December 18, 2002

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Rule on Implementation of Standards of Professional Conduct for Attorneys (Release Nos. 33-8150; 34-46868; IC 25829; File No. S7-45-02)

Dear Mr. Katz:

The Securities Industry Association ("SIA")[1/] and the Bond Market Association ("TBMA")[2/] (collectively, the "Associations") welcome the opportunity to comment on the Securities and Exchange Commission's Proposed Rule Implementing Standards of Professional Conduct for Attorneys ("Proposed Rule"), referenced above.

The Associations' members strongly support the SEC's efforts to improve corporate reporting, in order to address the accounting and financial disclosure scandals that, unfortunately, have overtaken several well-known public companies. Our members also understand the Commission's concern that some individuals who advised and counseled these companies may have failed to fulfill their professional responsibilities. We recognize that the Commission is determined to address this issue on its own accord and is required to do so in short order by Section 307 of the Sarbanes-Oxley Act of 2002

1/ SIA brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. More information about SIA is available on its website: www.sia.com.

2/ TBMA represents securities firms and banks that underwrite, distribute, and trade in fixed-income securities, both domestically and internationally. More information about TBMA is available on its website: www.bondmarkets.com.

(the "Act") (15 U.S.C. § 7201 *et. seq.*).[3/]

Historically, the Associations have worked cooperatively with the SEC to ensure effective regulation. We believe that appropriate, carefully considered regulation serves the interests of investors, issuers and the financial services industry itself, and we support regulations that improve the dissemination of material information to investors in public companies. We also fully agree with Congress' policy decision that issuers' attorneys should not use their legal skills to facilitate wrongdoing. We believe, however, that the Commission should reconsider aspects of the Proposed Rule. In particular, we urge the Commission to decide—and to state clearly—that the Rule applies to regulated entities only to the extent that they are public *issuers*. Broker-dealers, which already are among the most heavily-regulated of businesses, should be subject to regulations designed to enhance disclosure by public companies only to the extent that they themselves are (or are subsidiaries of) public companies.

The Commission also must balance carefully its desire to enhance the reporting obligations of attorneys who work for public companies with the equally laudable goal of encouraging a cooperative relationship and the free flow of information between business people and attorneys who work for securities firms. The Proposed Rule, because it does not strike the proper balance, would inhibit the flow of information within firms and between firms and their outside counsel, with the counterproductive effect of diminished regulatory compliance and public reporting. Non-attorney employees might not share with attorneys information that could conceivably lead to a reporting obligation, and in-house legal staff could become less integrated into business functions within securities firms. (The integration of attorneys into the consultation and approval process for business issues has been a salient trend in the securities industry.)

Alternatively, under these broadly drawn rules, unless the absence of a reporting obligation were crystal clear, attorneys would tend to report otherwise unremarkable events in order to shield themselves from potential liability. This could lead to more-senior attorneys being inundated with speculative allegations. They would have a diminished ability to address those issues that were truly significant and to attend to their other duties.

Because of the complexity of these and other issues (notably, the "reporting out" provision and the application of the Proposed Rule to foreign attorneys), we urge the Commission, at this juncture, to adopt only such rules as the Act specifically requires.

3/ The Act requires the Commission to adopt the rules required by Section 307 by January 26, 2003. The Commission has recognized that this is a short time frame in which to address comprehensively the complex issues that are the subject of the Proposed Rule, and has indicated that it may engage in supplemental rulemaking after adopting the rules that the Act strictly requires (*see* Proposing Release, n.4).

Affected parties, and the Commission and its staff, cannot fully consider the impact that the Proposed Rule will have on the marketplace during the abbreviated notice and comment period. The Commission should defer consideration of those aspects of the Proposed Rule that go beyond the statutory mandate until they can be afforded more thorough review. In addition, we suggest that the Commission phase-in whatever rules it adopts in accordance with the statutory mandate, so that companies and others affected would have an opportunity to educate their officers, directors and employees and to develop appropriate compliance procedures.

The Associations, because of the limited time available for comment, focus in this submission on those aspects of the Proposed Rule that are of greatest concern to our members. We emphasize the following, each of which is discussed in more detail below:

- The Associations' members believe that the Rule should not apply to broker-dealers *as broker-dealers*, but only to broker dealers *as issuers*.

- Securities firms, because they are subject to comprehensive regulation, tend to have extensive, active legal departments and to consult frequently with outside counsel. The Associations' members are concerned that the Proposed Rule, as a practical matter, will negatively affect this day-to-day activity.

- In particular, because the securities business is complex, securities firms encourage their employees to consult with attorneys frequently, and those employees tend to do so. The Associations' members are concerned that the Proposed Rule may affect the willingness of individual business people to consult with attorneys, particularly because of the "reporting out" provisions of the Rule as formulated.

- The securities industry employs in purely business capacities many people who happen to have attended law school and be members of a Bar. The Associations' members are concerned that lack of clarity in certain of the definitional sections of the Proposed Rule may cause confusion as to the obligations of these various individuals.

- The obligation of non-securities lawyers is another issue as to which the Proposed Rule's lack of clarity may cause confusion. Publicly-held securities firms (or their publicly-held parents) employ many lawyers who interact with the Commission but who perform no functions that relate to the firms or their parents as public entities. It is not clear how, if at all, the Proposed Rule would apply to such lawyers.

- An example of the definitional problems discussed in the two previous bullet-points is the potential application of the Rule to attorneys employed by a broker-dealer that is serving as an underwriter on behalf of an issuer. The Associations' members feel strongly that the responsibilities of attorneys under the Rule should be limited to their role as attorneys for the underwriter, and they should not be deemed to be attorneys for the issuer that the underwriter serves.

- Many of the Associations' members have overseas operations that lead them to employ persons who are licensed to practice law in foreign jurisdictions. We understand that those attorneys are subject to disciplinary rules that may simply prohibit their compliance with the Proposed Rule, an issue that the Commission has not addressed.

- Lawyers (both outside and in-house) who represent securities firms that find themselves subject to Commission investigations or enforcement actions must represent their clients zealously, not only because their professional obligations demand it, but because the Commission's processes work best when contrary views are presented in an articulate and informed manner. The Associations' members are concerned that the Commission's Proposed Rule (including, but not limited to, the "reporting out" provision) may chill counsel's ability to engage in such zealous advocacy.

