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The Role of In-House Counsel in Ensuring Corporate Governance Under the Provisions of the Sarbanes-Oxley Act

STATEMENT OF THE ASSOCIATION OF CORPORATE COUNSEL (ACC)

(formerly the American Corporate Counsel Association)

HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED SERVICES

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On behalf of the Association of Corporate Counsel, we are honored to present comments to this Subcommittee on the impact of the Sarbanes-Oxley Act of 2002 on legal compliance efforts within corporations: in specific, you have requested our impressions on the impact of Section 307's attorney conduct rules[2] on the roles and responsibilities of in-house attorneys and their relationship with their clients.

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[1] Please note that the comments presented today are those of ACC, and may not reflect the opinions or positions of Ms. Madrid's employer, CarrAmerica Realty.

[2] As promulgated by the Securities and Exchange Commission, the rules can be found at 17 C.F.R. Part 205 (Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer). ACC's executive summary of the rules is available at http://www.acca.com/legres/corpresponsibility/307/summary.pdf.

ACC is the in-house bar association, serving the professional needs of attorneys who practice in law departments of corporations and other private sector organizations worldwide. The association promotes the common interests of its members, contributes to their continuing education, seeks to improve understanding of the role of in-house attorneys, and encourages advancements in standards of corporate legal practice. Since its founding in 1982, the association has grown to almost 16,000 members, representing over 7,000 organizations; the association has 43 chapters and 12 committees serving the membership. ACC has members in 47 countries, representing a wide range of substantive interests and a diverse base of clients: public and privately held, large and small, in every industry. ACC members are represented in 47 of the Fortune 50 companies and 97 of the Fortune 100 companies. Internationally, its members are represented in 42 of the Global 50 and 75 of the Global 100 companies.

As the bar association for in-house counsel – lawyers from outside practice are not eligible for membership – everything we do – programs, publications, web resources, networking, advocacy – is strictly "by and for corporate counsel." Accordingly, we can say with confidence that we truly have our finger on the pulse of in-house issues in a way that no other organization can.

ACC has a long-standing interest in the Sarbanes-Oxley Act (SOX) and its provisions affecting our members and their representation of their clients. ACC submitted two sets of comments to the Securities and Exchange Commission (the SEC or Commission) regarding their proposed promulgation of the rules under Section 307, and our Corporate & Securities Law Committee filed several additional comment letters on a variety of Sarbanes-Oxley-related subjects. Today, we will focus primarily on the impact of Section 307, but we will also provide some insight into related, but broader issues of the lawyer's role in ensuring good corporate governance. Due to space and

time constraints, we will not address in specific, however, other SOX provisions and their impact on our members' practices (e.g., certification and accountability rules).

Our comments reflect information gleaned from our membership through research, surveys and other feedback. We have developed significant practice resources to assist our members to comply with SOX. A bibliography of related ACC material on Section 307 compliance issues is available online and the web address and listing of those resources is provided as an attachment at the end of this document.

General Comments and Key Points

The passage of the Sarbanes-Oxley Act reflects an understandable response to recent and devastating corporate scandals. The underlying premise of the Act is an attempt to restore shareholder and investor confidence. Corporate counsel have an important contribution to make in achieving that goal. Chief Legal Officers (CLOs) and their in-house legal teams can and should play a key role in helping management and the Board enact governance reforms that ensure that the company's ethical culture is supported by a framework of sound systems of compliance. Corporate counsel embrace their professional and fiduciary responsibilities as managers of the legal compliance function, which include reporting allegations "up the ladder" of responsible management to the highest authority necessary to insure that the *client* can and does remedy legal problems caused by rogue employees or executives. Indeed, lawyers who represent corporations owe their duties to the institution, not to any individual within it; this is a basic tenet of all professional ethics rules, not just the SEC's attorney conduct standards promulgated under SOX 307.

If there is one complaint that is regularly heard, it is that the Act has the unfortunate effect of burdening highly compliant companies with procedural reforms aimed at preventing the misconduct of the few. Hence, the response of many companies to SOX

in general is one of frustration. Many of our members question whether any of these procedural reforms would have prevented the financial failures of the companies whose names are now household synonyms for corporate misconduct. It goes without saying that procedural requirements and new structural mechanisms will not necessarily translate into better decision-making, nor can they guarantee moral behavior amongst those who are already prone to unethical or illegal behavior. Even the best governance systems are no substitute for sound decision-making by corporate leaders.

