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15TH ANNUAL

Investment Management Regulatory University

WEBINAR SERIES

September 30, 2021

Attorney Conduct Rules and Escalation of Issues

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Agenda

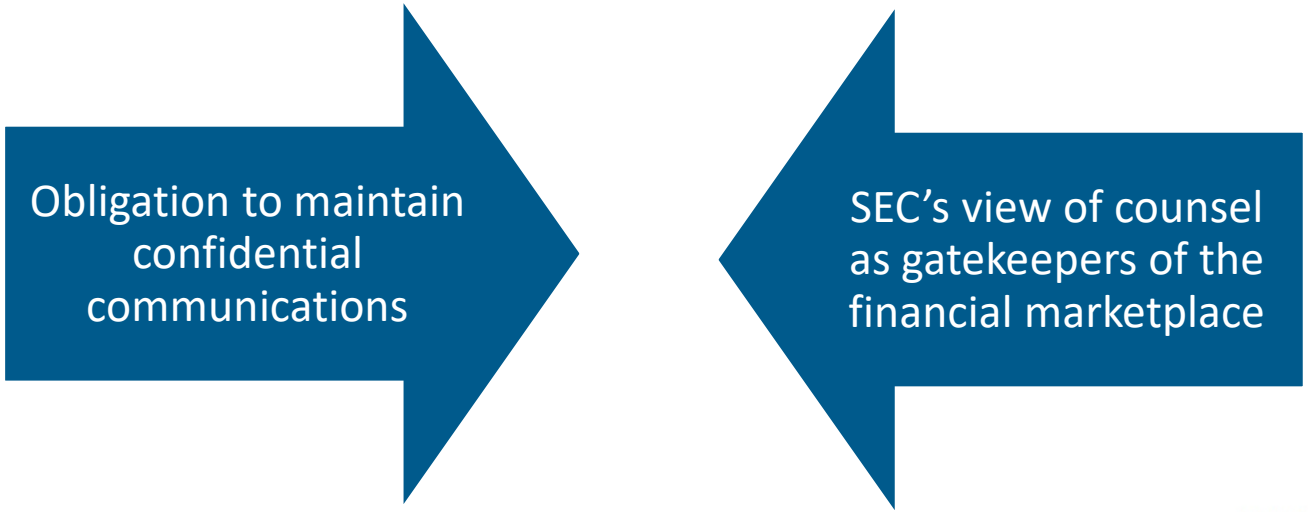
- SEC Attorney Conduct Rules – Overview
- Scenarios
- Interplay with State Ethics Rules
- Sanctions and Discipline
- Whistleblowers
- ICA Rule 38a-1
- Compliance Tips

Attorney Conduct Rules

- The Rules:
  - require attorneys to report evidence of a material violation of the securities laws "up-the-ladder" within an issuer, and
  - permit attorneys, in certain circumstances, to disclose outside of the organization confidential information related to the representation, including privileged communications, to prevent or rectify securities laws violations.
- Little guidance from the SEC or its staff on how to comply.
- The Rules provide that "an attorney appearing and practicing before the [SEC] in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.
- Thus, the Rules mandate internal reporting up the corporate ladder in appropriate circumstances. The rules also permit (but do not require) external reporting to the SEC.

Attorney Conduct Rules

- Attorneys must balance competing interests when representing corporate clients in securities-related matters.



General "Reporting Up" Structure

- Attorneys **appearing and practicing before the SEC in the representation of an issuer** must report **evidence of a material violation** of the federal securities law or breach of fiduciary duty or similar violation by the issuer or by any officer, director, employee, or agent of the issuer (e.g., an underwriter) to the issuer's chief legal officer or the equivalent ("CLO") forthwith.
- If an "appropriate response" to that report is not received, then the attorney must report the evidence to the audit committee of the issuer's board, another committee of independent directors, or to the full board.

Key Elements of the Rules

- "appearing and practicing before the Commission"
- "in the representation of an issuer"
- "evidence of a material violation"
- "subordinate attorney" and "supervising attorney"
- "appropriate response"

But first, who is an "issuer"?