If applied in the broker-dealer environment, the Proposed Rule would have damaging practical consequences. For example, subjecting compliance professionals to the Proposed Rule as well as to existing broker-dealer reporting and disclosure obligations would create substantial additional challenges for such persons as they go about their tasks. The practical problems created by the Rule would hamper these professionals' ability to perform the salutary self-policing or self-evaluative functions that have well served the securities industry and public investors. This letter highlights practical consequences for the financial services industry and suggests improvements to the Proposed Rule.

We also note our concern with the so-called "reporting out" provision, which would place attorneys subject to the different standards of different jurisdictions in untenable positions, and which would impinge on the attorney-client relationship in ways that could be detrimental to the Commission's processes and to the disclosures afforded investors. Because we believe that other commentors will address this provision in detail, we discuss it only in passing. Nevertheless, the Commission should not interpret

our decision to focus our comments elsewhere as acceptance of the wisdom of adopting such a provision.

Our primary recommendations[4/] are as follows:

- The Rule should apply only to attorneys acting in the context of an attorney-client relationship or the provision of legal services;
- The Rule should not apply to broker-dealers as *broker-dealers* but only as *issuers*;
- Attorneys representing issuers in investigations or litigation, or those who are conducting internal investigations, should be exempt from the Rule;
- The Commission should clarify that the concept of materiality incorporated into the Rule is to be interpreted in the context of the disclosure documents that a public company files with the Commission;
- The reporting obligation should be triggered upon "significant," "substantial" or "clear and convincing" evidence, or a similar heightened standard;
- The standard for the timing of required reporting should be "reasonable under the circumstances," rather than "forthwith" as stated in Proposed Rule § 205.3(b)(1);
- The Commission should eliminate or defer consideration of the "reporting out" provision;
- The Commission should exempt foreign attorneys from the Rule or defer consideration of the application of the Rule to such attorneys;
- The Rule should be subject to a phase-in period to allow time to train personnel and to develop appropriate procedures.

4/ The attached Appendix summarizes some of our more prominent suggestions for amending the language in specified sections of the Final Rule. The Appendix is not intended to be all-inclusive but rather highlights those sections for which we propose specific alternative terminology. The Appendix also identifies provisions in the Rule that we believe require clarification through either elaboration in the Adopting Release or further development of the text of the particular provision.

We discuss these and other specific issues below.

1. Definitional Issues

a. Who is an "Attorney?"

The Commission has proposed a status-based, rather than a functional, definition of "attorney." Because of the confusion that is likely to flow from the SEC's approach, the Commission should clarify that the Rule applies only to persons acting in their capacities as attorneys, and not to employees who happen to be licensed as attorneys. The brokerage industry frequently employs attorneys in non-legal positions, including compliance professionals, investment bankers, human resource specialists, and internal auditors. There is no reason to treat such business people differently from their similarly-situated non-lawyer colleagues.[5/] Further, Congress must have intended to regulate only those attorneys who actually are providing legal services. Section 307 is directed at attorneys who are "appearing *and practicing* before the Commission in any way in the *representation* of an issuer" (emphasis added). A licensed attorney who is working in a non-legal capacity is neither "appearing" nor "practicing" as an attorney and also is not "representing" anyone.

In addition to these problems, which relate to all employees who happen to be lawyers, a broad definition of "attorney" would prove particularly problematic for certain persons who are lawyers and who perform tasks that resemble legal functions but who do not provide legal advice to a client. For example, securities firms frequently employ compliance professionals who happen to be lawyers. There is no real need to extend the definition to cover such persons. Compliance professionals already are subject to a strict and detailed regulatory framework, including existing internal reporting obligations under securities firms' compliance procedures and reporting obligations under SEC, NASD and NYSE rules.

Thus, we recommend that the Commission define "attorney" as "a person who is in an attorney-client relationship with an issuer or a subsidiary of an issuer," which concept is well-understood in practice.

5/ The potential application of the Proposed Rule to persons who fill these positions would have significant implications for securities firms' recruiting and hiring practices, and would discourage firms from hiring lawyers to perform these non-legal functions.

However, if the Commission believes that our proposed definition is too restrictive,[6/] we suggest an alternative definition based on the concept of "providing legal services" or "acting in a legal capacity." Under this proposal, "attorney" would mean:

> Any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction and who, in the circumstances, is providing legal advice to an issuer.

b. What is "Appearing and Practicing . . . in the Representation of an Issuer?"

***(i)* The Proposed Rule Should Not Apply to Broker-Dealers as Regulated Entities but only as Issuers**

The Commission solicited comment on whether the Rule should apply to regulated entities that are not issuers. *See* Proposing Release, p. 37.[7/] Our answer to that question is "no." As explained below, we believe that the Rule should apply to regulated entities that are public companies or that are subsidiaries of public companies, only in their capacities as entities that have public investors.

To accomplish this clarification, the Commission should relate the definition of "appearing and practicing…in the representation of an issuer" to disclosure documents that issuers file with the Commission as issuers*. In particular, the Commission should clarify that the definition of "representation of an issuer" is not implicated by the preparation of filings that a broker-dealer is required to make* as a broker-dealer, *even if that broker-dealer happens to be a public company or a subsidiary of a public company.*

Further, the Commission should limit the Rule's application to attorneys who have direct contact with the Commission or its staff, or who have a reason to believe that their work will be incorporated into a public company disclosure document to be filed with the Commission. The Rule should be applied only where there is some logical

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6/ The Act's statutory language and legislative history support a narrow definition. The Senate sponsors of the amendment that became Section 307 repeatedly emphasized that attorneys can help prevent corporate misconduct by fulfilling their duties to their corporate *client*—the corporation and its shareholders. *See* 148 Cong. Rec. S6551-52 (daily ed. July 10, 2002) (statement of Sen. Edwards) (explaining distinction between client and management); *id.* at S6554-55 (statement of Sen. Enzi) (noting duty to disclose information to board, not just upper management); *id.* at S6556 (statement of Sen. Corzine) (emphasizing duty to report misconduct to client).

