an appropriate response, the attorney must withdraw from the representation and notify the issuer in writing that the withdrawal was due to "professional considerations"; and

  - The issuer must disclose that its counsel withdrew due to "professional considerations" in a Form 8-K, 20-F, or 40-F, as applicable.

DISCUSSION AND ANALYSIS OF THE ATTORNEY CONDUCT RULE

Section 205.3(a) of the Attorney Conduct Rule provides that an attorney appearing and practicing before the Commission in the representation of an issuer represents the issuer as an organization, as opposed to the issuer's directors, officers, and employees that the attorney regularly interacts with and advises on the issuer's behalf. The proposed version of this section further provided that an attorney shall "act in the best interest of the issuer and its shareholders." Commentators objected to this language on several grounds. First, commentators expressed concern that this language could have been construed as imposing duties on attorney directly to an issuer's shareholders. Second, a number of commentators objected to the vague requirement for attorneys to act in "the best interest of the issuer" on the ground that attorneys in giving *legal* advice to an issuer were typically not in a position to make decisions with important business implications for the issuer. Based on such comments, the SEC did not include the provision requiring an attorney to act in the "the best interest of an issuer and its shareholders" in the final version of the Attorney Conduct Rule.

SCOPE OF THE ATTORNEY CONDUCT RULE

The Attorney Conduct Rule applies to "attorneys appearing and practicing before [the SEC] in the representation of an issuer."[5] The definitions of these terms have been narrowed from the more expansive definitions set forth in the Proposed Rule.

The Attorney Conduct Rule defines the phrase "appearing and practicing" as including:

- transacting any business with the SEC, including communications in any form;
- representing an issuer in a SEC administrative proceeding or in connection with a SEC investigation, inquiry, information request or subpoena;
- preparing, or participating in the process of preparing, any document which the attorney has notice will be filed with, or incorporated into a document that will be filed with, the SEC; or
- advising an issuer that information or a statement, opinion, or other writing is required (or is not required) to be filed with, submitted to, or incorporated into that will be filed with or submitted to, the SEC.

"Appearing and practicing" does not include:

- conducting activities that would otherwise qualify as "appearing and practicing" that do not constitute providing legal services to an issuer; or
- an attorney that qualifies as a "non-appearing foreign attorney."

The Adopting Release notes that the SEC modified the definition of appearing and practicing in several significant respects in response to comments received on the Proposed Rule. For example, the Proposed Rule provided that an attorney is "appearing and practicing" before the SEC if the attorney drafts, or participates in drafting, any part of a document that the attorney has "reason to believe" will be filed with the SEC or incorporated into another document filed with the SEC, even if the attorney is not a securities lawyer. The final version of the Attorney Conduct Rule applies only where an attorney has "notice" that the document or writing at issue will ultimately be filed with the SEC.

Similarly, many commentators objected on the ground that the certain provisions of the Proposed Rule, such as the "noisy withdrawal" requirement, would likely conflict with foreign country rules governing attorney conduct. The final version of the Attorney Conduct Rule

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5 Section 205.2(h) defines "issuer" as a company with securities registered under Section 12 of Securities Exchange Act of 1934, that is required to file reports with the SEC under Section 15(d) or that has filed a registration statement that has not yet become effective and has not been withdrawn. The definition also encompasses any person "controlled by" an issuer.

provides that an attorney that qualifies as a non-appearing foreign attorney is not "appearing and practicing." A non-appearing foreign attorney means an attorney:

- who is admitted to practice in a jurisdiction outside the United States;
- who does not hold himself or herself out as practicing, and does not give advice regarding, U.S. securities laws; and
- who:
    - conducts activities that could constitute appearing and practicing only incidentally to the practice of law outside the United States; or
    - is appearing and practicing only in consultation with U.S. counsel.

