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Client Alert

A report for clients and friends of the firm

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SEC Adopts Rules to Require Attorneys to Report Violations "Up the Ladder" and Proposes to Require "Noisy Withdrawals" by Attorneys or Disclosure by Public Companies, if Responses Are Not Satisfactory

On January 23, 2003, the Securities and Exchange Commission adopted rules that require an attorney for a public company to report, internally within the company, material violations of federal and state securities laws and breaches of fiduciary duty of which he or she becomes aware. In some circumstances, the attorney also is permitted to reveal client confidences to the SEC. These rules, which apply to both inside and outside attorneys and foreign attorneys, also have important consequences for public companies.[1]

The SEC, in Rel. 33-8185 (the "Adopting Release"), as required by Sec. 307 of the Sarbanes-Oxley Act ("SOX"), announced adoption of Part 205 of Title 17 of the Code of Federal Regulations, *Standards of Professional Conduct for Attorneys Appearing Practicing Before the Commission in the Representation of an Issuer* ("Rule 205"), effective August 5, 2003. These rules govern the conduct of attorneys "appearing and practicing before" the SEC in "representation of an issuer." However, the rules also will affect the actions of public companies, their "chief legal officers" (CLOs) and other inside attorneys, chief executive officers (CEOs), audit committees, other committees of their boards of directors and their boards of directors.

In addition, in Rel. 33-8186, the SEC extended the comment period on its previously proposed rules requiring attorney "noisy withdrawals" (*See* Rel. 33-8150) and proposed, as an alternative to attorney "noisy withdrawals," that public companies be required to disclose promptly attorney withdrawals that are subject to the provisions of Rule 205.

These rules and proposal affect both domestic and foreign public companies that are subject to the periodic reporting provisions of the Securities Exchange Act of 1934 or that have filed registration statements under the Securities Act of 1933 in connection with an initial public offering that are not yet effective.

Summary of the Rules

The following is only a brief summary of the relevant provisions of SOX and the related and complex SEC rules. The text of and footnotes to the Adopting Release should be referred to for a fuller understanding of the rules.

Sec. 307 of SOX. Sec. 307 requires that the SEC adopt rules setting forth "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers," including a rule requiring:

- An attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
- if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with

[1] The application of these rules to registered investment companies is not discussed in this client alert.

respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.[2]

The SEC's Rule. Rule 205 goes well beyond these provisions of Sec. 307. While the Rule purports to apply only to attorneys, as a practical matter, it imposes obligations on others.

However, at least one thing is clear under Rule 205. Despite the broad definition of "appearing and practicing before the Commission," the rules apply only to attorneys for "issuers," as defined in Sec. 2(a)(7) of SOX and Rule 205.2(g) of the SEC's rules. Thus, Rule 205 does not apply to attorneys representing companies that do not have securities registered under section 12 of the Exchange Act or that are not required to file reports under section 15(d) of that Act, unless the company has filed a registration statement under the Securities Act that is not yet effective and has not been withdrawn.

Essentially, Rule 205 requires that an "attorney"[3] "acting on behalf of an issuer"[4] who becomes aware of credible evidence that would lead "an attorney to reasonably believe" that there has been or is about to be, a material violation of federal or state securities laws,[5] a breach of fiduciary duty or "other similar material violation" (which term is not defined in Rule 205) by the issuer or an officer, director, employee or "agent" of the issuer that would affect the issuer materially, must report the evidence to the issuer's CLO or to both the CLO and the CEO, unless the attorney believes that reporting to them would be futile. In that case, the attorney must take the next step up the ladder, that is to report to the issuer's audit committee or another committee comprised of directors who are not employed by the issuer[6] that the issuer has designated to receive these reports.

If the attorney does not receive a response within a "reasonable time"[7] that would lead an attorney to reasonably believe that there has been no material violation, a past violation has been remedied or a violation about to occur has been stopped, the attorney must report the evidence "up the ladder" to the audit committee or a committee with similar responsibilities, comprised of directors who are not employed by the issuer."[8] If the attorney does not receive a "timely" and satisfactory response from that committee, the attorney must report the evidence to the issuer's board of directors.

An attorney who has reported all the way up the ladder who does not receive a timely and satisfactory response from the board of directors, even if there is an ongoing violation, is not presently required to make a "noisy withdrawal" by withdrawing from all representations of the issuer (an inside lawyer is not required to withdraw), notifying the SEC of the withdrawal, "for professional considerations" and "disaffirming" documents submitted to the SEC that the attorney participated in drafting that are tainted by the violation. (In the context of SEC filings, past violations may constitute "ongoing" violations, if not disclosed.) However, such a noisy withdrawal would be required under the SEC's still outstanding proposal.