"Issuers"

- Under the Rules, an "issuer" means a person:
  - the securities of which are registered under section 12 of the Exchange Act;
  - that is required to file reports under section 15(d) of the Exchange Act; or
  - that files a registration statement under the Securities Act.

NOTE: Even if not an "issuer," an SEC registrant, e.g., a registered investment adviser, is obligated under applicable federal securities laws (e.g., the Advisers Act) to provide accurate and complete information to the SEC and in its filings with the SEC.

"Appearing and practicing" means:

1. transacting any business with the SEC (including communicating with the SEC).
2. representing an issuer in an SEC administrative proceeding or in connection with any SEC inquiry.
3. providing advice about federal securities laws or rules regarding any document filed with or submitted to the SEC.
   - An attorney must know or be on notice that a document he or she is preparing or assisting in preparing will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to the SEC.

"Appearing and practicing" (con't)

4. advising an issuer as to whether information is required to be filed with or submitted to the SEC including:
   - advising that a particular document need not be incorporated into a filing, registration statement, or other SEC submission; or
   - advising that registration is not required.

This concept is not limited to just those attorneys who sign documents that are filed with or submitted to the SEC.

"In the representation of an issuer"

- "Representation of an issuer" means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.
- Attorneys need not serve in the legal department of an issuer to be covered – the Rules apply to any attorney providing legal services to an issuer within the context of an attorney-client relationship.

"In the representation of an issuer" (con't)

So if I'm an attorney, but I don't serve as one (e.g., I'm in the compliance department), am I subject to the rules?

- Yes, if you provide legal services to an issuer in the context of an attorney-client relationship.
- What are legal services?
- Under what circumstances is an attorney-client relationship established?

“In the representation of an issuer” (con’t)

For purposes of determining whether an attorney is “appearing & practicing before the SEC in the representation of an issuer” . . .

- The term “issuer” includes any person controlled by an issuer (e.g., a wholly-owned subsidiary), where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of an issuer.
  - So, an attorney employed or retained by a non-public subsidiary of a parent issuer is “appearing and practicing” before the SEC “in the representation of an issuer” whenever acting on behalf of, or at the behest, or for the benefit of the parent.
  - This also encompasses any subsidiary wholly-owned or controlled by an issuer and covered by an implicit or explicit umbrella representation agreement or understanding under which the attorney represents the parent company and the subsidiary, and can invoke privilege claims with respect to all communications involving the parent and the subsidiary.

"Evidence of a material violation"

- Evidence of a material violation of
  - securities laws;
  - breach of fiduciary duty; or
  - a similar violation

  triggers an obligation to report.

“Evidence of a material violation” (con’t)

- “Evidence of a material violation” means **credible evidence** (not gossip, hearsay or innuendo), 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.
- “Under the circumstances” may include the attorney’s professional skills, background and experience, the time constraints under which the attorney is acting, the attorney’s previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult.
- To be “reasonably likely,” a material violation must be more than a mere possibility, but it need not be more likely than not.

Reporting Sequence
Step One: Report to CLO (or to CLO and CEO)

- The first reporting step is to report to the issuer's CLO (or the equivalent) or to both the issuer's CLO and its chief executive officer (or the equivalents thereof) forthwith. For an attorney employed by a fund adviser, the attorney would report evidence of a violation that is related to the fund to the fund's CLO (or equivalent).
- If the reporting attorney reasonably believes it would be futile to report evidence of a material violation to the issuer's CLO (or CLO and CEO), then the attorney can report directly to the issuer's audit committee or other independent committee, or the full board, without first reporting to the CLO (or CLO and CEO).

What about subordinate attorneys working with supervising attorneys?

