T O O U R F R I E N D S A N D C L I E N T S

July 18, 2003

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

A Partnership
Including
Professional
Corporations

New York
One New York Plaza
New York, NY 10004
212.859.8000

Washington, DC
1001 Pennsylvania
Avenue, NW
Washington, DC 20004
202.639.7000

Los Angeles
350 South Grand Avenue
Los Angeles, CA 90071
213.473.2000

London
99 City Road
London EC1Y 1AX
United Kingdom
44.20.7972.9600

Paris
5, boulevard de la Tour Maubourg
75007 Paris
France
33.140.62.22.00

www.friedfrank.com

The SEC's "up-the-ladder" reporting requirement for attorneys becomes effective on August 5, 2003. With the effective date fast approaching, public companies in the U.S. should be considering how their internal and outside counsel will comply with the new regulation and should consider developing, or updating, an internal compliance program with respect to these rules.

The first part of this memorandum is intended to provide practical suggestions for companies to consider in developing a compliance program for in-house lawyers. The second part describes some practical considerations relating to the establishment of a qualified legal compliance committee (QLCC). While there are both advantages and disadvantages to using a QLCC, companies who want to utilize a QLCC cannot form the committee in response to a specific incident, but must have previously formed the QLCC prior to an attorney's report of evidence of a violation. A more detailed description of the professional conduct rule is available in our memorandum dated February 10, 2003, which can be accessed at http://www.ffhsj.com/cmemos/030210_noisy_withdrawal.htm.

I Internal Compliance Policies

A number of issues need to be considered by companies in implementing a compliance policy for their in-house counsel. Each company will need to devise appropriate procedures based on its own culture, structure and needs and the size of its legal staff. In addition, any policies may need to be revised or modified as the new rules are interpreted over time. In this section we review certain questions that companies may want to consider in adopting their own procedures.

Who is covered?

The "up-the-ladder" reporting obligations apply to attorneys "appearing and practicing before the Commission" in the representation of an issuer. Attorneys "appear and practice before the Commission" if they (i) transact any business with the SEC, including any form of communication; (ii) represent an issuer in connection with an SEC administrative proceeding, investigation, information request, inquiry or subpoena; (iii) provide advice on U.S. securities

Copyright @ July 18, 2003 Fried, Frank, Harris, Shriver & Jacobson

laws, rules or regulations in connection with any document that the attorney has notice will be filed or submitted to the SEC, or incorporated in an SEC filing or submission; or (iv) advise an attorney whether an opinion or other writing needs to be filed with or submitted to the SEC, even if such a writing is not filed or submitted.

"Non-appearing foreign attorneys" are not covered by the rule. A foreign attorney will generally qualify as a "non-appearing foreign attorney" as long as (1) he or she is qualified as an attorney in a non-US jurisdiction, (2) he or she does not hold himself or herself out as giving US legal advice, and (3) either (a) he or she provides advice regarding U.S. law only in consultation with U.S. counsel or (b) he or she conducts activities that only incidentally involve appearing before the SEC in the ordinary course of his or her practice.

One question companies need to consider is whether their internal compliance policy should apply only to lawyers appearing and practicing before the Commission or to all of their in-house attorneys. In making this decision, companies should consider that even attorneys who do not normally "appear and practice before the Commission" may do so on occasion under the broad definition adopted by the SEC. Whether or not required by the rules, companies may want all attorneys to report evidence of material violations as a matter of company policy. Other companies may decide to adhere to the strict parameters of the SEC regulation, out of concern that a broader policy may create issues and even liabilities where none would otherwise exist.

Violations of which laws must be reported?

The new rules provide that attorneys must report evidence of (i) a material violation of United States federal or state securities laws, (ii) a material breach of fiduciary duty arising under United States federal or state law or (iii) a similar material violation of any United States federal or state law, in each case by the issuer or an officer, director, employee or agent of the issuer.

In adopting a compliance policy, companies need to consider whether they want violations of all laws reported or, again, whether to adhere to the specific requirements of the SEC's rule. Companies taking a broader approach also need to consider whether their policy should cover only U.S. law or also foreign law, since the SEC rules only cover violations of U.S. law.

How much evidence of a violation must an attorney have before reporting?

The final rules define "evidence of a material violation" as "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 ongoing, or is about to occur."

