

# **NEW SEC ATTORNEY PROFESSIONAL CONDUCT RULES**

*AN ANALYSIS FOR LIFE INSURERS  
ISSUING SEC-REGISTERED PRODUCTS*

*Paper presented to The Association of Life Insurance Counsel  
May 18, 2003 at The Greenbrier  
White Sulphur Springs, West Virginia*

*By  
Stephen E. Roth  
Partner  
Sutherland Asbill & Brennan, LLP*

**The Association of Life Insurance Counsel  
2003 Annual Meeting**

**NEW SEC ATTORNEY PROFESSIONAL CONDUCT RULES**

**AN ANALYSIS FOR LIFE INSURERS  
ISSUING SEC-REGISTERED PRODUCTS**

**Stephen E. Roth  
Sutherland Asbill & Brennan LLP  
1275 Pennsylvania Avenue, N.W.  
Washington, D.C. 20004  
(202) 383-0158  
steve.roth@sablaw.com**

Copyright © 2003  
All Rights Reserved

May 19, 2003

## 2003 ALIC ANNUAL MEETING

### NEW SEC ATTORNEY PROFESSIONAL CONDUCT RULES AN ANALYSIS FOR LIFE INSURERS ISSUING SEC-REGISTERED PRODUCTS

Stephen E. Roth  
Sutherland Asbill & Brennan LLP  
steve.roth@sablaw.com

#### INTRODUCTION

**Background.** Section 307 of the Sarbanes-Oxley Act of 2002 (the “Act”) required the Securities and Exchange Commission (“SEC” or “Commission”) to adopt rules that would set minimum professional standards for attorneys who appear and practice before the SEC in the representation of issuers. Section 307 mandated that the standards include a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation of law by the issuer “up-the-ladder” to the issuer’s chief legal counsel or chief executive officer. Section 307 also required the rule to provide that if the chief legal counsel or chief executive officer did not respond appropriately to the report, the reporting attorney must report the evidence to: (1) the audit committee of the issuer’s board of directors, (2) another board committee consisting of independent directors, or (3) the full board of directors.

In response to the Section 307 mandate, on January 23, 2003, the SEC adopted seven attorney conduct rules that together set forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC on behalf of issuers. The final rules, which are discussed in some detail in the release adopting them,<sup>1</sup> differ in several key respects from the initial rules proposed by the SEC last November.<sup>2</sup> The rules, designated 205.1 through 205.7 (each, a “Rule,” together, the “Rules”), take effect on August 5, 2003.<sup>3</sup>

The heart of the Rules are their reporting obligations pursuant to which covered attorneys must report evidence of material violations of specified laws by the issuer, or the issuer’s officers, directors, employees, or agents, initially to the issuer’s chief legal officer or to both the issuer’s chief legal officer and chief executive officer, and then, absent an appropriate response, to one or more of the following (depending on the circumstances): (1) the audit committee of the issuer’s board of directors, (2) another committee of the issuer’s board, (3) the entire board of directors, or (4) a qualified legal compliance committee of the issuer. Other parts of the Rules provide a number of important definitions, clarifications about how the reporting mechanism is intended to

---

<sup>1</sup> Inv. Co. Act Rel. No. 25919 (Jan. 29, 2003) (the “Adopting Release”).

<sup>2</sup> Inv. Co. Act Rel. No. 25829 (Nov. 21, 2002) (the “Proposing Release”).

<sup>3</sup> The rules are found in new Part 205 added to Title 17, Chapter II of the Code of Federal Regulations.

work, exceptions to the reporting requirements, and penalties for failing to make the required reports.

The rulemaking process is not over. The SEC delayed the adoption of, and requested further comment on, its so-called “noisy withdrawal” proposal and proffered an alternative for comment. The comment period on these proposals ended April 7.

At this point, apart from the actual Rule language and the discussion in the Proposing and Adopting Releases, there is no guidance concerning the scope, and practical implications, of the Rules. As discussed below, the Rules are unclear and ambiguous in a number of important respects. Moreover, there is not yet any “industry practice” to look to. It is possible that the SEC will provide further guidance on many of these areas before August; a number of those commenting on the noisy withdrawal proposal sought clarifications or changes to other aspects of the already adopted Rules. In the meantime, however, with the August 5 compliance date quickly approaching, issuers necessarily will need to undertake the process of implementing action plans for effecting good faith compliance with the Rules.

***Scope of Paper.*** The Rules apply to attorneys representing issuers, including companies registered under the Investment Company Act of 1940 (the “1940”) as open-end management investment companies (“mutual funds”) and unit investment trusts, such as life insurance company separate accounts (“separate accounts”). This paper discusses, in question and answer format, the principal elements of the Rules and identifies certain challenging aspects of their application to attorneys representing insurers and their separate accounts as well as attorneys representing mutual funds. Attached to this paper are several appendices.

**TABLE OF CONTENTS**

ATTORNEYS COVERED BY THE RULES..... 6

THE BASIC REPORTING REQUIREMENT..... 11

EXCEPTIONS TO THE BASIC REPORTING REQUIREMENT..... 18

RESPONSIBILITIES OF SUPERVISORY ATTORNEYS..... 19

RESPONSIBILITIES OF THE CHIEF EXECUTIVE OFFICER, DENOTED  
COMMITTEES, AND THE BOARD OF DIRECTORS..... 22

RECORDKEEPING AND COMPLIANCE PROCEDURES..... 24

SANCTIONS, DISCIPLINE AND REMEDIES..... 26

ATTORNEY-CLIENT ETHICS ISSUES..... 27

Appendices

    A. The Basic Reporting Requirement; Paragraphs (1), (2), (3), and  
        (8) of Rule 205.3(b)..... 29

    B. Definition of a Qualified Legal Compliance Committee (Rule 205.2(k))..... 31

    C. The Relationship of the Rules to State Bar Ethics Rules..... 32

## **ATTORNEYS COVERED BY THE RULES**

### ***Who is a covered attorney?***

A covered attorney is “an attorney appearing and practicing before the Commission in the representation of an issuer.” Who is covered therefore turns on the scope of “attorney,” “appearing and practicing before the Commission,” and “in the representation of an issuer.”

### ***How do the Rules define “attorney”?***

“Attorney” means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, or who holds himself or herself out as such. The definition includes both attorneys who are employees of an issuer and outside counsel retained by the issuer.

### ***What is meant by “appearing and practicing before the Commission”?***

“Appearing and practicing before the Commission” generally means:

- (1) transacting any business with the SEC, including communicating with the SEC or its staff in any form;
- (2) representing an issuer in a SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request, or subpoena;
- (3) providing advice about U.S. securities laws or SEC rules regarding any document that the attorney has notice will be filed with or submitted to the Commission (or incorporated into a document filed with or submitted to the Commission) including advice or assistance in preparing such a document;
- (4) advising an issuer as to whether or not federal securities laws or Commission rules require filing or submission of information or a document with or to the Commission (or the incorporation of information or a document into a document filed with or submitted to the Commission);
- (5) investigating, at the issuer’s direction, a report of evidence of a material violation; or
- (6) supervisory and directing an attorney who is appearing and practicing before the Commission in the representation of an issuer.

