

## SEC Previews Enforcement of “Up-the-Ladder” Reporting for Attorneys

The Securities and Exchange Commission (SEC) has adopted standards of professional conduct for attorneys appearing and practicing before the SEC, as mandated by Section 307 of the Sarbanes-Oxley Act of 2002. These new rules require attorneys appearing and practicing before the SEC in the representation of an issuer to report “up the ladder” (to the chief legal officer and, if necessary, to senior management and the board of directors) evidence of certain violations of the securities laws and breaches of fiduciary duties.

In a preview of how the SEC is likely to enforce these attorney conduct rules, the SEC has recently imposed a cease-and-desist order on a public company’s general counsel for failing to report to the company’s audit committee and outside auditors in a timely manner evidence of material fraud in the company’s reported financial results. While this failure occurred prior to the effective date of the Section 307 rules, the SEC is prepared to vigorously enforce the up-the-ladder reporting requirements set forth in the new rules.

### Electro Scientific Enforcement Action

In late September 2004, the SEC settled an enforcement action against John E. Isselmann, Jr., who had served as general counsel of Electro Scientific Industries, Inc. (ESI), a Nasdaq-listed high technology manufacturer. According to the SEC, ESI’s chief financial officer and controller had engaged in a scheme to fraudulently inflate ESI’s earnings for its quarter ended August 31, 2002, by improperly eliminating vested retirement and severance benefits in ESI’s Asian offices. The accounting for this transaction inflated ESI’s profits for the quarter by 28 percent, allowing it to avoid a loss for the quarter and meet profit expectations. Mr. Isselmann was not involved, present or consulted when the CFO and controller secretly and unilaterally decided to eliminate such benefits. However, the SEC found that, after he learned of the fraud, Mr. Isselmann’s failure to report the transaction up the ladder to ESI’s audit committee and outside auditors constituted a violation of the securities laws.

According to the SEC, Mr. Isselmann had several opportunities to report the fraudulent conduct. He learned of the transaction during a meeting with ESI’s audit committee and auditors to discuss the quarterly results. At the meeting, the CFO said that the benefits could be eliminated (the accounting for which would inflate ESI’s profits) because they were not legally required. The CFO also said that the decision to eliminate the benefits had been approved by legal counsel, which implied that Mr. Isselmann or outside legal counsel had reviewed it. Mr. Isselmann had not personally reviewed or sought outside legal review of the decision, but did not say anything to the audit committee at the meeting. At about the same time, Mr. Isselmann learned that the outside auditors had similarly been told that the elimination of benefits had legal support. He received a memorandum that he was told was written for the outside auditors and which stated that ESI had no legal obligation to provide the retirement benefits. Nevertheless, he did not inform the auditors that he had not reviewed or sought outside legal review of the benefits issue.

Mr. Isselmann later retained outside legal counsel to review the benefits issue and received written advice that, in fact, ESI could not unilaterally eliminate retirement benefits in Japan without the prior consent of its Japanese employees (which Mr. Isselmann knew had not been received). Mr. Isselmann had an opportunity to make this legal advice known to ESI's auditors and others at a meeting of ESI's Disclosure Committee to review ESI's Form 10-Q for the quarter, but he failed to do so. After the meeting, Mr. Isselmann provided the CFO with the outside legal advice he had obtained, but still did not bring that advice to the attention of ESI's auditors or the audit committee, even when one of the audit committee members later questioned Mr. Isselmann regarding the accounting for the elimination of the benefits. ESI filed its Form 10-Q for the quarter with financial statements that included the accounting entry for the elimination of the benefits.

Months later, Mr. Isselmann became suspicious of the accounting transaction. He consulted outside legal counsel and then informed the audit committee of his suspicions of the fraudulent behavior by ESI's CFO. The audit committee retained its own legal counsel and, after an investigation, determined that the accounting for the termination of the retirement benefits was improper. ESI reversed the transaction and restated its financial statements for the quarter.

The conduct that the SEC complained of occurred prior to the effective date of the rules under Section 307 of the Sarbanes-Oxley Act. Nevertheless, the SEC alleged that ESI's Form 10-Q had been false and misleading and that, even though Mr. Isselmann had later brought the fraud to the attention of the audit committee, his failure to convey in a timely manner the written legal advice he had received concerning the elimination of the Japanese retirement benefits was a cause of ESI filing the false and misleading Form 10-Q. Mr. Isselmann agreed to this finding and to the imposition of a cease-and-desist order.

## Implications

The rules under Section 307 have imposed important responsibilities on attorneys who appear and practice before the SEC in the representation of an issuer (a potentially broad category of in-house and outside attorneys). An attorney subject to the rules is now required to report up the ladder if he or she becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer of federal or state securities law or a material breach of fiduciary duty arising under federal or state law or similar material violation of any federal or state law that has occurred, is occurring or is about to occur. Upon becoming aware of evidence of a material violation, the attorney must immediately report such evidence to the issuer's chief legal officer (CLO) or to the CLO and the chief executive officer (or to a board committee previously established for purposes of receiving such reports) and to either receive an "appropriate response" or report further to the audit committee (or the committee established for this purpose) or to the full board of directors. As the Isselmann case makes clear, the SEC is committed to enforcing these up-the-ladder reporting requirements, even where the attorney's misconduct was simply in acting too late (in the SEC's view).

Stephen Cutler, the SEC's Director of Enforcement, recently stated that the SEC has named attorneys as defendants in more than 30 enforcement actions over the past two years and that more such actions against attorneys are to come. The SEC views attorneys as "gatekeepers" – enforcers of the rules of the capital markets – who are important actors in keeping the market fair and honest. The SEC looks to attorneys who play roles in the market to be responsible for insisting that companies comply with the law. They should not (in Mr. Cutler's words) "twist themselves into pretzels to accommodate the wishes of company management." Because the Sarbanes-Oxley Act's up-the-ladder reporting rules will be an important part of the SEC's enforcement of this role for attorneys, public companies' in-house lawyers and outside attorneys must be aware of their

responsibilities under the new rules and must remain ever vigilant of the actions of company management. All firms with in-house lawyers should review their policies, procedures and training programs to ensure compliance with these rules. We are happy to assist your organization with such efforts.

### For Further Information

If you have any questions about this Alert, please contact one of the members of the Duane Morris Securities Practice Group listed below or the lawyer in the firm with whom you are regularly in contact.

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Duane Morris' Securities Practice Group comprises more than 40 lawyers in our national network of offices.

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