The Attorney Conduct Rule defines "in the representation of an issuer" as "providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer." This definition, while clearly covering both in-house and outside counsel, was also narrowed in response to commentators' objections. The Proposed Rule defined "in the representation of an issuer" as "acting in any way on behalf, at the behest, or for the benefit of an issuer, whether or not employed or retained by the issuer." The narrower final definition makes clear that the requirements apply only to those attorneys providing legal services to an issuer *in the context of an attorney client relationship.* Thus, for example, the rules do not apply to an officer or employee of the issuer in a non-legal role who happens to have a law degree. Similarly, counsel for an underwriter involved in a securities offering is not acting "in the representation of an issuer" under the final Attorney Conduct Rule, even though an issuer may indirectly benefit from the services rendered by such counsel to the underwriter.

The Adopting Release does state that, notwithstanding the narrower definition in the final version, an attorney employed by an investment adviser who prepares, or assists in preparing, materials for a registered investment company that the attorney has notice will be filed with the SEC is appearing and practicing before the SEC in the representation of an issuer (even though the attorney is technically employed by the investment adviser).

TRIGGER FOR "UP THE LADDER" REPORTING OBLIGATIONS

Section 205.3 of the Attorney Conduct Rule provides that an attorney's obligation to report up the ladder is triggered when the attorney "becomes aware of evidence of a material violation by the issuer or by any officer, director, or agent of the issuer." "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 occurring, or is about to occur* " (emphasis added).[6]

The Adopting Release states that the SEC intends the triggering standard to be entirely objective, noting that "there is a range of conduct in which an attorney may engage without being unreasonable."[7] In evaluating whether reporting obligations have been triggered, the Adopting Release notes that an attorney may consider all relevant circumstances, including "the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult." The Adopting Release also underscores the need for "credible" evidence to trigger an attorney's reporting obligations as opposed to "gossip, hearsay, [or] innuendo." Part 205 does not, however, prescribe a process by which an attorney must evaluate evidence that becomes available to the attorney.

By adopting a standard based on "credible" evidence and by recognizing that an attorney may engage in a "range of conduct" while still acting reasonably, the final SEC Attorney Conduct Rule does not appear intended to impose a duty of inquiry on attorneys. To this extent, it is consistent with the Proposed Rule and the Proposing Release in which the SEC observed that the reporting standard was "not intended to impose upon an attorney, whether employed or retained by the issuer, a duty to investigate evidence of a material violation or to determine whether in fact there is evidence of a material violation." On the other hand, the Attorney Conduct Rule is not intended to discourage an attorney from making such inquiries.

One consequence of the Attorney Conduct Rule is that attorneys appearing and practicing before the SEC will be held to standards of professional conduct that are higher than currently in effect at the state level for lawyers who represent corporations or other organizations. For example, Rule 1.13 of the ABA Model Rules of Professional Conduct, which deals with the ethical obligations of lawyers representing organizations, requires a lawyer who "knows" that someone within the organization either is violating a duty to the company or is engaged in substantial illegal activity that may be imputed to the company, to "proceed as is reasonably necessary in the best interest of the organization."[8] While the ABA Model Rule is

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[6] In contrast, under the Proposed Rule, an attorney's reporting obligations would have been triggered if the attorney became aware of "information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur."

[7] Nonetheless, the revised standard may present difficulties in interpretation. Although the SEC intends an objective standard, an attorney's reporting obligations are not triggered unless and until the attorney "becomes aware of" the specified level of evidence. This phraseology appears to inject a subjective element into the triggering standard.

[8] Measures the lawyer may take under Model Rule 1.13 include requesting reconsideration of the matter; advising that a separate legal opinion on the matter should be obtained for presentation to appropriate authority in the organization; or referring the matter to higher authority in the organization, including, if

triggered only by *actual knowledge* of a violation, the SEC's Attorney Conduct Rule will require lawyers to report evidence of a material violation if it would be unreasonable for a prudent and competent attorney not to conclude that it is reasonably likely a material violation has occurred, is occurring, or is about to occur.

The Attorney Conduct Rule further defines "material violation" as a material violation of the securities laws, a material breach of fiduciary duty, or another similar material violation of any United States federal or state law. [9] The Adopting Release indicates that securities laws include both federal and state securities laws. Thus, the Attorney Conduct Rule reaches material violations of state statutes such as New York's Martin Act.[10]

With respect to a "material breach of fiduciary duty," the Proposing Release indicated that the definition was intended to cover those forms of breach of fiduciary duty recognized at common law, including "misfeasance, nonfeasance, abdication of duty, abuse of trust and the approval of unlawful transactions. " Nothing in the Adopting Release or the final version of the Attorney Conduct Rule states otherwise. Thus, the Attorney Conduct Rule is not limited to breaches of fiduciary duty involving the duty of loyalty (for example, self-dealing, dishonesty or conflicts of interest), but would appear to encompass even breaches of the duty of care resulting from negligence.