***How broad is the concept of “transacting business” with the SEC?***

The Rules state that transacting business includes communications with the SEC “in any form.” This, of course, covers any filings made with the SEC electronically or otherwise in writing, including registration statements, periodic reports, proxy statements or other materials formally filed with the SEC, as well as “no-action” letter requests, informal filings submitted to the SEC staff, or any other written communications. It also includes any conversations or discussions with SEC staff members (including those in regional offices), such as in connection with SEC exams or investigations.

***Is an attorney who prepares or reviews a document which he or she knows will be filed with or submitted to the SEC -- for example as an exhibit to a registration statement or periodic report -- a covered attorney?***

Only if the attorney provides advice “in respect of” the U.S. securities laws or the SEC’s rules or regulations regarding such a document. This seems to encompass securities specialists in virtually all circumstances. Thus, the scope of federal securities law advice does not appear limited to disclosure issues or advice with respect to disclosure documents (*e.g.*, prospectuses or periodic reports), but also seems to include non-disclosure related securities advice relating to a document filed as an exhibit, such as advice regarding compliance with regulatory requirements imposed by the 1940 Act, the Securities Act of 1933 (the “1933 Act”) or the Securities Exchange Act of 1934 (the “1934 Act”) or rules there under, and, possibly, rules of the National Association of Securities Dealers, Inc. (the “NASD”).

It is less clear when an attorney who is not a securities law specialist would become a covered attorney. The particular facts and circumstances of a non-securities specialist’s involvement in preparing or reviewing a document filed with or submitted to the SEC would drive this determination. A non-securities specialist who prepares or reviews a discrete section of a disclosure document probably is “appearing and practicing before the Commission” on the theory that any disclosure advice is advice “in respect of” the securities laws. In contrast, a non-securities specialist should not be “appearing and practicing before the Commission” simply by virtue of providing non-securities advice related to preparation of an exhibit (*e.g.*, an agreement). (Commenters have asked that this interpretation be confirmed.)

*Example.* If a tax attorney prepares or reviews tax disclosure in a separate account or mutual fund prospectus, then he or she is very likely a covered attorney.

*Example.* If an attorney prepares or reviews a principal underwriting, selling or investment advisory agreement from the standpoint of compliance with any of the federal securities laws, and the attorney knows the agreement will be filed with the SEC, he or she is very likely a covered attorney.

*Example.* If an insurance attorney working for a life insurance company depositor of a separate account prepares, negotiates or provides advice to the insurer about a reinsurance treaty covering some risks under variable contracts issued through the separate account, but that advice relates only to general commercial or state insurance regulatory issues, then the attorney is likely not covered even though he or she knows the treaty is to be filed as an exhibit to an N-4 or N-6 registration statement.

*Example.* If an attorney drafts or comments upon a variable annuity policy form that is the subject of a Form N-4 registration statement, he or she may or may not be providing federal securities law advice. Given that many terms of such a policy relate to 1940 Act requirements, a close examination of the facts and circumstances, including the role of other attorneys involved in preparing the registration statement, would be necessary before concluding that the individual was not a covered attorney.

***Is investment company sales literature a document filed with or submitted to the Commission?***

Yes. Because Rule 24b-3 under the 1940 Act deems all investment company sales literature filed with the NASD to be filed with the Commission pursuant to Section 24(b) of the 1940 Act, it appears that documents filed with the SEC encompass such sales literature. Therefore, attorneys preparing or reviewing sales material, or involved with the NASD filing and approval process, likely are covered attorneys, although neither the Proposing nor Adopting Releases discuss whether or not the SEC intended the Rules generally to cover transacting business with the NASD.

***Outside the context of information or documents that may be filed with or submitted to the SEC, is an attorney who otherwise advises an issuer about securities law regulatory matters –such as 1940 Act regulatory or compliance advice -- a covered attorney?***

On their face, the Rules suggest not. In fact, the language of the Rules is somewhat ambiguous on this point, and the Proposing and Adopting Releases do not provide helpful guidance.

Conceivably, providing 1940 Act regulatory advice to mutual funds or separate accounts could be interpreted as “transacting business” with the SEC, but there is nothing in the public record confirming or even suggesting that this broad interpretation was intended. In many circumstances, however, regulatory advice sooner or later may relate to a document filed with or submitted to the SEC, or to some other communication with the SEC. For example, providing advice about a 1940 Act regulatory requirement that does not directly relate to any document (*e.g.*, a prospectus or registration statement exhibit) that may be filed with or submitted to the SEC technically may not bring an attorney under the Rules, but a material violation of such a requirement may trigger a disclosure obligation that does relate to such a document, or may be the subject of an

SEC examination. Therefore, advice by the attorney about the various consequences of the violation may relate to disclosure of the violation or disclosure of remedial action to correct the violation, which, in turn, would turn him or her into a covered attorney. Similarly, advice about the same regulatory requirement provided at a later time (either by that attorney or a different attorney) may occur in connection with a document that is (or could be) filed.

***If advising an issuer about whether information or a document must be filed or submitted to the SEC triggers the Rules, does an attorney become a covered attorney by providing advice about whether or not an instrument should be registered as a security?***

If the company receiving the advice already is an issuer, generally yes. If the company receiving the advice is not an issuer, arguably not.

The rules as proposed last year explicitly covered such advice. The proposed definition of “appearing and practicing before the Commission” included advising “any party” that “the party is not obligated to submit or file a registration statement, notification, application . . . with the Commission or its staff.” Rule 205.2(a) as finally adopted, however, deletes the reference to “any party” and now refers to advising “an issuer”, and also deletes the reference to a “registration statement” and now refers to whether “information or a statement, opinion, or other writing is required . . . to be filed with . . . the Commission.”

The Adopting Release does not clearly explain the extent to which the Commission intended to narrow the Rules’ scope in this context. If a “statement” or “writing” is interpreted to encompass a registration statement, then “appearing and practicing before the Commission” would include providing advice to *issuers* concerning whether an instrument should be registered as a security, but it literally would not appear to cover such advice to companies that are not issuers, unless such advice were deemed to be “transacting any business with the Commission.” This seems somewhat anomalous, but is important for both life insurance company and money management lawyers. The following situations are noteworthy:

- For life insurance company lawyers where the companies are not (or not yet) issuers, attorneys may provide advice concerning the securities status of certain fixed annuity and life insurance contracts (such as modified guaranteed annuity contracts) under Section 3(a)(8) of the 1933 Act
- Both money management and life company lawyers may provide advice concerning the registration status under both the 1933 and 1940 Acts of hedge funds or other private offerings

***Are supervisory attorneys always-covered attorneys?***

An attorney who actually directs or supervises the actions of a subordinate attorney who is a covered attorney is also a covered attorney, provided that the authority encompasses the subordinate's practice before the SEC. The intent of the Rules appears to be to cover supervisory attorneys even if they are not securities specialists.

