SEC Adopts Final Rules Establishing Standards of Professional Conduct Under Section 307 of the Sarbanes-Oxley Act

The SEC recently adopted final rules[1] implementing Section 307 of the Sarbanes-Oxley Act (the "*Act*"), establishing minimum standards of professional conduct for attorneys appearing and practicing before the SEC. Section 307 of the Act requires the SEC to adopt rules:

- requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation to the chief legal counsel or the chief executive officer; and

- if the counsel or officer does not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee or to another committee of independent directors or to the board of directors.

As initially proposed, the rules would have required attorneys not only to report material violations to the officers and/or board of directors of the issuer, but also to make a "noisy withdrawal" from the representation (requiring notification to the SEC) if the issuer did not respond appropriately to the report. The SEC did not include the noisy withdrawal provisions in the final rules, but rather, in response to numerous comments, extended the comment period on this aspect of the rules for an additional period ending April 7, 2003 and proposed an alternative procedure described below.

The final rules implementing the up-the-ladder reporting obligations under Section 307 of the Act go into effect on August 5, 2003. We have previously distributed Securities Alerts that described the proposed rules and summarized the major changes from the proposed rules as discussed at the SEC's open meeting on January 23, 2003. These Securities Alerts are available on our web site, www.ropesgray.com, under "News & Events."

Attorneys Subject to the Rules

The Section 307 reporting obligation applies to "attorneys appearing and practicing before the Commission in any way in the representation of issuers."

- The term *"attorneys"* includes both domestic and foreign attorneys, inside and outside counsel, and nonlicensed individuals who hold themselves out as qualified to practice law. The final rules contain the following important exemptions to the set of attorneys subject to the reporting obligations which were not included in the proposed rules:

[1] The adopting release may be found at www.sec.gov/rules/final/33-8185.htm.

- Attorneys who appear and practice before the SEC (as described below) *other than* in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship (e.g., underwriters' counsel in connection with an issuer's public offering), and

- *"Non-appearing foreign attorneys,"* defined as attorneys licensed in foreign jurisdictions who do not give legal advice with respect to US federal or state law other than:

  - incidentally to a foreign law practice; or

  - in consultation with US counsel.

- The term *"appearing and practicing"* before the SEC is extremely broad and includes:

  - Transacting any business with the SEC, including communications in any form;

  - Providing advice to an issuer on federal securities laws or SEC rules with respect to any document that the attorney has notice (a more objective standard than the "reason to believe" formulation contained in the proposed rules) will be filed with, submitted to, or incorporated by reference in a document filed with or submitted to, the SEC, including advice delivered in connection with the preparation or participation in the preparation of any such document (e.g., participation in drafting or reviewing a registration statement or periodic report);

    - The final rules require a securities law advice component to the work done on filed or submitted documents. The adopting release provides that preparation of a document (such as a contract filed as an exhibit to a periodic report), without notice that such document would be filed or submitted, would not be sufficient to subject an attorney to the rules;

  - Advising an issuer as to whether a statement, opinion or other writing is required to be filed with, submitted to or incorporated into any document to be filed with or submitted to, the SEC (e.g., advice that a given contract need not be filed as an exhibit to the issuer's periodic report); and

  - Representing the issuer in a SEC proceeding or in connection with a SEC investigation, inquiry, information request or subpoena.

- The term *"in the representation of an issuer"* includes providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer. The SEC narrowed the proposed definition, "acting in any way on behalf . . . of an issuer," effectively excluding individuals licensed to practice laws who have relationships other than that of attorney-client with the issuer.

  - For example, an attorney retained by the investment advisor of a registered investment company who contributes to the investment company's disclosure document would be acting in the representation of an issuer without being retained or employed by the issuer (assuming such attorney has notice that the document will be filed with the SEC).

- The final rules also expand the definition of "issuer" to include controlled entities for which an attorney provides legal services at the behest or for the benefit of an issuer. Thus the rules cover an attorney for a nonpublic subsidiary of an issuer if the scope of representation (for purposes of privilege or otherwise) is intended, even implicitly, to include the parent, or if the attorney is otherwise assigned work by, or performing work at the direction of, the parent (in each case assuming the attorney's activities otherwise constitute "appearance and practice" before the SEC).