- A supervising attorney must make reasonable efforts to ensure a subordinate attorney that she supervises or directs conforms to the Rules.
- A subordinate attorney complies with his/her reporting obligations by reporting to his/her supervising attorney.
- The supervising attorney is then responsible for promptly complying with the reporting requirements.
- If a subordinate attorney reports to his or her supervising attorney, and the supervising attorney does not comply with his or her reporting obligations under the Rules, the subordinate attorney may, but is not obligated, to report to the CLO, CLO and CEO, QLCC, the foregoing board committees, or the full board.

Are there any alternatives to reporting to the CLO (or CLO and CEO)?

- Yes, if the issuer has previously formed qualified legal compliance committee ("QLCC") to which attorneys could report evidence of a material violation, then the attorney can report to the QLCC.
  - An issuer is permitted, but not required, to establish a QLCC, composed solely of at least one member of the audit committee (or equivalent) and two or more independent directors with written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation.
  - A QLCC cannot be established in response to a specific incident or report.
- The QLCC is responsible for notifying the CLO of the report, causing an investigation where appropriate, determining what remedial measures may be appropriate, and reporting the results of the investigation to the CLO.
- If the issuer fails to take remedial action the QLCC has recommended, the QLCC may take appropriate action, including notifying the SEC.
- The QLCC may be an audit committee or other committee of the issuer. The QLCC institutionalizes the process of reviewing reported evidence of a possible material violation.
- Note that if the attorney reports to a QLCC, the attorney has satisfied his/her obligation to report and is not required to assess the issuer's response. DONE!

QLCC must have the authority and responsibility to:

- Inform CLO & CEO (or equivalents) of any report of evidence of a material violation
- Determine whether an investigation is necessary and if so:
  - notify audit committee or board
  - initiate investigation, which can be done by CLO (or equivalent) or outside counsel; and
  - retain additional experts as necessary
- Recommend that issuer implement appropriate response to reported evidence of violation

QLCC must have the authority and responsibility to (con't):

- Inform CLO & CEO (or equivalents) and board of results of investigation and appropriate remedial measures to be adopted.
  - "Appropriate remedial measures" means appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriate address any material violation that has already occurred and to minimize the likelihood of its recurrence.
- Take all other appropriate action, including authority to notify the SEC in the event the issuer fails in any material respect to implement an appropriate response that the QLCC has recommended the issuer take

After reporting to the CLO, then what happens?

- After receiving a report of evidence of a material violation, the CLO (or CEO) must either refer the report to a QLCC (and inform the reporting attorney of the referral) or conduct an inquiry into the matter as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur.
- If the CLO determines that no material violation has occurred, is occurring, or is about to occur, he or she must notify the reporting attorney and advise the reporting attorney of the basis for such determination.

After reporting to the CLO (con't)

- The CLO must provide the reporting attorney with an "appropriate response," meaning that a response provides the reporting attorney with a reasonable belief that:
  - no material violation has occurred or is about to occur;
  - the issuer has adopted appropriate remedial measures; or
  - the issuer, with the consent of its board, a committee thereof, or a QLCC, has retained or directed an attorney to review the reported evidence of the material violation and either: (a) has substantially implemented any remedial recommendations made by the attorney after investigation and evaluation of the evidence; or (b) has been advised by the attorney that the issuer has a colorable defense in any investigation or judicial or administrative proceeding relating to the reported evidence.
- Receipt of an appropriate and timely response from the CLO concludes the reporting attorney's obligations under the Rules.

What happens if you are retained or directed to investigate the matter?

- An attorney retained or directed by an issuer to investigate evidence of a reported material violation is appearing and practicing before the SEC.
- An attorney has no obligation to report evidence of a material violation if he or she was:
  - retained or directed by the CLO (or equivalent) to investigate evidence of a material violation and (i) reports results of the investigation to the CLO (or equivalent) and (ii) CLO (or equivalent) reports the results of the investigation to issuer's audit committee, another committee of independent directors, full board of directors, or QLCC;
  - retained or directed by the CLO (or equivalent) to assert, consistent with professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the CLO (or equivalent) provides reports on the progress / outcome of the proceeding to the issuer's audit committee, another committee of independent directors, full board of directors, or QLCC; or
  - retained or directed by a QLCC to investigate such evidence of a material violation or assert, consistent with professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

What if the reporting attorney doesn't receive a reasonable response?