In addition, in certain circumstances, under Rule 205, an attorney may be permitted to reveal client confidences to the SEC. The attorney may, but is not required to, reveal client confidences to the SEC to prevent a fraud on the SEC or significant economic harm to the issuer or to investors or if the attorney's services have been used in connection with an illegal act.

Materiality. Rule 205 requires an attorney to assess the materiality of a possible violation. Materiality is a concept that is difficult to assess and, more often than not, should be assessed by the client's officials who are familiar with the issuer's business. For example, that is the approach under the ABA's 1975 Statement of Policy with respect to disclosure

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[2] In addition, Sec. 602 of SOX added section 4C to the Exchange Act to apply the same standards of conduct under its professional disciplinary rule, Rule 102(e), to attorneys subject to its rules as are applied to the conduct of accountants appearing and practicing before the SEC. Thus, even if the SEC could not proceed against an attorney, including an inside attorney, under Rule 205, it might be able to proceed under Rule 102(e), based on negligent conduct by the attorney. *See* Rule 205.6 Sanctions and discipline.

[3] An "attorney," for these purposes is any person qualified to practice law in any jurisdiction, including a foreign jurisdiction, or who holds himself or herself out as so qualified.

[4] An attorney who acts on behalf of an issuer is not required to be engaged or compensated by the issuer. Also, for the purposes of Rule 205, the term "issuer" includes entities that it controls.

[5] Rule 205 covers violations of U.S. state but no foreign securities laws. Although some may argue that violations of foreign laws are covered by the term "or other similar material violation," that was not intended by the SEC. The term "securities laws" which is used in Sec. 307 of Sarbanes-Oxley, the source of the SEC's only express statutory authority to adopt these rules, is defined in Sec. 2(a)(15) of that Act to mean the Federal securities laws, the Sarbanes-Oxley Act and the SEC's rules, regulations and orders thereunder. *See also*, section 3(a)(47) of the Exchange Act. Thus, with the possible exception of the SRO rules under Sec. 301 of Sarbanes-Oxley which requires that the SEC order the SROs to adopt specified rules (See Rel. 33-8173 (January 9, 2003)), the rules of the stock exchanges and the NASD should not be covered by Rule 205.

[6] The SEC may act at a later date to impose the director independence standards proposed in Rel. 33-8173 or stricter SRO standards on these directors.

[7] The term "reasonable time" is not defined in Rule 205. Accordingly, even if an attorney substantively complies with the rule, the SEC could challenge the timeliness of the compliance.

[8] The members of such a committee, thus, need not satisfy the more stringent "independence" requirements applicable to members of the audit committee under SOX and SRO rules.

of unasserted claims to auditors. Under that policy, the attorney has a duty to discuss unasserted claims with the client when the attorney has formed a conclusion during an engagement that an unasserted claim may require financial statement disclosure. The disclosure determination, however, remains with the client and the attorney may not disclose any such claims to the auditors, unless they are identified by the client. However, Rule 205 may require up the ladder reporting by the attorney if the issuer does not identify certain claims to the auditors.

There is an alternative to "reporting up the ladder" and, if ultimately required, "noisy withdrawal." An attorney, including a CLO, who, as discussed below, reports what the attorney reasonably believes is credible evidence of a material violation of securities laws, breach of fiduciary duty or similar material violation by the issuer or a director, officer, employee, or agent of the issuer to a previously formed "duly established " "qualified legal compliance committee" (QLCC), would not be required to report up the ladder or to determine whether the company's response to the attorney's report was appropriate under Rule 205.

SEC Proposals

In addition to requesting additional comment on its proposed mandatory attorney "noisy withdrawal" requirements, the SEC has proposed an alternative to mandatory attorney "noisy withdrawal (Proposed Rule 205.3(e)), that would require that the issuer, even if foreign company, report the attorney's withdrawal to the SEC pursuant to Item 13 of Form 8-K (Item 16E of Form 20-F or General Instruction B(15) of Form 20-F), within two business days.[9]

Impact on Issuers

The consequences of Rule 205 and the SEC's proposals to issuers are or would be substantial. They could entail revelation to the SEC of unadjudicated possible violations of law or breach of fiduciary duty; possible hindering of zealous defense in SEC investigations or administrative proceedings;[10] forced restatements of financial statements[11] or amendments to material disclosures, which could be asserted as admissions or other evidence of violations; exposure to private civil actions and SEC actions and criminal prosecution, among other things. Issuers also are at risk of violation of their confidences to the SEC; loss of the attorney-client privilege; and damage to the relationships with their attorneys.

