

# STATE BAR OF TEXAS



## BUSINESS LAW SECTION

February 2003

To: All Section Members

From: James R. Peacock III  
Chairman, Professional Ethics Committee

Subject: SARBANES-OXLEY ACT OF 2002 -- SEC ADOPTS RULES OF  
PROFESSIONAL CONDUCT FOR ATTORNEYS

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The Securities and Exchange Commission (the “SEC”) recently adopted final rules, as mandated by Section 307 of the Sarbanes-Oxley Act of 2002 (the “Act”), that will impose new standards of professional conduct on attorneys appearing and practicing before the SEC in the representation of public companies.<sup>1</sup> Additionally, due to a need for further consideration, the SEC approved a sixty-day extension of the comment period relating to the SEC’s proposed “noisy withdrawal” requirements while proposing an alternative reporting requirement that would require public companies to report the withdrawal of attorneys under certain circumstances.<sup>2</sup>

The final rules are intended to protect investors and increase their confidence in public companies by ensuring that attorneys working with those companies report evidence of material violations. This Memorandum addresses the new standards of professional conduct as adopted by the SEC in a new Rule 205 for members of the Business Law Section of the State Bar of Texas. Due to the controversial nature of the proposed rules, the SEC received over 150 comment letters challenging many aspects of the proposed rules, including who is covered by the rules, internal “up the ladder” reporting requirements, “noisy withdrawal” requirements, and possible sanctions for non-compliance. In adopting the final rules, the SEC both modified and clarified many of the proposed rules. The final rules will become effective on August 5, 2003 to allow those affected by the rules adequate time to establish compliance procedures.

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<sup>1</sup> The rules were adopted in SEC Release No. 33-8185 (Jan. 29, 2003), 68 Fed. Reg. 6296 (Feb. 6, 2003), and are available at <http://www.sec.gov/rules/final/33-8185.htm>

<sup>2</sup> The proposed rules regarding alternative reporting requirements are contained in SEC Release No. 33-8186 (Jan. 29, 2003), 68 Fed. Reg. 6324 (Feb. 6, 2003), and are available at <http://www.sec.gov/rules/proposed/33-8186.htm>

**1. *What does Section 307 of the Act require?***

Attorneys appearing and practicing before the SEC in any way in the representation of public companies must report evidence of a material violation by the company or by any officer, director, employee, or agent of the issuer, of securities law, breach of fiduciary duty, or similar violation to the chief legal officer (“CLO”) or the chief executive officer (“CEO”) of their public company clients. If the CLO or the CEO does not respond appropriately to the reported evidence, the attorney must report the evidence “up the ladder” to the audit committee of the board of directors, another committee comprised of independent directors, or finally to the board of directors.

**2. *To whom do the requirements apply?***

Any attorney appearing and practicing before the SEC in the representation of a public company is subject to the Section 307 requirements. A public company includes any company that either has securities registered under the Securities Exchange Act of 1934 (the “Exchange Act”), is required to file reports under the Exchange Act, or has a registration statement pending under the Securities Act of 1933, regardless of whether it has become effective. Under the rules, an “attorney” includes any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction (domestic or foreign), or who holds himself out as admitted, licensed, or otherwise qualified to practice law.

Generally, an attorney is deemed to “appear and practice” before the SEC by (1) transacting any business with the SEC, (2) representing a public company in an administrative proceeding or in connection with an SEC investigation, (3) providing advice in respect to U.S. securities laws regarding any document that the attorney has notice will be filed with or submitted to the SEC, and (4) advising a public company that a statement or other writing need not be filed with or submitted to the SEC. An attorney will not be deemed to “appear and practice” before the SEC if he (i) conducts any activities mentioned above outside the context of providing legal services to a public company with whom he has an attorney-client relationship, or (ii) is a “non-appearing foreign attorney.”<sup>3</sup>

Therefore, the definition of an attorney appearing and practicing before the SEC in the representation of a public company includes both outside and in-house counsel, but would not include attorneys employed by a public company in a non-legal capacity. Additionally, the rules include attorneys working at a non-public subsidiary of a public company if the attorneys are assigned work by the parent company that they have notice will be incorporated into documents submitted to the SEC by the parent company.

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<sup>3</sup> The rules exclude “non-appearing foreign attorneys,” who are foreign attorneys not admitted to practice law in the United States and who do not advise clients regarding U.S. law. However, foreign attorneys who provide legal advice regarding U.S. law, without working in conjunction with U.S. counsel, are covered by the rules to the extent they are otherwise found to be “appearing and practicing” before the SEC.