That said, in-house counsel are working hard within their companies to implement SOX requirements and to help their clients institutionalize the ethical behavior SOX is intended to encourage. And they are doing so within the framework established under Section 307.

Our concerns regarding the 307 rules are not about the reporting up procedures; they are about the rule's continuing ambiguities and some of the unintended consequences the rules have wrought, such as a marked increase in the number of threatened lawyer whistleblower actions in response to a negative performance review or a disagreement with the CLO's more informed judgment about the merits of an allegation brought forward by a junior attorney.

Additionally, our members are very concerned about the exposure they face in terms of increasing liability in light of constantly shifting rules and unclear standards of behavior as the SEC, the state bars, and even other federal and state agencies enter the fray to fight over the right to "own" the regulation of the professional behavior of lawyers representing corporations.

So long as Section 307 reforms help – rather than hinder – in-house lawyers in their efforts to team closely with the managers to instill compliance values and guarantee legal outcomes, they are fully supported by our members. However, we strongly

oppose mandatory reporting out requirements, because we believe that they will damage the underlying relationship between in-house lawyers and their clients to the detriment of corporate compliance initiatives and the protection of shareholder interests and the public's confidence.

Section 307 /The SEC Attorney Conduct Rules

The SEC's attorney conduct rules implementing Section 307 led many corporate law departments to adopt new or re-examine existing internal reporting practices and professional conduct policies. The 307 rules – now known as Part 205 rules (referring to the Federal Register section at which they are codified) became effective on August 5, 2003, and set minimum standards of professional conduct for attorneys "appearing and practicing before the Commission in the representation of an issuer." The rules require, among other things, that affected attorneys report up-the-ladder within the company certain matters upon discovery of "credible evidence of a material violation ."

Our comments will now address how companies and law departments – in general – are ensuring compliance with the 307 rules.

Many companies have developed written policies, standards, or memoranda describing their "up-the-ladder" reporting expectations.

While reporting up the ladder within an organization is not a new concept for in-house lawyers since it is written into each state's professional licensing code as a basic tenet of organizational client representation, as a result of Section 307, many law departments updated their conduct manuals or formalized up-the-ladder conduct rules for the first time in written policies, orientation and evaluation manuals, and mandatory-attendance educational programming. Although law department responses to the 307 rules may vary in form and substance, many include commonly shared key resource features to help attorneys understand expectations pertaining to circumstances that require

reporting, the types of information that must be reported, and the appropriate methods for complying with reporting requirements.

It is probably fair to state that even now, CLOs responsible for such policies and conduct compliance are carefully watching what everyone else is doing; even departments with policies in place concede that their policies are not set in stone because regulation under the new rules is so new and untested, and adverse and unintended consequences are now starting to pop up, as detailed below. They are also carefully watching whether the SEC will adopt a threatened amendment to the rule, which would change the standard from "permissive" reporting to an outside authority (in the event of client intransigence to remedying a problem) to a mandatory outside reporting requirement, which ACC and the vast majority of our members strongly oppose.

Reporting expectations are communicated and applicable to all attorneys within company; reportable allegations covered by department policies are generally broader in scope and application than the SEC rules may require.

Although the SEC rules regulate individual attorney conduct, most activity is focused at the organizational level, and thus made applicable to all attorneys working for the company at every location, including in non-US locations. The reasoning is: 1) the rules are unclear as to exactly which attorneys are subject to the rules and companies would rather be safe than sorry; 2) law department leaders dislike the idea that there are two sets of standards applicable to attorney conduct at the company (one for Section 307 lawyers and one for everyone else); and 3) if the idea behind better conduct rules is to codify and generally raise the bar on law department processes for reporting problems, then such better practices should be the rule for everyone.

Additionally, while the SEC rules offer a bit of wiggle room for reporting attorneys in beginning their progress of reporting up the ladder "forthwith," most company policies don't want inside lawyers mulling over whether they should or should not report

something amiss to the CLO or other senior designated counsel: they want allegations of wrongdoing reported up within the law department immediately (even if the matter will receive more considered attention and investigation, and even possibly remedial action before any report to other corporate leaders outside the legal department is made).

Thus, many company policies generally go beyond the SEC's definition of covered attorneys and apply to all company attorneys and any significant allegations brought to the lawyer's attention.

Up-the-ladder reporting procedures adopted may vary between companies, but most include the creation of internal "guidance resources" and extensive training.