- If the reporting attorney reasonably believes that the CLO has not provided an appropriate response within a reasonable time, the reporting attorney must report the evidence of a material violation:
  - to the issuer's audit committee;
  - if the issuer does not have an audit committee, to another committee of independent directors; or
  - if the issuer does not have an audit committee or another committee of independent directors, to the issuer's full board of directors.

Disclosure of Confidential Information

- The Rules allow but do not require an attorney to disclose to the SEC without an issuer's consent confidential information related to the representation of the issuer, including privileged information, outside of the organization, to the extent the attorney reasonably believes necessary to:
  - prevent the issuer 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 investors;
  - prevent the issuer from perpetrating a fraud on the SEC; or
    - "Perpetrating a fraud on the Commission" means conduct involving the knowing misrepresentation of a material fact to, or the concealment of a material fact from, the Commission with the intent to induce the Commission to take, or to refrain from taking, a particular action.
  - rectify the consequences of an issuer's material violations in the furtherance of which the attorney's services were used.
- The SEC originally proposed a rule that would have permitted or required attorneys in certain circumstances to withdraw from a representation and notify the SEC of such withdrawal. However, the proposed rule was never adopted.

Scenario One

- An attorney in the legal department of a registered investment adviser provides information to its parent's legal or compliance department that will be included in the parent's filing with the SEC. The parent is an "issuer."
  - Is the attorney "appearing and practicing" before the SEC "in the representation of an issuer?"
    - Yes – an attorney at a non-public subsidiary appears and practices before the SEC in the representation of an issuer when he or she is assigned work by the parent (*e.g.*, preparation of a portion of a disclosure document) which will be consolidated into material submitted to the SEC by the parent (*i.e.*, the issuer).

Scenario One (con't)

- The attorney for the advisory firm subsidiary believes there is evidence that the information she provided is not reflected in the filing in a materially accurate manner.
  - What is the attorney required to do, if anything, under the Rules?
    - If the attorney is a subordinate attorney, the attorney may report to her supervising attorney, who then must report to the issuer's CLO).
    - Otherwise, the attorney must report to the issuer's CLO.
    - If the attorney believes she has not received an appropriate response within a reasonable time, she must report up the ladder within the issuer.

Scenario Two

- An attorney in the legal department of an issuer is asked to review the Issuer's Form S-1 before it is filed with the SEC. Like Scenario One, the attorney is appearing and practicing before the SEC. If the attorney has a similar concern regarding the disclosure as in Scenario One, the attorney must report to the issuer's CLO.
- What if the attorney is the CLO?

Scenario Three

- An attorney in an issuer's legal department signs the issuer's SEC filing. Is the attorney appearing and practicing before the SEC? Yes, the attorney is.
- What if a compliance professional/employee in the compliance department of the issuer, whose job functions do not include the provision of legal advice, and who happens to be an attorney, signs the SEC filing?

Scenario Four

- An attorney in the legal department of an issuer reports a concern to the issuer's CLO pursuant to the Rules. The attorney received a response within a reasonable time, but does not believe that the response is reasonable.
- The attorney must report the matter to the issuer's audit committee, another committee of independent directors or to the full board.

Scenario Five

- A public company designates the General Counsel for one of its subsidiaries ("Sub A") to provide information to the SEC on behalf of all of the company's subsidiaries. This requires each subsidiary's General Counsel to provide information to the Sub A General Counsel. Such communications are covered by the attorney-client privilege. The General Counsel for another subsidiary ("Sub B") determines there is evidence that the Sub A General Counsel has provided materially false information to the SEC.
  - Does the General Counsel for Sub B have any obligations under the Rules?
    - Probably yes – the Sub B General Counsel likely has a reporting obligation, even though only the Sub A General Counsel is communicating with the SEC because the Sub B General Counsel participated in those communications by providing information contained in them. The SEC would also likely view both attorneys as subject to the Rules by virtue of the umbrella representation agreement or understanding.