7/ All page references in the Proposing Release are to the Public Reference Copy of the Release.

connection (or "nexus") between the attorney's duties and the public company's potential violation. Indeed, as noted above in our discussion of the definition of "attorney," to do otherwise would read out of the Rule the statutory language "and practicing" as redundant with "appearing." Similarly, a broader interpretation would make the statutory phrase "in the representation of an issuer" irrelevant to the Rule. The phrase is not redundant with the statutory language that precedes it. The phrase does not appear in Section 602 of the Act, which otherwise is identical in scope. The Commission should give effect to this difference in construing the statute. Finally, the "disaffirmation" requirement of Section 205.3(d) of the Rule would have no meaning were the material violation not to relate to a public company's filings with the Commission. Absent such a nexus, what would the attorney disaffirm?

We note that the existence of a clear nexus between an attorney's conduct and a public company's potential violation was exactly what troubled the Commission when it evaluated attorney conduct in *In the Matter of William R. Carter, Charles J. Johnson, Jr.*, 1981 WL 384414, SEC Release No. 34-17597 (1981) (*"Carter & Johnson").* In discussing what it characterized as "the special role of the securities lawyer giving disclosure advice," the Commission wrote:

> The securities lawyer who is an active participant in a company's ongoing disclosure program will ordinarily draft and revise disclosure documents, comment on them and file them with the Commission. He is often involved on an intimate, day-to-day basis in the judgments that determine what will be disclosed and what will be withheld from the public markets. When a lawyer serving in such a capacity concludes that his client's disclosures are not adequate to comply with the law, and so advises his client, he is "aware," in a literal sense of a continuing violation of the securities laws.

(*Carter & Johnson*, p. 29)[8]

The legislative history of Section 307 suggests that Congress was attempting to address the type of conduct at issue in *Carter & Johnson. See* 148 Cong. Rec. S6554 (daily ed. July 10, 2002) (statement of Sen. Enzi) (noting that lawyers are actively involved in preparing, and in advising with respect to, disclosure documents); *id.* at S6556 (statement of Sen. Corzine) (same). Senator Enzi, co-sponsor of the Amendment that became Section 307, made clear that the new Rule should not reach "all attorneys, just attorneys appearing and practicing before the Commission; that is, those who are

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8/ *See also In the Matter of Keating, Muething & Klekamp*, 1979 WL 186370, SEC Release No. 34-15982 (1979).

dealing with documents that deal with companies listed by the Securities and Exchange Commission." *Id.* at S6555 (statement of Sen. Enzi). The Senator clearly was referring to those periodic and other financial disclosure documents that one typically associates with public companies.

Our recommendation comports with the conventional definition of "practicing before the Commission" provided in SEC Rule of Practice 102(f). It also is consistent with the definition used for the analogous context of the IRS's regulation of attorneys who "practice before the Internal Revenue Service." *See* 31 C.F.R. § 10.2(d). The Act's legislative history indicates that Congress envisioned the SEC promulgating regulations similar to the IRS rules. *See* 148 Cong. Rec. S6555 (daily ed. July 10, 2002) (statement of Sen. Enzi).

Our recommended clarification is consistent with the Act's primary purpose of improving the transparency of financial reporting by public companies without unnecessarily subjecting to regulation all attorneys who have only the most peripheral involvement with public financial disclosure documents filed with the Commission. An alternative formulation would impose extraordinary compliance burdens on people who do not fall within the class of persons Congress intended to cover.

Finally, just as there is no need for the Commission to define "attorney" to include business people and compliance professionals, there is little purpose in broadening the concept of "in the representation of an issuer" to include filings that a broker-dealer makes *as a regulated entity*. Broker-dealers report (and regulators rigorously scrutinize) volumes of financial information. SEC Rule 17a-11, for example, requires every broker-dealer whose net capital declines below the minimum amount required under the SEC Net Capital Rule to give notice of such deficiency to the SEC and to the broker-dealer's designated examining authority. Such broker-dealers must do so telegraphically or by facsimile on the same day that the decline occurs. Similarly, Rule 17a-11(c) requires broker-dealers to provide prompt notice if their capital levels breach so-called "early warning" levels. Although these regulations apply specifically to securities firms rather than to individuals, the Commission can and does seek sanctions of associated persons of broker-dealers for aiding and abetting or causing violations of these provisions.

To summarize, the Associations believe strongly that the Commission should adhere to Congress' focus on public companies and not adopt a broader Rule that would apply to broker-dealers as regulated entities. Absent clarification of this point, for example, an attorney employed by a public company that maintains a small broker-dealer as a subsidiary, and who participates in the preparation of a routine update of the broker-dealer's Form BD, could become subject to the reporting requirements under the Proposed Rule despite the fact that the Form BD filing could not remotely have a material impact on the parent company's financial statements. It would be anomalous to

treat two attorneys – each of whom is preparing the same Form BD update – differently because one works for a broker-dealer that is a public company or a subsidiary of a public company and the other does not[9/]

(ii) The Rule Should Exclude Attorneys Acting on Behalf of Underwriters

One instance in which the Proposed Rule's lack of clarity as to the definition of "appearing and practicing . . . in the representation of an issuer" has particular implications for securities firms involves situations in which attorneys discover information relating to a company other than their own employer. The proposed definition of "in the representation of an issuer" is too broad inasmuch as it includes those acting for the benefit of an issuer, "whether or not employed or retained" by the issuer. Conceivably, the definition could reach an employee of a broker-dealer who happens to be an attorney and who is engaged to provide business advice or to perform business services for an issuer, or who performs due diligence concerning a company for which the broker-dealer is serving as an underwriter. In neither situation is it logical for the attorney to have a reporting obligation under the Rule. Extending the definition to this extent would confuse the obligation a broker-dealer has to an issuer to perform the services for which the issuer has contracted, with the decidedly different obligations that an attorney bears to his or her "client," *i.e.*, the broker-dealer.[10]

(iii) The Rule Should Exclude Attorneys Representing Clients in Connection with Regulatory Investigations and Litigation

The SEC should exempt attorneys who are representing securities firms or their employees, officers or directors in investigations or litigation being conducted by the SEC or other regulators (including investigations by self-regulatory organizations), and in private litigation. The SEC's Proposed Rule would deter such attorneys from vigorously representing their clients, and would hinder their ability to have frank and meaningful conversations with their clients.[11/] If an attorney were engaged in such a representation,

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9/ Presumably, an attorney working for any broker-dealer (*i.e.*, whether or not affiliated with a public company) would be subject to SEC Rule 102(e) in conjunction with filing a fraudulent Form BD.

