

**SEC ADOPTS FINAL RULES REGARDING MINIMUM STANDARDS  
OF PROFESSIONAL CONDUCT FOR ATTORNEYS**

**February 20, 2003**

On January 29, 2003, the Securities and Exchange Commission (the “SEC”) issued final rules implementing Section 307 (Rules of Professional Responsibility for Attorneys) of the Sarbanes-Oxley Act of 2002 (the “Act”) and setting forth “minimum standards” of professional conduct for attorneys appearing or practicing before the SEC.<sup>1</sup> The rules will be effective August 5, 2003. The SEC extended the comment period on the “noisy withdrawal” provision of the rules as originally proposed (the “Existing Proposal”) for 60 days and proposed an alternative to the proposed noisy withdrawal provision (the “Alternative Proposal”).<sup>2</sup>

The following is a brief summary of the final rules, which are contained in Part 205 of Title 17, Chapter II, of the Code of Federal Regulations (“Part 205”), as well as a recap of the Existing Proposal and a summary of the Alternative Proposal.

**Differences Between Proposed Rules and Final Rules**

In response to a significant number of comment letters from attorneys and professional organizations, the SEC has modified a number of the provisions contained in the proposed rules. The key changes in the final rules adopted by the SEC include:

- Narrowing the scope of attorneys who would be subject to Part 205;
- Clarifying that evidence of a material violation of securities laws or breach of a fiduciary duty would be based on an objective determination;
- Withdrawing the proposed requirement that attorneys and companies retain documentation of reports of evidence of a material violation;
- Extending the comment period for the Existing Proposal regarding “noisy withdrawal” for an additional 60 days;

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<sup>1</sup> Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8185 (January 29, 2003) (available at <http://www.sec.gov/rules/final/33-8185.htm>).

<sup>2</sup> For a description of the Existing Proposal, see Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8150 (November 21, 2002) (available at <http://www.sec.gov/rules/proposed/33-8150.htm>). For a description of the Alternative Proposal, see Proposed Rule: Implementation of Standards of Conduct for Attorneys, Securities Act Release 33-8186 (January 29, 2003)(available at <http://www.sec.gov/rules/proposed/33-8186.htm>). Comments on the Alternative Proposal are due by April 7, 2003.

- Proposing, as an alternative to the Existing Proposal, that the company, rather than the attorney, be required to notify the SEC when an attorney resigns under certain circumstances; and
- Providing a “safe harbor” from disciplinary action under conflicting state law for attorneys who in good faith comply with Part 205.

### **Attorneys Subject to Part 205**

Although narrowed somewhat in the final rules, Part 205 retains its fairly expansive view of those who are deemed to appear or practice before the SEC. Part 205 covers in-house attorneys, as well as outside counsel, if they perform any of the following services for an “issuer” (as such term is defined in the Act):

- transacting any business with the SEC, including oral or written communications with the SEC staff;
- representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request or subpoena;
- Providing advice with respect to U.S. securities laws or the SEC’s rules regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, including providing such advice in the context of preparing, or participating in the preparation of, any such document; or
- Advising an issuer as to whether information or a statement, opinion or other writing is required under U.S. securities laws or the SEC’s rules to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC.

The SEC clarified in the final rules that to be subject to Part 205, an attorney has to provide one or more of the above-referenced services in the context of providing legal services to a company with whom the attorney has an attorney-client relationship.<sup>3</sup>

### **The Reporting Requirements of Part 205**

*Reporting Evidence of a Material Violation.* Part 205.3(b) requires attorneys who appear or practice before the SEC in the representation of an issuer to report evidence of a material violation by the issuer or any of its officers, directors, employees or agents of federal or state securities laws, a material breach of fiduciary duty arising under federal or state law or a similar material violation.<sup>4</sup> When an attorney becomes aware that such a material violation has occurred,

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<sup>3</sup> This change was in response to criticisms that the proposed rules would cover individuals licensed to practice law but not acting as attorneys, as well as attorneys not having an attorney-client relationship with the issuer, such as underwriters’ counsel who assist in the preparation of a registration statement filed with the SEC.

<sup>4</sup> A breach of fiduciary duty refers to any breach of fiduciary duty recognized by federal or state statute or at common law, such as misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of an unlawful transaction. Fiduciary duties recognized under federal law include those owed to pension funds under the

is occurring or is about to occur, the attorney would be required initially to report such evidence to the company's Chief Legal Officer or equivalent ("CLO") or to its CLO and Chief Executive Officer ("CEO"). A report must be made in person or in writing or by telephone, e-mail or electronically, and it must be made directly to the designated recipient and not through third parties.

