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

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On November 21, 2002, the Securities and Exchange Commission ("SEC") released for public comment a proposed rule ("Proposed Part 205")[1] pursuant to Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act"), which requires 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 any way in the representation of issuers.[2]

The Act requires that the SEC adopt rules giving effect to Section 307 of the Act no later than January 26, 2003. The SEC has requested comments on Proposed Part 205 on or before December 18, 2002. This memorandum analyzes the most significant provisions of Proposed Part 205.

## STATUTORY BACKGROUND

Section 307 of the Act directs 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

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1 The SEC proposes to codify the rule as a new Part 205 to Chapter 17 of the Code of Federal Regulations.

2 SEC Release Nos. 33-8150; 34-46868; IC-25829; 67 FR 71,670 (the "SEC Release"). A web cast of the November 6, 2002 Open Meeting at which the SEC voted to propose Part 205 may be heard at *www.sec.gov/news/openmeetings.shtml.* 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.*

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 requires 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, authorizes 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." As discussed below, Proposed Part 205 not only defines attorneys' up the ladder reporting obligations but also sets forth additional requirements, including those mandating a "noisy withdrawal" by outside counsel in some circumstances.

## PROPOSED SEC RULE

### SUMMARY

The following is a summary of the most significant components of Proposed Part 205:

#### *SCOPE OF PROPOSED PART 205*

- Proposed Part 205 would apply to attorneys "appearing and practicing" before the SEC "in any way in the representation of an issuer." The proposed definitions of both terms are extremely broad and apply to both in-house and outside counsel.

#### *TRIGGER FOR "UP THE LADDER" REPORTING REQUIREMENT*

- "Up the ladder" reporting obligations would be 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 proposed to be defined as "information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur."

#### *"UP THE LADDER" REPORTING REQUIREMENT*

- Proposed Part 205 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 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 reporting attorney and the chief legal officer must take reasonable steps to document such inquiries and responses and to retain such documentation for a reasonable period of time.

***"NOISY WITHDRAWAL" REQUIREMENT***

- If a reporting attorney does 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 believes that a material violation is "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"—Proposed Part 205 would require that the attorney:

    - withdraw from the representation[3];

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

    - disaffirm any documents filed with the SEC tainted by the material violation.

***THE "QUALIFIED LEGAL COMPLIANCE COMMITTEE" ALTERNATIVE***

- Proposed Part 205 provides that an issuer may establish a so-called "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

[3] 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.

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 (including no noisy withdrawal duties).

***SUPERVISORY OBLIGATIONS UNDER PROPOSED PART 205***

- Proposed Part 205 delineates the duties and obligations of both supervisory and subordinate attorneys. A supervisory attorney would be obligated to make "reasonable efforts" to ensure that attorneys practicing under his or her supervision comply with Proposed Part 205. For in-house counsel, the chief legal officer would be the supervisory attorney. With respect to the up the ladder reporting requirement, a subordinate attorney would satisfy his or her obligations under Proposed Part 205 by reporting evidence of a material violation to a supervising attorney. Once the supervisory attorney receives a report from a subordinate, that supervisor would become responsible for complying with the reporting requirements of Proposed Part 205. A supervisory attorney who reasonably believes that information reported by a subordinate is not evidence of a material violation would have to take reasonable steps to document the basis for the supervisory attorney's belief. If the subordinate attorney reasonably believed that the supervising attorney did not subsequently comply with Proposed Part 205, the subordinate could, but would not be required to, make a noisy withdrawal.

## DISCUSSION AND ANALYSIS OF PROPOSED PART 205

As a threshold matter, Section 205.3(a) of Proposed Part 205 makes clear 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.

### SCOPE OF PROPOSED PART 205

Proposed Part 205 applies to "attorneys appearing and practicing before [the SEC] in any way in the representation of an issuer."[4] The SEC Release notes that the scope is "expansive." Proposed Part 205 thus defines the phrase "appearing and practicing" as including:

4 Proposed Part 205 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.

- 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 a 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.

The SEC Release makes clear 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.[5] Indeed, Proposed Part 205 defines appearing and practicing broadly enough to cover an officer or employee of the issuer in a non-legal role who happens to have a law degree—to the extent such an officer or employee transacts business with the SEC or assists in the preparation of documents filed with the SEC.

[5] The SEC Release states that an attorney ordinarily does not appear and practice before the SEC if his or her representation of an issuer involves no business or communication with the SEC, no participation in any way in a SEC process, and no assistance in the preparation of at least a portion of a document filed with or submitted to the Commission. The SEC Release also states that the conduct of attorneys in practice specialties other than securities law will be covered by Proposed Part 205 where their representation of an issuer involves contact with the SEC or where they have reason to believe they are assisting in the preparation of a document transmitted to the SEC, or where they supervise an attorney who does appear and practice before the SEC.