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

Companies need to consider whether their policy should adopt the SEC's standard for reporting or whether it should adopt a *lower threshold*, such as credible evidence suggesting, for example, a reasonable likelihood of a violation of law. Companies might also choose to require reporting of evidence without regard to the materiality of the violation. Using a lower threshold would permit reports to be received that do not yet reflect a firm conclusion by another lawyer that it meets the standard for "up-the-ladder" reporting.

To whom should reports be directed?

In the first instance, the new regulation requires internal and outside attorneys to report evidence of a material violation to the chief legal officer (CLO), or the CLO and the CEO. If an appropriate response is not forthcoming, the attorney is required to report further "up-the-ladder" to the audit committee, another committee of independent directors or to the full board of directors.

The rules have provided special provisions for subordinate attorneys. A "subordinate attorney" fulfills his or her obligations by reporting to a "supervisory attorney," who then assumes responsibility for reporting the evidence "up-the-ladder" where appropriate. A subordinate attorney is any attorney who is supervised by another attorney (other than the CLO).

An attorney's status as a "supervisory" or "subordinate" attorney, and the attendant reporting obligations, may vary from matter to matter. For example, a senior attorney acting under the supervision of another attorney on a particular matter may be a "subordinate attorney" with respect to that matter, while a junior attorney acting directly under the CLO would be considered a "supervisory attorney" (since an attorney working directly for the CLO cannot be a subordinate attorney under the rules).

In a large organization, it may be helpful for the company to adopt a formal chain of command in which "subordinate attorneys" clearly understand which senior attorneys would qualify as "supervisory attorneys" for reporting purposes. Particularly with respect to disclosure issues, a direct report to the CLO on every questionable issue may be overly cumbersome. In adopting a chain of command, however, "supervisory attorneys" must actually act in a supervisory role under the rule.

The compliance policy could also state (consistent with the new rules) that if an attorney reasonably believes that reporting to the CEO or CLO would be futile, the attorney may make a report directly to the appropriate committee of the board of directors.

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

In what form should the report be made?

The new rules do not specify the precise format (*e.g.,* oral, written or e-mail) pursuant to which reports should be made. Companies should consider whether they want to specify a particular format for reports, and whether they prefer all reports to be made orally or in writing.

Should the policy specify the steps that the CLO should take upon receiving a report?

Once the CLO becomes aware of evidence of a material violation, under the new rules he or she has a duty to conduct an inquiry. If the CLO determines that no material violation exists, the CLO must inform the reporting attorney of the basis for that conclusion. If a material violation does exist, the CLO must take all appropriate steps to insure that the company adopts an "appropriate response" and inform the reporting attorney of such steps. Alternatively, the CLO may refer the matter to a qualified legal compliance committee (QLCC), as discussed in the second part of this memorandum. If such a referral is made, the CLO must inform the reporting attorney.

Companies should consider whether their policy should require that the CLO prepare a written document memorializing the facts of each report, the steps taken to investigate it, and conclusions reached and actions taken.

What is an "appropriate response"?

Under the rules, an "appropriate response" is a response which leads the reporting attorney reasonably to believe:

- that no material violation has occurred, is ongoing, or is about to occur;

- that the issuer has adopted appropriate remedial measures to prevent any material violation that has yet to occur, and to remedy any material violation that has already occurred; or

- that the issuer, with the consent of the board of directors, audit committee or committee of independent directors, or a QLCC, has retained or directed another lawyer to review the evidence and either:

    (i) has substantially implemented any remedial recommendations made by such lawyer after a reasonable investigation; or

    (ii) has been advised that such lawyer 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).

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

How should reports be documented?

The rules do not mandate documentation of an attorney's initial report or the response to that report. However, companies should consider whether they wish to establish internal documentation procedures. Such procedures might require documentation by the reporting attorney and CLO that a report or response has been made. In this way, companies may seek to avoid an appearance of inconsistency in how reported matters are handled.

How should internal counsel learn about the rules?

A company should insure that each of its in-house attorneys is familiar with the professional conduct rules and the company's internal compliance policy. Companies should consider conducting training programs for both newly hired and existing attorneys explaining their obligations under the "up-the-ladder" reporting rules. The company could also consider designating a contact person for any questions or concerns relating to the rules. Companies might also consider whether all attorneys should, each year, sign a certificate certifying that they have not violated the "up-the-ladder" reporting system (similar to the confidentiality certificate which many companies use).

Companies may include in their policy a statement that legal consequences exist for attorneys who fail to fulfill their reporting obligations, such as SEC enforcement actions. In addition, if the company has also adopted internal disciplinary procedures for failure to comply with the "up-the-ladder" reporting rules, those may be stated as well.