***Does appearing and practicing before the Commission automatically subject an attorney to the Rules?***

No. The attorney must appear and practice before the Commission "in the representation of" an issuer. "In the representation of" means providing legal services as an attorney for an issuer, regardless of whether or not the attorney is employed or retained by the issuer. However, the Rules generally do not apply to an attorney for a third party who reviews part of an issuer's disclosure document or renders a legal opinion to an issuer who is not his or her client.

***Are employees of an insurance company depositor or an investment manager who are licensed attorneys but do not work in the law department or do not serve in a traditional attorney role covered attorneys?***

To be covered, attorneys must be providing legal services (*i.e.*, advice in the context of an attorney-client relationship). Therefore, attorneys outside a company's law department or in a law firm retained by the company may still be covered if their role is such that they have an attorney-client relationship with an issuer. According to the Adopting Release, the existence of such a relationship is a matter of federal law rather than state law and turns on the expectations of and understandings between the attorney and the issuer.

With regard to federal law, the Adopting Release indicates that whether or not the provision of legal services under particular circumstances establishes an attorney-client relationship under the laws or ethics codes of the state where an attorney practices or is admitted may be relevant to, but is not controlling on, under the Rules. Indeed, the Adopting Release also asserts that, in some cases, an attorney and an issuer may have an attorney-client relationship under the Rules even though state law does not establish an attorney-client privilege with respect to communications between the attorney and the issuer.

One positive aspect of the foregoing is that it is likely that many attorneys in business and compliance positions with insurance companies or investment managers may exclude themselves from coverage under the Rules by documenting an understanding between themselves and their employer to the effect that no attorney-client relationship exists between themselves and their employer or between themselves and an issuer (or potential issuer) affiliated with their employer. Of course, the ongoing behavior of such attorneys must be consistent with such a relationship (*e.g.*, such

attorneys should not indicate in any way that their written correspondence is “privileged”).

***What is the significance of the fact that an attorney may be “representing an issuer” “whether or not the attorney is employed or retained by the issuer”?***

It is significant because it is designed to encompass attorneys who indirectly provide legal services to issuers, such as attorneys who are employed or retained by a mutual fund’s investment manager or administrator or by a separate account’s depositor or affiliates of the depositor. Usually such services are provided pursuant to agreements between the issuer and a service provider who employs or retains the attorney.

Therefore, an attorney employed or retained by an insurance company (or parent of the insurance company) to provide legal services to the insurer’s separate account will usually be deemed to be appearing and practicing before the Commission on behalf of the separate account.

Similarly, an attorney employed or retained by an investment manager to provide legal services to a mutual fund managed by the manager will usually be deemed to be appearing and practicing before the Commission on behalf of the fund.

***Are an issuer’s officers, directors or employees ever a covered attorney’s client?***

No. Rule 205.3(a) states that an attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization, and that the issuer’s officers, directors and employees are not clients. Importantly, this Rule supercedes any conflicting applicable state bar rules.

## **THE BASIC REPORTING REQUIREMENT**

***What is the basic reporting obligation applicable to covered attorneys?***

An attorney appearing and practicing before the Commission in the representation of an issuer who becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer, must report such evidence to the issuer’s chief legal officer (or the equivalent thereof) (“CLO”) or to both the issuer’s chief legal officer and its chief executive officer (or the equivalent thereof) (“CEO”) forthwith.<sup>4</sup>

---

<sup>4</sup> The basic reporting requirements appear in subparagraphs (1), (2), (3), and (8) of Rule 205.3(b), the substance of which is recited in Appendix A.

### ***What is a “material violation”?***

“Material violation” is defined to encompass a material violation of an applicable federal or state securities law, a material breach of fiduciary duty arising under federal or state law, or a similar material violation of any federal or state law.

“Breach of fiduciary duty” means any breach of fiduciary or similar duty to the issuer recognized under applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse or trust, and approval of unlawful transactions. The “similar material violation” is not defined in the Rules nor is it explained or discussed in either the Proposing or Adopting Releases.

As proposed, the rules expressly defined “material” to mean “conduct or information about which a reasonable investor would want to be informed before making an investment decision.” The Adopting Release, however, states that the Rules as adopted do not define the term “material” because the definition is well-established under the federal securities laws and the SEC intends for that same meaning to apply in the Rules. The Adopting Release cites two Supreme Court opinions that address the meaning of “material” in the context of a material omission. The earlier of the opinions related to proxy statement disclosure where the court concluded that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote” and further stated that to be material, “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”<sup>5</sup> Likewise, the Proposing Release indicates that a material violation is one that a reasonable investor would want to know about.

The concept of materiality referred to in the Adopting Release may make sense in most contexts, particularly for issuers that are traditional 1934 Act reporting companies (typically operating companies), because the securities law requirements applicable to them relate almost entirely to disclosure. These disclosure requirements, in turn, relate primarily to information that would affect the price of such an issuer’s securities trading in the secondary market. For separate accounts and mutual funds, however, which are subject to additional substantive non-disclosure regulation under the 1940 Act, this concept of materiality leaves open the question whether significant regulatory or compliance violations themselves are always “material.” Such violations may be of keen interest or concern to the SEC and the issuer from an overall compliance or internal control perspective, but not all such violations may easily or readily translate into meaningful public disclosure (such as where investors do not suffer material financial harm). Some clarification of material violations in the context of registered investment companies would be very helpful.

---

<sup>5</sup> *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

***What does it mean to “become aware” of evidence of a material violation?***

The Commission has stated in connection with the adoption of Rule 10b-5 under the Securities Exchange Act of 1934, that the term “aware” commonly means having knowledge of something, being conscious of it, or being cognizant of it. This generally means that attorneys are not obligated to conduct an inquiry in order to make themselves aware of evidence of a violation. It is a standard relating to what an attorney knows about the evidence, not what he or she reasonably should know about it. Having said this, once a covered attorney knows about the evidence, he or she must report it even if they do not “know” whether a possible material violation suggested by the evidence actually occurred, is occurring or is about to occur. As the next question explains, the evidence must be reported if it is reasonably likely that it represents a material violation.

Although the Adopting Release does not discuss whether or not evidence of a material violation must relate to, or be obtained in connection with, the representation or advice being provided by the covered attorney, the use of the term “aware” suggest that there is no such limitation on the types of material violations that the attorney must report.

***What is “evidence” of a material violation?***

“Evidence” of a material violation means credible evidence, 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 occurring or is about to occur. Therefore, the attorney does not have to *know* that the evidence is evidence of an actual violation before it becomes reportable (*i.e.*, the attorney does not have to know that a violation actually occurred, is occurring or is about to occur) and is under no obligation to investigate evidence of a material violation to determine whether in fact there is a material violation.

The Adopting Release states that to be “reasonably likely” a material violation must be more than a mere possibility, but it need not be “more likely than not.” There appears to be an emerging consensus among practitioners that “reasonably likely” means a 30% to 40% chance of being the case. Again, however, commenters have urged the SEC to adopt a higher standard.

***Is the duty to report evidence of a material violation limited to matters related to the covered attorney’s representation of the issuer?***

Under the final Rules, there is no express language so limiting the reporting duty. The language of the final Rule (Rule 205.3(b)(1)) was changed from the proposed rule without explanation. The proposed rules would have limited the information triggering a duty to report to that information learned by the attorney “in connection with the representation.” As adopted, the Rules appear to require action based upon any information that may come to the attorney’s attention in a casual fashion outside a representation.

