CLIMBING "UP THE LADDER": CORPORATE COUNSEL AND THE SEC'S REPORTING REQUIREMENT FOR LAWYERS

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INTRODUCTION

At the height of the Cold War, the Home Blast Shelter served as a domestic line of defense against the unthinkable. As part of a civil defense plan to protect the public from the effects of a nuclear attack, the Federal Emergency Management Agency issued more than thirty million copies of do-it-yourself Home Blast Shelter plans.1 With the world’s two superpowers poised to unleash deadly arsenals on each other, the plans touted that such backyard shelters could “provide protection against thermal effects, fallout radiation, and blast effects from a nuclear weapon.”2 Faced with the prospect, however small, of a cataclysmic showdown, it was basic human instinct to seek some means of survival.

Blast shelters find their regulatory parallel in the vast expansion of the rules governing lawyers that the Securities and Exchange Com-

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mission (SEC or Commission) undertook with the passage of the Sarbanes-Oxley Act. Sarbanes-Oxley does not vest the SEC with the authority to regulate the attorney-client relationship in general. Instead, Section 307 of the Act directs the SEC to craft rules governing an extraordinary event: discovery by a lawyer of credible evidence of a material violation of law by the issuer or its directors, officers or employees. The Commission crafted rules that prescribe an “up-the-ladder” reporting regimen, placing the public company or issuer’s General Counsel or Chief Legal Officer at the epicenter.

An in-house lawyer with such responsibility does not have the luxury of debating either the merits of federalizing attorney-conduct regulation or the SEC’s authority to mandate a lawyer’s “noisy withdrawal.” The SEC’s rules are in effect. Therefore, it is important to understand their genesis, content, and effect on corporate law. For in-house counsel, the fundamental challenge is deciding how to adjust practices to the new rules.

I

THE GENESIS OF THE SARBAÑES-OXLEY LAWYER RULES

The advocates who championed an SEC-mandated up-the-ladder reporting requirement articulated a core principle in support of the rule: when a public company lawyer becomes aware that the company or its agents have materially violated the law, it is that lawyer’s duty to advise his client of this information. The rules governing lawyers typically did not compel a particular course of action; Section 307 was adopted to fill that perceived void.

After the collapse of Enron Corporation and other corporate scandals, there has been a particular analytic focus on the role of the “gatekeepers” associated with public companies. As the public scrutinized the performance of independent auditors, securities analysts, rating agencies and the financial press, it was inevitable that the role of lawyers would garner attention.

5 See, e.g., John C. Coffee, Jr., What Caused Enron? A Capsule Social and Economic History of the 1990s, 89 Cornell L. Rev. 269, 271 (2004) (“Above all, the fundamental developments that destabilized our contemporary corporate governance system were those ones that changed the incentives confronting both senior executives and the corporation’s outside gatekeepers.”).
6 See, e.g., Mike France, What About the Lawyers?, Bus. Wk., Dec. 23, 2002, at 58, 58 (“The lawyers not only drafted the documents that brought [Enron’s] deals to life but also wrote opinion letters that vouched for the legality of the company’s acrobatic maneuvers.”); see also Susan P. Koniak, When the Hurlyburly’s Done: The Bar’s Struggle with the SEC, 103 Colum. L. Rev. 1236, 1239 (2003) (“We lawyers are guilty. To commit most complex
The up-the-ladder reporting concept was advanced in a March 7, 2002 letter from a group of forty law professors sent to SEC Chairman Harvey Pitt. They noted that Model Rule 1.13 of the American Bar Association’s (ABA) Model Rules of Professional Conduct requires a lawyer representing an organization to act in the best interest of that organization. The letter added that Rule 1.13 suggests a number of ways in which a lawyer could respond if the organization acts illegally: report to management, report to the board of directors, or resign. Despite these alternatives, “[n]owhere . . . does Model Rule 1.13 require a lawyer to take a specific course of action.” The letter suggested that the foundation to require such a report exists in SEC Rule 102(e), which authorizes the SEC to suspend from practice before the Commission any attorney or other professional who violates the securities laws, assists another in the violation of the securities laws, “or otherwise engages in unprofessional conduct.” Specifically, the letter recommended that a Commission rule should “expressly require a lawyer who represents a corporation in connection with its securities compliance to inform the client’s board of directors if the lawyer knows that the client is violating the securities laws and senior management does not promptly rectify the violation.”

