The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC PROPOSAL TO IMPLEMENT STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS

[15397] November 27, 2002 TO: SEC RULES COMMITTEE No. 98-02 COMPLIANCE ADVISORY COMMITTEE No. 108-02 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 49-02 INVESTMENT ADVISERS COMMITTEE No. 29-02 UNIT INVESTMENT TRUST COMMITTEE No. 27-02 RE: SEC PROPOSAL TO IMPLEMENT STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS The Securities and Exchange Commission has issued a proposed rule that would prescribe minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers.1 The proposed rule, which implements Section 307 of the Sarbanes-Oxley Act, establishes an “up the ladder” reporting system, requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation to the chief legal officer (“CLO”) or CEO of the company. If the CLO or CEO does not appropriately respond to the evidence, the proposed rule requires the attorney to report the evidence to the issuer’s audit committee, another committee of independent directors of the issuer, or the issuer’s full board of directors. The proposed rule also addresses situations where an attorney would be permitted or required to withdraw from representing an issuer and where an attorney would be permitted to report evidence of material violations to the Commission. Comments on the proposed rule must be received by the SEC no later than December 18, 2002. We have scheduled a conference call for Tuesday, December 3, at 11:30 am Eastern to discuss the proposal. If you would like to participate on the call, please contact Monica Carter-Johnson by phone at 202-326-5823 or by e-mail at mcarter@ici.org by December 2. Otherwise, please provide comments to the undersigned by phone at 202-371-5408 or by e-mail at aburstein@ici.org by December 2. Detailed information regarding the conference call will be sent shortly. 1 Investment Company Act Release No. 25829 (November 21, 2002) (“Release”). The Release can be found on the SEC’s website at http://www.sec.gov/rules/proposed/33-8150.htm 2 I. Definitions The proposed rule contains a section defining certain terms used in the rule. Several of these proposed definitions raise issues of significance to investment companies and investment advisers. a. “Appearing and Practicing” The proposed rule broadly defines what constitutes “appearing and practicing” before the Commission. As proposed, this term includes, among other things: (1) transacting any business with the Commission, including communication with Commissioners, the Commission, or its staff; (2) preparing, or participating in the process of preparing, any statement, opinion, or other writing which the attorney has reason to believe will be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the Commissioners, the Commission, or its staff; or (3) advising any party that: (i) a statement, opinion, or other

writing need not or should not be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the Commissioners, the Commission, or its staff; or (ii) the party is not obligated to submit or file a registration statement, notification, application, report, communication or other document with the Commission or its staff. The Release states that the proposed definition of "appearing and practicing" is broad enough to include attorneys who do not serve in the legal department of an issuer or who do not act in their capacities as attorneys, but who either transact business with the Commission or assist in the preparation of documents filed with or submitted to the Commission. The Release specifically requests comment on whether the Commission should exclude any persons from the definition (e.g., in-house corporate attorneys working outside of a legal department who assist in preparing a document to be filed with the Commission) and whether the "has reason to believe" standard in the definition is too high or too low (e.g., whether an attorney must have actual knowledge or give express consent for a document to be sent to the Commission in order to be appearing and practicing before the Commission). b. "In the Representation of an Issuer" The proposed rule defines "in the representation of an issuer" as "acting in any way on behalf, at the behest, or for the benefit of an issuer, whether or not employed or retained by the issuer." The Release states that a broad definition of what constitutes "in the representation of an issuer" is essential to protect investors and that the term is therefore defined to cover attorneys providing any legal services for the issuer. The Release specifically states that an attorney employed by a privately-held investment adviser who prepares, or assists in preparing, materials that the attorney has reason to believe will be submitted to or filed with the Commission by or on behalf of a registered investment company, or will be incorporated into any document filed with or submitted to the Commission, is "appearing and practicing" before the Commission, and also is "representing" the investment company before the Commission. Therefore, where an attorney discovers evidence of a material violation by an officer of the investment adviser that is related to the 3 investment company, the attorney is required to report that evidence according to the provisions of the proposed rule. The Release also states that the proposed reporting obligation does not violate any attorney-client privilege. In particular, because an attorney is providing legal services for the registered investment company, the attorney is reporting to his or her client evidence of a material violation that is related to his or her representation of the client. The Release further states that an attorney employed by the investment adviser and representing the investment company before the Commission therefore has joint clients and that fairness and candor between co-clients regarding matters of common interest normally preclude any expectation of confidentiality regarding communications with their attorney, even regarding a communication of which one co-client was unaware at the time it was made. The Release states that this analysis must apply with special force where the co-clients are both organizations, with the investment adviser owing a fiduciary duty to the investment company, and where the attorney employed by the investment adviser, like any attorney employed by an organization, represents the investment adviser as an organization, not officers or employees who may have engaged in misconduct injuring the investment company. c. "Issuer" The proposed rule defines "issuer" as an issuer (as defined in Section 3 of the Securities Exchange Act of 1934), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn. The Release notes that this definition raises a question whether the proposed rule also should apply to attorneys who represent entities that are subject to comprehensive Commission regulation and oversight, and who regularly appear before the Commission but whose clients are not "issuers." The Release specifically cites investment