One important change contained in the final rules is the clarification that whether an action or statement constitutes "evidence of a material violation" is an objective determination. An action or statement will be considered evidence of a material violation if it constitutes "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 ongoing, or is about to occur." If the attorney reasonably believes that it would be futile to report evidence of a material violation to the CLO and CEO, the attorney instead may report directly to the company's audit committee, another committee comprised solely of independent directors (if the board has no audit committee) or to the full board of directors (if the board has no committee of independent directors).

The SEC stated that Part 205 is not intended to impose upon an attorney a duty to investigate evidence of a material violation or to determine whether in fact there has been a material violation. Likewise, the duty to report "up the ladder" would not arise from a consultation in which an attorney advises an employee of the issuer that the law regarding a proposed course of action is unsettled and that it is possible that a court might hold in the future that the action violated the securities laws. Similarly, according to the promulgating release, the duty to report does not arise where the officer tells the attorney that he intends to pursue a course of action that the attorney thinks is clearly illegal, since the officer might reconsider and opt not to follow that course of conduct.

Upon receipt of a report of evidence of a material violation, the CLO must conduct a reasonable inquiry to determine whether a material violation has occurred, is occurring or is about to occur. A CLO who reasonably concludes that no material violation has occurred, is occurring, or is about to occur, would be required to provide notice to the reporting attorney of this conclusion and the basis for it. A CLO who concludes that a material violation has occurred, is occurring or is about to occur would be required to take all reasonable steps to cause the company to adopt an appropriate response and so advise the reporting attorney.

If a reporting attorney reasonably believes he has received an appropriate response from the CLO or the CEO within a reasonable time, he has no further obligations under Part 205.

*Reporting "Up the Ladder"*. Unless the reporting attorney reasonably believes he has received an appropriate response within a reasonable time, the reporting attorney must report his evidence of a material violation to the audit committee or, if the company has no audit committee, to an equivalent committee of independent directors. If the company does not have an independent committee, the reporting attorney must report such evidence to the full board of directors.

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Employee Retirement Income Security Act. The final rules do not provide any guidance as to what a "similar material violation" may include.

Part 205.2 defines the phrase “appropriate response” as a response to a report of a material violation that provides a basis for an attorney reasonably to believe that:

- no material violation has occurred, is occurring or is about to occur;
- the company has, as necessary, adopted appropriate remedial measures, including appropriate disclosures, or imposed sanctions that can be expected to stop any material violation that is occurring, prevent any material violation that has yet to occur, or remedy or otherwise appropriately address any material violation that has already occurred and minimize the likelihood of its recurrence; or
- the company has retained or directed an attorney to review the reported evidence of material violation and either:
  - has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or
  - has been advised that such attorney may assert a colorable defense on behalf of the party alleged to have committed the material violation in any investigation or proceeding relating to the alleged material violation.

In response to criticism that attorneys retained to investigate evidence of a material violation should not be subject to up the ladder reporting, the SEC added new provisions in the final rules that relieve attorneys retained or directed by a CLO or Qualified Legal Compliance Committee (discussed below) to investigate evidence of a material violation or to assert a colorable defense in an investigation or judicial or administrative proceeding from the up the ladder reporting requirements of Part 205.3(b) except under certain narrow circumstances.

*Qualified Legal Compliance Committees.* Part 205 permits, but does not require, issuers to create a “Qualified Legal Compliance Committee” (a “QLCC”) of the issuer. Part 205 permits a reporting attorney to report evidence of a material violation to the QLCC rather than to the CEO and/or CLO. A reporting attorney (other than a CLO) who has reported evidence of a material violation to a QLCC would have fulfilled his obligations under Part 205, and thus would not be required to take further action contemplated by Part 205, such as assessing the issuer’s response to the reported violation and, if the response is not appropriate, reporting such evidence further up the ladder to the audit or other independent committee or to the board of directors in accordance with Part 205.3. In addition, the CLO may refer a report of evidence of a material violation to the QLCC in lieu of conducting an inquiry on his own, in which case the QLCC would be responsible for responding to the report of a material violation.