**3. *When and how should an attorney report evidence of a material violation “up the ladder” to management?***

Under the rules, an attorney appearing and practicing before the SEC in the representation of a public company must report “evidence of a material violation” of federal or state securities law, breach of fiduciary duty<sup>4</sup> arising under federal or state law, or similar violation of any federal or state law by the public company or by any officer, director, employee, or agent of the issuer, to the public company’s CLO (or the equivalent thereof) or to both the CLO *and* the CEO (or the equivalents thereof). The requirement to report evidence of a material violation is based on what the SEC calls an objective standard. This objective standard is met only when there is “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.”

Once an attorney reports evidence of a material violation to the CLO (or the equivalent thereof), the CLO is responsible for complying with the requirements of the rules. If the CLO reasonably believes that there is no material violation after conducting an investigation, he must advise the reporting attorney of his belief. If the CLO reasonably believes that there is a material violation, however, he must take all reasonable steps to cause the public company to adopt an appropriate response, and must advise the reporting attorney.

If the CLO (or the equivalent thereof) does not provide an “appropriate response”<sup>5</sup> to the report of evidence of a material violation, the reporting attorney must report “up the ladder” to the audit committee, another appropriate committee comprised of independent directors, or to the board of directors. An attorney who receives what he believes is a reasonable response to the report has satisfied his reporting requirement under the rules. If an attorney reasonably believes he has not received an appropriate response, the attorney must explain his reasons to the CLO, CEO, or directors to whom the attorney reported the evidence.

**4. *How would the proposed “noisy withdrawal” requirements affect attorneys?***

If, after reporting “up the ladder” through the public company, an attorney does not receive an appropriate response, the proposed “noisy withdrawal” requirements would impose certain duties upon the reporting attorney to withdraw from representation (only in the case of outside counsel), notify the SEC, and disaffirm any documentation filed with the SEC that may be false or misleading. Due to the overwhelming negative response to the “noisy withdrawal” proposal, the SEC has opened an additional sixty-day comment period and will consider

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<sup>4</sup> Under the rules, “breach of fiduciary duty” means “any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.”

<sup>5</sup> Under the rules, an “appropriate response” means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes (1) that no material violation has occurred, is ongoing, or is about to occur, (2) the issuer has adopted appropriate remedial measures to stop ongoing violations, to prevent any material violation that has yet to occur, and to remedy a material violation that has already occurred, or (3) the issuer has, with the board of director’s consent, retained an attorney to review the reported evidence of a material violation and either (i) has implemented any remedial recommendations made by the attorney after a reasonable investigation, or (ii) has been advised that the investigating attorney may present a colorable defense on behalf of the issuer in any investigation or proceeding relating to the reported evidence of a material violation.

alternatives, including the possibility of requiring the public company to report the attorney's withdrawal instead of the attorney.

**5. *How would the proposed alternative reporting requirement operate?***

Under the alternative proposed reporting requirement, an attorney may still be required to withdraw from representation, but would not have to report that fact to the SEC or disaffirm any documentation filed with the SEC. Instead, the public company, rather than its attorney, would be required to publicly disclose the attorney's notice of withdrawal or written notice indicating the attorney did not receive an appropriate response to a report of evidence of a material violation. The public company would be required to report the attorney's notice on Form 8-K, 20-F or 40-F (as applicable) within two business days after receiving the notice. According to the SEC, the proposed alternative reporting requirement does not contain a requirement to disaffirm false or misleading documents filed with the SEC. If a public company failed to make the disclosure the attorney believed to be required, the attorney would be permitted, but not required, to inform the SEC of his withdrawal. The SEC is seeking comments from the public regarding this proposed alternative reporting requirement during the extended comment period.

**6. *What is a qualified legal compliance committee and what is its function?***

Under the rules, a public company has the option of establishing a qualified legal compliance committee ("QLCC"). A QLCC must be comprised of at least one member of the public company's audit committee, or an equivalent committee of independent directors, and two or more independent directors. Additionally, a QLCC must first be established by the board of directors and must adopt written procedures for the receipt, consideration, and retention of reports of evidence involving material violations. Once established, a QLCC has the authority to investigate any report of evidence of a material violation. Therefore, a public company may desire to form a QLCC to act upon a report of evidence of a material violation.

**7. *How does a QLCC operate under the rules?***

If the public company has established a QLCC prior to a report of evidence of a material violation, an attorney who believes he has evidence of a material violation may report directly to the QLCC. If reporting to a QLCC is an option, an attorney who chooses to report directly to the QLCC will have fulfilled the reporting requirements under the rules and will not be required to monitor the public company's response. Additionally, a CLO may refer a report of evidence of a material violation to a QLCC in lieu of conducting his own investigation. After the CLO reports the evidence to the QLCC, the QLCC will be responsible for responding to the report of evidence of a material violation. The QLCC will be authorized to notify the CLO and CEO of the report, determine whether an investigation is necessary, and if so, to notify the audit committee or the board of directors. At the conclusion of any investigation, the QLCC has the authority and responsibility to recommend, upon majority vote, that the public company adopt appropriate remedial measures, and inform the CLO, CEO, and board of directors of the results of the inquiry and the measures to be adopted. If the QLCC determines that the public company has failed to take the recommended remedial measures, the QLCC has the authority and responsibility, upon majority vote, to notify the SEC.