It has been suggested that the Rules should be clarified so that the only information that triggers a reporting duty is information relating to the representation. This would be a narrower class of information than the SEC originally proposed, but would logically limit the reporting obligation to those situations within the lawyer's expertise.

***To whom must the report be made?***

Initially, a covered attorney must report evidence of a material violation to the CLO, or to both the CLO and the CEO. However, if the covered attorney is under the actual supervision of another attorney (other than the CLO), the Rules seem to assume (or presume) that the reporting attorney should make the initial report to that supervisory attorney. (Nonetheless, as discussed below, the Rules seem to leave flexibility as to the reporting up process within the law department.) In the event that a covered attorney reasonably believes that the supervisory attorney has not followed-up on the report as required by the Rules (discussed below), he or she may, but is not required to, follow-up – that is, to report the evidence of a material violation directly to the CLO or the CLO and the CEO.

Commenters have noted that a non-securities specialist should be able to satisfy his or her obligation by reporting to a securities specialist, even though there technically may not be a senior-subordinate attorney relationship. More generally, it has been suggested that, in order to allow law departments flexibility in establishing internal compliance procedures, such as reporting to a compliance attorney or compliance committee, a supervisory attorney to whom a subordinate attorney should be able to report should be permitted to include anyone designated a supervisory attorney and accepting that responsibility even though that person does not customarily supervise the subordinate attorney with respect to the matter.

***Must a report of evidence of a material violation take any particular form?***

No. The Rules define “report” to mean “to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.” The Proposing Release explains that the SEC included the word “directly” because it considers it essential that any report be made directly rather than through a third party.

***How quickly must the attorney report the evidence of a violation?***

The Rules currently require the evidence to be reported “forthwith.” Commenters have expressed concern that “forthwith” suggests that attorneys may not have the flexibility to assess what preliminary steps might be taken in the best interests of the issuer before the reporting obligation is triggered, and have recommended either that “forthwith” be changed to “reasonably promptly” or that the SEC clarify that attorneys may take preliminary steps before the reporting obligation is triggered.

***What do the Rules require of a covered attorney after he or she has made an initial report of evidence of a material violation?***

If the covered attorney is under the actual supervision of another attorney (other than the CLO), then he or she has satisfied the reporting requirements of the Rules by making the initial report to his or her supervisory attorney. The Rules do not require such an attorney to take any further action. Nonetheless, if he or she reasonably believes that the supervisory attorney has not followed-up on the initial report as required by the Rules, he or she *may* make a second report of the evidence of a material violation to:

- The audit committee of the issuer’s board of directors;
- Another committee of the issuer’s board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a separate account or mutual fund, “interested persons” (as defined in Section 2(a)(19) of the 1940 Act) of the issuer (if the issuer’s board of directors has no audit committee); or
- The issuer’s board of directors (if the issuer has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a separate account or mutual fund, “interested persons”).

Likewise, if a covered attorney under the actual supervision of another attorney (other than the CLO) reasonably believes that the CLO or CEO has not provided an appropriate response to the report within a reasonable period of time, he or she *may* make the same type of second report.

A covered attorney under the direct supervision of the CLO or not supervised by another attorney must make an initial report to the CLO or the CLO and the CEO. If that attorney reasonably believes that the CLO or CEO has provided an appropriate response within a reasonable period of time, he or she has no further obligations under the Rules.

If, however, the attorney does not reasonably believe that an appropriate response has been forthcoming within a reasonable period of time, he or she must: (1) explain to the CLO and the CEO his or her reasons for that belief, and (2) make a second report the evidence of a material violation to:

- The audit committee of the issuer’s board of directors;
- Another committee of the issuer’s board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a separate account or mutual fund, “interested persons” (as defined in Section 2(a)(19) of the 1940 Act) of the issuer (if the issuer’s board of directors has no audit committee); or

- The issuer’s board of directors (if the issuer has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a separate account or mutual fund, “interested persons”).

***What do the Rules require of a covered attorney after he or she has made a second report of evidence of a material violation to the audit committee or another appropriate committee of the issuer’s board of directors, or to the board itself?***

If the covered attorney under the direct supervision of the CLO or not supervised by another attorney reasonably believes that the issuer has provided an appropriate response to the second report within a reasonable period of time, he or she has no further obligations under the Rules. If, however, the attorney does not reasonably believe that an appropriate response has been forthcoming within a reasonable period of time, he or she must explain to the CLO, the CEO, and to any directors to whom the report was made, why he or she believes that their response was deficient.

***With regard to a covered attorney’s report of evidence of a material violation, what is an “appropriate response”?***

An “appropriate response” to a covered attorney’s report of evidence of a material violation is one that causes the attorney to reasonably believe that:

- no material violation has occurred, is occurring or is about to occur;
- the issuer has adopted appropriate remedial measures, including appropriate steps or sanctions to stop any ongoing material violations, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any past material violation and to minimize the likelihood of its recurrence; or
- the issuer (with the consent of its board of directors), a committee of the issuer’s board of directors to whom a report could be made under Rule 205.3(b)(3), or a qualified legal compliance committee (“QLCC”), has retained or directed an attorney to review the reported evidence of a material violation and either (1) has, after a reasonable investigation and evaluation of the evidence, substantially implemented any remedial recommendations made by such attorney, or (2) has been advised that such attorney may, consistent with his or her professional obligations, assert 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 related to the reported evidence of a material violation.

***What does it mean to “reasonably believe” that an appropriate response has been provided?***

As just noted, the Rules generally require covered attorneys to reasonably believe either that no material violation exists or that an issuer has taken proper remedial steps. In these contexts, “reasonably believe” means that an attorney believes that matter in question and that the circumstances are such that the belief is not unreasonable. As to an attorney’s reasonable belief that an issuer has taken proper remedial steps, the Adopting Release explains that the attorney may take into account all attendant circumstances, including the amount and weight of the evidence of a material violation, the severity of the apparent material violation and the scope of the investigation into the report.

***What is the “noisy withdrawal” provision and what is its current status?***

Under the Rules as proposed by the SEC last November, the most controversial provision, the so-called “noisy withdrawal” provision, would have required a covered attorney whose issuer client did not adequately address the attorney’s report of evidence of a material violation to respond forcefully to the client. The exact type of required response would depend on the circumstances and would be different for attorneys retained by the issuer (*i.e.*, outside counsel) and attorneys employed by the issuer (or an affiliate of the issuer) (*i.e.*, in-house counsel).

By way of example, where a covered attorney does not receive an appropriate response or does not receive a response in a reasonable time *and* the attorney 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 investors, the “noisy withdrawal” provision would have required outside counsel to: (1) withdraw from representing the client, (2) notify the SEC within one day of the withdrawal, and (3) promptly disaffirm any misleading documents filed with the SEC that the attorney prepared or assisted in preparing. Similarly, in the same circumstances, the “noisy withdrawal” provision would have required an in-house attorney to: (1) notify the SEC within one day that he or she intends to disaffirm certain misleading documents filed with the SEC that the attorney prepared or assisted in preparing, and (2) promptly disaffirm the misleading documents to the SEC. In circumstances the same as the foregoing, except that the covered attorney did not believe that the material violation was ongoing, the “noisy withdrawal” provision would have permitted, but not required, the attorney to take the foregoing actions.