The company should also consider including a statement that any attorney who complies in good faith with the requirements of the rule will not be subject to any form of company discipline or dismissal. The policy may also describe what steps should be taken internally for attorneys who believe they were dismissed for making a report under the rule.

What steps, if any, should be taken with regard to the company's outside lawyers?

An issuer's outside counsel will often appear and practice before the Commission in the representation of an issuer and is also bound by the "up-the-ladder" reporting rules. Companies may wish to discuss their compliance policies and reporting procedures with their outside counsel. Companies should consider whether outside lawyers should be instructed as to a specific form and procedure for making reports. Companies should also consider whether their outside lawyers should be informed in writing that the company expects them to meet their obligations. Alternatively, companies may be guided by the fact that outside counsel are subject to the SEC rule regardless of any action that companies may take and, thus, decide not to communicate with outside counsel.

II The Qualified Legal Compliance Committee (QLCC) Alternative

As an alternative to reporting to the CLO and/or the CEO, the rules allow both inside counsel and outside attorneys to report evidence of a material violation to a pre-existing qualified legal compliance committee (QLCC). Once an attorney reports to a QLCC, he or she is not obligated to assess the response to the report of evidence of a material violation and has no other "up-the-ladder" reporting obligations. As discussed above, a CLO may also report any evidence of a material violation to the QLCC in lieu of conducting an investigation.

To satisfy the requirements of the rule, the QLCC must be formed prior to the attorney's report of a material violation (and not in response to a specific incident). Consequently, issuers that wish to avail themselves of the QLCC option would need to have a preexisting QLCC.

Attached to this memorandum are samples of a draft QLCC charter and draft QLCC procedures. These examples may not be appropriate for all companies and, if a QLCC is used, each company will need to develop documents appropriate to its circumstances.

Composition of a QLCC

The QLCC must be composed of at least one member of the audit committee (or another committee consisting solely of independent directors) and two or more directors who are not employed, directly or indirectly, by the company. The committee must adopt written procedures for the confidential receipt and consideration of reports of evidence of material violations. The board of directors must also grant the committee the authority and responsibility to:

- notify the CLO and CEO of a report of evidence of a material violation,
- undertake investigations of such evidence through the CLO or outside attorneys, and notify the audit committee or full board of such investigations,
- recommend by majority vote the appropriate remedial actions, and inform the CLO and CEO of such recommendation, and
- take all other appropriate action, including notification to the SEC if the issuer fails in any material respect to implement the QLCC's recommendations.

The rules do not require that a separate committee be formed if an existing committee (such as the audit committee) meets the requirements for a QLCC. Some companies may designate the governance/nominating committee as the QLCC in cases where such committee includes at least one member of the audit committee. However, since the audit committee is responsible for legal and regulatory compliance under the NYSE's proposed governance standards and is required to receive employee complaints about questionable auditing or

accounting matters under Section 301(4) of the Sarbanes-Oxley Act, many companies may elect to designate the audit committee as the QLCC. Since the audit committee is designated as one of the parties that may be notified if either the QLCC undertakes an investigation or an attorney does not receive an appropriate response from an "up-the-ladder" report to the CLO, the audit committee likely will have to review the evidence of a material violation at some point even if it is not designated the QLCC.

Advantages and Disadvantages of a QLCC

The most important advantage of having an established QLCC is that it relieves in-house and outside attorneys of their obligations to assess the adequacy of the issuer's response to a report of evidence of a material violation. In addition, the SEC release adopting the rule states that a QLCC may produce broader benefits, such as encouraging early reporting of possible violations of law so that they can be more effectively stopped. The adopting release also clarifies that the SEC does not intend that service on a QLCC will increase any liability of a board member under state law and expressly finds that it would be inconsistent with the public interest for a court to so conclude (although, as a practical matter, the QLCC members may be more exposed).

On the other hand, establishing a QLCC also has disadvantages. First, use of the QLCC takes the inquiry out of the hands of the CLO. Since any attorney could in theory report evidence of a material violation directly to the QLCC in the first instance, the CLO would not have an opportunity to filter out frivolous reports. The CLO may also be in a better position to assess and address claims than a committee that meets only a few times a year. The company may want the CLO, who may be more familiar with the day to day legal operations of the company, to manage the process.