Written up-the-ladder reporting expectations vary in length, style, and content. Some take the form of short memoranda or electronic communications summarizing key requirements and identifying contacts for consultation or reporting. Others are more formal and detailed written policies, standards, or guideline documents. Some companies have not developed formal written policies, but have more casually reinforced continuing expectations that all lawyers are invited to communicate problems up-the-ladder, or otherwise focused lawyers' attention on the desirability of broadly sharing information that could trigger an attorney's reporting responsibilities under the SEC rules.

Some of these variances in communication are directly connected to the size of the legal department: in larger or more geographically dispersed departments where attorneys may be faced with complex or heavily populated reporting up channels, one is more likely to see longer, more detailed policies, and find online or in-person ethics training resources and advisory or reporting committees in place. Many of these departments have designated an internal advisory counsel or committee to help attorneys who are confused or who have a difficult situation to navigate and need advice.

In smaller departments, where all the attorneys communicate openly on a daily basis, a formal written guideline may exist, but it is more likely that the CLO will simply reinforce the duties implied by the rule in a summary "all staff" email or a regularly scheduled department meeting; this is often accompanied by permission to attend an outside-sponsored ethics training event, and a suggestion that anyone with a concern about something they run across should simply tell the CLO immediately.

Even with SEC regulatory and corporate policy guidance to direct them, in-house counsel – from the CLO to the junior-most attorney – are concerned about how procedural and remedial responses will be judged by others with 20/20 hindsight.

Whatever form these communications or policy prescriptions take, they are unlikely to fully answer questions about how attorneys should proceed when caught between employer policies, the SEC's rules, their client's "best interests" (which each attorney is presumably left to define individually), public and shareholder expectations in this highly charged prosecutorial environment, and the professional conduct rules of their state licensing entities, all of which may suggest a different manner of responding, or even different responses to the same matter.

Most internal 307 policies, therefore, are mindful of separating the purpose of these rules (which is to set a floor for attorneys' proper professional conduct) from the client service and risk management/liability concerns of the law department (to mandate acceptable department policies that ensure reports are made and a remedy to allegations is pursued). Many CLOs are concerned that these rules and policies, delivered alone, may generate an atmosphere in which lawyers are more concerned about their compliance with the technicalities of proper reporting up than with the remedy of the underlying client problem they may have discovered. This would obviously be a perverse result of this rule's application, but feedback from our members suggests that it is an emerging problem, especially for more junior attorneys.

SOX 307 rules are impacting lawyers who work in private and non-profit companies.

The SEC's rules regulate only public companies and thus, public company lawyers, but the "best practice" standards they are setting, and the momentum at the state legislatures, in the state bars, and certainly amongst stakeholders of all kinds is that all companies and all lawyers, representing any entity (public, private, for or not for profit) should take steps to encourage their lawyers live up to these requirements and procedures.

The rules are nonetheless untried, often undefined or ambiguous, and even in conflict with other rules that lawyers are required to professionally follow.

The interplay between the SEC rules and changing state bar rules regulating lawyers under each state's version of the Model Rules of Professional Conduct (regarding client confidentiality standards and proper representation of an organizational client when allegations of wrongdoing surface) adds yet another layer of necessary analysis and angst to the issue. While the SEC has openly stated that they believe that their rules "trump" state bar rules which do not regulate lawyers to the SEC's more aggressive standard or are in direct contradiction to state bar professional rules of practice (under the theory of pre-emption), some state bars are already taking issue, claiming that the regulation of lawyers is a practice reserved to the states, and advising state bar members that they will be disciplined for any and all breaches of the state bars' rules, even if the lawyer was attempting good faith compliance with the requirements of the SEC's rules. In other words, lawyers are getting caught in a regulatory turf war.

QLCCs may create more problems than they are intended to resolve.

The SEC's response to many of these concerns raised during the rule-making process was a proposal to allow companies worried about placing their lawyers in the middle of a professional standards wrestling match to establish a QLCC or Qualified Legal Compliance Committee. This board level committee was to be composed in a manner

to include independent directors, and was to be a vehicle to which lawyers who uncovered an allegation could report concerns and be discharged of virtually all other reporting obligations under the rule. The concept sounds appealing (in theory), yet only a few companies have adopted such a committee.

The vast majority of companies and CLOs find the creation of a QLCC to be a practical disaster. ACC has published a paper listing the reasons why so many companies that adopted every other board-level SOX reform option made available chose to forego creating a QLCC: this paper is available through our resource listing attached. In a nutshell, most in-house counsel disparage the idea that they would ask their board to assume the additional burden of establishing yet another "audit" type committee so that lawyers who are paid well by the company could be removed from responsibility for handling legal matters: the message to the board would be that the company's in-house counsel is not interested in, should not be trusted, or is not equipped to handle the most sensitive issues of legal compliance the company faces. Other practical concerns were raised, as well, and are detailed in our paper.