As adopted, the Rules do not include the “noisy withdrawal” provision. Instead, the SEC issued another release postponing the effectiveness of the provision and requesting further comment on the provision and on an alternative “less noisy” withdrawal provision. Under this alternative, a covered attorney retained by an issuer who does not receive an appropriate or timely response to reports and reasonably *concludes that there is substantial evidence of* a material violation that is ongoing or is about to occur and is likely to cause substantial injury to the financial interest or property of the issuer or investors, must withdraw from representing the issuer. Unlike the noisy withdrawal provision, however, the issuer rather than the attorney would have to notify the SEC.

## EXCEPTIONS TO THE BASIC REPORTING REQUIREMENT

*Are there situations when an attorney does not have to report evidence of a material violation?*

Yes. There are four sets of circumstances where an attorney is relieved of the obligation to report certain types of evidence of a material violation. These are:

- The attorney was retained or directed by the issuer's CLO to investigate evidence of a material violation. This exception is conditioned upon the attorney making periodic reports about the investigation to the CLO and (with certain exceptions) reports of the results of the investigation to the issuer's board of directors (or to a committee thereof as referenced in 205.3(b)(3) or to a QLCC).
- The attorney was retained or directed by the issuer's CLO to assert, consistent with his or her 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 evidence of a material violation. This exception is conditioned upon the CLO providing reasonable and timely reports on the progress and outcome of the proceeding to the issuer's board of directors (or to a committee thereof as referenced in 205.3(b)(3) or to a QLCC).
- The attorney was retained or directed by the issuer's QLCC to investigate evidence of a material violation.
- The attorney was retained or directed by the issuer's QLCC to assert, consistent with his or her 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 evidence of a material violation.

In each case, the attorney does not have to report evidence of material violations that he or she is investigating or litigating. The attorney does, however, have to report evidence of material violations of which he or she becomes aware that are not related to the investigation or litigation.

*Upon taking effect, do the Rules require attorneys to report past evidence of material violations or of evidence of past material violations?*

Neither the Rules nor the Proposing or Adopting Releases discuss this question, but the Rules certainly can be read to require that if a material violation has not been corrected at the time that the Rules take effect, then covered attorneys must report the

evidence of the violation. As discussed above, in general, a violation is material if it affects investors; therefore, it remains material if it still affects investors.

***May an attorney making an initial report of evidence of a material violation go around the CLO and/or CEO?***

Yes. If an attorney believes that it would be futile to report evidence of a material violation to the issuer's CLO and CEO, the attorney may report directly to the audit committee, another committee of the board of directors comprised solely of independent directors, or the board of directors itself (*i.e.*, proceed directly to make a "second" report).

Presumably reporting attorneys have the same flexibility to go around designated supervisory attorneys under similar circumstances, although this is not addressed in the Rules or the Releases.

***What rights and obligations does a covered attorney have in the event that he or she reasonably believes that his or her employment has been terminated as a result of reporting a material violation?***

An attorney formerly employed by or retained by an issuer who believes that he or she was discharged for having reported evidence of a material violation, may notify the issuer's board of directors, or any committee thereof, that he or she believes that he or she was discharged for making such a report.

## **RESPONSIBILITIES OF SUPERVISORY ATTORNEYS**

***Who is an issuer's chief legal officer?***

Neither the Rules nor the Adopting Release explain who the chief legal officer is or should be, other than to define it as "the issuer's chief legal officer (or the equivalent thereof)." The Proposing Release, however, does offer some functional insight. It indicates that the Rules do not impose a duty to investigate evidence of material violations on covered attorneys other than the CLO, because such subordinate attorneys are often not in a position, or may lack resources or experience, to pursue such an investigation. In contrast, the Rules place this responsibility squarely on the CLO who is deemed to be in a position to: (1) conduct an inquiry into the reported evidence, (2) determine whether or not a material violation has occurred, is occurring, or is about to occur, and (3) in the latter event, ensure that the issuer adopts appropriate remedial measures. Thus, under the Rules, a CLO must be someone who can fulfill these obligations. The Proposing Release also seems to recognize that the CLO does not have to be an attorney to perform the requirements of a CLO under the Rules, and in that vein explains that for an issuer that has no CLO or general counsel, the phrase "or equivalent thereof" means the CEO because he or she is in a position to fulfill these obligations.

Commenters have requested that the SEC add a definition of "chief legal officer" to the Rules before the effective date which would provide issuers (and by implication, their affiliates) with the flexibility to designate the person or persons who will serve in

that role. These commenters have noted that some organizations have several senior supervisory attorneys who each have responsibility for their organization's activities in connection with particular areas of law, and that the most senior attorney is not always in the best position to serve as CLO as contemplated by the Rules. Likewise, commenters also have pointed out that some organizations may have one or more compliance officers who might be in a better position to serve in this function than the organization's general counsel. Though commenters did not focus on this, a definition of who is a CLO would likely bring much needed clarity for organizations where there is (or potentially could be) more than one issuer or where, as is often the case for separate accounts and mutual funds, an issuer is a subsidiary of a non-issuer (or otherwise under the control of a non-issuer affiliate). Without referring specifically to the issue of the identity of the CLO, the Proposing Release helpfully did recognize that larger organizations with greater numbers of attorneys would have to create procedures designed to facilitate compliance with the Rules.

The CLO of a mutual fund complex is often fairly easy to identify. In many cases, it may be the general counsel of the fund's investment manager. If an investment manager has no general counsel or other obvious CLO, but is part of a larger organization that employs a general counsel and/or other attorneys, it may be more difficult to establish the identity of the appropriate CLO. Much the same is often the case in a large insurance organization where identifying the most appropriate senior attorney or other official to play the role of CLO for the organization's separate accounts may require some thoughtful consideration.

***What do the Rules require the CLO to do when he or she receives a report of evidence of a material violation?***

The CLO must initiate such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether or not the material violation described in the report has occurred, is occurring, or is about to occur. As an alternative to initiating an inquiry, the CLO may refer the report of evidence of a material violation to a qualified legal compliance committee.

***What must the CLO do if he or she finds that there was or is no material violation?***

If the CLO determines that no material violation has occurred, is occurring, or is about to occur, then he or she must notify the reporting attorney and advise that attorney of the basis for the determination.

***What must the CLO do if he or she finds that there was or is a material violation?***

Unless the CLO reasonably believes that no material violation has occurred, is occurring, or is about to occur, then he or she must take reasonable steps to cause the issuer to adopt an appropriate response and advise the reporting attorney accordingly.