In response, SEC General Counsel David Becker noted that it may be reasonable to prefer one uniform rule of conduct governing lawyers whose securities practice is national. Mr. Becker’s letter also stated that the SEC had not utilized Rule 102(e) for proceedings against lawyers based on allegations of improper professional conduct or to set rules regarding the professional responsibilities in the legal profession. He summarized the prevailing view “that these matters are more appropriately addressed by state bar rules, which historically have been the source of professional responsibility requirements for lawyers, and have been overseen by state courts.” The letter concluded that there were “good reasons why consideration of such a significant change in established practice should be undertaken in the context of Congressional legislation, as opposed to agency rulemaking.”

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8 Id. at 1.
9 Id. at 2.
11 Id.
12 Id.
That federal legislation followed four months later in the form of the Sarbanes-Oxley Act.\(^{13}\) Patched together in a frenetic flurry of legislative activity, Section 307 of the Act mandates that the SEC adopt rules “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).”\(^{14}\) In the absence of an appropriate response, Section 307 also requires rulemaking that would mandate a report to the issuer’s board of directors.\(^{15}\)

The scant legislative history of Section 307 consists almost entirely of the floor statements made by the provision’s legislative sponsors. The statements contain three principal themes. First, the sponsors stressed that lawyers assume a ubiquitous presence in the modern corporate world. “The truth is that executives and accountants do not work alone,” stated Senator John Edwards. “Anybody who works in corporate America knows that whenever you see corporate executives and accountants working, lawyers are virtually always there looking over their shoulder.”\(^{16}\) That access, the sponsors argued, provides counsel with the opportunity to prevent misconduct. Indeed, Senator Jon Corzine emphasized that “we cannot overlook the role corporate


\(^{14}\) 15 U.S.C.A. § 7245(1) (2003). The language of this section is terse. The full text follows:

**RULES OF PROFESSIONAL RESPONSIBILITY FOR ATTORNEYS.**

Not later than 180 days after July 30, 2002, the Commission shall issue rules, in the public interest and for the protection of investors, 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 —

(1) 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

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with 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.

*Id.* § 7245.

\(^{15}\) *Id.*

\(^{16}\) 148 CONG. REC. S6551 (daily ed. July 10, 2002) [hereinafter *Sponsors’*]; see also *id.* at S6556 (statement of Sen. Corzine):

In fact, in our corporate world today—and I can verify this by my own experiences—executives and accountants work day to day with lawyers. They give them advice on almost each and every transaction. That means when executives and accountants have been engaged in wrongdoing, there have been some other folks at the scene of the crime—and generally they are lawyers.
lawyers, the lowest common denominator, can play in addressing abuses and ensuring that our markets have integrity."17

Second, in supporting the amendment that ultimately became Section 307, the sponsors emphasized that it merely requires corporate lawyers to report to the corporate entity that is their client. Senator Edwards argued that some corporate lawyers had forgotten the identity of their clients:

[T]hey decide they are working for the chief executive officer or the chief operating officer who hired them. They get to thinking that playing squash with the CEO every week is more important than keeping faith with the shareholders every day. So the lawyers may not do their duty and say to their pal, the CEO, "No, you cannot break the law."18

Finally, the sponsors underscored the fact that Section 307 was crafted precisely to limit the scope of the reporting requirement. For example, Senator Edwards stated that the duty to report "applies only to evidence of a material violation of the law . . . mean[ing that] no reporting is required for piddling violations or violations that don't amount to anything."19 In the same vein, Senator Michael Enzi dismissed as "ludicrous" any concerns that Section 307 could cause a breach of the attorney-client privilege: "By reporting a legal violation to management and then the board of directors, no breach of privilege occurs, because it is all internal—within the corporation and not to an outside party, such as the SEC."20