> *Essentially, our members tell us that the bottom line is that Section 307's conduct rules – when properly working -- build and support procedural mechanisms through which the legal department can formally participate in improved corporate governance initiatives; the rules help to insure that lawyers are responsible and empowered to individually contribute to a stronger ethical culture in the company. When improperly applied or misused, however, aberrant results will flow, and should be addressed.*

Once over the initial shock of finding themselves accountable to the SEC for professional standards of conduct, most ACC members would agree that there is little in the rules that is theoretically objectionable, and that there is much to be done in order to address the crisis of accountability and the devastation that recent corporate failures have brought to the marketplace and the public's trust in corporate responsibility.

In-house lawyers accept the reporting up responsibilities of the 307 rules, since to do so is highly consistent with their professional obligations to represent the client entity's interests and not any one malfeasant executive's motives. In addition, while the SEC codification of the reporting up principle is more detailed than the states' comparable rule version of the "organization as client" rules, the underlying principles are already well-established, accepted and understood. The main issues outstanding involve the definition or the appropriate threshold that triggers a reporting up requirement, as well the triggers for *permissive* "reporting out" in the rare circumstance that the intransigent client refuses to remedying an illegal action which the lawyer believes he must breach the client's confidence and report to an outside authority. But the concept of authorizing the lawyer to use her judgment to exercise a permissive report outside the company is not controverted, especially since history and practice shows us that it is used only rarely and most judiciously because of its dire consequences.

What is not accepted is the SEC's continuing flirtation with the imposition of an additional rule that would require *mandatory* reporting out by lawyers. Mandatory reporting out will inhibit (rather than support) legal compliance efforts by discouraging clients from welcoming lawyers into every aspect of the company's most sensitive business; in-house lawyers are only effective if they are integrated and trusted members of corporate executive, strategic, and compliance management teams. If clients view mandatory reporting lawyers as in-house policemen whose fiduciary duties flow to regulators and not to the client's need for confidential counsel, then the attorney-client relationship has been undermined in a manner which is both counterproductive to the purpose and intent of this legislation, and a disservice to the effective protection of the public and the client.

Concerns Beyond the 307 Rules:
Full Employment for Attorneys and Consultants

SOX has spawned a cottage industry for "experts" to "assist" companies in compliance with regulatory obligations. This industry often preys upon the unease of board members and senior executives by playing up their potential personal liability for corporate malfeasance, and feeding their belief that they need outside and independent counseling in order to make sound decisions. While there is a place and a need for independent counsel in certain well-defined situations, what is often sold as independent counsel would be more appropriately called "lack of any institutional knowledge or practical experience in solving your problems!"

As the fiduciaries within the company who are responsible for the management of legal costs, our members are very concerned about the unnecessary retention of leagues of outside legal advisors at high cost to the company, as well as over the possible turmoil their disparate advice can cause. While many in-house counsel do consult with outside firms in areas in which the in-house team lacks experience or the staff to execute compliance requirements, CLOs are concerned that lawyers hired by board members and executives in an effort to by-pass the legal department are seeking independent counsel on the company's dime for legal advice that is already being provided in-house.

Conclusion

ACC thanks the Committee and Subcommittee for this opportunity to present our views. If we can be of any assistance, or if there are additional subjects that you would like addressed from our perspective, we are happy to help.

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Additional ACC Resources and References of Interest:

The following documents are accessible at the following URL:
http://www.acca.com/testimony/

ACC Member Briefing: Executive Summary of the 307 Rule and its Application

99 Questions and Answers about Complying with the 307 Rules

ACC Member Briefing: *"ABA Adopts New Model Rules Affecting In-House Practice"*

ACC Member Briefing: *"Five Practical Steps" (for In-House Counsel Concerned About Lawyer Regulation Pursuant to Sarbanes-Oxley Section 307)"*
ACC Article: *"It's Private Companies' Turn to Dance the Sarbox Shuffle"*

ACC Member Briefing: "Why haven't more companies adopted a QLCC?"

ACC / NACD Comparative Survey on CLO and Director Impressions of Governance Issues Post Sarbanes-Oxley

ACC's Leading Practice Profile: Indemnification and Insurance Coverage for In-House Lawyers: What companies are doing.