Circumstances That Give Rise to the Duty

The duty to report "up the ladder" at an issuer is triggered when an attorney becomes aware of evidence that a material violation of the federal or state securities laws, [2] a material breach of fiduciary duty arising under federal or state law or a similar material violation of any federal or state law (each a *"material violation"*), by the issuer or by any officer, director, employee or agent of the issuer, has occurred, is occurring, or is about to occur.

- The term *"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. The change in the final rules from "information that would lead an attorney reasonably to believe" to "credible evidence based upon which it would be unreasonable…for a prudent and competent person not to conclude" was designed to emphasize that:
  - the standard is intended to be an objective standard; and
  - there is a range of conduct in which an attorney may engage in response to any given set of facts without being unreasonable. Circumstances to be considered expressly include, among others, the skills, experience and time constraints with which the attorney acts, as well as the availability of other lawyers for consultation.

- The term *"reasonably likely"* means more than a mere possibility but less than "more likely than not"" (such that probability need not exceed 50%). The attorney has no duty to investigate whether the violation suggested by such evidence actually is occurring or did or will occur.

- The term *"breach of fiduciary duty"* is intended to cover any breach of fiduciary duty recognized under an applicable federal or state statute or at common law (examples include misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of unlawful transactions).

- The term *"similar violations"* remains undefined in the final rules, the stated intention being to establish its meaning over time through SEC decisions, but the final rules qualify the term to refer only to violations of federal or state law.

Although the duty applies to attorneys appearing and practicing before the SEC in the representation of an issuer, the evidence that triggers the duty is not limited to matters learned in the course of such

[2] The final rules clarify that the term "securities law violations" includes violations of state as well as federal securities laws.

representation. Evidence learned in the course of unrelated activities may trigger the reporting obligation of issuer's counsel appearing and practicing before the SEC.

Reporting Up the Ladder

Level One: Report to Officer
The final rules require the attorney, upon becoming aware of evidence of a material violation that meets the standards described above, to report the evidence without delay to the chief legal officer or to both the chief legal officer and chief executive officer of an issuer. This report may be communicated in person, by telephone, by email or other electronic means or in writing.

- The requirement that the attorney document all such reports and responses contained in the proposed rules was eliminated in the final rules.

Level Two: Investigation/Response
The chief legal officer must conduct such investigation into the reported evidence as he or she reasonably believes is appropriate to determine whether a material violation has occurred, is occurring or is about to occur. If the chief legal officer determines that no material violation exists, he or she must so advise the reporting attorney. [3] If the chief legal officer does not reasonably believe that no material violation has occurred, is occurring or is about to occur, the chief legal officer must take all reasonable steps to cause the issuer to adopt an appropriate response and advise the reporting attorney of the response.

- An *"appropriate response"* by the issuer to a material violation means a response to an attorney based on which the attorney reasonably believes:
    - The issuer has undertaken appropriate remedial measures, such as steps or sanctions to stop any ongoing material violation, to prevent any impending material violation and to remedy or otherwise appropriately address,[4] and minimize the recurrence risk of, any past material violation; or
    - With the consent of the board of directors, audit committee or another appropriate committee (an Alternative Independent Committee, as defined below), the issuer has retained or directed another attorney to review the evidence of material violation and has either:
        - substantially implemented any remedial recommendations made by such investigating attorney after a reasonable investigation and evaluation of the reported evidence; or
        - been advised that such investigating attorney may assert a colorable defense[5] on behalf of the issuer in any investigation or judicial proceeding related to such evidence.

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[3] A reporting attorney may not blindly rely on a chief legal officer's assurance that no material violation exists or that the issuer has undertaken an appropriate response. However, the attorney may rely on reasonable and appropriate factual representations and legal determinations of persons upon whom it is reasonable to rely.

[4] The adopting release states that the issuer must "consider the feasibility of restitution" as part of an appropriate response.

[5] A *"colorable defense"* is one that an attorney may assert consistent with his or her professional obligations not to assert frivolous claims or defenses.

- Any investigating attorney is also deemed to be appearing and practicing before the SEC, subject to the reporting obligations of the Act. However, the investigating attorney has no reporting obligation with respect to the evidence of material violation which he or she has been retained to investigate as long as:

  - the investigating attorney reports the results of such investigation to the chief legal officer, and the chief legal officer reports the results of the investigation to the board of directors or appropriate committee, unless both the investigating attorney and chief legal officer reasonably believe that no material violation exists; and

  - if the investigating attorney was directed by the chief legal officer or QLCC (defined below) to assert a colorable defense in any investigation or judicial or administrative proceeding, the chief legal officer regularly delivers progress reports to the board of directors or appropriate committee.