"UP THE LADDER" REPORTING REQUIREMENT

Assuming an attorney's reporting duties are triggered, the Attorney Conduct Rule sets forth a two-step up the ladder reporting requirement. The first step of the up the ladder reporting scheme envisioned by the Attorney Conduct Rule provides in pertinent part:

> If an attorney, appearing practicing before the [SEC] 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

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warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law.

9 The SEC has not attempted to define the phrase "similar material violation," but the Proposing Release indicates that the phrase is intended to "extend" beyond violations of securities laws or breaches of fiduciary duty. No examples are provided, however, of violations falling into this third category under the Attorney Conduct Rule.

10 *See* New York General Business Law, Art. 23-A. As has been widely-reported, New York's State Attorney General has used the Martin Act to bring securities fraud actions in many of the recent high profile corporate scandals. *See, e.g.,* Jerry Markon and Charles Gasparino, *New York Prosecutors Are Scoring As They Use the Martin Act, A 1921 Weapon That Still Works*, Wall St. J., October 10, 2002, at C1.

> the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or to the equivalents thereof) forthwith. . . .

As described in the preceding section, the key issue with respect to the first step of the up the ladder reporting requirement is when an attorney "becomes aware of evidence of a material violation." Assuming an attorney does become so aware and makes a report to the chief legal officer (or to that officer and the chief executive officer), the reporting attorney's further reporting obligations depend on the response from those individuals.[11]

The Attorney Conduct Rule requires that after receiving a report of a material violation, the chief legal officer of an issuer must investigate the report. If the chief legal officer concludes 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 an appropriate response."[12]

If the reporting attorney "reasonably" believes that he or she has received an appropriate and timely response to the report, the reporting attorney has no further obligations with respect to the evidence of a material violation. An "appropriate response" is defined as a response to a reporting attorney as a result of which that attorney reasonably believes:

- that no material violation is occurring, has occurred, or is about to occur;
- that the issuer has, as necessary, adopted 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 issuer's board of directors, a committee thereof to whom a report could be made pursuant to §205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

[11] If the attorney reasonably believes that reporting to the chief legal officer and chief executive officer would be futile, the attorney may report evidence of a material violation directly to the audit committee, another committee consisting solely of independent directors or the full board of directors. In addition, if an issuer has an established QLCC, the attorney may report directly to the QLCC.

[12] Section 205.3(b)(6) provides that the act of directing or retaining an attorney to investigate a report of a material violation does not relieve the officer or director to whom the evidence was reported of his or her obligation to respond to the reporting attorney.

- 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.

The Adopting Release indicates that an attorney's evaluation of, and the appropriateness of an issuer's response to, evidence of material violations will be evaluated against a reasonableness standard. The circumstances that an attorney might weigh in evaluating the appropriateness of an issuer's response include "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."

The Proposing Release offered examples of an appropriate response. For example, if an issuer responds to an attorney's report regarding the legality of a particular transaction by informing the attorney that a reputable law firm has reviewed the transaction and concluded that there has been no violation, and if the issuer provides a copy of the opinion to the attorney, the attorney could reasonably believe that the issuer's response was appropriate so long as the opinion satisfactorily addresses all of the reporting attorney's reasonable legal and factual concerns and is otherwise reasonable. Similarly, if an issuer responds to an attorney's report concerning an employee's potentially illegal conduct by, for example, disciplining or terminating the employee, and remedying any impact of the employee's misconduct, the attorney could reasonably believe that the issuer's response was appropriate.

An appropriate response where there has been a disclosure violation would include disclosure of the material information or the correction of any material misstatement. Moreover, a past instance of misconduct that nevertheless may have an ongoing impact (for example, a misstatement contained in a prior filing that investors may continue to rely upon) would require a similar corrective disclosure.