10/ Of course, if an attorney, appearing and practicing before the Commission in the course of working on an underwriting, discovers evidence of a violation that would materially affect the financial statements of a publicly-held broker-dealer (or the broker-dealer's publicly-held parent) by which he or she is employed, we would expect such persons to fall within the scope of the Rule.

11/ Footnote 47 of the Proposing Release notes that "circumstances in which the Commission is already investigating an issuer and the attorney is defending the

and a court, the Commission or an Administrative Law Judge were to determine subsequently that a violation had occurred, an implication would be raised, almost by definition, that the attorney should have reported the violation under the Proposed Rule, and the attorney could be subject to an investigation as to whether he or she had done so.[12/] The application of the Rule in the context of investigations also is unnecessary as a means of uncovering possible wrongdoing; in such circumstances the SEC staff already is aware of a potential violation.

The SEC also should exempt outside counsel whom securities firms retain to conduct internal investigations. Broker-dealers often retain outside counsel to help them fulfill statutory obligations to self-monitor and enforce their employees' compliance with the complex requirements of the SEC, NASD, NYSE and other regulators, which benefits the investing public. The reporting and disclosure requirements, however, could cause corporate officers or directors to disfavor such investigations, or to retain non-legal consultants – who may not possess the requisite skills – to perform such investigations, causing some violations to go undetected or unresolved. Moreover, it is not necessary for the Commission to impose this obligation on outside counsel. If outside counsel reports to an in-house attorney results of an investigation that constitute evidence of a material violation, the in-house attorney would assume a reporting obligation based on his or her receipt of the information.

(iv) The Commission Should Defer Rulemaking in Regard to Foreign Attorneys

The SEC should exempt foreign attorneys from the Rule, or at least defer rulemaking in this area pending appropriate opportunity for comment on the Rule. Regulation of foreign attorneys raises myriad unique concerns.

The Proposed Rule likely conflicts with non-U.S. regulation of professional conduct. We doubt that non-U.S. courts would recognize SEC regulations as primary in governing the conduct of attorneys subject to those courts' regulation. Such conflicts – especially as to issues of privilege and confidentiality – could affect the comity of U.S.

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issuer may well be fundamentally different from circumstances in which an issuer is preparing a filing," but the Proposed Rule does not reflect this difference.

12/ We note that this issue has particular bite where an attorney is representing a client in a criminal matter, and is defending the client's conduct under the "beyond a reasonable doubt" standard. Because the triggering standard under the proposed Rule appears to be substantially lower, the attorney might decide that he or she has to report that he or she is aware of evidence of a material violation and could have to withdraw (assuming the court would allow withdrawal) from any representation—including the representation in the criminal matter—if the CLO to whom he or she has reported the information fails to respond "appropriately."

and non-U.S. judicial systems and place well-meaning, respected attorneys in an unyielding vise. Further, the Proposed Rule extends beyond violations of federal securities laws to such concepts as "breach of fiduciary duties" which are subject to different definitions in different jurisdictions.

Finally, the application of the Proposed Rule to non-U.S. attorneys raises difficult organizational and practical concerns which require careful thought. Does a senior securities attorney employed by the U.S. subsidiary of a non-U.S. corporation, who reports in the business structure to a non-U.S. attorney who has limited securities experience and who resides overseas, have to report to that attorney for purposes of the Rule? If so, can a reporting attorney allow for the difficulty of international communication (including, potentially, the need to translate relevant documents) in deciding whether the supervisory attorney's response is appropriate? Moreover, the practical effect of applying the Rule in these circumstances could be to require overseas issuers to modify their established procedures for conducting internal investigations, and even their corporate structures, to the extent that the Rule would provide an impetus for companies to establish Qualified Legal Compliance Committees (QLCCs), discussed below. For these and other reasons, the application of this Rule to foreign attorneys merits careful consideration and an appropriate opportunity for comment.

c. What is "Evidence of a Material Violation?"

The SEC should clarify the term "material" so that it is clear that: First, the definition is coextensive with the *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), standard (information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" to an investment decision, and if it would "significantly alter the 'total mix' of information made available"). This definition is well understood in the business community.[13/] Second, the SEC should clarify that, to trigger a reporting obligation, the potential violation would have to be material to investors *in the public company*. A potential violation could be "important" to the broker-dealer's customers who, presumably, are "investors," but not to people who are investors in the broker-dealer itself, as a public company or as a subsidiary of a public company. One reason why we believe that the Proposed Rule's treatment of this issue is unclear is that, as noted above, the Commission has requested comment on whether the Rule should apply to regulated entities that are not issuers. *See* Proposing Release, p. 37. To clarify this point, the Commission should use the phrase "material to investors in the issuer" rather than the current "material violation." *More generally, the Commission should clarify that the type of potential violations that would trigger a reporting*

13/ The definition of "material" in the Proposed Rule ("conduct or information about which a reasonable investor would want to be informed") is too amorphous, and is particularly confusing where an alternative, familiar definition is readily available.

obligation are limited to issues that would materially impact the public company's disclosure documents.[14/]

Similarly, the Commission should clarify the meaning of the term "evidence." The term should not be considered in isolation but, rather, as part of the phrase "evidence of a material violation." As drafted, the Rule could be misinterpreted as meaning that an attorney's discovery of *any* evidence would trigger a reporting obligation, regardless of whether the *weight* of the evidence suggested that no violation had occurred. Similarly, where a potential violation has several legal elements, the weight of the evidence might support a conclusion that a number of those elements have been met, but there might be no or minimal evidence as to one or more of the other elements. We do not believe that the Commission intends that either situation should trigger a reporting obligation. (The Proposing Release (p. 33) implies these "weight of the evidence" concepts, but it is ambiguous.) Accordingly, the Commission should modify the term "evidence" with the words "significant," "substantial" or "clear and convincing" to avoid an unduly low trigger point. This concept also should expressly include "aggregation" or "weighing" of the evidence.[15/]

The list of material violations, § 205.2(i), contemplated by the reporting requirement also requires clarification. First, the phrase "violations of securities laws" should be modified to reflect that Rule 205 applies only in the context of the *federal* securities laws. The Commission has regulatory authority only pursuant to federal securities law and should concern itself with state regulations only to the extent that federal disclosure obligations are implicated.[16/] Second, "breach of fiduciary obligations" should be clarified so that it is clear that the existence of the breach must be material to investors in the public company. It is doubtful that Congress intended for the Commission to interpret state-law fiduciary duties; instead, the Rule is properly addressed to breaches of duty that impact public disclosure documents. Finally, the phrase "similar violation" is fraught with ambiguity. The Proposing Release (p. 23) suggests that this definition could take form through case-by-case Commission decisions.