Scenario Six

- Counsel for the adviser of a registered investment company (fund) is responsible for preparing periodic reports filed with the SEC on behalf of the fund, and has control over those documents. The General Counsel for the fund's sub-adviser becomes aware of evidence that there are materially misleading statements in those filings.
  - Does the sub-adviser GC have any obligations under the Rules?
    - Only if the sub-adviser participated in preparation of the reports, provided advice concerning the reports, or was party to an umbrella representation agreement with the adviser and/or fund.
      - Participating in the preparation of reports includes both adding and excluding information or a particular characterization of the information incorporated into materials submitted to the SEC.

Scenario Six (con't)

- Assuming the answer to the first question is "yes," then the GC for the sub-adviser must report to the fund (e.g., the fund's CLO).
- The GC for the sub-adviser may (but is not required to) disclose confidential client information to the SEC to the extent necessary to prevent the fund from "perpetrating a fraud on the Commission" or committing a material violation that the attorney reasonably believes is likely to result in substantial injury to the financial interest or property of the fund or investors.

Interplay with State Ethics Rules

- The Rules on permissible disclosure govern where they conflict or are inconsistent with state ethics rules, but do not preempt state ethics rules that establish more rigorous reporting obligations (such as a mandatory disclosure requirement imposed by a state).
- The majority of state ethics rules permit (and some require) disclosure of information in the circumstances covered by the Rules.
  - Corresponds to Model Rule 1.6.
- Specifically, the state ethics rules of Connecticut and New York are consistent with Model Rule 1.6 and the SEC Rules with respect to reporting out of confidential client information.

Model Rule 1.6: Client-Lawyer Relationship

- (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
- (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary: (1) to prevent reasonably certain death or substantial bodily harm; (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services; (4) to secure legal advice about the lawyer's compliance with these Rules; (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; (6) to comply with other law or a court order; or (7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.
- (c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

Interplay with State Ethics Rules

	A lawyer may reveal client information to:
Model Rule 1.6	1. **Prevent the client from committing a crime or fraud** that is reasonably certain to result in substantial injury to the financial interests or property of another. 2. **Prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted** from the client's commission of a crime or fraud.
Connecticut Rule 1.6	1. **Prevent the client from committing a criminal or fraudulent act** that the lawyer believes is likely to result in substantial injury to the financial interest or property of another. 2. **Prevent, mitigate or rectify the consequence of a client's criminal or fraudulent act** in the commission of which the lawyer's services had been used.
New York Rule 1.6	1. **Prevent the client from committing a crime.** 2. **Withdraw a written or oral opinion or representation previously given by the lawyer and reasonably believed by the lawyer still to be relied upon by a third person**, where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud.

Interplay with State Ethics Rules (con't)

- In jurisdictions where disclosure without client consent is not permitted in these circumstances, attorneys who permissively disclose under the Rules may violate their ethical duties of confidentiality.
- The Rules state that an attorney who complies in good faith with the Rules shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other US jurisdiction.
  - Nonetheless, the California State Bar issued an "Ethics Hotliner" in 2004 stating that "California attorneys cannot presume there is a safe harbor if they disclose client confidences to the SEC in contradiction with California ethics rules."

Sanctions and Discipline

- For violations of the Rule, the SEC could initiate disciplinary proceedings against the attorney, which may result in the attorney being censured, or temporarily or permanently denied the privilege of appearing and practicing before the SEC.
- However, an attorney who complies in good faith with the Rules would not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other US jurisdiction.
- The Rules do not create any private right of action against an attorney, law firm or issuer for violations of the Rules.