Second, independent directors serving on the QLCC may be diverted from other board duties, which may be particularly problematic if the audit committee is designated as the QLCC. Even if independent directors conclude that service on the QLCC itself does not increase their liability, they may be reluctant to accept additional obligations that divert time from other duties, such as audit committee service, for which they perceive their risk of liability to be increasing.

Third, the board of directors must grant the QLCC the authority and responsibility to take all appropriate steps, including notification of the SEC, in the event that the company does not implement the QLCC's recommended response to evidence of a material violation. This could be deemed to be an obligation to report out if the QLCC feels that an appropriate response has not been taken.

SEC "Up-the-Ladder" Reporting Requirement: Practical Suggestions for In-House Attorneys

"Noisy Withdrawal" considerations

If the SEC adopts either of its proposed "noisy withdrawal" requirements, the balance of risks might shift in favor of establishing a QLCC. Under the original "noisy withdrawal" proposal, which is still under consideration, an in-house attorney who does not receive an appropriate response after fully reporting evidence of a future or current material violation "up-the-ladder" must submit a written disaffirmation to the SEC which disaffirms the opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the SEC or incorporated into such a document. Under the alternative proposal, an in-house attorney would have to notify the company that he or she will cease participating in any matter relating to the suspected violation, and the *issuer* would be required to disclose receipt of such notice to the SEC in a filing under Form 8-K, 20-F or 40-F, as appropriate. Outside counsel would be required to withdraw from representing the issuer under both proposals, citing professional considerations, after which time either the outside counsel (under the original proposal) or the issuer itself (under the alternative) must notify the SEC that counsel has withdrawn, citing "professional considerations," which is meant to serve as a red flag to the SEC.

If a QLCC is established, both in-house attorneys and outside counsel would be permitted to make reports directly to the QLCC. In doing so, they would not have any further obligations to assess the company's response or pursue some form of "noisy withdrawal" or disaffirmation.

III Conclusion

There is no "one size fits all" with respect to the "up-the-ladder" reporting system. Each company will need to devise appropriate procedures based on its own culture, structure and needs. This memorandum has not attempted to provide legal advice or guidance with respect to any particular policy but instead attempts to raise questions which companies may consider in adopting their own procedures. Attorneys should also recognize that the SEC's "up-the-ladder" reporting requirements are in addition to state ethics rules and ABA rules which are also relevant in this area.

We would be pleased to consult with any company in order to help tailor a policy appropriate for its own circumstances. For further information, please call your regular Fried Frank contact or any of the attorneys listed below:

New York

Valerie Ford Jacob	212.859.8158
Kenneth R. Blackman	212.859.8280
Stuart Gelfond	212.859.8272
Barbara Gillers	212.859.8746
Lois Herzeca	212.859.8076
Michael Levitt	212.859.8735

Washington, DC

Karl Groskaufmanis	202.639.7314
Dixie Johnson	202.639.7269
Matt Morley	202.639.7034

London

Daniel Bursky	44.(0).20.7972.9674
Robert P. Mollen	44.(0).20.7972.9604
Timothy Peterson	44.(0).20.7972.9676

MODEL FORM OF

QUALIFIED LEGAL COMPLIANCE COMMITTEE CHARTER

PURPOSE

The purpose of the Qualified Legal Compliance Committee (the "Committee") of the Board of Directors (the "Board") of [ ] (the "Company") is to: (i) receive, review and take appropriate action with respect to any report made or referred to the Committee by an attorney of evidence of a material violation of applicable U.S. federal or state securities law, material breach of a fiduciary duty under U.S. federal or state law or a similar material violation by the Company or by any officer, director, employee, or agent of the Company, (ii) otherwise fulfill the responsibilities of a qualified legal compliance committee pursuant to Section 307 of the Sarbanes Oxley Act of 2002 and the rules promulgated thereunder and (iii) perform such other duties as may be assigned to it, from time to time, by the Board.

CHARTER

The scope of the Committee's responsibilities and its structure, process and membership requirements are set forth in this charter (the "Charter"), which has been adopted and approved by the Board and may be amended by the Board from time to time in compliance with applicable laws, rules and regulations.

COMPOSITION

[Alternative 1:] The Committee shall consist of at least one member of the Audit Committee of the Board and two members of the Board who are not employed directly or indirectly by the Company.[1]

[Alternative 2:] The Company's Audit Committee shall serve as the QLCC.

The members of the Committee shall be appointed and replaced by the Board.