14/ Consistent with the definitions at Section 205.2(h) and (i), the suggested language would confirm that materiality is measured with respect to investors in a public company, not, for example, with respect to clients of a broker-dealer.

15/ Some commentors have suggested that "evidence" for purposes of Section 307 means that an attorney who becomes aware of a reportable violation must report to the CLO not merely the *fact* of his conclusion, but the *evidence* supporting it. In other words, the attorney is not required to report *evidence* of a violation unless he or she concludes that a violation, in fact, occurred. The Commission should clarify whether it intended its Proposed Rule to reflect this interpretation.

16/ The Commission could address this concern simply by defining the term "securities laws" as the term is defined by Section 3(a) 47 of the Exchange Act.

That course would cast too much uncertainty on the reporting obligation and therefore the Commission should clarify the phrase in the final Rule along the same lines as our suggestion as to "breach of fiduciary obligations." That is, by referring to breaches of the duties of loyalty and care that an employee bears to his or her employer, to the extent that any such breach would be material to investors in the public company.

2. The "Reporting Up" Provision

a. What is the Trigger Point?

The Commission has recognized that the reporting requirement is not triggered by "mere suspicion." *See* Proposing Release, p. 33. In practice, clients often consult attorneys for guidance on whether particular actions can be undertaken or continued where the law is unsettled or unclear. Attorneys must be free to give candid, disinterested advice without the obligation to report unless there is clear, substantial evidence of a material violation. Without an appropriate reporting standard, clients would be reluctant to seek counsel, which would lead to more wrongdoing and less public disclosure. *We believe that the Rule should require reporting only when an attorney becomes aware of evidence from which any reasonable attorney would conclude that there is "significant," "substantial" or "clear and convincing" evidence of a material violation.*

As a corollary to these principles, and in order to promote flexibility, the Rule should afford attorneys a reasonable opportunity to exercise appropriate, deliberate professional judgment as to the inferences that may be drawn from the evidence. The Proposed Rule, requiring reporting "forthwith" when an attorney "becomes aware of evidence" of a material violation, §205.3(b)(1), could be read as imposing an immediate reporting obligation as soon as an attorney discovers any evidence of a material violation, which would countermand that evaluative process.

The Proposed Rule also inappropriately requires attorneys to second-guess themselves. The Proposing Release (p. 33) states that the objective standard underlying the Rule would require reporting "whether or not the reporting attorney subjectively believes" that a violation has occurred. This assumes that there can only ever be one "reasonable" interpretation of the evidence. In other words, if an attorney reasonably comes to believe that no violation occurred, but can imagine a hypothetical reasonable attorney coming to a different conclusion, that attorney would have an obligation to report the evidence to a superior and to take further steps if he or she did not receive an "objectively" reasonable response. The full panoply of the processes envisioned under the Rule could be triggered where no one involved *actually* believed that the weight of the evidence supported the existence of a violation. To avoid this irrational result, the Commission should apply a reasonableness standard to the real attorney's decision-making and require the Commission to demonstrate that the decision was *not* reasonable.

The concept of materiality as it relates to the reporting trigger (*i.e.*, when the attorney "becomes aware of evidence of a material violation") should explicitly reflect the fact that not all attorneys are equally equipped to judge the materiality of a particular violation. For example, outside counsel retained for a single litigation matter usually would not have detailed knowledge about the issuer's entire financial picture. If outside counsel were to report a possible violation to the CLO, outside counsel would have to depend on the CLO's judgment whether or not that particular violation was in fact "material" and required further action. As the Commission has observed, the materiality determination and the question of when an attorney "becomes aware of" violations will depend, at least in part, "on the attorney's training, experience, position, and seniority." *See* Proposing Release, p. 50. We suggest that the text of the Rule (or, at a minimum the text of the Adopting Release) explicitly recognize that the materiality determination will depend on the attorney's position, including the attorney's experience with the particular issuer, his or her relative position within the organization and his or her access to information from which he or she can make appropriate judgements as to materiality.

The Commission also should clarify that an attorney's reasonable, but mistaken, determination that information was not material would not subject the attorney to sanction under the Rule. In a similar context, the Commission took the position that "[I]ssuers will not be second-guessed on close materiality judgments. Neither will we, nor could we, bring enforcement actions under Regulation FD for mistaken materiality determinations that were not reckless." Adopting Release for Regulation FD, p. 7. For purposes of the Rule, the Commission similarly should make clear that it will not sanction attorneys for making good faith, reasonable materiality determinations that the Commission, in hindsight, determines were erroneous.

b. How Would the Reporting Process Work?

(i) The Need for Intermediate Reporting Channels

Because we believe that the Rule will result in attorneys reporting a large number of immaterial violations or irrelevant information to the CLO, we believe strongly that the Rule should allow CLOs to establish intermediate reporting channels. The Proposing Release specifies that subordinate attorneys may report to their supervisors rather than directly to the CLO, but that they can report directly to the CLO if they so choose. *See* §205.5(c). The Proposed Rule, however, does not promote "reporting up the ladder" as much as it promotes "jumping to the top of the ladder." The Proposed Rule does not authorize companies to implement formal intermediate reporting mechanisms so that they can better manage the reporting process, avoid having their CLOs distracted as they focus on the most serious allegations, and otherwise enable their CLOs to devote their attention to those matters that most merit their energies. Indeed, such intermediate reporting structures likely would prove more effective in encouraging reporting and in accomplishing the Commission's stated goals.