Whistleblower Retaliation Protection

- Provisions of Dodd-Frank protect whistleblowers who experience retaliation for making disclosures protected under the Rules.
- An attorney who only reports violations internally but not to the SEC may be protected from retaliation under SOX but is not entitled to the more robust protections afforded to whistleblowers under Dodd-Frank.
  - In *Digital Realty Trust, Inc. v. Somers*, the Supreme Court ruled that whistleblower protections afforded by Dodd-Frank only apply in cases where a whistleblower has reported directly to the SEC, and not just internally.
- An attorney formerly employed or retained by an issuer and who reasonably believes he was discharged for reporting evidence of a material violation under the Rules may notify the issuer's board or any committee of the board.

Attorneys may collect whistleblower awards under Dodd-Frank only in limited circumstances

- In order for a whistleblower to be eligible for an award under Dodd-Frank, four requirements must be met:
  - The whistleblower must **voluntarily** provide the SEC,
  - With **original information** about a violation of securities laws,
  - That leads to the **successful enforcement of an SEC action** that,
  - Results in **sanctions exceeding $1 million**.

Attorneys may collect whistleblower awards under Dodd-Frank only in limited circumstances (con't)

- "Original information" cannot be obtained in any of six ways, the first two of which are listed here for their special applicability to attorneys and in-house counsel:
  - Through a privileged communication; or
  - In connection with the legal representation of a client on whose behalf the attorney(s) or their employer or firm are providing services.
- However, confidential client information can be disclosed to the SEC without client consent, and therefore qualify as "original information" for purposes of the SEC Whistleblower Program, if such disclosure would otherwise be permitted under the **SEC attorney conduct rules, the applicable state attorney conduct rules**, or "**otherwise**".

Other whistleblower award exclusions and exceptions that sometimes apply to attorneys

- Additionally, the SEC does not consider information to be "original" if it was obtained because the attorney was:
  - An officer, director, trustee, or partner of an entity, and another person informed the attorney of allegations of misconduct, or the attorney learned the information in connection with the entity's processes for identifying, reporting, and addressing possible violations of law;
  - An employee whose principal duties involve compliance or internal audit responsibilities, or the attorney was associated with a firm retained to perform compliance or internal audit functions for an entity; or
  - Employed by or otherwise associated with a firm retained to conduct an inquiry or investigation into possible violations of law.

Other whistleblower award exclusions and exceptions that sometimes apply to attorneys (con't)

- However, these additional 3 exclusions to the definition of "original information" will not apply if an attorney has:
  - A reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors;
  - A reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct; or
  - At least 120 days have elapsed since the attorney provided the information to the relevant entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or his or her supervisor, or if the attorney received the information under circumstances indicating that the entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or his or her supervisor was already aware of the information.

Are companies required to alert in-house counsel of their right to be whistleblowers?

- No, but neither are companies allowed to do anything that might impede an individual from reporting a securities violation to the Commission.

Investment Company Act Rule 38a-1

- Under Rule 38a-1, registered fund CCOs must report, at least annually, to the fund's board each "material compliance matter" that occurred since the date of the last report.
- "Material compliance matter" means any compliance matter about which the fund's board of directors would reasonably need to know to oversee fund compliance, and that involves, without limitation:
  - a violation of the federal securities laws by the fund, its investment adviser, principal underwriter, administrator or transfer agent (or officers, directors, employees or agents thereof),
  - a violation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent, or
  - a weakness in the design or implementation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent.

Reporting to Chief Compliance Officers

- The obligation of a fund adviser's attorney to report material violations under the Rules is not satisfied by reporting to the Chief Compliance Officer ("CCO") unless the CCO also acts as the CLO.
- An adviser's or an issuer's internal compliance policies may impose an additional obligation, separate from the Rules, to report material violations or other issues to the CCO or similar person.

Compliance Tips

- Provide training
- Develop policies and procedures
- Share information
- Identify “issuers”
- Cover internal legal and compliance department structure
- Cover reporting and supervisory lines; clarify relationship with/differences from other reporting or supervisory lines and related escalation, reporting and whistleblower policies and procedures, other regulatory or legal requirements (e.g., Rule 38a-1; state laws)
- Identify attorneys/legal departments within the firm
- Identify CLOs, CEOs, QLCC and other committees, and supervising attorneys and their subordinate attorneys

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