Level Three: Report to Board/Committee

If the reporting attorney does not reasonably believe that the chief legal officer or chief executive officer has provided an appropriate response within a reasonable time, the reporting attorney must report the evidence of material violation:

- to the issuer's audit committee; or

- if the issuer does not have an audit committee, to another committee of directors without employment relationships (direct or indirect) with the issuer[6] (an *"Alternative Independent Committee"*); or

- if the issuer has neither an audit committee nor an Alternative Independent Committee, to the full board of directors.

If a reporting attorney reasonably believes that reporting evidence of the material violation to the chief legal officer and/or chief executive officer would be futile, the reporting attorney may skip that step (Level Two above) and proceed directly to report evidence of the material violation to the board of directors or a specified committee (Level Three above).

Duties in the Absence of an Appropriate Response

The final rules provide that an attorney who has followed the appropriate steps to report evidence of a material violation, and who *still* does not reasonably believe that the issuer has made an appropriate response within a reasonable time, must explain his or her reasons for such belief to the chief legal officer, chief executive officer and the directors to whom the report was made.

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[6] This standard will be conformed eventually to the "independent director" criteria in rules adopted pursuant to Section 301 of the Act. In the case of registered investment companies, such directors may not be "interested persons" as such term is defined in the Investment Company Act of 1940.

- As mentioned above, the proposed "noisy withdrawal" provisions, which would permit, and in some cases require, attorneys to withdraw from the representation (and disaffirm any "tainted" filings) of an issuer who has failed to appropriately respond to reported evidence of a material violation and to notify the SEC of such withdrawal, were not adopted. The comment period on the proposal was extended to April 7, 2003.

The SEC has also proposed an alternative set of "reporting out" requirements in the absence of an appropriate response for public consideration in a new proposing release.

- Similar to the original noisy withdrawal proposal, the alternative proposal would require an outside attorney who does not receive an appropriate response from an issuer to a report of evidence of a material violation, and who reasonably concludes that there is substantial evidence of a material violation that is ongoing or about to occur and that is likely to result in substantial injury to the financial interest or property of the issuer or of investors, to withdraw from the representation, notifying the issuer in writing that such withdrawal is based on professional considerations.

- Under like circumstances, an attorney employed by the issuer would be required to cease participation or assistance in any matter concerning the violation and to notify that issuer in writing of his or her belief that an appropriate response to a report of evidence of material violation has not been provided.

- In either circumstance, or upon an attorney's notification to an issuer's chief legal officer that he or she reasonably believes that his or her representation or employment has been terminated for reporting evidence of a material violation, the issuer would be required to disclose such notice and the circumstances related thereto to the SEC within two business days after receiving such notice as a material event on Form 8-K, 20-F or 40-F, as applicable.

    - There would be no requirement for the attorney serving such notice to publicly disaffirm any issuer filings.

    - Under this alternative proposal, a chief legal officer would be required to notify any attorney retained or employed to replace an attorney who has given such notice that the previous attorney has withdrawn, ceased to participate or been discharged under the relevant section of the rules.

Alternative Procedure Involving Qualified Legal Compliance Committee

The final rules provide for an alternative reporting procedure, using a special Qualified Legal Compliance Committee (*"QLCC"*) formed at the option of the issuer.

- The QLCC alternative procedures allow an attorney, in the first instance, to report directly to a previously established committee rather than reporting first to the appropriate officers at the issuer.

- A QLCC is a committee of the board of directors, consisting of one member of the issuer's audit committee and two or more directors not employed, directly or indirectly, by the issuer. The committee must have the authority and responsibility to determine whether reported evidence of a material violation warrants investigation and to:

- Initiate such investigation (to be conducted by the chief legal officer or outside attorneys);
- Recommend an appropriate response to the issuer; and
- Take all other appropriate action.

- "Appropriate action" expressly includes the authority to notify the SEC if the issuer fails in any material respect to implement an appropriate response recommended by the QLCC.[7]

- An attorney who becomes aware of evidence of a material violation may report such evidence to the QLCC rather than the chief legal officer only if the QLCC has been previously established by the issuer. An issuer may not establish a QLCC to respond to an incident once the incident has occurred.
  - After reporting to the QLCC, the reporting attorney will have no further duty to assess the issuer's response and will have satisfied his or her obligations under Section 307.
  - In addition, a chief legal officer who has received a report of evidence of a material violation may turn the report over to the QLCC for investigation and response (although doing so does not relieve a chief legal officer of all obligations as described below).