We recommend, therefore, that the CLO be allowed to delegate his or her responsibility for receiving and responding to reports from subordinates to a person or persons subject to his or her direct supervision. For example, assume that the CLO of a multinational company resides in New York and that his or her deputy, who serves the company's West Coast operations, resides in Los Angeles. Assume also that an attorney at the company's office in San Diego decides that he or she needs to report evidence of a material violation. The CLO should be able to have the attorney report the matter to the CLO's deputy in Los Angeles in the first instance, as long as that deputy is subject to the CLO's supervision. Of course, in situations where there is some compelling reason for the attorney to wish not to report to the CLO's deputy, the CLO should receive the report directly. Similarly, where the reporting attorney feels that the CLO is not being sufficiently responsive, he or she should be permitted to report to the CLO's superior (CEO, COO or others, depending on the organizational structure) before reporting to the audit or similar committee.

A question could be raised in considering this recommendation as to what responsibilities a CLO would retain if he or she were to delegate to a subordinate the responsibility to receive reports from other attorneys in the corporation's law department. We suggest that the Commission address this issue on a case-by-case basis, considering all applicable facts and circumstances. We note that the Commission's *Report of Investigation Pursuant to Section 21(a) (Donald M. Feuerstein)*, 1992 WL 362753, SEC Release No. 34-31554 (December 1992), provides guidance in this area.

(ii) The Qualified Legal Compliance Committee

The Commission should refine the QLCC concept. First, the Commission should not underestimate the practical obstacles to implementation of a QLCC, including the difficulties companies will face in identifying appropriate persons who would be willing to assume the liabilities associated with membership on a QLCC, and the drafting of the detailed and complex charters the Rule seems to require. Second, as currently drafted, the QLCC is a reporting mechanism available to everyone *other* than the CLO. Under the Proposed Rule, the CLO is permitted to refer matters to the QLCC, § 205.3(b)(3), (c)(2), but the CLO is not relieved of the continuing duty to assess the issuer's response to the reported violation, nor is the CLO relieved of the possible duty to "report out" to the Commission under Section 205.3(d). *See* § 205.3(b)(3), (c)(1). Why exclude the CLO from using the QLCC mechanism? The CLO should not be saddled with an ongoing monitoring responsibility once the CLO makes a report to the QLCC, which itself should be fully equipped to properly monitor and resolve reported material violations.

(iii) The Documentation Requirements

The Commission should dispense with the express requirement that attorneys document their reporting and the responses thereto. *See* § 205.3(b)(2). The Commission stated in the Proposing Release that it included this provision primarily for the attorney's

own benefit, and recognized that prudent attorneys are likely to document their actions, whether or not required by the Commission. *See* Proposing Release, p. 58. Prescribing particularized form and content for record-keeping would impose an undue burden on reporting attorneys, and proper documentation should be left to the attorney's own discretion.

If the Commission includes a documentation provision as part of the final Rule, any memorandum that a reporting attorney prepares should be subject to applicable privileges; such a memorandum likely would reflect communications between the attorney and his or her client regarding legal advice (*e.g.*, whether there is evidence of a violation) and reflect the attorney's mental processes. The Rule should specify that, with the exception that the attorney can use the memorandum to defend his or her conduct, any applicable privileges lie with the company, and only the company may waive them generally.

(iv) The Need For A Phase-In Period

It will be difficult for complex, national and international securities firms to effectively implement the required reporting mechanisms. Such implementation efforts will require the development and dissemination of procedures, training, and subsequent monitoring of the implementation effort. This is especially true because companies are grappling even now with implementation of other aspects of the Act, including provisions, such as the whistleblower provisions, that intersect with the Proposed Rule. Accordingly, the Commission should allow a phase-in period as companies implement the Rule. (We suggest a period of at least nine months.)[17/]

c. What Constitutes an Appropriate Response?

The Proposed Rule does not adequately define the term "appropriate response." As Senator Edwards recognized, the appropriate response "will vary dramatically, depending on the circumstances. In some circumstances, a short investigation to determine that there has been no violation may be appropriate." 148 Cong. Rec. S6552 (daily ed. July 10, 2002) (statement of Sen. Edwards); *see also* 148 Cong. Rec. S6556 (daily ed. July 10, 2002) (statement of Sen. Corzine).

17/ The Associations also believe that the Commission has significantly underestimated the costs and burdens of the Proposed Rule in the Proposing Release's cost/benefit analysis. Because of the various reports and investigations mandated by the Rule, and the documentation requirements that attend those processes, large and small companies will be subject to burdens disproportionate to the benefit derived.

The Proposing Release implies that remedial steps are the *sine qua non* of an appropriate response, but this unfairly makes the leap from "evidence of a violation" to a "finding of violation." How can an issuer (and an individual supervisory attorney) prove that they responded appropriately where they reasonably concluded that no remedial steps were warranted? Further, the Proposed Rule presumes that the CLO is in fact empowered to impose remedial measures, issue corrective disclosures, sanction violators and engage in ongoing monitoring and direction of implementation efforts. *See* §205.3(b)(3). In many organizations, however, the CLO lacks practical authority to impose such measures; the CLO may provide forceful advice, but he or she must depend on business people to make and implement decisions. The CLO in these circumstances may need to rely on other members of management, the audit committee or the full board of directors, or on a properly constituted QLCC.

In many instances, reporting attorneys are not in a position to judge whether discipline and corrective action suffice as an "appropriate response," and it is impractical to expect reporting attorneys to second-guess the decisions of senior management. For example, the Proposing Release suggests that a reporting attorney cannot trust representations from a supervising attorney that he or she has looked into the issue and decided that there was no violation. The Proposing Release (p. 28) states that, if a supervisory attorney tells a reporting attorney that he or she consulted with an outside law firm, the reporting attorney should not be satisfied until the supervisory attorney shows the reporting attorney an opinion from the outside law firm. First, a written opinion should not be necessary in all cases and should not be required in every case involving consultation with outside counsel. Second, this definition of reasonable conduct would heighten tensions within corporate legal departments (and law firms where attorneys practice before the Commission) and discourage reporting of violations because reporting attorneys would have to act as if they did not trust their supervisors.

Accordingly, the Commission should modify the phrase "appropriate response" with the phrase "reasonable under the circumstances" and specify that the response should be measured by the magnitude and quality of the evidence that a violation existed in the first place, the severity of the violation, and whether there is potential for an ongoing or recurring violation. The Commission also should expressly acknowledge the following: First, only a short investigation may be required if the supervising attorney or CLO determines, based on a either a brief inquiry or institutional knowledge, that there is insufficient evidence of a material violation. (Indeed, under appropriate facts and circumstances, no investigation may be required at all). Second, an "appropriate response" may include taking no remedial action if the supervising attorney or CLO reasonably believes that such action is not warranted.