Subsidiaries of Issuers. Rule 205 applies to attorneys who represent both wholly-owned and majority-owned subsidiaries of issuers and to its controlled companies.

Impact on CLOs and other inside attorneys. CLOs are or would be subject to the reporting "up the ladder" and the proposed "noisy withdrawal" provisions of Rule 205 (as are the issuer's other inside lawyers).

As discussed, the CLO generally will be the initial rung on the ladder for the outside attorney (or another inside attorney) to report to. Rule 205 requires a CLO either to refer a matter to a QLCC or to investigate the matter. Thus, although a duty to investigate is not imposed on outside counsel, the Rule does impose such a duty on CLOs.

CLOs also automatically have the responsibilities of "supervisory attorneys"[12] under these rules and automatically are deemed to be appearing and practicing before the SEC if one of their "subordinate attorneys" appears and practices before the SEC.[13] A supervisory attorney has all of the responsibilities imposed by Rule 205 and, in addition, must receive reports of possible violations from subordinate attorneys and provide them with timely and satisfactory responses. A subordinate attorney who does not receive a satisfactory and timely response may, but is not required to, report up the ladder.

Accordingly, CLOs, may bear the heaviest burden of all under Rule 205 and now are joined with the members of the audit committee or the QLCC, the CEO and the CFO as the principal corporate enforcers of, not only the Federal and state securities laws, but also corporate fiduciary principles.

On the other hand, if a CLO, unlike an outside attorney, is discharged for complying with Rule 205, the CLO may have additional protections under SOX. Sec. 806 of SOX protects CLOs who are "whistleblowers." Sec. 806 also may provide a right of action for discharged whistleblowers.

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[9] Foreign companies only would be required to file that cover page and signature page and the information about the attorney's withdrawal. They would be required to disclose receipt of the attorney's notice of withdrawal, based on "professional consideration," and "the circumstances related thereto." The phrase "the circumstances related thereto" is not elaborated on in the rule.

If the issuer does not comply with this rule, the reporting attorney may, but would not be required to, make a noisy withdrawal.

[10] Attorneys are not required to report credible evidence of a material violation if the attorney was directed by the CLO with the consent of the board of directors to assert a colorable defense on behalf of the issuer. In addition, an attorney retained by the CLO with the consent of the board of directors to investigate a reported material violation is not subject to the up the ladder reporting requirements if the CLO reports the results of the attorney's investigation to the board of directors, the committee to whom the violation was initially reported or a QLCC.

[11] If the issuer restates its financial statements as the result of "misconduct," the CEO and CFO, under Sec. 305 of SOX, may be required to surrender certain of their incentive compensation.

[12] A "supervisory attorney" is an attorney supervising, directing or having supervisory authority over another attorney.

[13] For these purposes, a subordinate attorney is any attorney "supervised" by the CLO. It is not clear whether the issuer's outside counsel would be considered "supervised" by the CLO for these purposes.

Impact on CEOs. Assuming that a company takes appropriate action, the reporting up the ladder requirements should assist the CEO in complying with the certification requirements of Sec. 906 of SOX and of the SEC's rules under Sec. 302 of SOX.[14] If the company has not taken appropriate action, then the CEO may not be able to furnish the required certifications.

Impact on audit committees. Under Rule 205, audit committees, unless the responsibility is assigned to another committee, are required to assume responsibilities in addition to those already imposed by SOX, the other rules of the SEC and the listing standards of the SROs. They may be the second rung of the ladder for an attorney required to go up the ladder. The audit committee also could be assigned the responsibility to act as the QLCC, if the issuer adopts that alternative. If the audit committee is not assigned that responsibility, at least one member of the audit committee will have to serve on the QLCC, if that alternative is chosen.

Impact on QLCC members. As discussed elsewhere in this client alert, members of a QLCC will bear a heavy burden under these rules.

Impact on other committees of the board of directors. Should the issuer determine that, under its policies and procedures, attorneys should report to a committee comprised of directors who are not employed by the issuer, other than audit committee, a compliance committee, for example, the board of directors would have to develop a charter and policies and procedures for that committee and that committee would bear the same responsibilities as those that would have been assigned to the audit committee under Rule 205.

