MEMO# 15620

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SEC ADOPTS "UP THE LADDER" REPORTING REQUIREMENTS FOR ATTORNEYS AND RESOLICITS COMMENTS ON "NOISY WITHDRAWAL" PROVISIONS

[15620] February 6, 2003 TO: SEC RULES MEMBERS No. 15-03 COMPLIANCE ADVISORY COMMITTEE No. 11-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 12-03 UNIT INVESTMENT TRUST MEMBERS No. 4-03 RE: SEC ADOPTS “UP THE LADDER” REPORTING REQUIREMENTS FOR ATTORNEYS AND RESOLICITS COMMENTS ON “NOISY WITHDRAWAL” PROVISIONS As we previously informed you, the Securities and Exchange Commission issued a release requesting comments on a proposed rule prescribing minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers.1 The SEC has issued a release adopting the portion of the proposed rule establishing an “up the ladder” reporting system within an issuer.2 At the same time, the SEC has issued a companion release3 extending the comment period for, and proposing an alternative to, the provisions of the proposed rule relating to an attorney’s notification to the Commission when an attorney, after reporting evidence of a material violation “up the ladder” within an issuer, reasonably believes the issuer has either made no response or has not made an appropriate response (“noisy withdrawal”). The most significant aspects of the final rule and the alternative to the “noisy withdrawal” provisions are summarized below. 1 Memorandum to SEC Rules Members No. 105-02, Compliance Advisory Committee No. 108-02, Closed-End Investment Company Members No. 62-02, and Unit Investment Trust Members No. 40-02, dated November 27, 2002. 2 SEC Release No. IC-25929 (January 29, 2003) (“Adopting Release”). The Adopting Release can be found on the SEC’s website at http://www.sec.gov/rules/final/33-8185.htm. The effective date of the rule is 180 days after the date of publication in the Federal Register. 3 SEC Release No. IC-25920 (January 30, 2003) (“Proposing Release”). The Proposing Release can be found on the SEC’s website at http://www.sec.gov/rules/proposed/33-8186.htm. Comments are due to the SEC no later than 60 days after publication in the Federal Register. 2 I. Reporting Within an Issuer Evidence of a Material Violation A. Requirements of Final Rule The final rule, which implements Section 307 of the Sarbanes-Oxley Act, requires that attorneys appearing and practicing before the Commission in the representation of an issuer report evidence of a material violation “up the ladder” within the issuer. In particular, the rule requires an attorney to report such evidence to the issuer’s chief legal officer (“CLO”) or to both the CLO and the issuer’s CEO. The issuer’s CLO is required to inquire into the evidence