II
THE SEC'S PART 205 RULES

In early 2003, the Commission adopted rules to implement Section 307's requirements.21 The rulemaking was highly anticipated because the 172 words of Section 307 (and its limited legislative history) provided little direct guidance on the reach of the Section 307 requirements. Specifically, the Commission's release delineated (a) the universe of lawyers subject to the rule; (b) the obligation of these lawyers to report, initially, violations to an issuer's management; (c) the subsequent obligation to report to the board of directors; and (d) the recourse of these lawyers after exhausting these requirements.22

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17 Id. at 6556.
18 Id. at 6552.
19 Id.
20 Id. at 6555.
A. Lawyers Subject to the Rules

The up-the-ladder reporting obligation under the new rules is limited to attorneys "appearing and practicing before the Commission."\(^{23}\) For purposes of the Part 205 rules, lawyers "practice" before the Commission if they

- transact "any business with the Commission," including contact with the Commission in any form;
- represent an issuer in an SEC administrative proceeding, investigation, inquiry, information request or subpoena;
- provide U.S. securities law advice in connection with any document that the attorney "has notice that will be filed with or submitted to" the Commission; or
- advise an issuer "whether information or a statement, opinion or other writing is required" under the federal securities laws.\(^{24}\)

The Commission's Adopting Release explained that this broad definition was necessary "to reflect the reality that materials filed with the Commission frequently contain information contributed, edited or prepared by individuals who are not necessarily responsible for the actual filing of the materials . . . ."\(^{25}\) The SEC noted a warning from fifty academics that excluding from the definition lawyers who draft documents or provide disclosure would "facilitate circumvention of these rules . . . [and] risk gutting these rules and [Section] 307."\(^{26}\)

At the same time, the Commission relented to a vigorous lobbying effort and excluded most foreign lawyers from the rules. The rules expressly exclude "non-appearing foreign attorneys,"\(^{27}\) who are defined as attorneys who (a) are admitted to practice in a jurisdiction outside the United States; (b) do not hold themselves out as practicing U.S. securities laws; and (c) conduct "activities that would constitute appearing before the Commission only incidentally" to the practice of law outside the United States (or, alternatively, appear and practice before the Commission only in consultation with counsel admitted to practice in the United States).\(^{28}\) However, the Commission's release cautioned that foreign attorneys who, for example, independently counsel issuers regarding the application of SEC rules to a periodic report filed with the Commission would be subject to the rules.\(^{29}\)

\(^{23}\) 17 C.F.R. § 205.1.

\(^{24}\) Id. § 205.2(a)(i)-(iv).

\(^{25}\) Adopting Release, supra note 22.

\(^{26}\) Id. (quoting comments of Susan P. Koniak et al.)

\(^{27}\) 17 C.F.R. § 295.2(ii) (specifically excluding nonappearing foreign attorneys from coverage).

\(^{28}\) Id. § 205.2(j).

\(^{29}\) Adopting Release, supra note 22.
B. "Credible Evidence of a Material Violation"

For lawyers subject to Part 205, their obligations are triggered when they receive credible evidence of a "material violation" of law "by the issuer or any officer, director, employee or agent of the issuer." The triggering standard set by the rule is credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that a material violation has occurred, is ongoing or is about to occur.

Linguistic gymnastics aside, two aspects of the definitions—related definitions and the Commission’s guidance—are important for any lawyer who is required to apply the standard.

First, the universe of relevant violations is not limited to the federal securities laws. A "material violation" includes a material breach of federal or state securities laws, "a material breach of fiduciary duty arising under United States federal or state law, or a similar violation of any United States federal or state law." A breach of fiduciary duty is further defined to include "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." The Commission expanded the definition in order to capture fiduciary standards articulated in federal statutes. The breadth of this standard is considerable; indeed, the federal securities laws alone have been interpreted to capture a broad cross-section of misdeeds.