The Commission also should clarify that the reporting attorney's judgment should be evaluated in light of that attorney's training, experience, and position. For example, outside counsel working on limited matters should be permitted to defer to the credible representation of in-house counsel that he or she is properly addressing a reported

violation, including describing the nature of the steps being taken to resolve the matter. Placing any greater onus on the reporting attorney in these circumstances would hamper the essential flow of information between in-house and outside counsel; in-house counsel would be reluctant to share institutional knowledge at the outset for fear of possible second-guessing from outside counsel, which in turn would diminish outside counsel's ability to effectively advise the company. Similarly, in situations where the reporting attorney is junior or inexperienced in a particular area, allowing the less seasoned lawyer to rely on the experience and judgment of the more senior lawyer is appropriate, and consistent with ABA Model Rule 5.2(b), which allows a junior lawyer to rely on a supervisory lawyer's "reasonable resolution of an arguable question of professional duty."

3. Noisy Withdrawal/ Reporting Out Provisions

The noisy withdrawal provisions strike at the heart of the attorney-client relationship with enormous implications, not the least of which could be to undermine an issuer's willingness to consult counsel. Attorneys cannot effectively counsel their clients if clients are reluctant to provide complete information for fear that their confidences will be shared with the Commission. This is particularly so given that a noisy withdrawal "virtually ensur[es] an immediate inquiry by the Commission." Proposing Release, p. 76.

The application of the withdrawal and "reporting out" provisions to enforcement and investigations provides a clear example of how the Proposed Rule could chill effective representation. Lawyers cannot be effective, focussed advocates if they must constantly question whether information that they receive from their clients constitutes evidence of a material violation that may trigger a reporting obligation. They cannot develop the professional bond so essential in this context if they must evaluate whether their clients' responses are "appropriate." These issues have particular effect when there are pending SRO or private suits because the provisions would provide notice to plaintiffs as well as to the Commission, which is patently unfair.

Section 205.3(d)(3)'s simple statement that noisy withdrawal "does not breach the attorney-client privilege" may have no preemptive effect absent clear Congressional intent to preempt state (or foreign) law. The statement purports to restate "largely settled law," but the implications of leaving open any possibility that an attorney would be required to choose between compliance with an SEC rule and compliance with state (or foreign) ethics or other legal requirements are so significant as to provide still more reason for the Commission to reject or defer consideration of this provision.

Further, the SEC's position that a disclosure pursuant to a confidentiality agreement with the Commission does not waive privilege with respect to other parties, § 205.3(e)(3), is an "unsettled question", as the Commission acknowledges. Proposing Release, p. 49-51 & nn. 75-79; *see also Fidelity & Cas. Co. of N.Y. v. Mobay Chem. Corp.*, 625 N.E.2d 151 (Ill. App. Ct. 1992) (rejecting reliance on selective waiver to government despite government's confidentiality agreement). Although we welcome this

positive statement of Commission policy, given sharp disagreements among courts on the question of selective waiver, issuers and attorneys cannot be secure in their disclosures absent a statutory statement of express preemption. In addition, because the Commission is taking the position that provision of such information would not constitute a waiver, counsel will be less able to negotiate on equal terms with the SEC's staff over what information is to be produced, under what circumstances, and with what protections.

As the Commission recognizes, the withdrawal and "reporting out" provisions exceed the Act's required regulation. Moreover, the Proposed Rule raises difficult preemption issues as it may conflict with laws in states (or foreign jurisdictions) where "reporting out" is not mandatory or not permitted. Accordingly, the Commission should reject these provisions, or at least defer consideration of them until substantially more study of the implications can be completed and there is an additional opportunity for comment.

4. Supervisory Attorneys

The Proposing Release states that a supervisory attorney (other than the CLO) to whom a subordinate attorney has reported essentially steps into the shoes of that subordinate attorney in terms of further reporting obligations. If so, the company should be able to take steps to ensure that subsequent reporting with respect to the same matter is not redundant and potentially confusing (*e.g.*, the company should be able to direct the subordinate attorney that subsequent reporting will be to and by the supervisory attorney to whom the subordinate reported).

The Commission should require documentation, § 205.4(d), only in the supervisory attorney's reasonable judgment, taking account of the seriousness of the suggested violation, the magnitude of evidence, and the subordinate attorney's relative experience with the issues. A supervisory attorney could be inundated with questions from subordinate attorneys as part of the ordinary learning process for inexperienced attorneys. For example, a first-year lawyer working for a client for the first time may have frequent questions regarding the materiality of and the need to report certain matters. Documenting each and every instance in which such a junior attorney raises a question could prove onerous and may dampen communication between junior and senior attorneys. Thus, the supervisory attorney should be able to completely "step into the shoes" of a subordinate such that the supervisory attorney would make the informed judgment whether any further investigation and reporting is required.[18/]

18/ The Proposed Rule requires supervisory attorneys to make "reasonable efforts" to ensure that subordinate attorneys comply. This will require training and continuing education programs. Broker-dealers will need time to develop these programs, and the Commission should allow a short phase-in period to accomplish this task.

We also note that the language of the Proposed Rule literally requires supervisory attorneys to ensure that subordinates "comply with the statutes and other rules administered by the Commission." If the Commission intends this language literally, it represents an extraordinary expansion of the Commission's authority to regulate attorneys, well beyond the statutory mandate and the Commission's traditional reticence to extend its regulation of attorneys beyond what is necessary to protect its processes. Because the Commission did not discuss this concept in the Proposing Release, we suspect that this is simply a matter of draftsmanship in the Proposed Rule. If so, the Commission should clarify the provision. If not, it should issue a supplemental proposing release to solicit discussion and comment.

5. Sanctions

The Commission should specify that it generally will address violations of the Rule through Rule 102(e) proceedings, rather than through administrative proceedings or injunctive actions. The prospect of Exchange Act sanctions – including cease and desist orders and Remedies Act penalties – could cause the Enforcement staff to view the institution of such actions as the preferred course, even in routine investigations. Companies would be burdened with the costs of adopting "bulletproof" compliance programs. Individual attorneys, faced with the possibility that the Commission would seek such sanctions routinely, would tend to overreact to immaterial information and overtax the CLOs, QLCCs and others who would receive their reports and be tasked with conducting the requisite investigations.

