Client ALERT

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Final SEC Regulations Require In-House and Outside Counsel to Report Securities Violations

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On January 29, 2003, the Securities and Exchange Commission (the "SEC" or "Commission") issued final regulations to implement provisions of the Sarbanes-Oxley Act of 2002 (H.R. 3763) (the "Act"), requiring "up the ladder" reporting of suspected corporate wrongdoing by in-house and outside attorneys. Entitled "Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of Issuers," the regulations cover material violations of the securities laws and breaches of fiduciary duty. The text of the final regulations can be found at http://www.sec.gov/rules/final/33-8185.htm or at 68 Fed. Reg. 6295.

These regulations, which become effective August 5, 2003, are part of Congress' and the SEC's recent efforts to increase dramatically the responsibility of directors, officers and others who oversee or participate in the preparation of public company financial statements and other disclosures. The SEC received 167 comments on the proposed regulations which were issued on November 21, 2002. Public companies should take immediate steps to implement a plan to comply with these reporting obligations.

"Noisy Withdrawal" Provisions Not Finalized

The final regulations do not include the controversial "noisy withdrawal" provisions, although the SEC has not dropped this element of the initial proposal, under which outside and in-house counsel alike were to report material violations of the securities laws directly to the SEC and disavow related SEC filings that counsel believed were inaccurate if the company failed to appropriately respond when counsel informed it of those violations. Under the previously proposed regulations, outside counsel were required to withdraw from representing the company and provide the SEC with notice of his or her withdrawal for "professional considerations." The SEC has issued alternative proposed regulations that would require the issuer itself to disclose in its public filings with the Commission (*e.g.*, Forms 8-K) the fact that the issuer's attorney has given notice of withdrawal based on material violations of the securities law and the circumstances of the withdrawal. *See* 68 Fed. Reg. 6324 (Feb. 6, 2003). The SEC has solicited comments on the alternative proposed regulations and has also extended the time to comment on the original "noisy withdrawal" proposal.

Summary of Key Provisions of Final Regulations

These far-reaching regulations provide that:

- Awareness of credible evidence that would lead a reasonable attorney to believe that a material violation of federal or state securities laws or a breach of a fiduciary duty has occurred, is occurring, or is about to occur triggers the reporting obligation.
- In-house, outside and foreign attorneys are covered by the regulations. Supervisory attorneys are covered if their subordinates are covered.
- The reporting obligation can be satisfied by informing a single source – the company's Qualified Legal Compliance Committee ("QLCC"), comprised of at least one member of the audit committee and two or more independent directors.
- If the company does not have a QLCC, then the information must be reported up the ladder until the reporting attorney receives an appropriate response: first to the chief legal officer, then to the audit committee, another committee that is comprised solely of independent directors, or the full board of directors.
- An "appropriate response" includes the reporting attorney's reasonable belief that:

  - no violation occurred;

  - remedial measures, including disclosures and sanctions, to address the violation have been taken; or

  - the board of directors or audit or other independent committee has engaged an attorney to investigate the reported evidence where either the company has been advised by the investigating attorney that there is a "colorable defense" in any proceeding relating to the reported violation or remedial recommendations made by the investigating attorney have been implemented.

Implementing Section 307 of the Sarbanes-Oxley Act

The proposed regulations implement § 307 of the Act, which provides:

> Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, 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 –
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> 1. Requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
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> 2. If the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to 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.

Attorneys Covered by Regulations Broadly Defined

On their face, the regulations adopted pursuant to § 307 of the Act apply to attorneys "appearing and practicing before" the SEC, suggesting that only those attorneys who represent a party in an SEC administrative proceeding, represent an issuer in drafting and filing a registration statement or periodic report, or represent a company in conjunction with an SEC investigation, inquiry or subpoena are covered. Although the definition of covered attorneys has been narrowed from the definition in the proposed regulations, the definition remains broad. While it is not surprising that attorneys who communicate directly with the SEC are covered, § 205.2(a)(1)(i); 68 Fed. Reg. 6295, 6296 (Feb. 6, 2003), the definition of covered attorneys is far broader, and reaches those with only indirect involvement with the SEC or its staff or a company's filings with the SEC. The SEC did clarify that attorneys at public broker-dealers and other issuers who are not in the legal department and who do not provide legal services within the context of an attorney-client relationship are excluded.