advisers, broker-dealers, self- regulatory organizations, and transfer and clearing agents that are required to register with the Commission. Given that many of these entities may not have a board of directors or an audit committee or even a CLO, the Release notes that imposing the proposed rule on these entities may be inappropriate. The Release therefore specifically requests comment whether some form of “up the ladder” reporting should be implemented for attorneys employed by regulated entities that are not issuers. II. Reporting within the Issuer Evidence of a Material Violation The proposed rule prescribes the duties of an attorney who appears or practices before the Commission in the representation of an issuer to report evidence of a material2 violation by any officer, director, employee, or agent of the issuer. In particular, if an attorney becomes aware of evidence of a material violation, the attorney must report any evidence of the violation “up the ladder” to the issuer’s CLO or to both the issuer’s CLO and CEO. 2 Under the proposed rule, “material” is defined as conduct or information about which a reasonable investor would want to be informed before making an investment decision. 4 The Release notes that the report of evidence of a material violation is not comparable to a judicial determination that a material violation actually occurred. When an attorney “becomes aware” of information that would lead an attorney reasonably to believe in the existence of a material violation would turn, at least in part, on the attorney's training, experience, position and seniority. The Release states that the proposed rule is not intended to impose upon an attorney, whether employed or retained by the issuer, a duty to investigate evidence of a material violation or to determine whether in fact there is a material violation. On the other hand, an attorney cannot ignore evidence of a material violation of which he or she is aware.3 The proposed rule also requires that an attorney reporting evidence of a material violation take steps reasonable under the circumstances to document the report and the response to the report and to retain this documentation for a “reasonable time.”4 The Release notes that a subordinate attorney who reports evidence of a material violation to his or her supervising attorney also is required to take such steps. The Release states that requiring such a contemporaneous record of the report may protect the attorney in any proceeding in which his or her compliance with the proposed rule.5 III. Chief Legal Officer’s Duty to Investigate The proposed rule would require the CLO to make a reasonable inquiry into the evidence of a material violation to determine whether the material violation described in the report has occurred, is occurring, or is about to occur. A CLO who reasonably concludes that there has been no material violation must notify the reporting attorney of this conclusion. A CLO who concludes that a material violation has occurred, is occurring, or is about to occur must take reasonable steps to ensure that the issuer adopts appropriate remedial measures and/or sanctions, including appropriate disclosures. Furthermore, the CLO is required to report “up the ladder” to the CEO, to the audit committee of the issuer’s board of directors, or to the issuer’s board of directors what remedial measures have been adopted or sanctions imposed and to advise the reporting attorney of his or her conclusions. The CLO also must take reasonable steps to document his or her inquiry and to retain such documentation for a reasonable time. IV. Reporting a Material Violation to the Issuer’s Directors Where an issuer’s CLO and/or CEO fail to appropriately respond to the reported evidence of a material violation, an attorney must report the evidence of the violation to the 3 The Release specifically requests comment on whether the “reasonably believes” standard is an appropriate standard to trigger the requirement that an attorney make a report or whether the requirement should be triggered only in instances where the attorney “knows” or “reasonably should know” of a material violation. 4 The Release states that what is a reasonable time will depend on the circumstances but would probably not be shorter than the statute of limitations applicable to the material violation at issue. 5 The Release specifically requests comment on (1) whether the rule should require an attorney making a report to maintain a written record of that report; (2) whether the rule should