The Commission also should limit its use of Section 15(b) proceedings against associated persons in situations where the underlying violation was a violation of the Rule. It would be unfair to bar or suspend someone from doing business as an associated person of a broker-dealer for violations committed as an attorney.

Finally, the Commission should expressly provide that the Rule is enforceable only by the SEC and that no private right of action is implied. As the Commission recognizes, *see* Proposing Release at p. 104 & n.81, this is consistent with Congressional intent. *See* 148 Cong. Rec. S6552 (daily ed. July 10, 2002) (statement of Sen. Edwards); *id.* at S6555 (statement of Sen. Enzi). In analogous circumstances, the Commission "recognize[d] that the prospect of private liability for violations of Regulation FD could contribute to a 'chilling effect' on issuer communications." *See* Adopting Release for Regulation FD, p. 23. Acknowledging that the proposed Regulation FD may have offered insufficient protection from private lawsuits, *see id.*, the Commission adopted section 243.102 (No Effect on Antifraud Liability) to expressly deny any private right of action for failure to make disclosures under Regulation FD. Here, the Commission should do the same and adopt a provision that expressly states that there shall be no private right of action for violations of Section 307's reporting and disclosure requirements.

* * *

We hope that the Commission finds our observations and suggestions helpful in formulating rules that:

- Recognize the important distinction between securities firms as *issuers* and as *regulated entities* and apply the Rule only to securities firms as *issuers*.

- Define "material" violations in terms of what is material to investors in a public company.

- Establish an appropriate triggering point for reporting obligations.

- Draw appropriate distinctions between attorneys that are truly "appearing and practicing . . . in the representation of an issuer" and those who are not.

- Recognize the important public policy implications of infringing on the relationship between attorneys and their clients, especially in the context of enforcement investigations and litigation.

The Proposing Release obviously raises many complex (and controversial) issues that can only be resolved through informed deliberation. We reiterate that the Commission should adopt only such rules as are required by the Act and defer rulemaking on other proposals to provide opportunity for more thorough review and additional opportunity for comment.

We appreciate the opportunity to comment on the Proposed Rule. If you have any questions about this letter or would like additional information, please contact the undersigned, or George Kramer ((202) 296-9410) of the SIA staff, John Ramsay ((646) 637-9200) of the BMA staff or Paul Huey-Burns ((202) 739-5586), Robert C. Mendelson ((212) 309-6303) or Christian J. Mixter ((202) 739-5575) of Morgan Lewis & Bockius LLP, the Associations' special counsel for this matter.

Respectfully submitted,

Stuart J. Kaswell, Esq. Senior Vice President and General Counsel Securities Industry Association	Paul Saltzman, Esq. Executive Vice President and General Counsel The Bond Market Association

c: The Honorable Harvey L. Pitt
The Honorable Cynthia A. Glassman
The Honorable Paul S. Atkins
The Honorable Harvey J. Goldschmid
The Honorable Roel C. Campos

Giovanni P. Prezioso, Esq.
Meyer Eisenberg, Esq.

Alan L. Beller, Esq.
Stephen M. Cutler, Esq.
Annette L. Nazareth, Esq.
Paul F. Roye, Esq.

APPENDIX

Suggested Changes to Rule's Language

205.2(c) Attorney means a person who is in an attorney-client relationship with an issuer or a subsidiary of an issuer. [Alternatively: Attorney means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, and who is providing legal advice to an issuer.]

205.2(e) Evidence of a material violation means information that would lead an attorney reasonably to believe that a violation material to investors in a public company has occurred, is occurring, or is about to occur.

205.2(h) Material refers to conduct or information that would impact the public company's disclosure documents and which a reasonable investor would consider to be an important part of the total mix of information available.

205.2(i) Material violation means a violation of the federal securities laws or a material breach of fiduciary duty that is material to investors in a public company.

205.3(b) Duty to report evidence of a material violation. (1) If, in appearing and practicing before the Commission in the representation of an issuer, an attorney becomes aware of evidence from which any reasonable attorney would conclude that there is ["significant," "substantial" or "clear and convincing"] evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report any evidence of a material violation 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 to the equivalents thereof) as soon as is reasonable under the circumstances (unless the issuer has a qualified legal compliance committee and the attorney chooses instead to report the evidence of a material violation to that committee under paragraph (c) of this section). An attorney does not reveal client confidences or secrets by communicating information related to the attorney's representation of an issuer to the issuer's officers or directors.

Provisions Requiring Clarification

205.2(a) Appearing and practicing

- The Rule should apply to regulated entities only in their capacities as entities that have public investors. Thus, the Rule should apply only to issuers *as issuers*.
- The definition should relate to financial disclosure documents that issuers file with the Commission as issuers.

- The Rule should apply only to attorneys that have direct contact with the Commission or its staff, or who have reason to believe that their work will be incorporated into public company financial disclosure documents to be filed with the Commission.
- The Rule should apply only where there is a logical connection between the attorney's duties and the public company's potential violation.
- The Rule should exclude attorneys representing clients in connection with regulatory investigations, internal investigations, and litigation.

205.2(b) Appropriate response

- An appropriate response should be reasonable under the circumstances, measured by the magnitude and quality of the evidence that a violation existed in the first place, the severity of the violation, and whether there is potential for an ongoing or recurring violation.
- The Rule should expressly acknowledge that only a short investigation, or no investigation in some circumstances, may be appropriate.
- A reporting attorney's judgment of the appropriateness of a response should be evaluated in light of the attorney's training, experience, and position.

205.2(e) Evidence of a material violation

- This concept should expressly include "aggregation" or "weighing" of the evidence.

205.3(b) Duty to report evidence of a material violation

- The Rule should clarify that attorneys should have a reasonable opportunity to evaluate the evidence and to exercise their professional judgment before any duty to report is triggered.
- The Rule should reflect that an attorney's judgment as to materiality will depend on that attorney's training, experience, position, and seniority, including the attorney's experience with the particular issuer, his or her relative position within the organization, and his or her access to relevant information.