Second, the rule is intended to set meaningful credibility and materiality thresholds. For example, the evidence must be sufficiently credible to indicate that a material violation is likely to occur or has occurred. The Adopting Release also emphasized that "an attorney is not required (or expected) to report 'gossip, hearsay [or] innuendo.'" Similarly, the release noted that, by requiring only the reporting of a "material" violation, the Commission was adopting a "term [with] well-established meaning"—information sufficiently im-

30 17 C.F.R § 205.3(b).
31 Id. § 201.205.2(e).
32 Id. § 205.2(i).
33 Id. § 205.2(d) (emphasis added).
34 Adopting Release, supra note 22.
35 For example, the law of insider trading has been developed in the absence of a statutory or regulatory definition of the offense. Judicial interpretations of general antifraud provisions of the federal securities laws have largely defined the violation instead. See, e.g., United States v. O'Hagan, 521 U.S. 642, 651–66 (1997).
36 Adopting Release, supra note 22.
portant that any reasonable shareholder would want the information in deciding whether to purchase, sell, or vote the issuer's securities.37

C. The Reporting Requirement

A lawyer's receipt of credible evidence of a material violation triggers a two-step process under the Part 205 rules.

1. Step One: Report to Management

First, the attorney possessing credible evidence of a potential material violation must report this evidence "to the issuer's chief legal officer or to both the chief legal officer and its chief executive officer."38 Chief legal officers, in turn, are obligated to investigate whether, in fact, a material violation has occurred.39 Upon completion of the chief legal officer's investigation, the rules contemplate two possibilities. If the chief legal officer determines that no material violation has occurred, he is required to notify the reporting attorney and outline the basis for the determination.40 Otherwise, the chief legal officer must take the necessary steps to have the issuer adopt an "appropriate response," advising the reporting attorney of that response.41 An "appropriate response" is a response that leads the reporting attorney to reasonably believe that

- "no material violation [of law] has occurred, is ongoing or is about to occur";
- the issuer has adopted "appropriate remedial measures" that could include steps to stop or prevent material violations or to remedy any violation that has occurred; or
- the issuer, with the consent of the issuer's board of directors or a board committee, has retained counsel to investigate the report and has either (a) "substantially implemented any remedial recommendations" made "after a reasonable investigation and evaluation of the reported evidence[,]" or (b) has been advised of counsel's good faith belief that the issuer or the officer, director, employee or agent involved has a "colorable defense" to assert.42

If the reporting attorney "receives what he or she believes to be an appropriate and timely response," then that attorney has no further obligations under the Part 205 rules.43

37 Id.; see, e.g., TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").
38 17 C.F.R. § 205.3(b)(7).
39 Id. § 205.3(b) (2).
40 Id.
41 Id. § 205.3(b).
42 Id.
43 Id. § 205.3(b)(8).
2. *Step Two: Report to the Board*

The second step is triggered when the reporting attorney believes that the issuer’s senior management has failed to provide an appropriate response within a reasonable period of time. At that point, the reporting attorney is required to report the evidence of the material violation to (1) “the audit committee of the issuer’s board of directors”; or, if the board has no audit committee, then (2) another committee comprised of directors who are not employed by the issuer; or (3) the issuer’s board of directors. The rules also provide that a reporting lawyer may report evidence of a material violation to the board if the reporting attorney reasonably believes that it would be futile to report the evidence to the chief legal officer or the chief executive officer. A reporting attorney who believes that an appropriate response has not been provided “shall explain his or her reasons” to the chief legal officer, chief executive officer, or the board.

This last situation gives rise to one of the most contentious issues associated with Section 307: the course to be followed when the reporting attorney does not receive an appropriate response following disclosure to the board or a board committee. As adopted, Part 205 rules permit disclosure of confidential information to the SEC without the issuer’s consent under limited circumstances:

- “[t]o prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors”;
- “[t]o prevent the issuer . . . from committing . . . or suborning perjury” or illegal false statements in connection with an SEC investigation or administrative proceeding; or
- “[t]o rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors” when that material violation was effected through the use of the attorney’s services.