By contrast, if the issuer responds to the attorney's report by peremptorily informing the attorney that the reported matter is not cause for concern, and fails to provide any factual or legal basis for the reporting attorney to conclude there was no violation, an attorney may not reasonably view such a response as appropriate.

Although these examples of an appropriate response are still valid, the final Attorney Conduct Rule also provides that a response will be appropriate as long as the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to §205.3(b)(3), or a qualified legal compliance committee, has retained an attorney to review the reported evidence of a material violation and has been advised that such attorney may, consistent with his or her professional obligations, assert a "colorable defense" on behalf of the issuer in any investigation or proceeding relating to such reported evidence.

If the reporting attorney does not receive an appropriate response after his or her initial report, step two of the Attorney Conduct Rule's up the ladder reporting provision requires the attorney to report the evidence of a material violation to the issuer's audit committee, another committee consisting solely of independent directors, or the full board of directors. If an attorney still does not believe the issuer has made an appropriate response after reporting further up the ladder, the attorney must explain his or her reasons therefore to the chief legal officer, the chief executive officer, and the directors to whom the attorney reported the evidence of a material violation.

"QUALIFIED LEGAL COMPLIANCE COMMITTEE" ALTERNATIVE

The Attorney Conduct Rule provides for an alternate up the ladder reporting system for attorneys that become aware of evidence of material violations. Under the Attorney Conduct Rule, an issuer may create a Qualified Legal Compliance Committee, or "QLCC." A QLCC must consist of at least one member of an issuer's audit committee and two or more additional directors not employed by or affiliated with the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in the Investment Company Act of 1940. If an issuer has established a duly appointed QLCC, an attorney may report evidence of material violations to the QLCC in lieu of utilizing the "up the ladder" reporting procedure described above.

The QLCC must be authorized to: (i) investigate any report of evidence of a material violation by the issuer, its officers, directors, employees or agents; (ii) to take all necessary actions on behalf of an issuer to provide an appropriate response to reports of evidence of material violations; and (iii) in certain circumstances, to notify the SEC in the event the issuer fails in any material respect to implement remedial measures recommend by the QLCC.

Specifically, the QLCC must be given the authority and responsibility to:

- inform the chief legal officer and chief executive officer of any report of evidence of a material violation;

- decide whether an investigation of the report is necessary and, if so:

    - notify the audit committee or the full board of directors;

    - initiate the investigation (which may be done by the chief legal officer or outside counsel); and
    - retain additional expert personnel as the QLCC deems necessary;

- at the conclusion of the investigation:
    - recommend, by majority vote, that the issuer adopt appropriate remedial measures;
    - inform the chief legal officer, the chief executive officer and the board of directors of any investigation and the remedial measures to be adopted; and
    - to take all appropriate action, including the authority to notify the SEC, in the event the issuer fails to adopt a recommended remedial measure.

In addition, the QLCC is required to adopt written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation. At the same time, the Attorney Conduct Rule does not specify the content of such procedures and does not mandate that reports of evidence of material violations be made, evaluated or responded to in writing. In contrast, the Proposed Rule had imposed documentation requirements for any reports of evidence of material violations —whether or not an issuer had established a QLCC. The proposed documentation requirements were critiqued on attorney-client privilege and other grounds, and the SEC eliminated those requirements in the final Attorney Conduct Rule.

The QLCC procedure is different from the up the ladder procedure in several significant respects. First, as noted, an attorney who has reported evidence of a material violation to a duly appointed QLCC has no further obligations under the Attorney Conduct Rule, including the obligation to evaluate the appropriateness of an issuer's response to a material violation.

Second, if the SEC adopts one of the "noisy withdrawal" proposals (discussed more fully below), an attorney who reports evidence of a material violation to a QLCC will neither be required to withdraw from representing the issuer nor, in the case of the Original Proposal, to communicate the fact of that withdrawal to the SEC and disaffirm filings tainted by the material violation. As a result, an issuer's establishment of a QLCC appears less likely to chill communications between a client and an attorney. Although several issuers have already established QLCCs, we believe that the number of such issuers will increase substantially if the SEC approves either version of the "noisy withdrawal" requirement under consideration.