prescribe in detail the form and content of the report, and if so, what form and content should or should not be prescribed; and (3) whether the rule should prescribe specific time deadlines for the preparation of the report, and if so, what time deadlines would or would not be appropriate. 5 issuer's audit committee, or to another committee of independent directors (if the issuer does not have an audit committee), or to the full board (if the issuer does not have another committee of independent directors). The proposed rule specifically states that in the case of a registered investment company, the directors must not be "interested persons" as defined in Section 2(a)(19) of the Investment Company Act. The proposed rule also provides that if an attorney reasonably believes that it would be futile to report evidence of a material violation to the CLO and CEO, the attorney may report directly to the issuer's audit committee, to another committee of independent directors, or to the full board. The proposed rule also requires a reporting attorney who has reported a matter all the way "up the ladder" within the issuer and who reasonably believes that the issuer has not responded appropriately to take reasonable steps to document the response, or absence thereof. Once an attorney has reported evidence of a material violation and reasonably believes that the issuer's response to that reported evidence is appropriate, the proposed rule states that the attorney would fully comply with the rule's requirements and needs to do nothing more regarding the evidence of a material violation. V. Qualified Legal Compliance Committee The proposed rule provides an alternative system for reporting evidence of material violations. In particular, issuers may, but are not required to, establish a qualified legal compliance committee ("QLCC") composed of at least one member of the issuer's audit committee, and two or more independent members of the issuer's board, for the purpose of investigating reports of material violations made by attorneys. A QLCC must have the authority and the responsibility to conduct any necessary inquiry into the reported evidence, to require the issuer to adopt appropriate remedial measures to prevent an ongoing, or alleviate a past, material violation, and to notify the Commission of the material violation and disaffirm any tainted document submitted to the Commission. The QLCC would be required to notify the board, the CLO, and the CEO of the results of any inquiry and the remedial measures the QLCC decided were appropriate. In the event the issuer fails to take remedial measures as directed by the QLCC, each member of the QLCC, the CLO, and the CEO would each be individually responsible for notifying the Commission of the material violation and for disaffirming any tainted submission to the Commission. The proposed rule provides that an attorney who reports evidence of a material violation to a QLCC has satisfied his or her obligation to report evidence of a material violation within the issuer and is not required to assess the issuer's response to the reported evidence of a material violation. The proposed rule also states that a CLO may refer a report of evidence of a material violation to a QLCC in lieu of causing an inquiry to be conducted under the rule. VI. Notification to the Commission Where There Is No Appropriate Response The proposed rule also discusses the obligations of an attorney who has not received an appropriate response from the issuer to their report of evidence of a material violation. This provision of the proposed rule distinguishes between material violations that have already 6 occurred and are not ongoing and material violations that are either ongoing or have not yet occurred. It also distinguishes between outside attorneys retained by an issuer and in-house attorneys employed by an issuer. If an outside attorney retained by the issuer reasonably believes that a material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors, the attorney is required to withdraw from representing the issuer, indicate that the withdrawal is based on "professional considerations"6 (i.e., a "noisy withdrawal"), notify the Commission of their withdrawal, and disaffirm any submission to the Commission that they have participated in preparing which is tainted by the violation. If the attorney is an in-house attorney employed by an issuer, the attorney is required to disaffirm any tainted

submission they have participated in preparing, but is not required to resign. If the reported material violation has already occurred and is not ongoing, and is likely to have resulted in substantial injury to the financial interest or property of the issuer or of investors, the attorney is permitted, but not required, to take the steps noted above. The Release specifically requests comment whether an attorney who is employed by an investment adviser and who is appearing and practicing before the Commission in the representation of the investment company should be treated as an outside attorney retained by the investment company or as an in-house attorney for purposes of this aspect of the proposed rule. VII. Disclosure of Issuer Confidences The proposed rule sets forth the specific circumstances under which an attorney is authorized to disclose confidential information related to his or her appearance and practice before the Commission in the representation of an issuer. In particular, the proposed rule permits an attorney to use the documentation he or she has prepared under the rule to defend themselves against charges of attorney misconduct. The proposed rules also would allow an attorney to reveal confidential information to the extent necessary to prevent the commission of an illegal act which the attorney reasonably believes will result either in the perpetration of a fraud upon the Commission or in substantial injury to the financial or property interests of the issuer or investors. Finally, an attorney may disclose confidential information to rectify an issuer’s illegal actions when such actions have been advanced by the issuer’s use of the attorney's services. VIII. Responsibilities of Supervisory and Subordinate Attorneys Under the proposed rule, a supervisory attorney must make reasonable efforts to ensure that a subordinate attorney that he or she supervises, directs, or has supervisory authority over in appearing and practicing before the Commission, conforms to the rule. The Release makes 6 The Release states that the use of the phrase “professional considerations” to explain the withdrawal keeps confidential the particular facts underlying the withdrawal while signaling that the withdrawal reflects substantially more than a disagreement about the best legal strategy or a dispute over the cost of representation. The Release also states that a purely silent withdrawal would be likely to assist an issuer in carrying out an ongoing or intended violation. 7 clear that subordinate attorneys are not exempt from the rule solely because they operate under the supervision or at the direction of another person. The proposed rule provides, however, that a subordinate attorney complies with the rule if he or she reports to the supervising attorney evidence of a material violation that the subordinate attorney becomes aware of in the course of appearing and practicing before the Commission. IX. Sanctions The proposed rule describes the manner in which violations of the rule will be addressed by the Commission. The Release states that a violation of the proposed rule will subject the violator to all the remedies and sanctions available under the Exchange Act, including injunctions and cease and desist orders. An attorney who violates a provision of the rule also will have engaged in improper professional conduct and may be subject to administrative disciplinary proceedings that can result in a censure, or a suspension or bar from practicing before the Commission. The Release states that the Commission does not believe, however, that violations of the proposed rule would, without more, meet the standard prescribed in Section 32(a) of the Exchange Act, which provides for the imposition of criminal penalties. The Release also notes that nothing in Section 307 of the Sarbanes-Oxley Act creates a private right of action against an attorney. Therefore, the Commission does not intend the provisions of the proposed rule to create any private right of action against an attorney based on his or her compliance or non-compliance with its provisions. Ari Burstein Associate Counsel

should not be considered a substitute for, legal advice.