The Commission does not, however, require that a reporting attorney take any of these steps. In the event that an attorney does elect to make a disclosure, Part 205 provides that no inconsistent state standard may subject an attorney to liability when he has complied in good faith with these requirements.

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44 Id. § 205.3(b).
45 Id. § 205.3(b)(3).
46 Id. § 205.3(b)(4).
47 Id. § 205.3(b)(9).
48 Id. § 205.3(d)(2).
49 Id. § 205.6(c).
When the Commission adopted Part 205, it also extended comment on another, more controversial requirement. Specifically, it sought reaction to a "noisy withdrawal" rule that, when an issuer's board failed to provide an "appropriate response," would require the reporting attorney to

- withdraw from representation of the issuer, indicating that the withdrawal was based on professional considerations;
- provide written notice to the SEC of the withdrawal within one business day indicating that the withdrawal was based on professional considerations; and
- promptly disaffirm to the Commission any document or representation filed with or made to the SEC by the reporting attorney that the attorney believed to be materially false and misleading.\(^{50}\)

The proposal sparked a flood of adverse commentary questioning the SEC's authority to promulgate such a rule, the inconsistency of the proposal with state ethics rules requiring lawyers to maintain client confidences, and whether the specter of a noisy withdrawal, even if remote, would chill issuer/attorney contacts on the difficult questions that most acutely require the assistance of counsel. As the Commission adopted the Part 205 rules, the SEC proposed an alternative to the noisy withdrawal provision: a requirement that the issuer disclose publicly (on a Form 8-K) the resignation of counsel for professional considerations much like issuers presently must disclose the resignation of their independent auditors.\(^{51}\)

III.
HAS ANYTHING REALLY CHANGED?

A corporate general counsel returning from a yearlong sabbatical in January 2003 might wonder why the Part 205 rules generated so much flotsam. In many respects, the new rules mandate precisely the conduct that most in-house counsel already expect from both peers and outside counsel. In its adopting release, the Commission emphasized that most of its requirements were consistent with the standards to which many lawyers are subject already. Specifically, the SEC noted that the "vast majority" of jurisdictions permit or require disclosure of ongoing illegal conduct.\(^{52}\) Given these facts, the key question for an issuer's in-house counsel is whether the Part 205 rules will affect their lives on a day-to-day basis. Two predictions inform that analysis.

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\(^{52}\) Adopting Release, supra note 22, at 92–93.
First, there is reason to believe that the number of reports under the new rules will be modest. The structure of the rule requires creditable evidence of a material violation. Few lawyers will uncover evidence of illegal conduct that is material to the issuer.

Further, the historical precedent with the most analogous provision of the federal securities laws—Section 10A of the Securities Exchange Act—supports a prediction that there will be few reports. Section 10A imposes upon auditors an obligation to report "illegal acts," whether material or not, discovered over the course of an audit. Like Part 205, Section 10A requires reports in stages: First, auditors must direct their reports to the appropriate level of management. Then, in the absence of appropriate remedial action, they must go to the board of directors. At that point, the auditors must tell the board if "the illegal act has a material effect on the financial statements of the issuer," and if the company's "failure to take remedial action is reasonably expected to warrant departure from the standard report of the auditor or warrant resignation [of the firm] from the audit engagement." The board is then required to provide the SEC with a copy of the audit firm's report within one business day. If the board fails to do so, the accounting firm must resign from the engagement with the issuer and must furnish the SEC with a copy of the report.

Over nearly eight years, Section 10A reports have been relatively rare. The General Accounting Office recently reported that from January 1, 1996 through May 15, 2003, the SEC received only twenty-nine reports under Section 10A. While the Commission has brought enforcement actions addressing auditor failures to issue Section 10A reports, that approach itself suggests that Section 10A reports remain extraordinary events. There is no question that Section 10A arose in an entirely different legislative context from Section 307 of the
Sarbanes-Oxley Act. Nonetheless, nearly a decade of experience under Section 10A suggests that, under the Part 205 rules, reports, too, will be infrequent happenings.