A QLCC must be comprised of at least one member of the company’s audit committee or, if the company has no audit committee, at least one member of an equivalent committee of independent directors, and two or more independent members of the company’s board of directors. Part 205 permits an issuer to designate an existing committee as the issuer’s QLCC if it satisfies the requirements of Part 205. However, a QLCC may not be established or designated

on an *ad hoc* basis; the QLCC must be established or designated prior to the issuer's receipt of a report of a material violation that the QLCC intends to investigate. A QLCC is required to adopt written procedures for the confidential receipt, retention and consideration of reports of material violations. If established, a QLCC must have the authority and the responsibility to:

- inform the company's CLO and CEO (or their equivalents) of any report of evidence of a material violation;<sup>5</sup>
- decide whether an investigation is necessary to determine whether a material violation has occurred, is occurring or is about to occur;<sup>6</sup> and
- at the conclusion of the investigation, to recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation and inform the CLO, the CEO and the board of directors of the results of the investigation and the appropriate remedial measures to be adopted.

If an issuer fails in any material respect to implement an appropriate response that is recommended by the QLCC, the QLCC would have the authority to notify the SEC of such failure.

An attorney formerly employed or retained by a company who reasonably believes that he has been discharged because he fulfilled the reporting obligation imposed by Part 205 may, but is not required to, notify the company's board of directors or any committee of his belief. This provision is designed to ensure that a CLO cannot block a report to the board or audit committee by firing a reporting attorney.

### **Supervisory and Subordinate Attorneys**

Parts 205.4 and 205.5 detail the respective responsibilities of supervisory and subordinate attorneys, both in-house and outside attorneys. These provisions broadly define who is serving as a supervisory attorney and specifically include the CLO of a company (or equivalent) within the definition. The provisions also place the responsibility for compliance with Part 205's reporting requirements upon the supervisory attorney after he has been informed of evidence of a material violation by a subordinate.

Subordinate attorneys are not exempt from the rule, though they will have complied with the rule where they report evidence of material violations to their supervisory attorney. A subordinate attorney who has reported evidence of a material violation to a supervisory attorney, and who reasonably believes that the supervisory attorney has failed to comply with his reporting requirements, is permitted, but not obligated, to report the evidence "up the ladder."

### **Confidentiality Concerns**

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<sup>5</sup> If the QLCC believes that to do so would be futile, it may report the evidence to the company's audit or other independent committee or to the board of directors in accordance with Part 205.3.

<sup>6</sup> If the QLCC determines that an investigation is necessary or appropriate, it must: (1) notify the audit committee or full board of directors; (2) initiate an investigation conducted by either the CLO or outside attorneys; and (3) retain any additional expert personnel necessary for conducting the investigation.

Part 205.3(d) defines the circumstances under which an attorney appearing or practicing before the SEC would be authorized to disclose a company's confidential information. Pursuant to this provision, an attorney may use any documentation prepared to document the reporting of a material violation or a response to the report to defend against charges of attorney misconduct. This provision also allows an attorney to reveal confidential information without the company's consent to the extent necessary to:

- prevent the commission of a material violation that is likely to cause substantial injury to the financial interest or property of the company or its investors;
- prevent the company, in an SEC investigation or administrative proceeding, from committing or suborning perjury or perpetrating a fraud on the SEC; or
- rectify a company's material violation that caused, or may cause, substantial injury to the financial interest or property of the company or its investors when the attorney's services have furthered such actions.

This provision is based on the American Bar Association's Model Rule 1.6 and rules of professional responsibility adopted by the vast majority of states.

However, the potential remains for conflict between the provisions of Part 205 and state ethics requirements. In theory, an attorney could comply with both the SEC rule permitting disclosure of confidential information and a state's rule forbidding disclosure by not disclosing the information, just as an attorney could comply with both the rule permitting disclosure of confidential information and a state's rule requiring disclosure by disclosing the information. Part 205.1 states that if state standards conflict with Part 205, Part 205 will govern.<sup>7</sup> Therefore, an attorney appearing and practicing before the SEC who is admitted in a jurisdiction that forbids disclosure of confidential information under circumstances where Part 205 would permit disclosure may disclose the information to the SEC, notwithstanding the contrary state rule. A different case exists when a state rule requires disclosure in a case where Part 205 would merely allow it. In such a case there will likely be no conflict between the SEC rule and the state rule, and the attorney should thus be bound by the state rule requiring disclosure.