***Who is a supervisory attorney?***

A supervisory attorney is any attorney who supervises or directs another attorney who is appearing and practicing before the Commission. The Rules do not limit supervisory attorneys to securities specialists. A CLO is always a supervisory attorney. However, except for a CLO, only a senior attorney who actually directs or supervises another attorney in the performance of duties that cause the other attorney to be practicing and appearing before the Commission is a supervisory attorney. Thus, a senior attorney who supervises or directs a subordinate attorney on matters unrelated to the subordinate's appearance and practice before the Commission is not a supervisory attorney under the Rules. Conversely, an attorney who does not usually exercise authority over another attorney but does direct the other attorney in the specific matter involving the other attorney's appearance and practice before the Commission is a supervisory attorney under the Rules.

***What must supervisory attorneys other than the CLO generally do under the Rules?***

First, supervisory attorneys must make reasonable efforts to ensure that their subordinate attorneys follow the Rules.

Second, when such a supervisory attorney receives a report of evidence of a material violation from a subordinate attorney, he or she becomes responsible for compliance with all of the reporting requirements in the Rules. For a supervisory attorney who reports to the CLO, this means that he or she must pass on the initial report of evidence of a material violation from the subordinate attorney to the CLO, or the CLO and the CEO. For a supervisory attorney who reports to another supervisory attorney, this means that he or she should pass on the report to next level of supervisory attorney.

For supervisory attorneys who report to another supervisory attorney, there is no third step. Their responsibilities under the Rules end once they pass their subordinate's report to their own supervisory attorney; they do not have to evaluate the appropriateness or timeliness of the response to the report or otherwise follow-up on the report. Supervisory attorneys who report to the CLO, however, have a third obligation. They must consider the appropriateness and timeliness of the response to any reports that they have made or passed on to the CLO.

If a supervisory attorney who reports to the CLO reasonably believes that the CLO or CEO has provided an appropriate response within a reasonable period of time, he or she has no further obligations under the Rules. If, however, the supervisory attorney does not reasonably believe that an appropriate response has been forthcoming within a reasonable period of time, he or she must: (1) explain to the CLO and the CEO, his or her reasons for that belief, and (2) make a second report of the evidence of a material violation to:

- The audit committee of the issuer’s board of directors;
- Another committee of the issuer’s board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a separate account or mutual fund, “interested persons” (as defined in Section 2(a)(19) of the 1940 Act) of the issuer (if the issuer’s board of directors has no audit committee); or
- The issuer’s board of directors (if the issuer has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a separate account or mutual fund, “interested persons”).

As with any covered attorney, a supervisory attorney may: (1) skip the initial report and make a “second” report to the appropriate board committee, or the full board (as appropriate) if he or she reasonably believes that an initial report to the CLO, or the CLO and the CEO, would be futile, and (2) alternatively report the evidence of a material violation to a QLCC if the issuer has previously established a QLCC.

## **RESPONSIBILITIES OF THE CHIEF EXECUTIVE OFFICER, THE DENOTED COMMITTEES, AND THE BOARD OF DIRECTORS**

### ***Who is an issuer’s chief executive officer?***

For a mutual fund, it usually is the person signing the fund’s Form N-CSR certification as principal executive officer. For a separate account the answer is less clear. Although it often would be the chief executive officer of the depositor, in many large organizations it might be an officer who is responsible for variable product operations and reports to the depositor’s chief executive officer. In other organizations it may be someone to whom the depositor’s chief executive officer reports and who is responsible for variable product operations across a number of insurance company subsidiaries. The Rules do not appear to contemplate a situation where the responsible senior officer is not the CEO of the issuer.

### ***Is the CEO subject to the Rules, and if so what responsibilities does the CEO have?***

The Rules and available sanctions for violations (discussed below) clearly are intended to apply only to covered attorneys. Unless the CEO is deemed to be the CLO, the Rules do not directly apply to the CEO. As to this last point, the Adopting Release indicates that for an issuer that has no general counsel, the reference to “the equivalent” in the phrase “chief legal officer (or the equivalent)” means the CEO. (Whether the SEC will continue to interpret this reference in this manner is not clear.) Similarly, though only covered attorneys are subject to sanctions under the Rules, the Rules force such attorneys to demand appropriate responses (to reports of evidence of material violations)

from CEOs -- thereby indirectly subjecting them to the Rules' required procedures. Likewise, the Rules may have the effect of prompting a committee of the issuer's board of directors, or the board itself, to demand remedial actions from a CEO on behalf of the issuer.

***Must an officer or director of an issuer always respond to an attorney who reports evidence of material violations to them?***

Yes. Even if the officer or director (or another person) directs or retains another attorney to investigate reported evidence of a material violation, they should also respond back to the reporting attorney so that the reporting attorney can judge the appropriateness of the response.

***Who is an issuer's board of directors?***

The answer is obvious in the context of an issuer that is an operating company or a mutual fund. The answer is not as obvious in the context of a UIT separate account. Neither the Rules nor the Adopting Release or Proposing Release discuss this issue. A reasonable interpretation of the Rules in this context is that the board of directors of an insurance company depositor is supposed to serve the function of the board of the separate account issuer in this context. The fact that, as the depositor, the insurance company's directors have 1933 Act liability for the information in Form N-4 and N-6 registration statements filed under that Act, supports this conclusion. Nonetheless, for other purposes and as to other requirements under the Act, a separate account, and not its insurance company depositor, is considered the issuer.

***What is a "qualified legal compliance committee"?***

A qualified legal compliance committee is a committee established by an issuer pursuant to paragraph (c) of Rule 205.3 to which reports of evidence of material violations is made in lieu of reporting "up-the-line" as outlined in paragraph (b). Rule 205.2 provides a detailed definition of a QLCC, including a number of specific requirements necessary in order to "qualify" as QLCC. The definition of a QLCC is found in Appendix B.

If established before the receipt of a report of evidence of a material violation, a properly constituted QLCC becomes an alternative party to whom such reports may be made by any covered attorney (including the CLO). Commenters have urged the Commission to recognize the appropriateness of special committees and to permit a QLCC to be formed at any time, rather than requiring that it be previously formed.

***What are the responsibilities of a QLCC?***

The principal responsibilities are of a QLCC are:

- Informing an issuer's CLO and CEO of reports of material violations;

- Determining whether or not an investigation of a report is necessary or appropriate;
- If found to be necessary or appropriate, notifying the audit committee of the board of directors or the full board of this determination;
- If found to be necessary or appropriate, initiating such an investigation;
- If found to be necessary or appropriate, retaining assistance from experts in conducting an investigation;
- At the conclusion of an investigation, recommending the implementation of an appropriate response to the evidence of a material violation;
- At the conclusion of an investigation, informing the CLO, CEO and the issuer's board of directors of the results of the investigation and any appropriate remedial measures to be adopted;
- To take all other appropriate action, including, in the event that an issuer fails to implement an appropriate response recommended by the QLCC, to use its discretion in notifying the SEC.

## **RECORDKEEPING AND COMPLIANCE PROCEDURES**

### ***Do the Rules require attorneys to maintain any records in connection with their reports of evidence of material violations?***

No. Although as originally proposed, the Rules included a requirement that a covered attorney and a CLO take reasonable steps to document his or her reports of evidence of a material violation and the issuer's responses thereto, this requirement was left out of the Rules as adopted. Likewise, as originally proposed, the Rules required supervisory attorneys to document any determination that they made that evidence of a material violation presented by a subordinate attorney need not be reported. This requirement also was left out of the Rules as adopted. It is significant that the requirement that covered attorneys report evidence of material violations may be fulfilled by verbal reports in person or over the telephone.