Section 205.2(a)(2)(iii) includes attorneys who provide securities advice to an issuer regarding "any documents that the attorney has notice will be filed with or submitted to" the SEC. *Id.* at 6297. In addition, under § 205.2(a)(1)(iv), attorneys who advise issuers that information need not be disclosed or documents need not be filed or incorporated into an SEC filing are covered by the regulations. Thus, arguably outside or in-house counsel who review a single filing or advise an issuer that a document need *not* be filed are covered by the regulations, even if the attorney does not regularly advise the company regarding securities law issues. For example, an attorney employed by an investment adviser who prepares or assists in preparing materials for a registered investment company that the attorney has reason to believe will be submitted to or filed with the SEC by or on behalf of a registered investment company is appearing and practicing before the SEC.

Supervisory Attorneys Covered

In keeping with the broad coverage of the regulations, attorneys "supervising or directing" another attorney who "appears and practices before" the SEC are covered, and are required to make "reasonable efforts to ensure" that subordinate attorneys comply with the regulations. § 205.4(a) and (b); 68 Fed. Reg. at 6313. The supervising attorney is required to report material violations "up the ladder" when informed by a subordinate attorney of such a violation, even if the supervising attorney's knowledge is based solely upon the information provided by the subordinate attorney. § 205.4(c); *Id.* A subordinate attorney fulfills his or her obligations under the regulations by making a report to his or her supervisor, § 205.5(c); *Id.*, and has a duty to report violations to the supervising attorney notwithstanding the fact that he or she acted at the direction of another. § 205.5(b); *Id.*

Foreign Attorneys Covered in Some Situations

In response to comments challenging the broad applicability of the proposed regulations to foreign attorneys, the final rules "exclude many, but not all, foreign attorneys." 68 Fed. Reg. at 6303. Generally, a "non-appearing foreign attorney" is not covered. The regulations define a "non-appearing foreign attorney" as an attorney admitted to practice law outside of the United States who does not provide legal advice or hold himself out as practicing U.S. federal or state securities or other law. § 205.2(j); *Id.* at 6321. Conduct that would otherwise constitute "appearing and practicing" before the SEC will not trigger application of the regulations to foreign attorneys so long as those activities are "only incidental to" the attorney's practice of law in a foreign country or such foreign attorney appears and practices before the SEC only in consultation with counsel admitted or licensed to practice in a U.S. jurisdiction. *Id.* at 6303. Furthermore, the preparation of a document will not trigger application of the regulations unless the attorney was on notice that the document would be submitted to the SEC and the attorney provides advice on U.S. securities or other law in preparing the document. *Id.* at 6304.

Evidence of "Material Violation" Triggers Attorney Reporting Obligation

Covered attorneys are required to report evidence of a past, present or future material violation up-the-ladder. Material violations include violations of federal and state securities laws and breaches of fiduciary duty, or similar violations. § 205.2(i); 68 Fed. Reg. at 6304. An objective, reasonable person standard is used to determine whether conduct rises to the level of a material violation. In order for information to constitute "evidence of a material violation," it must be credible such that "it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur." § 205.2(e); *Id.* at 6304.

The SEC's adopting release lists some of the circumstances that may be relevant in assessing whether conduct constitutes a material violation, including the attorney's legal skills, background and experience, the time constraints the attorney was under, the attorney's experience and familiarity with the client, and the availability of other attorneys with whom the attorney may consult. *Id.* at 6302. Quoting a comment submitted concerning the proposed regulation, the SEC states that attorneys need not report "gossip, hearsay, [or] innuendo[es]." *Id.* at 6302, n.46.[1] The material violation "must be more than a mere possibility, but it need not be 'more likely than not.'" *Id.* at 6302.

