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COMMITTEE ON INVESTMENT MANAGEMENT REGULATION

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December 16, 2002

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys; File No. S7-45-02; File No. 33-8150 (the "Release")

Dear Mr. Katz:

The Committee on Investment Management Regulation of the Association of the Bar of the City of New York (the "Committee") is composed of lawyers with diverse perspectives on investment management issues, including members of law firms, and counsel to financial services firms, investment company complexes and investment advisers. A list of our current members is enclosed.

The Committee is pleased to comment on the proposed professional conduct rules. In light of the limited period within which comments are required to be prepared and submitted and the number and character of comments being submitted by other interested persons, the Committee's comments will focus on those issues presented by the proposed rules in the context of registered investment companies.

The Committee's comments are:

- The proposed conduct rules go substantially beyond rules required by Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act"). Because of the unique complexities of investment company representations and the shortness of the comment period, the Committee urges the Commission to defer adoption, and continue consideration, of those provisions of the proposed rules which go beyond the mandate of the Act. Adoption in the form proposed would, for registered investment companies and counsel involved in their affairs, be particularly

burdensome and ill-advised inasmuch as it risks disrupting a unique system of legal relationships that has operated to keep registered investment companies remarkably free of scandal.

- The existence of fiduciary and agency relationships between investment companies and their investment advisers is not a basis on which to deny effective legal representation to investment advisers, or to reverse the reasonable and historic expectation of investment advisers to registered investment companies that their affairs will be treated confidentially by their own lawyers.

- The conduct of the business and legal affairs of registered investment companies takes place in a unique and fragile environment, dependent on the cooperative efforts of many parties and their lawyers. The proposed rules represent a serious threat to that environment without commensurate benefit to investment companies and their shareholders.

- The proposed conduct rules ignore the salutary effect on the conduct of investment companies' legal affairs of the longstanding practice, now codified in Rule O-1(a)(6)(i) under the 1940 Act, that independent directors of investment companies are generally represented by independent legal counsel. This has not generally been the practice of other public companies and their boards of directors.

Unreasonably short comment period. The Act enshrines the concept that, when a lawyer is counsel to an issuer, it is the issuer, and not the officers, directors or employees, which is the lawyer's client. This concept is widely recognized in state professional ethics codes. Among other things, the Act does not require that external or internal lawyers to persons other than an issuer have a personal professional duty to the issuer's board of directors. The labored argument in the Release that the structure of professional responsibilities proposed in the conduct rules are consistent with the proposals of various professional groups and have generally been debated is unpersuasive to the Committee generally, but is simply not true in respect of the applicability of these rules to lawyers who are not engaged or employed by registered investment companies. Surely, an informed debate over more than the two months following the Release until January 26, 2003 is appropriate to such a fundamental restructuring of lawyer-nonclient relationships. Accordingly, the Committee urges the Commission to adopt on or prior to January 26, 2003 only those provisions of the proposed rules specifically mandated by Section 307 of the Act and begin the debate on the important parts of the Commission's proposals that go beyond those so mandated, including the proposed obligations of lawyers to issuers which are not clients.

The Committee specifically notes that, while the proposed rule provides "an attorney . . . in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information . . .", the proposed rules do not even address the expectations that the same lawyer's actual client or employer has that its confidences be maintained.

Denying legal representation to investment advisers. The Committee recognizes that multiparty representations present difficult issues for lawyers and that multiparty representations, whether of outside or internal counsel, are common in the investment company industry. However, except for the remark that "the investment adviser [owes] a fiduciary duty to the investment company", the Committee disagrees substantially with the text accompanying footnotes 33 and 34, and more importantly with the proposed direct obligation of lawyers acting for investment advisers and others to report evidence of material violations to the investment company's representatives (most likely the board or a committee). In carrying out their responsibilities, internal lawyers of advisers are acting as employees of the adviser which has contract responsibility to provide comprehensive services to the investment company. The Release misapplies the fiduciary duty of the investment adviser to the investment company by confusing it with a purported professional responsibility of a lawyer to a non-client. The obligation of such a lawyer to report to an investment company destroys the lawyer-client privilege between the lawyer and the investment adviser. At the very least, the implications of such a destruction of privilege should be thoroughly considered before it is mandated, particularly where undue haste is not necessary to meet statutory requirements.