Although the Rules do not require the maintenance of any specific records, in-house attorneys may find it difficult to demonstrate compliance with the Rules in the absence of written documentation of the actions they have taken under the Rules. Therefore, CLOs, and even issuers (or appropriate affiliates of issuers) should consider whether they should develop written compliance procedures that permit or require such records, and, in this connection, consider whether to prescribe the form such records should take, the level of detail such records should encompass, and any requirements or guidelines for the maintenance and retention of such records.

***Do issuers need to have written procedures designed to ensure compliance with the Rules?***

The Rules themselves do not require written compliance procedures. This is probably a result of the fact that they are directed at attorneys as individuals rather than issuers. It is not entirely clear at this time to what degree the SEC will infer from the Rule requirements that issuers have obligations either to facilitate or ensure that compliance with the Rules by their attorneys. However, we know from the Proposing Release that the SEC expects supervisory attorneys in larger organizations, in response to their obligation to take affirmative steps to ensure that subordinates comply with the Rules, to create procedures both to facilitate reporting evidence of material violations and to increase awareness of such evidence among subordinates.

Although there are considerations that could mitigate against the development of written compliance procedures, it seems highly likely that most issuers and law firms will prepare and maintain written compliance procedures that at the very least clearly delineate the reporting chain and process. This would seem to be particularly important for large law departments with several levels of supervisory attorneys with both direct and “dotted line” reporting obligations. It would also be important where the senior attorney in a business unit or division reports to the principal executive officer in that division and has only a dotted line relationship with the issuer’s general counsel.

***What should any compliance procedures cover?***

Organizations should carefully consider what their written compliance procedures should cover with regard to the Rules. Any procedures should reflect the structure of the organization, particularly its law and compliance departments, as well as the role and relationship with outside counsel. Among other things, any written compliance procedures could:

- set forth criteria for establishing when attorneys outside the law department(s) do or do not have an attorney-client relationship with the issuer or include lists of such persons
- set forth criteria for determining who is a supervisory attorney and the covered attorneys that each supervises or include lists of such persons
- identify the CLO and CEO of each issuer in the organization for purposes of the Rules
- specify procedures for covered attorneys (including outside counsel) to make reports required by the Rules and evaluating responses to such reports, including the persons that each covered attorney must report or respond to
- set forth any record keeping requirements

- identify the members of any committee of the issuer's board of directors (such as a QLCC) that could receive reports of evidence of material violations

## **SANCTIONS, DISCIPLINE AND REMEDIES**

***What penalties and remedies are covered attorneys subject to for failure to comply with the Rules?***

All civil penalties and remedies available to the SEC for a violation of the federal securities laws when it brings an action under those laws. These include civil injunctions, money penalties, and cease and desist orders. An attorney also is subject to discipline and potential suspension under the SEC's rules of practice based on prevailing standards for disciplining attorneys. For example, an administrative disciplinary proceeding initiated by the SEC for violation of the Rules may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the SEC. Attorneys who violate the Rules are not subject to criminal liability for that violation.

***Is the SEC's ability to discipline a covered attorney constrained by the fact that the attorney's conduct is not subject to discipline by the jurisdiction in which he or she is admitted to practice law?***

No. If an attorney appearing and practicing before the SEC violates any provision of the Rules, he or she is subject to the disciplinary authority of the SEC regardless of whether or not he or she is subject to discipline for the same conduct in a jurisdiction where he or she is admitted or practices.

***Does good faith compliance with the Rules by an attorney practicing and appearing before the Commission limit or eliminate liability arising under inconsistent standards imposed by a jurisdiction in which the attorney is admitted to practice law?***

Yes. Rule 205.6(c) provides that an attorney is not subject to discipline or otherwise liable under inconsistent standards imposed by a state or other U.S. jurisdiction where the attorney is admitted or practices if the attorney complies in good faith with the Rules.

***May an attorney use his or her reports of material violations as a defense in a proceeding where their compliance with the Rules is at issue?***

Yes. Rule 205.3(d) expressly permits a reporting attorney to use any report they make under the rules (or contemporaneous record thereof) or any response to a report (or contemporaneous record thereof) in connection with any investigation, proceeding, or litigation in which the attorney's compliance with the Rules is at issue.

***Do the Rules provide an issuer or holders of an issuer's securities with a private right of action against covered attorneys?***

No. Rule 205.7 states that the Rules are not intended to, and do not, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with their provisions and that only the SEC may enforce the Rules. However, commenters have suggested that the language of the safe harbor does not go far enough to encompass the concept that a violation of the Rules cannot form the basis for a breach of a duty to a client.

***Are the CEO, the board of directors, the QLCC or the issuer itself subject to sanctions for violations of the Rules?***

No. The Rules apply to individual attorneys. Violations by those individuals should not result in a violation by the issuer, or by individuals up the ladder who are not themselves covered attorneys. However, the SEC could attempt to use evidence of material violations to sanction issuers or others under other theories of liability.

## **ATTORNEY-CLIENT ETHICS ISSUES**

***How do the Rules' reporting requirements relate to state bar ethics rules?***

Except where state bar ethics rules conflict with the Rules, the SEC intends the Rules to supplement rather than supplant state bar ethics rules. Thus, covered attorneys always must comply with the Rules as well as with state bar ethics rules that impose requirements in addition to those found in the Rules. Where state bar ethics rules does conflict with the Rules, the SEC intends that the Rules supercede state rules.

***How do the Rules' reporting requirements compare with those of state bar ethics rules?***

Though compatible with certain emerging trends in state bar ethical requirements, the reporting requirements of the Rules are more specific, leave less discretion to a subject attorney and require action from an attorney in a greater number of circumstances than do the ethics requirements of most states. This topic is discussed in more detail in Appendix C.

***Where an attorney is employed or retained by an investment manager does appearing and practicing before the Commission on behalf of the manager's mutual funds has the potential to compromise the attorney's representation of the manager?***

The mutual fund industry believes so. However, the Adopting Release indicates that the SEC does not agree. In comments on the proposed version of the Rules, the Investment Company Institute asserted that if attorneys employed or retained by the investment manager are deemed to be appearing and practicing before the Commission on behalf of mutual funds managed by the manager when such attorneys work on, or

provide advice about, the funds' registration statements, the Rules' reporting requirements may undermine the attorney-client privilege between the manager and the attorney, and damage the ability of such attorneys to conduct internal investigations or other internal compliance inquiries. In the Adopting Release, the SEC brushed off this criticism saying that the commenter did not contest either the fact that such an attorney is providing legal services to the mutual funds, or the logical implication of that fact, which is that the attorney is thereby representing the funds before the SEC.