Impact on the board of directors and impact on attorney directors and officers. The board of directors is the final rung of the ladder and has the ultimate responsibility to respond to attorney reports under Rule 205. Moreover, members of the board of directors (or committees of the board) who are attorneys are subject to Rule 205, as are attorneys serving as corporate officers, such as corporate secretaries or assistant secretaries, if they are engaged or employed by the issuer to provide it with legal advice.

Attorney responses to audit inquiry letters. Attorneys, including inside attorneys, responding to audit inquiry letters are subject to Rule 205 and responding in compliance with the ABA's 1975 Statement of Policy may not always satisfy Rule 205.[15]

Sec. 303 of SOX. Sec. 303 of SOX and the SEC's rules thereunder also apply to attorneys. On October 18, 2002, the SEC, in Rel. 34-46685 (the "Sec. 303 Rel."), proposed rules prohibiting improper influence of auditors.

The SEC's proposed rule. The SEC, to implement Sec. 303 of SOX,[16] proposed Rule 13b2-2, which would prohibit officers and directors of an issuer from, directly or indirectly:

- Making or causing or to be made a materially false or misleading statement;
- Omitting to state or causing another to omit to state, any material fact necessary to make statements made; or in light of the circumstances under which they were made, not misleading to an accountant in connection with an audit or examination of the financial statements of the company or the preparation or filing of any document or report required to be filed with the SEC.

Also, no officer or director of an issuer, or any other person, including a lawyer[17] "acting under the direction of" an officer or director, directly or indirectly may take any action to fraudulently influence, coerce, manipulate or mislead an independent public or certified public accountant ("CPA") engaged in an audit or review of the financial statements of the issuer that are required to be filed with the SEC, if that person knew or was unreasonable ("negligent") in not knowing that the action could, if successful, result in rendering

[14] In addition, the SEC stated, in Release 33-8138, that the provision in the code of ethics for CEOs and senior financial officers required by the SEC's rules under Sec. 406 of SOX relating to compliance with applicable government rules and regulations includes compliance with the SEC's rules under Sec. 307 of SOX.

[15] In this regard, the Auditing Standards Board ("ASB") has considered adding the following language to its suggested form of audit inquiry letter: "For SEC engagements, a statement by the client that the client understands that whenever, in the course of performing legal services for the client, the lawyer has formed a professional conclusion that there have been material violations of securities laws or a breach of fiduciary duty or similar violation by the company, the lawyer, as a matter of professional responsibility to the client, will so advise the client."

The ASB also is considering requiring that, in connection with SEC engagements, to include the following representation from management: "information concerning whether legal counsel has informed the entity as to any material violations of securities laws, material breach of fiduciary duty, or similar material violations by the entity or any officer, director, employee, or agent of the entity." The ASB has deferred consideration on those matters until they can be discussed with representatives of the ABA Committee on Law and Accounting of the Section of Business Law. It is not known whether the ASB's auditing standards will be adopted by the Public Company Accounting Oversight Board, authorized by of SOX to set auditing standards.

[16] Sec. 303(a) of SOX required the SEC to adopt rules that prohibit an officer or director of an issuer or any person acting under their "direction" to take any action to "fraudulently influence, coerce, manipulate or mislead any independent or public certified accountant auditing the financial statements of the issuer for the purpose of rendering those financial statements materially misleading." The SEC has stated that "fraudulently" only modifies "influence." Sec. 303 Release, footnote 16. The SEC interprets "direction" to include "supervision" and thus to include employees, customers, vendors or creditors and attorneys (providing "inaccurate" or misleading responses to audit inquiry letters, for example), securities professionals or other advisors. Sec. 303 Release, II.B.

[17] This provision could cover lawyers responses to audit inquiry letters. *Cf. In re Fitzheny*, SEC Admin. Proc. File No. 3-10943 (November 21, 2002) (settled proceeding in which the SEC alleged that an inside lawyer mislead the outside accounts by signing misleading management representation letter).

those financial statements materially misleading. The prohibited actions include those that could cause the CPA to:

- Issue a report on the issuer's financial statements not warranted in the circumstances due to material violations of GAAP, GAAS or other standards;
- Not perform an audit, review or other procedure required by GAAS or other professional standards;
- Not withdraw an issued report; or
- Not communicate matters to the issuer's audit committee.

These proposed rules would apply to foreign private issuers and to small business issuers.[18]

Enforcement. Under Sec. 303(b) of SOX, the SEC has the exclusive authority to enforce Sec. 303(a) and its rules thereunder in "any civil proceeding." However, Sec. 303(c) of SOX provides that Sec. 303(a) "shall be in addition to, and shall not supersede or preempt, any other provision of law or any rule or regulation issued thereunder."