The definition of appearing and practicing would also include non-U.S. counsel retained by foreign issuers who participate in the preparation of documents and who have reason to believe that the documents will be filed with the SEC. Certain provisions of Proposed Part 205, such as the "noisy withdrawal" requirement, would likely conflict with foreign country rules governing attorney conduct. The SEC specifically requested comment on whether Proposed Part 205 should apply to foreign counsel and in what manner in light of the potential conflicts.

Proposed Section 205.3(b)(6) provides that an attorney retained by an issuer to investigate evidence reported pursuant to Proposed Part 205 would also be deemed to be "appearing and practicing" before the SEC.

Proposed Part 205 defines "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." Although the SEC Release indicates that this definition is intended to have a broad scope, the examples given by the SEC are more discrete and limited in scope. Thus, the SEC Release indicates that an attorney employed by a non-public subsidiary of an issuer would be acting "in the representation of an issuer" when the subsidiary is covered by an umbrella representation agreement or understanding under which the attorney represents the parent company and its subsidiaries and can invoke privilege claims with respect to all communications involving the parent and its subsidiary. According to the SEC Release, such an attorney would also be acting in the representation of an issuer if the attorney is assigned work by the parent that will be consolidated into a disclosure document filed with the SEC.[6]

## TRIGGER FOR "UP THE LADDER" REPORTING OBLIGATIONS

Section 205.3 of Proposed Part 205 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." Proposed Part 205 defines "evidence of a material violation" as "*information that would lead an attorney reasonably to believe* that a material violation has occurred, is occurring, or is about to occur (emphasis added).

As a result, the up the ladder reporting requirements would be triggered when an attorney becomes aware of information that would lead an attorney reasonably to believe that a material violation of the securities laws, a material breach of fiduciary duty or material violation of other similar law has occurred, is occurring, or is about to occur. Proposed Part 205 does not prescribe a process by which an attorney must evaluate evidence that becomes available to the attorney.

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6 As another example, the SEC Release states that Proposed Part 205 would apply to an attorney employed or retained by a privately-held investment adviser who prepares materials that the attorney has reason to believe will be filed with the SEC by a registered investment company.

The proposed reporting obligations trigger may raise substantial difficulties in terms of its application because it mixes subjective and objective standards. Proposed Section 205.3 provides that the attorney must actually become aware (a subjective standard) of information that would lead an attorney "reasonably to believe" that a material violation occurred, is occurring or is about to occur (an objective standard). The SEC Release states that the standard is an objective one, and that an attorney is not excused from reporting evidence of a material violation simply because the attorney personally believes that a material violation has not occurred, is not occurring or is not about to occur.

On the other hand, the SEC Release emphasizes that an objective standard is intended to preclude reports by attorneys "based on mere suspicion of a material violation." In addition, the SEC Release confirms that Proposed Part 205 is "*not intended to impose* upon the 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 a material violation " (emphasis added).[7] Moreover, in relation to material violations of the securities laws, the SEC Release suggests that an attorney's reporting obligation would not be triggered in situations where a particular course of action is not "clearly illegal," or unless the attorney "can be sure" that an officer or employee will "actually pursue an illegal course of action."

These clarifications, while helpful, are not clear from the text of Proposed Part 205. For example, if an attorney's reporting obligations are not intended to be triggered unless the attorney "can be sure" that the client is pursuing or intends to pursue "clearly illegal" activity, one might expect Proposed Part 205 to condition the reporting obligation on an attorney's becoming aware of "clear and convincing" evidence of such a material violation of law.

One consequence of Proposed Part 205 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

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7 Notwithstanding this clarification, it may still be a fine line between an awareness of information that is insufficient to lead an attorney to have a reasonable belief that a material violation has occurred, is occurring, or is about to occur (and therefore information insufficient to investigate a possible violation further), on the one hand, and information that would be sufficient to form such a reasonable belief that there is a material violation, on the other. Moreover, the necessity or fairness of exposing internal or outside counsel to the full gamut of SEC sanctions based on acts or omissions that may be judged in hindsight as "unreasonable," but that involved no bad faith, dishonesty or even recklessness is questionable.

necessary in the best interest of the organization."[8] While the ABA Model Rule is triggered only by actual knowledge of a violation, the SEC's Proposed Part 205 will require lawyers to report evidence of a material violation if they reasonably should have believed that there was a material violation.