The Committee believes that the Commission's off-handed remark that "[i]n effect, an attorney employed by the investment adviser and representing the investment company before the Commission has joint clients . . . ." is remarkable given the rule-making proceeding resulting in the adoption of Rule O-1(a)(6)(i) and the amendment of 10 important exemptive rules (the "Independent Counsel Rules"). See Role of Independent Directors of Investment Companies, IC-24082 (Oct. 14, 1999) (proposing release); and Rel. 33-7932; 34-43786; and FC-24816 (Jan. 2, 2001) (adopting release). In the adopting release relating to the Independent Counsel Rules, the Commission acknowledged that counsel to the adviser may have conflicts that make it inappropriate for independent directors to rely on them for advice. The entire basis if not necessity for the Independent Counsel Rules is thrown into question if the fund and the adviser are viewed as being "co-clients" with no conflicting interests, as far as counsel is concerned.

The Committee's view is that lawyers, and their investment adviser clients, ought not be put into the situation where the client adviser is unable to engage in fact finding, and appropriate legal research and analysis, in order to evaluate whether the client adviser, or the client investment company, may have violated securities laws, fiduciary duties or similar laws prior to reporting "evidence" to an investment company or its board. The Committee does not believe that a contrary conclusion is compelled "with special force" because of a fiduciary duty between an adviser and an investment company. The Committee believes, instead, that the fiduciary duty of the adviser compels <u>it</u> to investigate fully any evidence of possible material violations of law and to bring before the boards of any affected investment companies a mature conclusion on the evidence, or an action plan to resolve any uncertainties.

Unique and fragile environment. Unique among U.S. public companies, registered investment companies (with only a handful of exceptions) carry out their activities of investing assets, selling and redeeming securities, and complying with applicable laws and regulations through contract service providers. As a result, investment companies are entirely dependent on the collaborative efforts of their investment advisers, administrators (if any), and their respective lawyers, among others. At the same time, and as the Investment Company Act recognizes, there

is not an identity of interests among any of the relevant parties, and contract and fiduciary relationships are key to the well-functioning of each fund and the industry as a whole. Moreover, for better or worse, because of the regulatory complexity of investment company activities, lawyers appear to play a larger role in investment company affairs than they do in those of many other public companies.

The Committee believes that this unique and fragile environment is threatened by the proposed rules requiring lawyers employed by investment advisers and others to report evidence of material violations to investment company representatives.

The Committee believes that the consequences of the proposed rules include:

1. Investment advisers and others, principally administrators, will determine that their advisory or other agreements with registered investment company clients do not require that they provide "legal services" and, coincident with that, will limit or eliminate the participation of their internal and outside lawyers in the preparation of fund filings and materials so that such lawyers are not "involved in the representation of an issuer" or "practicing before the Commission" within the meaning of the proposed rules.

2. Legal expenses for investment companies will substantially increase because only outside lawyers who are only the investment company's lawyers will be required to fill the roles vacated by internal and/or outside lawyers of investment advisers and administrators.

3. There is an unreasonably high risk that the quality of and access to legal advice may suffer, particularly with respect to day-to-day advice to investment adviser personnel managing an investment company's affairs. For example, greater responsibility for preparation and filing of required documents may devolve to paraprofessional and other non-lawyer personnel.

4. After the roles of counsel have become more clearly defined and exclusive, the relationship between investment companies and their independent directors, on the one hand, and their advisors, on the other, will become increasingly adversarial. Among the points of aggravation will be increased expense ratios (or the exclusion of legal fees from expense caps), ready and real-time access to information, and contests over privilege and confidentiality.

The Committee believes not only that these consequences of the unnecessary extension of Section 307 to investment adviser lawyers are undesirable, but that they are not remote. Indeed, as the Commission is surely aware, the certifications now required by Section 302 of the Act and the rules thereunder have already had a profound effect on the willingness of many professional administration firms in the investment company industry to continue to provide their officers to serve as the chief executive or chief financial officers of investment companies, apparently because of the perceived imbalance between the potential liability and compensation.