Finally, the Attorney Conduct Rule expressly notes that an issuer's audit committee may also serve as its QLCC. Because evidence of material violations reported to a QLCC would, in many cases, involve areas within the purview of the audit committee, issuers may consider the option of having the audit committee act as the QLCC rather than appointing another committee of independent directors. In this regard, it should be noted the New York Stock Exchange proposed new Section 303A.7 to the Listed Company Manual, which would require that all legal and regulatory matters be referred to the audit committees of listed companies.

"NOISY WITHDRAWAL" PROPOSALS

The provision of the Proposed Rule engendering perhaps the most debate was the mandatory "noisy withdrawal" requirement. Under the Original Proposal, an attorney who does not receive an "appropriate response" after reporting evidence of a material violation up the ladder to an issuer's audit committee, another committee of the board comprised solely of independent directors, or the board of directors, would need to take affirmative steps to minimize the consequences of the material violation. The noisy withdrawal concept is not expressly required, or even suggested, by Section 307 of the Act or the related legislative history.

The affirmative steps required by the Original Proposal depend on whether the "material violation" is past, present or future, and whether the reporting attorney is outside counsel or an in-house attorney employed by the issuer.

With respect to "material violations" that are either *ongoing or about to occur*, the Original Proposal would mandate what is commonly called a noisy withdrawal if the attorney has not received an "appropriate response," and the attorney "reasonably believes" that the material violation "is likely to result in substantial injury to the financial interest or property of the issuer or of investors." If both factors are met, outside counsel *must* take the following steps:

- withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations[13];
- within one business day of withdrawing, give written notice to the SEC of the attorney's withdrawal, indicating that the withdrawal was based on professional considerations; and
- promptly disaffirm to the SEC any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the SEC, or incorporated into such a document, that the attorney

[13] The issuer's chief legal counsel is obligated to inform an attorney retained to replace an attorney who has withdrawn that the previous attorney's withdrawal was based on "professional considerations."

> has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.[14]

In-house counsel is required to disaffirm any tainted filing (and to notify the SEC of any such disaffirmance), but, unlike outside counsel, is not required to resign.

In the case of *past* material violations, an attorney *may*, but is not required to, take each of the same steps if the attorney reasonably believes that the past material violation "is likely to have resulted in substantial injury to the financial interest or property of the issuer or investors."

The Original Proposal provides that a noisy withdrawal to the SEC in either situation does not breach the attorney-client privilege. This may be a helpful assertion, but there remains a question whether the SEC's authority under Section 307 of the Act extends so far as to permit rules preempting all applicable federal and state rules regarding the attorney-client privilege.

The Original Proposal's noisy withdrawal provisions raise several significant issues. First, the Original Proposal creates a substantial risk of chilling communications between attorneys and their clients. Courts have long recognized that the attorney-client privilege serves an important public policy purpose. As the Supreme Court observed in *Upjohn Co. v. United States,* 449 U.S. 383, 389 (1981):

> [The purpose of the attorney-client privilege] is to encourage full and frank communication between attorneys and their clients and thereby promote the broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends on the lawyer's being fully informed by the client.

The New York Court of Appeals similarly recognized the importance of the attorney-client privilege in *Priest v. Hennessy,* 51 N.Y.2d 62, 67-68 (1980), stating:

> The attorney-client privilege . . . exists to ensure that one seeking legal advice will be able to confide fully and freely in his attorney, secure in the knowledge that his confidences will not later be exposed to public view to his embarrassment or legal detriment (internal citations omitted).

Notwithstanding the basic principles underlying the attorney-client privilege, the Original Proposal would *require* an attorney who has gone up the ladder and not received an

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[14] The Original Proposal is unclear regarding how detailed the attorney must be in disaffirming documents filed with the SEC. It does indicate that an attorney must at least identify those portions of documents containing tainted opinions, affirmations, representations, characterizations, or the like.

appropriate response to his or her report of evidence of a material violation to withdraw from representing the issuer *in all matters*, notify the SEC, and disaffirm any filings that the attorney believes to be tainted by the misconduct. Moreover, an SEC investigation of the issuer and substantial private civil litigation are likely to follow any noisy withdrawal made pursuant to the Original Proposal. Thus, a noisy withdrawal is likely to have dramatic consequences for the issuer—even if the attorney's assessment of the evidence of a material violation or the lack of an appropriate response turns out to be erroneous. Such requirements would be counterproductive if they discourage issuers from confiding candidly and completely in their attorneys to the detriment of issuers and the investing public.

