



CORPORATE GOVERNANCE ALERT

SEC PROPOSES RULES REGARDING STANDARDS FOR ATTORNEY CONDUCT

On November 21, 2002, the Securities and Exchange Commission (SEC) solicited comments on proposed rules that, if adopted, will implement Section 307 (Section 307) of the Sarbanes-Oxley Act of 2002 (the Act) by setting forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC on behalf of issuers. The SEC must announce the final rules by January 26, 2003.

“UP THE LADDER” REPORTING

Central to the proposed rules is a requirement that an attorney appearing and practicing before the SEC in the representation of an issuer who becomes aware of evidence of a material violation of the securities laws or breach of fiduciary duty or similar violation by the issuer or any of its officers, directors or agents must report such evidence to the issuer’s chief legal officer (CLO). If a reporting attorney does not receive an appropriate response to such a report within a reasonable time, he or she must then report the evidence “up the ladder” to the issuer’s audit committee (or other committee of independent directors, or, if the issuer does not have another committee of independent directors, to the full board). The proposed rules provide that if the attorney believes that reporting the evidence of a material violation to the issuer’s CLO would be futile, he or she can bypass the officer and report the evidence directly to the issuer’s audit committee (or other committee of independent directors or full board). Additionally, the proposed rules provide an alternative to “up the ladder” reporting by permitting an attorney to report evidence of a material violation directly to a qualified legal compliance committee (QLCC), which is a committee of independent directors, with at least one member from the audit committee, formed by the issuer to investigate reports of evidence of a material violation by the issuer.



CHIEF LEGAL OFFICER’S DUTY TO INVESTIGATE

Once a CLO is presented with a report of a possible material violation, he or she must either refer the report to the issuer’s QLCC or perform such inquiry that he or she reasonably believes is necessary to determine whether



the reported violation has occurred, is occurring or is about to occur. If, after investigation, the CLO determines that no material violation has occurred, is occurring or is about to occur, he or she must advise the reporting attorney. If the CLO determines that a material violation has occurred, is occurring or is about to occur, he or she must take steps to ensure that the issuer adopts remedial measures, including appropriate disclosures, and must impose appropriate sanctions to stop any material violation that is occurring, prevent any material violation that is about to occur, or rectify any material violation that has already occurred. The CLO must then report the remedial measures and sanctions to the audit committee or the board of directors and the reporting attorney.

KEY ISSUES PRESENTED BY THE PROPOSED RULES

The proposed rules present a number of issues that bear further scrutiny. These issues include the breadth of the definitions of “attorney,” “awareness of evidence of a material violation,” “appearing and practicing before the Commission” and “in the representation of an issuer.” For example, the definition of “awareness of evidence of a material violation” is obviously critical to the operation of the rules, because they define the event that precipitates the reporting requirements. The SEC proposes an objective “reasonable lawyer” standard as opposed to one based on actual awareness of a violation.

The SEC also proposes to extend the rules to non-U.S. lawyers. Since there are many companies outside the United States that are reporting issuers under the Exchange Act, the rule’s breadth poses serious questions for the non-U.S. lawyers representing these companies.

Moreover, the proposed rules bring within their ambit licensed attorneys who are not acting as lawyers. The reason for such an extension is not at all clear.

However, the most controversial aspect of the proposed rules is one that goes beyond the mandate of the Act: the provision that imposes a requirement that a lawyer and his or her firm withdraw from representation of an issuer.

“NOISY WITHDRAWAL”

If an attorney reports evidence of a material violation to the CLO or audit committee (or other committee of independent directors or full board) — rather than to a QLCC, which is discussed below — and has not received an appropriate response within a reasonable time and if he or she believes that a material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or investors, the attorney is required to —

- withdraw promptly from representing the issuer, indicating that the withdrawal is based on “professional considerations”
- within one business day after withdrawing, notify the SEC that he or she has withdrawn and was required to do so for “professional considerations”
- promptly disaffirm in writing 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.

If the reporting attorney is an inside attorney retained by the issuer, he or she is only required to disaffirm any tainted filing and not required to withdraw from representing an issuer. If an attorney believes that a material violation has occurred but is not ongoing, then withdrawal (if applicable) and disaffirmance is permissive, not required.

The SEC believes that allowing the attorney to withdraw for “professional considerations” provides the ability to signal that something is wrong with an issuer without revealing confidential or privileged communications. Critics argue, however, that confidential and privileged communications are at risk with a “noisy withdrawal” because it is foreseeable — and likely — that the SEC will ask the issuer, either pursuant to a formal investigation or otherwise, for an explanation of the circumstances underlying the withdrawal. This SEC proceeding could very possibly result in the issuer revealing confidential and privileged information, voluntarily or otherwise. Moreover, the SEC may request that the attorney provide evidence that he or she withdrew in a timely manner. Because the proposed rules permit an attorney to disclose issuer confidences in connection with any investigation in which compliance with the proposed rules is at issue, this request by the SEC may result in lawyers revealing additional client confidences and privileged disclosures.

The “noisy withdrawal” provisions of the proposed rules could result in issuers withholding certain sensitive disclosure questions from their attorneys for fear of a “noisy withdrawal” and the potential negative effects of such a withdrawal.