### **Sanctions and Discipline for Violations of Part 205**

Violation of Part 205 would subject the violator to all the remedies and sanctions available under the Securities Exchange Act of 1934, including injunctions, cease and desist orders and civil monetary penalties. An attorney who violates a provision of Part 205 would have engaged in improper professional conduct and may also be subject to administrative disciplinary proceedings that can result in a censure or a suspension or bar from practicing before the SEC.

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<sup>7</sup> Without stating that its authority to preempt inconsistent state law is based on the U.S. Constitution, the adopting release notes that it received comment letters supporting the proposition that the Commerce Clause of the U.S. Constitution grants the SEC the authority to regulate the securities industry and, under the Supremacy Clause of the U.S. Constitution, SEC rules will preempt conflicting state rules.

Attorneys who comply in good faith with Part 205 will not be subject to discipline for violations of inconsistent standards imposed by a state or other U.S. jurisdiction. However, this provision applies only to an attorney's liability for violating inconsistent standards of a state or other U.S. jurisdiction and is therefore not available where the state or other jurisdiction imposes additional requirements on the attorney that are consistent with Part 205.

Part 205.7 provides that nothing in Part 205 creates a private right of action against any attorney, law firm or issuer for violations of Part 205, and that the SEC has the sole authority for enforcing Part 205.

### **The Pending Noisy Withdrawal Proposal**

In response to the concerns of the securities bar and others, the SEC dropped from the final rules its proposal to permit or require "noisy" withdrawal under certain circumstances. However, in a separate release the SEC extended the comment period on these controversial provisions for 60 days and proposed an alternative to them.<sup>8</sup>

Although not mandated by Section 307 of the Act, the Existing Proposal provides that if, after reporting up the ladder, the reporting attorney reasonably believes that the company has not responded appropriately, he must take the further steps discussed below if he believes a material violation is ongoing, is about to occur or has occurred and is likely to result in substantial injury to the financial interest or property of the issuer or investors.<sup>9</sup>

The Existing Proposal distinguishes between outside attorneys and in-house counsel in prescribing the steps to be taken by a reporting attorney who has not made a report to a QLCC if a company fails to implement appropriate remedial measures or sanctions. Outside attorneys who have reported material violations and have not received an appropriate response, and who reasonably believe that a material violation is either ongoing or is about to occur and is likely to result in substantial injury to the financial interests of the company or its investors, are required to:

- withdraw from representing the issuer and notify the SEC within one business day of such withdrawal, in each case indicating that the withdrawal was based on professional considerations; and
- promptly disaffirm to the SEC any statement that the attorney has participated in preparing that the attorney reasonably believes is or may be false or misleading in a document filed with or submitted to the SEC.

Under the Existing Proposal, in-house attorneys who reasonably believe that the material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest of the company or its investors are required to disaffirm to the SEC any tainted submission they have participated in preparing, but are not required to resign.

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<sup>8</sup> See footnote 2 above.

<sup>9</sup> These steps are not required to be taken by an attorney (other than a CLO) who has made a report to a QLCC.

In the event an attorney reasonably believes that a material violation has occurred but has no ongoing effect, the attorney is permitted, but not required, to take the foregoing steps under the Existing Proposal, so long as he also reasonably believes that the material violation is likely to have caused substantial injury to the financial interest or property of the company or its investors. A company's CLO must inform any attorney retained or employed to replace the attorney who has withdrawn that the previous attorney's withdrawal was based on professional considerations.

### **Alternative Proposal**

In addition to extending the comment period for the Existing Proposal, the SEC also issued the Alternative Proposal, which would still require any attorney to withdraw from representing the issuer, but would relieve the attorney of the obligation to disclose his withdrawal. Instead, the Alternative Proposal would shift this obligation to the issuer, which would be required to disclose publicly the withdrawal and the circumstances surrounding it in a Form 8-K. Under the Alternative Proposal, withdrawing attorneys would not be required to notify the SEC or disaffirm any SEC filings that the attorney prepared or assisted in preparing. Unlike the Existing Proposal, which permits withdrawal in the case of a past violation that the attorney believes is likely to have caused significant injury to the financial interest of the issuer or its investors, the Alternative Proposal neither requires nor expressly permits withdrawal in such cases. Withdrawal by an outside attorney would remain mandatory for ongoing or future violations under the Alternative Proposal.

If you have any questions about the standards of professional conduct for attorneys that are discussed in this memorandum, or if we can be any further assistance, please do not hesitate to contact the Womble Carlyle attorney with whom you work or any one of the attorneys listed below.

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