***May a covered attorney reveal to the SEC confidential information related to his or her representation of an issuer without the issuer's consent?***

In limited circumstances, yes. Under the Rules, an attorney appearing and practicing before the SEC in the representation of an issuer may reveal confidential information related to the representation to the SEC without the issuer's consent, to the extent that he or she reasonably believes necessary to:

- Prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
- Prevent the issuer, in a SEC investigation or administrative proceeding, from committing perjury, suborning perjury or committing any act proscribed by 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the SEC; or
- Rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

However, it is important to note that because this Rule is permissive, it should not supercede a state bar ethics rule that would prohibit such disclosure under such circumstances.

\* \* \*

*This paper has been prepared solely for informational purposes and is not intended as legal advice as to any particular set of facts.*

May 12, 2003

**Sutherland's Financial Services Team**

*Stephen Roth \* James Heffernan \* George Bostick \* Peter Anderson \* Neil Lang \* Frederick Bellamy \* Jack Blaine \* Michael Miles \* W. Mark Smith \* Steven Boehm \* Thomas Gick \* James Cain \* Susan Krawczyk \* Tom Conner \* Terry Weiss \* Carol Weiser \* David Goldstein \* William Walderman \* Eric Arnold \* Holly Smith \* David Massey \* Mary Jane Wilson-Bilik \* Mary Thornton \* Stephen Herbert \* Charles Locke \* Ian Herbert \* Catherine Woledge \* Thomas Bisset \* Pamela Ellis \* Carol McClarnon \* Rebecca Burnaugh \* David Kritz \* Adam Cohen \* Michael Koffler \* Beth Knickerbocker \* Patrice Pitts \* Elisabeth Grano \* John Fahey \* Katherine Milin \* Ronessa Butler \* Thomas Reyes \* Heather Parr \* Kali Banks \* Michael Ponder \* Owen Donley \* Maggie Harris \* Jelani Roper \* Timothy White \* David Yang \* Kevin Palmer*

## Appendix A

### **The Basic Reporting Requirement; Paragraphs (1), (2), (3), and (8) of Rule 205.3(b)**

The heart of the Rules are the basic reporting requirements which appear in subparagraphs (1), (2), (3), and (8) of Rule 205.3(b). These subparagraphs state, in relevant part:

*(b) Duty to report evidence of a material violation. (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalent thereof) forthwith. . .*

*(2) The chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation 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 chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer (or the equivalent thereof) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof. In lieu of causing an inquiry under this paragraph (b) a chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a qualified legal compliance committee prior to the report of evidence of a material violation.*

*(3) Unless an attorney who has made a report under paragraph (b)(1) of this section reasonably believes that the chief legal officer or chief executive officer of the issuer (or the equivalent thereof) has provided an appropriate response within a reasonable period of time, the attorney shall report the evidence of a material violation to:*

*(i) The audit committee of the issuer's board of directors;*

*(ii) Another committee of the issuer's board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" (as defined in Section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19))(if the issuer's board of directors has no audit committee); or*

*(iii) The issuer's board of directors (if the issuer has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in Section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19))).*

*(8) An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made pursuant to paragraph (b)(1), (b)(3), or (b)(4) or this section need do nothing more under this section with respect to his or her report.*

## Appendix B

### Definition of a Qualified Legal Compliance Committee (Rule 205.2(k))

(k) Qualified Legal Compliance Committee means a committee of an issuer (which also may be an audit or other committee of the issuer) that:

(1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));

(2) Has adopted written procedures for the confidential receipt, retention, and consideration or any report of evidence of a material violation under §205.3;

(3) Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in circumstances described in §205.3(b)(4));

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines that an investigation is necessary or appropriate, to: (A) notify the audit committee of the full board of directors; (B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and (C) Retain such additional expert personnel as the committee deems necessary; and

(iii) At the conclusion of any such investigation, to: (A) recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and (B) Inform the chief legal officer and chief executive officer (or equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

## Appendix C

### The Relationship of the Rules to State Bar Ethics Rules

It is difficult to generalize about state bar ethics requirements, but some general sense of state requirements may be gleaned from the ABA Model Rules of Professional Conduct (the “Model Rules”). The Model Rules address what an attorney must do if he or she discovers misconduct on the part of a corporate client. Model Rule 1.13(b) (which has been adopted in various forms by 45 states) provides that an attorney *shall* proceed “as is reasonably necessary in the best interests of the organization” if the attorney knows (*i.e.*, has actual knowledge) that:

an officer, employee, or other person associated with the organization is engaged in action, intends to act or refuses to act in a manner related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization.

Therefore, as with the Rules, Model Rule 1.13(b) embodies the principle that the corporation is the attorney’s client. In other respects, however, the Model Rule is less specific. Most significantly, it authorizes action by the attorney if the client violates a “legal obligation.” Such a violation probably encompasses the same as a material violation of federal or state law or a material breach of fiduciary duty, but having actual knowledge of the violation is a much higher standard than having credible evidence of a violation. Similarly, Model Rule 1.13(b) and related commentary describe a range of actions available to an attorney in responding to knowledge of client misconduct, but these actions must “be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside of the organization.”

Under Model Rule 1.13(b), if, despite an attorney’s efforts, the highest authority in the organization *insists upon* action (or inaction) that *clearly violates* the law and is “likely to result in substantial injury to the organization” the attorney *may* withdraw from the representation in accordance with Model Rule 1.16. The withdrawing attorney, must, however, take steps to protect the client’s interests, such as giving reasonable notice where practicable.

A number of distinctions may be drawn between these Model Rules and the Rules. First, whereas the Rules require an attorney to act upon “credible evidence of a violation,” the Model Rules merely permit an attorney to act in the face of an actual violation of a “legal obligation.” Likewise, under the Model Rules, an attorney may (but is not required to) withdraw from the representation only upon a “clear violation” of the law that is likely to result in substantial injury to the organization, and then, only when a person of authority in the organization specifically insists upon an action or inaction that causes the violation. Second, whereas the Rules require attorneys to act in the absence of an appropriate

response within a reasonable period of time, the Model Rules merely permit such action by an attorney.

Under the current Model Rules, there is little that an attorney may do to prevent misconduct by a corporate client once internal appeals to persons in authority have failed. Model Rule 1.6 prohibits an attorney from revealing confidential client information relating to a representation of the client without the client's consent. This contrasts sharply with the Rules which permit an attorney to reveal credible evidence of a violation to the Commission in certain circumstances (and may even require such disclosure in certain circumstances). Though Model Rule 1.6 contains an exception to permit disclosure to third parties when necessary "to prevent certain death or substantial bodily harm," it does not, in contrast to the Rules, permit third party disclosure to prevent injury or financial harm to the client or its shareholders or to prevent perjury or fraud.

Model Rule 1.6, however, is losing ground to reform efforts and no longer reflects the rules in a majority of the states. By the end of 2000, 37 states permitted disclosure of confidential client information to third parties to prevent financial harm to such parties, provided that the harm arises in connection with criminal conduct by the client. Likewise, an additional 4 states require such disclosure. Still, most states do not permit, much less require, such disclosure in the absence of criminal conduct nor do they permit or require disclosure to the Commission or any other regulatory authority. Therefore, taken together, Model Rules 1.13(b) and 1.6 limit an attorney's ability to take remedial action in connection with a wayward corporate client and may even limit his or her leverage when advocating such action within the organization.