Moreover, the provision creates the potential for conflict between the SEC’s rules and the rules of professional conduct of the state in which the lawyer practices. Although violating the rules can trigger the enforcement provisions of the Exchange Act, the SEC has indicated that violations would trigger criminal sanctions.

Since the Act does not contain a requirement relating to “noisy withdrawals,” a number of law firms have asked the SEC to refrain from implementing this aspect of the rules until it can be more fully discussed and evaluated.

THE QUALIFIED LEGAL COMPLIANCE COMMITTEE

Another significant proposal contained in the proposed rules that is not mandated by the Act is the provision relating to a QLCC. A QLCC is defined by the rules as a committee duly established by the board of directors and consisting of at least one member of the audit committee and two or more members of the board of directors who are not employed directly or indirectly by the issuer. The QLCC must be authorized to investigate any report of evidence of a material violation by the issuers, or its officers, directors, employees or agents, and is subject to several other requirements.

The proposed rules provide that if a reporting attorney elects to report evidence of a material violation to a QLCC — rather than to an issuer’s CLO or audit committee (or other committee of independent directors or the full board) — he or she —

- has satisfied his or her obligations to report evidence of a material violation under the proposed rules
- is not required to assess the issuer’s response to the reported evidence, and



- is not required to withdraw from representing the client, alert the SEC of such withdrawal or disaffirm any of the issuer's filings.

The proposed rules provide that a QLCC which receives a report of a material violation is responsible for —

- responding to the evidence of the material violation
- notifying the CLO of the report of evidence of a material violation (unless such notification would be futile)
- causing an investigation where appropriate
- determining what remedial measures are appropriate where a material violation has occurred, is occurring, or is about to occur
- reporting the results of the investigation to the CLO, the CEO and the full board of directors
- notifying the SEC if the issuer fails in any material respect to take any of those appropriate remedial measures.

If the issuer fails to take remedial measures as directed by the QLCC, each member of the QLCC, as well as the CLO and the CEO, are individually responsible for notifying the SEC of the material violation and for disaffirming any tainted submission to the SEC.

Issuers and their counsel will have to closely examine the costs and benefits of setting up a QLCC.

SELECTIVE WAIVER OF PRIVILEGES

In an attempt to inject itself into a legal issue that has been described as one of “hopeless confusion,” the proposed rules provide that if an issuer, through its attorney, shares with the SEC, pursuant to a confidentiality agreement, information related to a material violation, such disclosure shall not constitute a waiver of any otherwise applicable privilege as to other persons.

The SEC believes that this provision serves the public interest because it enhances the SEC's ability to conduct expeditious investigations and obtain prompt relief for defrauded investors. However, the issue of sharing the results of internal investigations with the SEC is a complex one. An issuer that has conducted an internal investigation usually wants to cooperate with the SEC in the hopes of ultimately limiting its exposure to various sanctions. On the other hand, the issuer is usually faced with private shareholder litigation and is concerned that disclosing its report and findings with the SEC will constitute a waiver of attorney-client and work product privileges.

The courts are divided on whether to allow the selective waiver of applicable privileges. Therefore, an issuer that decides to cooperate with the SEC does so without knowing whether the disclosure to the SEC will waive the privileges with respect to third parties. The proposed rules may or may not help resolve the “hopeless confusion.” The reasoning of the courts that hold that selective waiver is impermissible focuses on the common law rationale for the privilege and may not be affected by the SEC's rules.

However, there is a potential solution to this dilemma. The Act and the pending revised listing

standards of the New York Stock Exchange (and other exchanges) and the Nasdaq impose a number of requirements on the audit committees of issuers. Thus, the role and duty of the audit committee in protecting the integrity of the company's financial statements may be deemed to be closely aligned with that of the SEC. This common interest may be sufficient to maintain the cloak of the privilege even if the results of the internal investigation are shared with the SEC. Assuming that this provision of the proposed rules survives, it could significantly advance a company's interest in cooperating with the SEC without hampering its ability to defend itself against litigation.

In addition, the Delaware Court of Chancery recently issued an opinion in *Saito v. McKesson HBOC, Inc.*, No. Civ. A. 18553, 2002 WL 31458233 (October 25, 2002), in which it upheld the concept of selective waiver pursuant to a confidentiality agreement with law enforcement agencies. It remains to be seen whether the SEC's expressed support for such a result will be taken into account by the courts.

* * *

Our lawyers are monitoring these corporate reforms and will keep you apprised of any developments that arise from the requirements imposed under the Sarbanes-Oxley Act and from regulatory activity of the SEC. For a summary of other key provisions of the Act, as well as other Corporate Governance Alerts that provide detailed analyses of certain other key provisions of the new law, please visit our Web site at <http://www.akingump.com/publication.cfm>.



CONTACT INFORMATION

If you have any questions or would like to learn more about this topic, please contact the partner who normally represents you, or:

Dawn M. Gertz
Director of Client Services
dgertz@akingump.com
1.866.AKINLAW

Albany Austin Brussels Chicago Dallas Denver Houston
London Los Angeles Moscow New York Northern Virginia
Philadelphia Riverside Riyadh (Affiliate)
San Antonio Washington, D.C.