Second, even if reports under the Part 205 rules are unusual, the existence of these rules will increase significantly the opportunities for the Commission and its enforcement staff to second-guess judgments made by counsel when issuers or their agents violate the federal securities laws. These new high-profile rules must be viewed in the context of the Commission's existing enforcement program. During the 2002 fiscal year, the SEC initiated a record 598 enforcement actions. In many of these actions, the Commission's staff developed a comprehensive evidentiary record regarding law violations by issuers and their directors, officers, and employees. Now, in addition to assessing whether the lawyers involved with these issues themselves violated the law, the Commission's staff will weigh whether the lawyers reported the violators in compliance with the Part 205 rules. While state ethical rules may have imposed comparable requirements, there is little to suggest that state disciplinary boards were compiling hundreds of investigative files that highlighted these issues each year. The SEC enforcement program creates such investigative files; the Part 205 rules will invite an assessment of lawyers with the benefit of perfect hindsight.

IV
THE PRAGMATIC RESPONSE

Placed at the epicenter of the Part 205 rules, corporate counsel now face the immediate question of how to proceed in response to the new requirements. No one formula is right for all issuers, but at least three considerations will be relevant to most.

A. General Reporting Requirement

First, as a matter of corporate policy, an issuer's General Counsel should apply a reporting requirement to all internal and external counsel for the company. Regardless of how the Part 205 rules apply to various counsel serving the company, there should be a single operating assumption that any material violation will be reported to the General Counsel. Even in the absence of any SEC reporting requirement, the General Counsel has a strong business interest in being apprised of potentially material legal concerns.

While this point may seem elementary, there is merit in making this the first principle of any public company policy developed to address the new up-the-ladder reporting requirements. Considerable

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debate has been devoted to delineating the class of lawyers covered by the Commission's rules. As discussed above, foreign lawyers lobbied effectively to be excluded from the reach of these rules. Similarly, lawyers with an expertise outside any aspect of the federal securities laws may argue logically that they are incapable of practicing and appearing before the SEC. Such discussions are necessary for the rulemaking exercise. For an issuer's General Counsel, they are less important; corporate General Counsel have the same interest in getting notice of an improper payment to a foreign government official or a senior employee of the Food and Drug Administration as they do in learning about notice expressly mandated by the Part 205 rules.

While in principle a policy should not be necessary to ensure that material violations are reported to the General Counsel, the flow of legal engagements may test that principle. For example, it is not uncommon to vest business managers with discretion regarding the retention of outside counsel. Counsel who have had little or no contact with an issuer's General Counsel might not place the first call to that lawyer when confronted with potentially illegal conduct. The adoption of the Part 205 rules make it prudent to ensure that all lawyers serving the issuer understand that they must inform the General Counsel promptly of any material violation.

B. Reporting Structure

Second, the reporting structure typically should begin with the corporate General Counsel. This discussion puts aside discussions regarding those limited situations in which the allegation relates to the conduct of the General Counsel. In most instances, there will be a premium on the efficiency that the General Counsel can provide in screening the reports and supporting any investigation that follows.

The question of reporting structure merits separate discussion because current efforts at corporate reform generally place a disproportionate burden on independent directors. In the up-the-ladder rules, this tendency personifies itself in rules relating to "Qualified Legal Compliance Committees" (QLCC). The QLCC is defined as a committee that consists of "at least one member of the issuer's audit committee" (or equivalent committee in the absence of an audit committee) and "two or more members of the board of directors who are not employed by the issuer."\(^6\)\(^3\) An existing committee, such as the audit committee, may serve as the QLCC. In whatever form, the rules require the QLCC to adopt written procedures for the "confidential

receipt, retention and consideration of any report of evidence of a material violation . . . ."64

If an issuer’s board has created a QLCC, the Part 205 rules create an alternative track for reporting credible evidence of a material violation. Specifically, the rules provide that rather than contacting management, the reporting attorney may report to a QLCC, if such a committee has been formed. Referring the matter directly to a QLCC allows a reporting attorney to satisfy his reporting obligations (and, as a result, the reporting attorney is freed from any obligation to assess the issuer’s response).65 The issuer’s chief legal officer also may elect to refer evidence to an established QLCC, advising the reporting attorney that the QLCC will assume responsibility for responding to the report.66