The "QLCC" alternative. Reporting to a QLCC is an alternative to "reporting up the ladder" all the way and to the proposed "noisy withdrawal." An attorney, including a CLO, under Rule 205.3(c), can report the violation to a "duly established" QLC.

The SEC, in Rule 205.2(j), defines the term "Qualified Legal Compliance Committee" as follows:

> (j) Qualified legal compliance committee means a committee of an issuer that:
>
> (1) Consists of at least one member of the issuer's audit committee . . . .and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer . . .;[19]
>
> (2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under §205.3(c);
>
> (3) Has been duly established by the issuer's board of directors, with the authority and responsibility:
>
> (i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in §205.3(b)(4));
>
> (ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate to:
>
> (A) Notify the audit committee or the full board of directors:
>
> (B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys;[20] and
>
> (C) Retain such additional expert personnel as the committee deems necessary;[21] and
>
> (iii) At the conclusion of any such investigation to:
>
> (A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and
>
> (B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and
>
> (4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

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An attorney, including a CLO or other inside attorney, who reports[22] what the attorney reasonably believes is credible evidence of a material violation of the securities laws, breach of fiduciary duty or similar material violation by the issuer or a director, officer, employee, or agent of the issuer to a QLCC (which could be the audit committee), will not be required to withdraw from representation of the issuer and would not be subject to the proposed "noisy withdrawal" requirement.

If the QLCC engages an outside attorney to investigate an attorney's report of a violation to the QLCC, this latter attorney also becomes subject to Rule 205. If the outside attorney engaged by the QLCC to investigate the matter reports to the

[18] Presumably, the term "GAAP," in the case of a foreign private issuer, means the issuer's home country GAAP.

[19] Sec. 301 of SOX and the SEC's proposed implementing rules would require national securities exchange and the Nasdaq to impose a similar requirement under their listing standards. See Rel. 33-8173

[20] These outside attorneys would be subject to Rule 205.

[21] Presumably, the issuer would be required to fund the fees of outside attorneys or other experts.

[22] An attorney need not report to the QLCC in writing.

QLCC, the outside attorney is not subject to reporting up the ladder and would not be subject to the proposed noisy withdrawal requirement.

Rule 205.3(c) is a viable alternative for an outside attorney or a "subordinate" inside attorney. It might be less so for the attorney's client, the issuer, or the members of the QLCC, the audit committee or other responsible committee, CEOs or CLOs. The alternative shifts the burden of possibly reporting to the SEC unadjudicated violations of law to the QLCC.

An issuer might be reluctant to confer on a committee of the board of directors, the QLCC, the authority required under Rule 205.2(j), not only to conduct any "necessary" inquiry into the reported evidence, which may be appropriate, if the QLCC can exercise its judgment as to what is "necessary," but to recommend that the issuer take any "appropriate" remedial measures, and, possibly, to notify the SEC of the material violation and "disaffirm" (an undefined term) any tainted document submitted to the SEC, if the issuer, in any material respect, fails to take any remedial measure recommended by the QLCC.

Despite the substantial obligations that the Sarbanes-Oxley Act, the SEC's rules and stock exchange and NASDAQ listing standards place or will place on members of audit committees, Rule 205 requires that at least one member of the QLCC also be a member of the issuer's audit committee. This could be yet another barrier to an issuer attracting qualified individuals to serve on a QLCC.[23]

Impact of Rule 205 on Preservation of Client Confidences and the Attorney Client Privilege

Rule 205.3(d) provides that:

- Reports under Rule 205 and responses thereto may be used by an attorney in connection with any investigation, proceeding or litigation in which the attorney's compliance with Rule 205 is in issue; and
- An attorney subject to Rule 205 may reveal to the SEC, without the client's consent, confidential information related to the attorney's representation of the client "to the extent the attorney reasonably believes is necessary:

  To prevent the client from committing a specified illegal act that the attorney reasonably believes is likely to perpetrate a fraud on the SEC;

  To prevent the client from committing a material violation that the attorney reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer; or

  To rectify the consequences of the client's illegal act in furtherance of which the attorney's services had been issued."