- In either circumstance, the QLCC, rather than the chief legal officer, will assess the need for further inq uiry into the reported evidence, initiate the necessary or appropriate investigation, determine whether a material violation exists, and, if so, take the following action:
  - Recommend, by majority vote, that the issuer implement an appropriate response (note that the "recommendation" language in the final rules replaced compulsory language in the proposed rules); and
  - Inform the chief legal officer, chief executive officer and board of directors of the results of the QLCC's investigation and the appropriate remedial measures to be undertaken; and
  - Acting by majority vote, take all other appropriate action.

The attached diagram charts an attorney's reporting obligations under the rules, using either the conventional procedures (under §205.3(b)) or the alternative QLCC procedures.

Supervisory and Subordinate Attorneys

The rules distinguish between supervisory attorneys and subordinate attorneys for purposes of the reporting obligation.

[7] In a later section of the release, the staff states that the QLCC "is not required to [notify the SEC] in every case," suggesting, by negative implication, that there may be circumstances in which notification of the SEC *is* required.

- An attorney appearing and practicing before the SEC on a matter under the supervision or direction of another attorney is a *"subordinate attorney."*

  - Attorneys acting under the direct supervision or direction of the chief legal officer or equivalent (e.g., an assistant general counsel reporting directly to the chief legal officer) are an important exception to this rule, however. Such attorneys are also considered supervisory attorneys and their obligation under the rules is not limited to reporting to their supervisors, as is the usual case for subordinate attorneys.

- An attorney supervising or directing an attorney who is appearing and practicing before the SEC in the representation of an issuer is a *"supervisory attorney."*

  - A chief legal officer is always considered a supervisory attorney.

  - The supervisory attorneys of a subordinate attorney who appears and practices before the SEC in the representation of an issuer are also deemed to practice before the SEC.

- Supervisory attorneys are charged with reporting evidence of material violations that they discover on their own as well as evidence that is reported to them by subordinate attorneys. Supervisory attorneys also must make reasonable efforts to ensure that the attorneys they supervise comply with the rules.

- Subordinate attorneys are bound by the rules regardless of whether they are acting on the direct instruction of a supervisory attorney. The reporting obligation of a subordinate attorney, however, only extends as far as his supervisory attorney.

- If a subordinate attorney reasonably believes that his supervisor has failed to comply with the rules, a subordinate attorney may, but is not required to, report up-the-ladder at the issuer.

Privilege

The rules explicitly authorize, but do not require, an attorney's disclosure of confidential information, without the issuer's consent, if the attorney reasonably believes such disclosure is necessary in order 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;

- Prevent the issuer from committing, in any SEC investigation or administrative proceeding, perjury, subornment of perjury or other illegal acts to perpetrate fraud upon the SEC; or

- Rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in furtherance of which the attorney's services were used.

A reporting attorney is also explicitly authorized to use any documented reports of evidence of a material violation to defend against a claim of noncompliance with the rules, even though client confidences may be revealed. This provision is consistent with the ABA's Model Rules and comparable rules in each state.

Sanctions

Violations of the rules by attorneys constitute violations of the Securities Exchange Act of 1934, subjecting the attorney to civil penalties and remedies such as actions for injunctive or other equitable relief and cease-and-desist proceedings in actions brought by the SEC. The attorney may also be temporarily or perma nently barred from the privilege of appearing and practicing before the SEC.

- The final rules expressly state that they do not create a private right of action and that authority to enforce the rules will be vested exclusively in the SEC.[8]

- Attorneys viola ting the SEC's rules will be subject to SEC disciplinary authority regardless of whether the attorney may also be subject to discipline for the same conduct at the state level.

- An attorney who complies in good faith with the rules will not be subject to discipline or otherwise be liable under inconsistent standards imposed by any state or other jurisdiction where the attorney is admitted to practice.

    - The SEC view, clearly expressed in the final rules, is that the federal laws do preempt any less stringent standards at the state level.

    - Attorneys practicing outside the U.S. are not required to comply with the rules to the extent that such compliance is prohibited by applicable foreign law.

Contact Information

If you have any questions or would like to learn more about the se rules, please contact the lawyer who normally represents you.

[8] In part to make its intentions clear on this point, the SEC deleted a clause appearing in the proposed rules stating that attorneys subject to the rules must act in the best interests of the issuer *and its shareholders*.