**8. *What are the roles of supervisory and subordinate attorneys under the rules?***

A “supervisory attorney” is an attorney that supervises or directs another attorney who is appearing and practicing before the SEC in the representation of a public company. A “subordinate attorney” is an attorney who appears and practices before the SEC in the representation of a public company under the supervision or direction of another attorney (other than the direct supervision or direction of the public company’s CLO (or the equivalent thereof)). Supervisory and subordinate attorneys may be employed by the public company or by outside law firms. A subordinate attorney is responsible for reporting evidence of a material violation to a supervisory attorney, and upon such a report, the supervisory attorney is responsible for complying with the reporting requirements. If a subordinate attorney reports evidence of a material violation to the supervisory attorney, the subordinate attorney has complied with the reporting requirement under the rules. Additionally, the rules require a supervisory attorney to take reasonable efforts to ensure that a subordinate attorney conforms to the rules. A supervisory attorney is also permitted to report evidence of a material violation to a QLCC if the public company's board of directors has established a QLCC.

**9. *What may an attorney reveal without the public company’s consent?***

Under the rules, there are three circumstances in which an attorney is permitted, but not required, to reveal confidential communications to the SEC relating to his representation of a public company. An attorney is permitted to reveal confidential communications to the extent the attorney reasonably believes necessary to (1) prevent the public company from committing a material violation that is likely to cause substantial injury to the financial interest or property of the public company or its investors, (2) prevent the public company, in an SEC investigation or administrative proceeding, from committing perjury, suborning perjury, or committing any act proscribed that is likely to perpetrate a fraud upon the SEC, or (3) rectify the consequences of a material violation by the public company that caused, or may cause, substantial injury to the financial interest or property of the public company or its investors in the furtherance of which the attorney’s services were used.

**10. *Do the rules preempt state legal ethics rules?***

The SEC's rules govern in the event they conflict with state legal ethics rules applicable to attorneys; however, the rules “will not preempt the ability of a state to impose more rigorous obligations on attorneys that are not inconsistent with the rules.” Thus, attorneys who disclose the type of information contemplated by the rules to the persons specified by the rules should not be deemed to be in violation of any state rules regarding attorney-client privilege or other legal ethics matters.

**11. *What are the sanctions and discipline for noncompliance?***

If an attorney violates the rules, he may be subjected to the civil penalties and remedies applicable to a violation of the federal securities laws in an action brought by the SEC. An attorney will be subjected to the SEC’s disciplinary authority for violation of the rules regardless of whether the attorney is disciplined for the same conduct in the jurisdiction where the attorney

is admitted or practices. Additionally, an administrative disciplinary proceeding initiated by the SEC for violation of the rules may result in an attorney being censured, or temporarily or permanently denied from appearing or practicing before the SEC. An attorney who complies with the rules in good faith, however, will not be subject to discipline under inconsistent standards imposed by any state or jurisdiction where the attorney is admitted or practices.

The rules affirmatively provide that the rules do not create a private cause of action against any attorney, law firm, or public company based upon compliance or noncompliance with the rules. Moreover, the authority to enforce an attorney's compliance with the rules rests solely with the SEC.

***Practical Suggestions.*** Because of the breadth of the new rules, it may be prudent for companies to establish QLCCs (which may be the audit committee). Ultimately, a properly-functioning QLCC may benefit the company, investors, directors, officers, and the attorneys involved. Under the rules, if an attorney reports evidence of a possible material violation to a QLCC, his reporting requirement has been satisfied. Additionally, a QLCC can relieve the CLO (or the equivalent thereof) of the obligation to investigate and respond to reports of potential violations, which could preserve time and resources. These benefits alone may outweigh the costs of establishing and maintaining a QLCC.

In-house attorneys may wish to educate and train the public company's officers and directors so that they will be equipped to adequately handle reports of evidence of a material violation. The board of directors may wish to establish and circulate throughout the company written procedures for handling the receipt, consideration, and retention of any report of evidence of a material violation. Additionally, supervisory attorneys working both in-house and in law firms should take steps to make sure that every attorney, not only those working in a corporate/securities practice group, is aware of Section 307 and its implications. Attorneys may also want to consider modifying agreements with clients that refer to applicable ethical rules that are now supplemented by the SEC's Part 305.

*This Memorandum has been prepared for members of the Business Law Section of the State Bar of Texas, does not constitute legal advice, is not intended to create an attorney-client relationship and covers only some of the many issues raised by the SEC's rules under the Sarbanes-Oxley Act.*

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