In addition, the Original Proposal may fundamentally transform the role of attorneys representing issuers from that of a zealous advocate for the client to a quasi-watchdog of the public interest. The traditional core of the attorney-client relationship is that the client decides what is in its own best interests and the lawyer—owing a duty of undivided loyalty to the client—advocates that position zealously but always within the bounds of the law. The Original Proposal, however, creates the potential for a conflict of interest between the attorney's duty to his client and the attorney's SEC reporting obligations.

In response to these and other similar concerns expressed by commentators, the SEC released an Alternative Proposal for public comment. Under the Alternative Proposal, an attorney who has not received an appropriate response after reporting evidence of a material violation all the way up the ladder, and who reasonably concludes that there is substantial evidence that a material violation is ongoing or about to occur, must withdraw from the representation. The attorney must notify the issuer, in writing, that the withdrawal is based on "professional considerations."[15] The Alternative Proposal requires that the issuer must then disclose any such withdrawal within two business days in a Form 8-K, 20-F or 40-F (as appropriate).

The Alternative Proposal raises many of the same concerns as the Original Proposal. The differences between the Original Proposal and the Alternate Proposal may be largely cosmetic. Under the Original Proposal, an attorney may be forced to report his or her client to the SEC. Under the Alternative Proposal, an attorney can effectively force his or her client to report itself to the SEC. A number of commentators have observed that the risk of chilling attorney-client communications is substantially the same under either proposal.

In addition, the lack of a specific disaffirmance requirement in the Alternative Proposal may do more harm than good. If an issuer discloses the withdrawal of its counsel in a Form 8-K, an SEC investigation of the issuer and substantial private civil litigation are just as likely to

[15] As with the Original Proposal, an attorney employed by the issuer need not resign, but instead must immediately cease any participation in the material violation and notify the issuer, in writing, that the issuer has not provided an appropriate response to reported evidence of a material violation.

follow as under the Original Proposal. However, without the disaffirmance requirement, the market will not have information as to which of the issuer's public filings may be tainted. As a result, a cloud may be placed on all of an issuer's filings, even though many filings may be unrelated to, and untainted by, the material violation at issue.

The comment period for both the Original Proposal and the Alternative Proposal has ended. The SEC, however, has given no indication as to whether or when it intends to adopt either proposal. In the event either proposal is adopted, we will supplement this memorandum.

PERMISSIVE DISCLOSURE OF CONFIDENTIAL INFORMATION

In addition to the up the ladder reporting requirements, the Attorney Conduct Rule sets forth the circumstances in which an attorney representing an issuer may disclose to the SEC confidential information learned in the course of the representation. The Attorney Conduct Rule provides with respect to issuer confidences that:

- any report or response (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with the Attorney Conduct Rule is in issue.

- an attorney appearing and practicing before the SEC in the representation of an issuer may reveal to the SEC, without the issuer's consent, confidential information related to the representation 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 or suborning perjury or committing any act likely to perpetrate a fraud on 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.

SANCTIONS

A violation of the Attorney Conduct Rule constitutes a violation of the Exchange Act and subjects the offending attorney to the same penalties and remedies as any other violation of that Act. Thus, an attorney who violates the Attorney Conduct Rule could be subject to a federal court injunction, an administrative cease and desist order and monetary penalties.

An attorney who violates the Attorney Conduct Rule is also subject to an administrative disciplinary proceeding initiated by the SEC. In such a proceeding, the attorney may be censured or temporarily or permanently barred from appearing and practicing before the SEC.

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This memorandum is for general informational purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding the proposed new standards of professional conduct for attorneys appearing and practicing before the SEC. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, www.simpsonthacher.com.

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