Once the attorney concludes that there has been or will be a material violation, he or she has two options for discharging his or her reporting obligations. As discussed, the first option requires that reports be made to up to three different persons or bodies, and that the response of the first two be monitored and assessed by the reporting attorney. The second option requires a single report to a single body, with no continuing obligation for the reporting attorney to monitor the response of that body.

What Constitutes a Reasonable Belief?

Both the reporting attorney and the CLO are required to act based upon reasonable beliefs. For example, the CLO is required to conduct an inquiry of evidence of material violations "as he or she reasonably believes is appropriate," § 205.3(b)(2), 68 Fed. Reg. at 6307, and the reporting attorney's obligations to report material violations beyond the CLO depend upon whether he or she reasonably believes the CLO has responded to the report appropriately. §§ 205.3(b)(4), (8) and (9); *Id.* at 6307-6309. The explanatory material issued with the regulations provides that, in making a "reasonable" determination, the attorney should consider "all attendant circumstances," including the amount and weight of the evidence, the severity of the violation, and the scope of the investigation into the reported violation. *Id.* at 6300. Notably, the explanatory material also cautions that the reporting attorney cannot take the CLO's determination that there was no material violation as "dispositive of the issue," although the attorney can rely on "reasonable and appropriate factual representations and legal determinations of persons on whom a reasonable person would rely." *Id.*

Reporting Option One: Chief Legal Officer/Board

Under the first reporting option, the attorney reports the violation to the chief legal officer ("CLO") (and, at the attorney's option, to the chief executive officer as well). Under this reporting option, the attorney is responsible for assessing the adequacy of the CLO's response. If the attorney reasonably believes that the CLO's response is adequate no further action is required.

As discussed below, if the CLO does not provide an "appropriate response" to the reported violation, the reporting attorney is required to report the violation "up the ladder" to either (1) the company's audit committee; (2) another committee of the board comprised solely of independent directors; or (3) if there is no committee comprised solely of independent directors, the board of directors.[2]

Once the CLO receives a report of a material violation, he or she must conduct an inquiry to determine whether the reported violation occurred, is occurring or is about to occur, unless he or she reports the matter directly to the QLCC, in which case no further action is required. If the CLO determines that violations have occurred, are occurring or will occur, he or she must ensure that the issuer adopts "appropriate 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 reoccurrence." 205.3(b)(2); 68 Fed. Reg. at 6307. The CLO must report the remedial measures (including appropriate disclosures) and sanctions taken or imposed to the CEO, the audit committee or the board of directors, and to the reporting attorney.[3]

Once the reporting attorney receives a report from the CLO he or she must then determine whether the CLO's conclusion constitutes an appropriate response. If not, the reporting attorney must report the material violation to one of the board level bodies identified above.[4] Any attorney who is advised that the company, with the consent of the board or audit or other independent committee, has engaged counsel to investigate a violation and that remedial steps have been taken or that counsel can assert a colorable defense in any proceeding will have received an appropriate response and will not be obligated to report the violation to the board level bodies.

The proposed regulations imposed a final reporting obligation on attorneys who did not receive a satisfactory response. The final step – reporting the violation to the SEC – has been removed from the final regulations. New proposed regulations requiring the issuer to report the attorney's notice of withdrawal in the issuer's public filings with the Commission are found at http://www.sec.gov/rules/proposed/33-8186.htm.

Reporting Option Two: Qualified Legal Compliance Committee

At each step of the first reporting option, the reporting attorney is required to assess the adequacy of the company's response, and where the response is inadequate the attorney must go to a higher level within the company.[5] Yet the regulations offer an alternative reporting procedure that requires just a single step. By reporting a material violation to a Qualified Legal Compliance Committee ("QLCC"), the reporting attorney can satisfy all obligations under the regulations. The reporting attorney is not required to assess the issuer's response to the reported evidence of a material violation. 68 Fed. Reg. at 6309. The CLO may refer a report of evidence of a material violation to the QLCC as well.