of the material violation and, unless he or she reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she must take reasonable steps to cause the issuer to adopt an appropriate response to the attorney's report. Unless an attorney reasonably believes that the CLO or CEO has provided an appropriate response within a reasonable period of time to his or her report, the attorney must report the evidence to the 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).4 The final 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 an investigation into the reported evidence and to recommend (but not to require) that the issuer implement an appropriate response to evidence of a material violation.5 B. Attorneys for Investment Company Advisers The final rule amends the definition of certain terms used in the rule. In particular, in response to comments that the proposed definition of "appearing and practicing" before the Commission was overly broad, the SEC narrowed the definition of the term in certain respects. For example, under the final rule, an attorney must have notice that a document he or she is preparing or assisting in preparing will be submitted to the Commission to be deemed to be "appearing and practicing" under the revised definition. The Commission also clarified that attorneys need not serve in the legal department of an issuer to be covered by the final rule, but they must be providing legal services to an issuer within the context of an attorney-client relationship.6 4 The proposed rule also provides that if the 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. 5 The Adopting Release clarifies that an audit or other committee of the issuer may serve as the QLCC. In addition, language has been included in the final rule to clarify that decisions and actions of the QLCC must be made and taken based upon a majority vote. 6 The Adopting Release states that an attorney-client relationship may exist even in the absence of a formal retainer or other agreement and even though the attorney-client privilege would not be available with respect to communications between the attorney and the issuer. 3 The final rule also provides that "in the 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." The final rule substitutes the phrase "providing legal services" for the term "acting" in the proposed rule in response to comments that the rule should apply only to attorneys who are rendering legal advice to the issuer. The Commission, however, reaffirmed their view that an attorney representing an investment adviser to an investment company is jointly representing the investment company. In particular, the Adopting Release states that an attorney employed by an investment adviser who prepares, or assists in preparing, materials for a registered investment company 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 is appearing and practicing before the Commission under this definition. The Commission noted the Institute's opposition to this position. However, the Commission stated that because attorneys employed by an investment adviser are providing legal services for the investment company, the logical implication of that fact is that the attorney employed by the investment adviser is accordingly representing the investment company before the Commission for purposes of the rule. C. Other Modifications Made to Proposal The final rule has been modified in several ways in response to comments received on the proposal. For example, the triggering standard for reporting evidence of a material violation has been modified to clarify and confirm that an attorney's actions will be evaluated based on an objective standard. The final rule also eliminates all requirements that reports and responses be documented and maintained for a reasonable period. In addition, the final rule makes clear, through an express "safe harbor" provision, that the rule does not create a private right of action against an attorney, a law firm or an issuer, based upon their compliance or non-compliance with the rule and that only the Commission may enforce the requirements of the rule. II. "Reporting Out" and "Noisy Withdrawal" Provisions In addition to the "up the ladder" reporting requirements, the proposed rule, under certain circumstances, permitted or required attorneys to effect a "noisy withdrawal" by notifying the Commission that they have withdrawn from the representation of the issuer, and permitted attorneys to report evidence of material violations to the Commission. In response to comments requesting that the Commission allow additional time for consideration of the impact of the "noisy withdrawal" provisions, the Commission determined to extend the comment period for this portion of the proposal. At the same time, the Commission determined to solicit comments on an alternative proposal to the "noisy withdrawal" provisions. Under the proposed rule, an attorney who has not received an appropriate response from the issuer to their report of evidence of a material violation has certain obligations. In particular, 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 4 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," 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 Commission is resolicitng comment on several aspects of the "noisy withdrawal" provisions, including, among other things, whether an attorney who is employed by an investment adviser or manager and who is appearing and practicing before the Commission in the representation of an investment company should be treated as an outside attorney retained by the investment company or should be treated as an in-house attorney (the determination of which will impact the attorney's requirements under the proposal). Under the alternative proposal to the "noisy withdrawal" provisions, an attorney retained by the issuer who has reported evidence of a material violation and has not received an appropriate or timely response would be required to withdraw from representing the issuer and to notify the issuer, in writing, that the withdrawal is based on professional considerations. In the same circumstances, an attorney employed by the issuer is required to cease participating or assisting in any matter concerning the violation and to notify the issuer, in writing, that he or she believes the issuer has not provided an appropriate response. The issuer (rather than its attorney) would be required to report to the Commission an attorney's written notice of withdrawal or failure to receive an appropriate response. The alternative proposal permits (but does not require) an attorney to inform the Commission of his or her withdrawal if the issuer does not comply with the provisions of the alternative proposal. Unlike the original proposal, the alternative proposal does not require an attorney to disaffirm documents filed with the Commission. The alternative proposal would require an issuer who has received notice from an attorney to report the notice in an appropriate filing with the Commission. In particular, the proposal would require that the filing be made by the issuer on Form 8-K within two business days of receiving the written notice. The

Proposing Release states that this filing requirement would apply to issuers that are registered investment companies. The Proposing Release notes that although Exchange Act Rules 13a-11(b) and 15d-11(b) generally exempt registered investment companies from Form 8-K filing requirements, the Commission recently amended those rules to require registered investment companies to file on Form 8-K in order to meet any filing obligations that might arise under Regulation BTR. The Commission is therefore proposing an additional amendment to these Exchange Act rules that would subject registered investment companies to Form 8-K filing requirements for the purpose of meeting any filing obligations that arise under the alternative proposal. The Commission requested specific comments on this aspect of the alternative proposal, including, among other things: (1) whether Form 8-K is the appropriate form to use for this type of disclosure or whether the Commission should adopt a new form exclusively for such reports; (2) whether two business days is the appropriate amount of time in which to require issuers to 5 make the filing; (3) whether the Commission should exclude registered investment companies from the proposed disclosure requirements and, if so, the rationale for the exclusion; and (4) if the Commission excludes registered investment companies, should the Commission require them to meet the filing requirements in some other manner, e.g., by filing a new form specifically for registered investment companies, Form N-CSR, or some other means.7 Ari Burstein Associate Counsel 7 The Commission also requested comment on whether an issuer should be permitted not to disclose an attorney’s written notice where a committee of independent directors of the issuer's board determines, based on the advice of counsel that was not involved in the matters underlying the reported material violation: (i) that the attorney providing such written notice acted unreasonably in providing such notice; or (ii) that the issuer has, subsequent to such written notice, implemented an appropriate response.