---

[1] If the Company is a registered investment company, such persons also must not be "interested persons" as defined in Section 2(a)(19) of the Investment Company Act of 1940.

PROCEDURES

The Committee shall adopt written procedures for the confidential receipt, retention, and consideration of any oral or written reports received by the Committee. The Committee shall have the authority to establish other rules and operating procedures in order to fulfill its obligations under this Charter and under applicable law, rules and regulations. The Chairman of the Committee shall call a meeting of the Committee wherever circumstances warrant.

AUTHORITY AND RESPONSIBILITIES

1. The Committee shall have the following authority and responsibilities in respect of reports of evidence of a material violation:

   a. The Committee shall inform the chief legal officer and chief executive officer of any report of evidence of a material violation.

   b. The Committee shall determine whether an investigation is necessary regarding any such report.

   c. If the Committee has determined that an investigation is necessary, the Committee shall: (i) notify the Audit Committee or the Board, (ii) initiate an investigation to be conducted either by the Company's chief legal officer or by an outside attorney retained by the Committee and (iii) retain such additional expert personnel as the Committee deems necessary.

   d. At the conclusion of an investigation, the Committee shall: (i) recommend, by majority vote, that the Company implement an appropriate response and (ii) inform the chief legal officer, the chief executive officer and the Board of the results of the investigation and the appropriate remedial measures that it recommends to be adopted.

2. The Committee has the authority and responsibility to act, by majority vote, to take all other appropriate action, including the authority to notify the Securities and Exchange Commission in the event that the Company fails in any material respect to implement an appropriate response that the Committee has recommended to the Company.

3. The Committee shall report to the Board on a regular basis regarding the matters that it oversees.

QUALIFIED LEGAL COMPLIANCE COMMITTEE PROCEDURES

Any attorney or the chief legal officer of [ ] (the "Company") may submit a report (a "Report") of evidence of a material violation of applicable U.S. federal or state securities law, material breach of a fiduciary duty under U.S. federal or state law or a similar material violation by the Company or by any officer, director, employee or agent of the Company to the Qualified Legal Compliance Committee (the "Committee").

In order to facilitate the Committee's confidential receipt, retention, and consideration of Reports, the Committee has established the following procedures:

1. The Committee shall send a written acknowledgement of receipt of each oral or written Report to the sender.

2. The Committee shall notify the Company's chief legal officer and the chief executive officer promptly upon receipt of a Report.

3. The Chair of the Committee shall convene a meeting of the full Committee as often as deemed necessary or desirable and, in any case, promptly upon receipt of a Report.

4. The Committee shall keep minutes of each of its meetings.

5. The Committee shall review each Report and determine whether an investigation is necessary or desirable in connection with the matters addressed in such Report.

6. The Committee may consult with appropriate officers of the Company, who may include the chief legal counsel, or retain outside attorneys or experts in connection with its determination as to whether to commence an investigation in connection with a Report. The Committee may rely on the chief legal counsel or his or her designee to perform a preliminary investigation and advise the Committee as to whether further investigation is required.

7. If the Committee has determined that further investigation is necessary or desirable in connection with a Report, the Committee shall: (i) notify the Audit Committee of the Company's Board of Directors or the full Board of Directors, (ii) initiate an investigation, (iii) determine who shall conduct such investigation (which person may include the chief legal counsel or his or her designee), and (iv) retain such outside attorneys and expert personnel as the Committee deems necessary.

8. The Committee shall have the authority to enter into engagement letters, as appropriate, with outside attorneys and experts retained by it.

9. At the conclusion of an investigation, the Committee shall: (i) recommend, by majority vote, that the Company implement an appropriate response, if any, and (ii) inform the chief legal officer, the chief executive officer and the Board of Directors of the results of the investigation and the appropriate remedial measures, if any, that it recommends to be adopted.

10. The Committee shall take appropriate action to determine whether the Company has implemented an appropriate response to a Report, as recommended by the Committee, and, if not, shall determine what, if any, additional action should be taken.

11. The Committee shall retain a log of all Reports, tracking their receipt, investigation and resolution and shall periodically report on these matters to the Board of Directors.

12. The Committee shall take appropriate measures so that, to the maximum extent possible, consistent with its obligations, the Company's legal privileges are protected in connection with the Committee's activities.

13. The Committee shall maintain all documents received or reviewed by it in accordance with the Company's document retention policy.

14. The Committee shall maintain confidentiality in its activities to the maximum extent possible consistent with performing a full and fair investigation.