Proposed Part 205 further defines "material violation" as a material violation of the securities laws, a material breach of fiduciary duty, or another similar material violation. The SEC Release indicates that securities laws include both federal and state securities laws. Thus, Proposed Part 205 reaches material violations of state statutes such as New York's Martin Act.[9]

With respect to a "material breach of fiduciary duty," the SEC Release indicates that Proposed Part 205 is 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. "[10] Thus, Proposed Part 205 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, Proposed Part 205 sets forth a two-step up the ladder reporting requirement. The first step of the up the ladder reporting scheme envisioned by Proposed Part 205 provides in pertinent part:

> If, in appearing and practicing before the SEC in the representation of an issuer, 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 shall report any evidence of a material violation to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or to the equivalents thereof)

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

9 *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.

10 The SEC has not attempted to define the phrase "similar material violation," but the SEC 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 Proposed Part 205.

> forthwith (unless the issuer has a qualified legal compliance committee and the attorney chooses instead to report the evidence of a material violation to that committee….

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]

Proposed Part 205 would require 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[12] concludes that a material violation has occurred, is occurring, or is about to occur, he or she must:

> 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 chief legal officer shall promptly report the remedial measures adopted and/or sanctions imposed to the chief executive officer, to the audit committee of the issuer's board of directors, or to the issuer's board of directors, and to the reporting attorney. The chief legal officer shall take reasonable steps to document his or her inquiry and to retain such documentation for a reasonable time.[13]

If the reporting attorney "reasonably" believes that he or she has received an appropriate and timely response to the report and has taken reasonable steps to document the report and the response, 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 evidence of a material violation reported to appropriate officers or directors of an issuer that provides a basis for an attorney reasonably to believe:

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[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] The SEC Release notes that the chief executive officer is obligated to investigate the evidence of a material violation if the issuer does not have a general counsel or chief legal officer.

[13] 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.

- 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.

The SEC Release indicates that the actions of an attorney in evaluating the appropriateness of a response made by an issuer will be evaluated based on an objective reasonableness standard. The SEC Release offers examples of an appropriate response. 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 another 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, the SEC Release indicates that an attorney may not reasonably view such a response as appropriate.

If the reporting attorney does not receive an appropriate response after his or her initial report, step two of Proposed Part 205'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.

### "NOISY WITHDRAWAL" REQUIREMENT

The provision of Proposed Part 205 engendering perhaps the most debate is the mandatory "noisy withdrawal" requirement. Under Proposed Part 205, 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 Proposed Part 205 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*, Proposed Part 205 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[14];
- 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 has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.[15]

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."

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

15 Proposed Part 205 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.

Section 205.3(d)(3) 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.

Proposed Part 205's noisy withdrawal provisions raise several significant issues. First, Proposed Part 205 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 noisy withdrawal provisions of Proposed Part 205 would *require* an attorney who has gone up the ladder and not received an 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 Proposed Part 205. 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, Proposed Part 205 may fundamentally transform the role of attorneys representing issuers or acting for their benefit from that of a zealous advocate for the client to 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 proposed "noisy withdrawal" requirements, however, create the potential for a conflict of interest between the attorney's duty to his client and the attorney's SEC reporting obligations.

Section 205.3(a) of Proposed Part 205 provides, *inter alia*, that an attorney "shall act in the best interests of the issuer and its shareholders." Coupled with the noisy withdrawal requirements, this component of Proposed Part 205 arguably requires the attorney to decide for himself or herself what is in the client's "best interests" and to act accordingly. The problem with asking attorneys to substitute their judgment for that of their client and to take steps with profound consequences for the client is exacerbated because attorneys are not always in the best position to make these decisions. A public issuer often retains the services of multiple outside law firms. Any one lawyer at a given firm simply may not have access to the wealth of legal and business information that may be required to decide what is in the client's best interests.

**"QUALIFIED LEGAL COMPLIANCE COMMITTEE" ALTERNATIVE**

Proposed Part 205 provides for an alternate up the ladder reporting system for attorneys that become aware of evidence of material violations. Under Proposed Part 205, 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 investigate any report of evidence of a material violation by the issuer, its officers, directors, employees or agents, to take all necessary actions on behalf of an issuer to provide an appropriate response to reports of evidence of material violations and, in certain circumstances, to notify the SEC of material violations and to disaffirm tainted filings or submissions. Specifically, under Proposed Part 205, 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, to initiate the investigation (which may be done by the chief legal officer or outside counsel);
- retain additional expert personnel as the QLCC deems necessary; and
- at the conclusion of the investigation, direct the issuer to adopt appropriate remedial measures.

Each member of the QLCC as well as the chief legal officer and chief executive officer must have the authority and responsibility, in the event the issuer fails in any material respect to take the remedial measures ordered by the QLCC, to notify the SEC that a material violation has occurred, is occurring or is about to occur, and to disaffirm in writing any document filed with or submitted to the SEC that the QLCC or such individuals reasonably believe is false or materially misleading.