Although the regulations state that companies are not required to create a QLCC, the regulations encourage the creation of a QLCC by greatly eliminating the burden on a reporting attorney to monitor the company's response, and to report further "up the ladder" when the corporate response is inadequate.

Creation of Qualified Legal Compliance Committee Favored

A QLCC must consist of at least one member of the board's audit committee, and two or more board members who are independent and not employed by the company. In order for the QLCC to qualify to serve as the body to investigate and respond to reports of material violations, the board must empower the QLCC to investigate reports, and require it to (1) inform the CLO and CEO of the report; (2) determine whether an investigation of the report is necessary, and, if so, initiate an investigation; and (3) if appropriate, direct remedial measures, including making disclosures and imposing sanctions to stop the violations and prevent them in the future. The QLCC must have written procedures for receiving and addressing such reports.

Although the regulations do not require the creation of a QLCC, the greatly streamlined reporting structure available to those companies that have a QLCC establishes a strong incentive to create one. The regulations do not prohibit a company from utilizing its audit committee as the QLCC, so long as its members are independent.

Limited Applicability to Attorneys who Conduct Internal Investigations of Material Violations

Attorneys who are retained or appointed to investigate a report of a material violation in most instances are not required to comply with the reporting obligations. Retained outside counsel and in-house counsel alike have no reporting obligations whatsoever when directed by the QLCC to investigate a material violation. § 205.3(b)(7); 68 Fed. Reg. at 6308. On the other hand, attorneys retained or directed by the CLO to investigate are required to report the results to the CLO and, unless the attorney and the CLO conclude that there has been no material violation, the CLO is required to report the results of the investigation to the board of directors or audit or other independent committee or the QLCC. § 205.3(b)(6); *Id.*

Limited Applicability to Attorneys Defending Company Regarding the Alleged Violations

Both outside and in-house counsel who are directed by the QLCC to defend the company in an SEC investigation, administrative proceeding or lawsuit are not under any reporting obligation, so long as any defense that is asserted is "colorable." § 205.3(b)(7)(ii); 68 Fed. Reg. at 6308. The same standard applies to attorneys retained or directed by the CLO to defend the company, provided that the CLO keeps the QLCC or the board of directors or audit or other independent committee informed about the litigation. § 205.3(b)(6)(ii); *Id.*

In determining whether the claim is "colorable," the SEC refers to its Rule of Practice 153(b)(1)(ii), which provides that an attorney who files a document with the Commission 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." *Id.* at 6301. Thus, the attorney must have a good faith argument that the asserted defense is viable.

Sanctions

A violation of these regulations is treated as a violation of the Securities Exchange Act of 1934. § 205.6; 68 Fed. Reg. at 6314. Therefore, the attorney may be subject to injunctions, cease and desist orders, or disciplinary proceedings that could include a suspension or permanent bar from practicing before the SEC.

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ENDNOTES

[1] The rules proposed by the SEC pursuant to Section 301 of the Act require audit committees to implement and oversee procedures for the anonymous submission of complaints concerning questionable accounting and auditing matters. The anonymous nature of a complaint would not in and of itself render the information not credible for purposes of § 205.2(2).

[2] If the attorney reasonably believes that reporting the violation to the CLO would be futile, the attorney may bypass the CLO and make the initial report to these board-level bodies.

[3] Presumably, in developing remedial measures that involve corrective disclosure, the CLO would consult with the CFO and other appropriate executive officers.

[4] If the CLO determines that no violation has occurred, the reporting attorney must also be so informed.

[5] Although a subordinate attorney may discharge the reporting obligation by making the report to his or her supervisor, who need not be the CLO, if the subordinate reasonably determines that the supervisor's response was inadequate the subordinate must continue to report the violation "up the ladder." § 205.5(c).