Requiring an attorney to report up the ladder in the prescriptive manner which the SEC has chosen, may be troublesome, but it does not result directly in the revelation of client confidences or affect the attorney-client privilege. Moreover, it is a process recognized in the ethical standards for attorneys adopted by most states. However, attorney noisy withdrawal, as proposed by the SEC, would implicate these results. Noisy withdrawal and permissive revelation of client confidences to the SEC, in circumstances permitted or under its rules or as proposed to be mandated, would not be required or even permitted under the ethical standards of many states, and it is not clear whether the SEC rules can protect the attorney-client privilege as to other parties, once a client confidence is revealed to it or protect the attorney who reveals client confidences to the SEC.

Safe Harbor

Rule 205.7 provides that Rule 205 is not intended to and does not create a private right of action against any attorney, law firm or issuer based on compliance or non-compliance with Rule 205. Rule 205.7 also provides that the SEC has the exclusive authority to enforce Rule 205.

Impact on Foreign Companies and Foreign Lawyers

Despite the different governance structures of foreign companies and different ethical and legal standards for foreign attorneys, these rules would apply to foreign attorneys (including CLOs and other inside attorneys) and their client companies, with some exceptions. Foreign attorneys would not be required to comply with Rule 205 if compliance would be prohibited by applicable foreign law. In addition, a "non-appearing foreign attorney" would not be subject to Rule 205. A "non-appearing foreign attorney" is.

- An attorney licensed in a foreign jurisdiction;
- Does not hold himself or herself out as practicing and does not give legal advice regarding U.S. federal or state securities laws, except "appearing and practicing before" the SEC only in consultation with counsel, other than a non-appearing foreign attorney, admitted in a U.S. jurisdiction; and

[23] In addition, Rule 205.3(c) permits an attorney to report evidence of a material violation or breach of fiduciary duty to the QLCC, as an alternative to reporting to the SEC only if the issuer has "duly established" (an undefined term) the QLCC. This requirement could nullify the attorney's alternative if the QLCC was not "duly established." It is not clear whether this puts a burden on an outside attorney or an inside "subordinate" attorney to determine whether the QLCC was duly established. Such a burden would be inappropriate, since, for example, the attorney may not know whether the member of the audit committee serving on the QLCC is qualified to be a member of the audit committee; may not know whether the QLCC has the authority and responsibility required by the proposals; and may not know whether members of the QLCC are "indirectly" employed by the issuer. Even if the attorney inquires and receives answers satisfactory to her, the QLCC still may not, in fact, be "duly established" or meet other requirements of Rule 205 and the alternative might not be available.

- Who conducts activities that would constitute appearing and practicing before the SEC only incidentally to, and in the ordinary course of, the practice of law outside of the U.S.

Impact on Small Business Issuers

Those rules apply to small business issuers and attorneys for small business issuers.

The Need for Internal Policies, Procedures and Structure

Issuers whose outside and inside attorneys are subject to these Rule 205 will need to develop policies and procedures to deal with up the ladder reporting; responsibilities of inside "subordinate attorneys; CLO disclosure either to the CEO or an appropriate committee; audit or other committees' responsibilities; if the issuer so determines, QLCC functions; and the responsibilities of the board of directors and, if the SEC's proposed prompt issuer disclosure alternative to mandatory attorney noisy withdrawal is adopted, policies and procedures with respect to such reporting.

Some possible policies and procedures are discussed below.

A QLCC charter. A QLCC charter will have to be developed, if that alternative is followed. In addition, the persons to serve on the QLCC will have to be identified. The appropriate attorneys and others will have to be advised of the QLCC's procedures.

Audit committee and other committees. Audit committee charters will have to be revised or a charter for any other committee, if not the QLCC, designated by the company to receive attorney reports, will have to be developed and the appropriate attorneys and others will have to be advised of the relevant procedures.

CEOs and CLOs. Internal procedures for CEOs and CLOs will have to be developed for handling attorney reports, including reports from "subordinate attorneys" and record retention procedures for inside attorneys, as well as their own reporting and investigative policies and procedures. Outside and inside attorneys, as appropriate, should be advised of these procedures, as well as appropriate committee members.

Boards of Directors. Board of directors will have to develop their own policies and procedures for responding to these attorney reports; reports from audit committees; or QLCCs or other committees; and reports from CEOs and CLOs and, if adopted, the company's reporting obligation under the SEC's proposed issuer prompt issuer reporting proposal. Boards also will have to approve new committee charters and any amendments to the charter of the audit committee.[24]

Conclusion

These rules may have important effects on the relationships between attorneys and their company clients.

[24] Amended audit committee charters also are required to be furnished to shareholders with a company's proxy statement.

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