Independent legal counsel. For many years, the independent directors of a substantial portion of registered management investment companies have been separately represented in connection with the satisfaction of their duties and responsibilities by counsel independent of the investment adviser. The importance of such independent legal counsel to the role of independent directors of investment companies as "independent watchdogs"[1] of the shareholders has been emphasized by the Commission in the rule-making proceeding resulting in the Independent Counsel Rules.

The Committee believes that the proposed conduct rules, designed clearly to establish as a matter of federal law, quite apart from the investment company context, that the lawyer's client is the public company "issuer", ignore the fact that, under the 1940 Act, independent directors have the statutory responsibility for overseeing the conflict-laden relationships between investment companies and their investment advisers, principal underwriters and affiliated persons, and that those directors have in substantial and increasing numbers been assisted by separate, independent counsel. The only role of such counsel is to represent the independent directors in their capacity as "watchdogs of the shareholders".

As a result, the problems experienced in certain other public companies, whether from confusion, lack of attention or other causes, over whose interests the directors represent, which are resolved by the Act do not exist in the investment company industry. The related question, for attorneys, of "who is the client," has received substantial attention in the investment company context, but much less outside. Accordingly, the compass of "practicing before the Commission" and "involved in the representation of the issuer" as applied to registered investment companies and the lawyers acting in various capacities for the investment company's adviser and other service providers is unnecessarily broad and, indeed, unnecessary, particularly in light of the lawyer's duties to clients and the potential adverse consequences discussed above.

Other comments. Many investment company directors, including many who are independent directors, are attorneys but do not provide legal advice in their capacities as directors. In addition, many executives in the fund industry began their careers as lawyers, but at one or another stage of their careers moved outside of the legal sphere. The Committee believes that neither of these categories of lawyers should be considered "practicing before the Commission" or "involved in the representation of an issuer" in their capacities as such. The Committee believes that the proposed rules or the adopting release should make this clear.

Many investment companies are structured to employ one or more subadvisers to manage, under the general supervision of their investment manager and boards, portions of their assets. Typically, subadvisers' activities do not involve the maintenance of books and records (other than portfolio records) of the investment company or the provision of administrative support, each of which are provided by the investment manager. Neither investment managers nor fund directors have or expect to have any relationship with the subadvisers' lawyers. The Committee believes that capturing such lawyers within the universe of those "involved in the representation of the issuers" will magnify the problems discussed under "Unique and fragile

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[1] Burks v. Lasker, 441 U.S. 471, 485 (1979).

environment" above, increase costs to registered investment companies and provide no discernible benefits.

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The Committee believes that the Commission's approach to investment companies in its rule-making under the Act unnecessarily and disproportionately increases the burdens on registered investment companies compared to other public companies notwithstanding that investment companies were not the cause of corporate reforms mandated by the Act and in most relevant respects conducted their affairs in accordance with the principles of those reforms. The proposed conduct rules for attorneys, in ignoring the statutory and regulatory framework within which investment companies operate and the very substantial historical and increasing reliance of independent directors on independent counsel in fulfilling their duties, continue that unnecessary and disproportionately burdensome approach.

In the time frame available for discussion, the Committee believes that it is not practical to construct an articulated and practical framework for professional conduct giving effect appropriately both to the requirements of the Act and the complexity of the business arrangements and representations by counsel within the investment company industry. However, such a framework would give effect to the special roles played by independent directors of investment companies, the role of independent legal counsel, the core contractual relationship between investment companies and their investment advisers and others, and the privilege and confidentiality that contract service providers reasonably expect in their relationships with their own lawyers and personnel. For example, consideration might be given to the negotiation of arrangements between the independent directors of a fund, assisted by independent legal counsel, and the adviser and other service providers whose lawyers might be deemed "involved in the representation" of the fund which would govern the reporting responsibilities of those lawyers. These arrangements could reflect the collaborative efforts made by all parties in the legal affairs of investment companies, preserve appropriate privilege and confidences, and lever the existing practices which have protected investment companies and their shareholders.

The Committee obviously believes that there must be a balance struck between and among these and other elements and the objectives of the Act, but the Committee strongly believes that the balance struck in the rule proposals is not the right one and may have serious adverse effects on the industry, and not just the lawyers.

Very truly yours,

/s/ John E. Baumgardner, Jr.

John E. Baumgardner, Jr.
Chair

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