Executive Summary

At an open meeting on January 23, 2003, the Securities and Exchange Commission ("SEC") adopted new rules establishing standards of professional conduct for attorneys who represent publicly traded companies and other issuers of SEC registered securities. These rules were mandated by Section 307 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). These final rules implement a number of changes to the SEC’s initial proposed rules, which were released for public comment in November of 2002.

As required by Section 307, and consistent with the SEC’s proposed rules, the new rules will require attorneys with evidence of a corporate client’s misconduct to report the misconduct “up the ladder” within the organization, all the way to the board of directors, if necessary. However, faced with substantial negative reaction to the “noisy withdrawal” provisions of the proposed rules, the SEC extended the comment period on these provisions for an additional 60 days and proposed alternative provisions that would require the company, rather than the attorney, to disclose the attorney’s withdrawal from representation. Other aspects of the proposed rules also were revised in response to public comments.

The new rules will become effective 180 days after publication. The text of the rules and the SEC’s release discussing the rules are not yet available. Pending the issuance of the rules, this alert will summarize some of the more significant aspects of the new rules, the principal differences between the proposed and final rules, and the additional alternative provisions proposed by the SEC.

Summary of the Rules Adopted

- Scope of the Rules

As adopted, the new rules will apply to attorneys who provide legal services to, and have an attorney-client relationship with, an SEC reporting company. Non-U.S. lawyers will be excluded from the rules, unless they provide advice on U.S. law without consulting with a U.S. attorney. Similarly, licensed attorneys who act solely in other capacities for a company are
excluded from the rules. The rules will apply to attorneys “practicing and appearing before the Commission,” defined broadly in the rules to include representation in connection with SEC administrative proceedings, investigations, information requests, or subpoenas, as well as preparation of documents that the attorney has notice will be filed with or incorporated into SEC filings or submissions.

- **“Up the Ladder” Reporting**

  Attorneys with “credible evidence” that a “prudent and competent attorney” would conclude gives rise to a “reasonable likelihood” that a material violation of securities laws, a breach of fiduciary duties, or similar violation has occurred, is occurring or is about to occur, will be required to report such evidence to the CEO or chief legal officer (“CLO”) of the company. The CEO or CLO will then be required to conduct a reasonable investigation; take remedial measures and/or impose sanctions as necessary; and report back to the reporting attorney, the CEO, and to the audit committee or full board. If the CEO or CLO does not adequately respond to the report, the attorney would be required to report the evidence to the board of directors or to the audit committee or another committee of independent directors.

- **Disclosure of Confidential Information**

  The rules will permit, but not require, an attorney to reveal confidential client information related to the attorney’s representation to the extent necessary (1) to prevent the client from committing a material violation likely to result in substantial financial injury to the company or investors; (2) to prevent an illegal act; or (3) to remedy a past violation in which the attorney’s services were used.

- **Qualified Legal Compliance Committee**

  As an alternative reporting mechanism, the rules permit companies to establish a “qualified legal compliance committee” (“QLCC”). The QLCC must be composed of independent directors, at least one of which is on the audit committee. An attorney with evidence of a material violation could fully discharge his or her reporting obligations by reporting directly to the QLCC. Likewise, a CLO who receives a report could ask the QLCC to investigate the report in lieu of the CLO’s own investigation. The QLCC would then be responsible for recommending appropriate remedial action.

**“Noisy Withdrawal” Not Adopted; Comment Period Extended**

The SEC’s proposed rules would have required a reporting attorney who does not receive an appropriate or timely response from the issuer to not only withdraw from the representation, but also notify the SEC of his or her withdrawal and disaffirm any SEC filings or submissions.
tainted by the misconduct – a so-called “noisy withdrawal.” Faced with significant negative reaction to this aspect of the proposed rules, the SEC is extending the comment period on this provision for an additional 60 days, as well as proposing an alternative to the “noisy” portion of the withdrawal requirements. Under the alternative proposal, an attorney in this situation would be required to withdraw, and the withdrawing attorney would be required to notify the company in writing of the reasons for his or her withdrawal. The company would then be required to file a Form 8-K within two days disclosing the receipt of this notice and the circumstances of the withdrawal. If the company does not make this filing, the attorney would be permitted (but not required) to disclose the withdrawal and notice directly to the SEC. This alternative is designed to satisfy concerns that direct disclosure by attorneys to the SEC may violate attorney-client confidentiality and conflict with state ethics rules governing attorney conduct.

Other Significant Differences between the Proposed and Final Rules

The SEC made other changes to the final rules in response to the extensive public comment on the proposals. In particular, the final rules reflect the following changes:

- The definitions of “attorney” and “appearing and practicing before the Commission” were narrowed to exclude licensed attorneys acting in non-attorney capacities, as well as to require that an attorney have notice that his or her representation is related to an SEC proceeding or submission.

- The final rules will not apply to non-U.S. attorneys who do not provide advice regarding U.S. law, or who provide such advice only in consultation with U.S. counsel.

- The standard of evidence that triggers a reporting obligation was revised. Under the SEC’s proposed rules, “evidence of a material violation” was defined as information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur. By comparison, the rules as adopted define “evidence of a material violation” as “credible evidence,” based upon which it would be unreasonable 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 SEC stated that this change was made in an effort to make the standard more objective; however, it appears that applying the standard will necessitate some subjective judgments.

- The final rules clarify that they do not create a private right of action against attorneys who violate the rules. Instead, the SEC will be the sole enforcement entity for these rules.

- The final rules state that the new rules supercede state law in the event of a conflict, but that states are free to impose stricter obligations on attorneys.
Conclusion

To allow both public companies and their attorneys time to establish procedures to comply with the new rules, the rules will not go into effect until 180 days from the date of their publication. The Commission indicated in the open meeting, however, that it may consider the additional comments and adopt the remaining proposals within that 180-day period. We expect to provide a more detailed alert once the text of the new rules and proposals has been issued.

This publication has been prepared solely for informational purposes and is not intended as legal advice. Please call your usual contact at Sutherland if you would like additional information about the matters discussed in this Legal Alert.

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