The QLCC option creates an incentive to “kick the question upstairs.” That incentive should be complemented by an assumption that, in most instances, the General Counsel will take the lead in assessing reports of material violations. As the lawyer most familiar with an issuer’s business, organization, individuals, and quirks, the General Counsel is most capable of facilitating an efficient and effective response to reported material violations. As a preliminary matter, in-house counsel can offer an assessment regarding the purported violation and the credibility of the evidence. Beyond that, the General Counsel can enhance the efficiency of the investigation by identifying sources of information, documents, and the relevant participants. Even when independent counsel has been retained, the General Counsel and other in-house counsel may provide important information for the review.

Efficiency may be critical because the mere existence of an unresolved report under 205 may impair the company’s capacity to report results through its periodic filings with the SEC. Recent rulemaking has shortened the reporting deadlines for an issuer’s quarterly and annual reports and requires the Chief Executive Officer and Chief Financial Officer to certify the completeness and accuracy of periodic reports filed with the SEC.67 In the absence of a prompt resolution, the report of a material violation could effectively delay

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64 See id. § 205.2(k)(2).
65 Id. § 201.205.3(c)(1).
66 Id. § 205.3(c)(2).
the issuer's next periodic report, possibly diminishing the company's market capitalization and endangering the issuer's exchange listing. Such repercussions may be necessary but bitter medicine if, for example, the issuer confronts significant unresolved accounting issues. Conversely, it would be a tremendous waste for all involved if the reporting cycle was delayed because a baseless allegation could not be resolved in a timely manner. While the General Counsel's participation cannot guarantee against those results, it may minimize the risk that an immaterial issue produces dramatically adverse results.

C. A Predetermined Game Plan for Directors

Third, each issuer's board of directors should consider, in advance, how they will address any reports mandated by Part 205. For corporate boards, Section 307 and the Part 205 rules represent a departure from the norm in one respect: they provide a fairly precise prescription for the actions required of the board and management when counsel discovers potential material violations of law. Each board should develop a game plan for the receipt of such reports, be it a QLCC, the audit committee or an individual director designated to serve as the board's "point person" in monitoring management's response.

The content of the board's policy may be less important than ensuring its placement in the broader context of the board's oversight of the issuer's legal compliance efforts. The Part 205 rules relate to an extraordinary event. More routine, but equally important, is the board's ongoing oversight of company's legal compliance efforts. In the normal course, boards monitor management's effort to identify, monitor, and address the company's principal legal risks. Responding appropriately to reports of material violations is an important part of that oversight, but only a part.

CONCLUSION

The SEC's Part 205 rules effectively require in-house counsel to construct a blast shelter for their companies, a set of practices to respond to extraordinary reports of material violations of law. This mer-

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68 Both the Delaware courts and the SEC had emphasized the oversight obligations of directors well before Enron and Sarbanes-Oxley became part of the corporate governance lexicon. See, e.g., In re Caremark Int'l Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) (discussing the responsibility of directors to inform themselves and monitor the operations of the company's compliance efforts); Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., Securities Exchange Act Release No. 39157 (Sept. 30, 1997) (issuing report of investigation to "emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information").
its attention from a company-specific perspective. Even if the reports are rare and the possibility seems remote, the mere existence of the rules makes it prudent to have practices in place.

Implementing a policy to address Part 205 rules is not the real challenge. In-house lawyers arguably add the most value when they are embedded in the organization and, through that proximity, help manage risks and exercise judgment when it matters most. Immeasurable harm to the company’s franchise and tremendous cost may be avoided when a prescient counsel avoids a protracted dispute, resolves an employment situation, or presses the issuer to make a prudent but unpopular disclosure. Companies must find a way to create the structure that Sarbanes-Oxley requires while preserving the in-house counsel’s role as a bulwark and a resource in a hostile public company environment.