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 would have no further obligations under Proposed Part 205, including the obligations to withdraw, notify the SEC and disaffirm.

Second, an issuer that has established a QLCC will not cede to the reporting attorney control over the decision whether or when to report evidence of material violations to the SEC. Because the issuer through the members of the QLCC is likely to be in a better position to make these momentous decisions and because the QLCC has less potential for chilling communications between a client and an attorney, we believe issuers will give serious consideration to establishing QLCCs if Proposed Part 205 is adopted in its current form.

Finally, Proposed Part 205 would not prevent an issuer from using its audit committee as the QLCC. Because evidence of material violations reported to a QLCC would, in many cases, involve areas within the purview of the audit committee, we believe 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 recently 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.

**PERMISSIVE DISCLOSURE OF CONFIDENTIAL INFORMATION**

In addition to the up the ladder reporting requirements and noisy withdrawal provisions, Proposed Part 205 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 Proposed 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 Proposed 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 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 upon 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.

Section 205.3(e)(3) of Proposed Part 205 provides that an issuer does not waive attorney-client or work product privilege in a subsequent litigation if the issuer reveals confidential information related to a material violation to the SEC pursuant to a confidentiality agreement. This provision, although not eliminating all doubt as to the effect of such confidentiality agreements, should prove helpful in clarifying an area that has divided courts—specifically, whether and in what circumstances voluntary disclosure of privileged attorney-client or work product materials to the SEC waives applicable privileges in subsequent civil litigation.[16]

## RECORD RETENTION

An attorney reporting evidence of a material violation under Proposed Part 205 would need to take reasonable steps under the circumstances to document the report and the response(s) thereto and to retain the documentation for a reasonable period of time. Similarly, a chief legal officer responding to a report of a material violation under Proposed Part 205 would need to take reasonable steps to document his or her inquiry and to retain such documentation for a reasonable period of time. Proposed Part 205 does not prescribe the contents of the required documentation.

## SANCTIONS

Section 205.6 provides that a violation of Proposed Part 205 would constitute a violation of the Exchange Act and would subject the offending attorney to the same penalties and remedies as any other violation of that Act. Thus, an attorney who violates Proposed Part 205

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[16] *Compare In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2d Cir. 1993) (observing that disclosure of privileged materials to the SEC pursuant to an explicit confidentiality agreement might be sufficient to preserve privilege); *with Permian Corp. v. United States,* 665 F.2d 1214, 1219-20 (holding that voluntary disclosure of privileged attorney-client communications to the SEC waives the privilege in subsequent litigation notwithstanding confidentiality agreement); *Navajo Nation v. Peabody Holding Co.,* 209 F.Supp.2d 269, 285-86 (D.D.C. 2002) (finding that disclosure to government agency pursuant to confidentiality agreement waived attorney-client privilege in subsequent litigation).

could be subject to a federal court injunction, an administrative cease and desist order and monetary penalties.[17]

Section 4C(a) of the Exchange Act authorizes the SEC to censure or bar from practice before the SEC any attorney that, *inter alia,* engages in "unethical or improper professional conduct." Proposed Section 205.6 defines "improper professional conduct" under section 4C(a) of the Exchange Act to include:

- Intentional or knowing conduct, including reckless conduct, that results in a violation of any provision of Proposed Part 205; and
- Negligent conduct in the form of:
  - a single instance of highly unreasonable conduct that results in a violation of any provision of Proposed Part 205; or
  - repeated instances of unreasonable conduct, each resulting in a violation of a provision of Proposed Part 205.[18]

Although the definition of "improper professional conduct" under proposed Section 205.6 tracks the language now in Rule 102(e) of the SEC's Rules of Practice, which has been used by the SEC largely as a tool to discipline accountants who practice before it, the SEC has indicated it does not intend for Proposed Part 205 to supplant Rule 102(e). Rather, the SEC Release indicates that the SEC intends to enforce the attorney reporting requirements by bringing injunctive cases or cease and desist actions, in addition to possible disciplinary action by the SEC.

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[17] The SEC Release indicates that it does not believe that violations of the "up the ladder" reporting rules, by themselves, would subject an attorney to criminal sanction under section 32 of the Exchange Act.

[18] That negligence would suffice for the imposition of Exchange Act sanctions creates differing standards of liability between the scienter that is required to prove a primary violation of the antifraud provisions of the Exchange Act (*i.e.*, intentional or extremely reckless conduct) and the mental element required to prove a violation of the reporting provisions for attorneys (*i.e.*, conduct judged only negligent).

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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