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17 CFR Parts 205, 240, and 249
Implementation of Standards of Professional Conduct for Attorneys; Final Rule and Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 205

[Release Nos. 33–8185; 34–47276; IC–25919; File No. S7–45–02]

RIN 3235–AI72

Implementation of Standards of Professional Conduct for Attorneys

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is adopting a final rule establishing standards of professional conduct for attorneys who appear and practice before the Commission on behalf of issuers. Section 307 of the Sarbanes-Oxley Act of 2002 requires the Commission to prescribe minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers. The standards must include a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer up-the-ladder within the company to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and, if they do not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors. Proposed Part 205 responds to this directive and is intended to protect investors and increase their confidence in public companies by ensuring that attorneys who work for those companies respond appropriately to evidence of material misconduct. We are still considering the ''noisy withdrawal'' provisions of our original proposal under section 307; in a related proposing release we discuss this part of the original proposal and seek comment on additional alternatives.

EFFECTIVE DATE: August 5, 2003.

FOR FURTHER INFORMATION CONTACT: Timothy N. McGarey or Edward C. Schweitzer at 202–942–0835.

I. Executive Summary

Section 307 of the Sarbanes-Oxley Act of 2002 (the ''Act'') (15 U.S.C. 7245)[1] mandates that the Commission issue rules prescribing minimum standards of professional conduct for attorneys appearing and practicing before it in any way in the representation of issuers, including at a minimum a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer or any agent thereof to appropriate officers within the issuer and, thereafter, to the highest authority within the issuer, if the initial report does not result in an appropriate response. The Act directs the Commission to issue these rules within 180 days.[2]

On November 21, 2002, in response to this directive, we published for comment proposed Part 205, entitled ''Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission in the Representation of an Issuer.'' The proposed rule prescribed minimum standards of professional conduct for attorneys appearing and practicing before us in any way in the representation of an issuer. The proposed rule took a broad view of who could be found to be appearing and practicing before us. It covered lawyers licensed in foreign jurisdictions, whether or not they were also admitted in the United States. In addition to a rigorous up-the-ladder reporting requirement, the proposed rule incorporated several corollary provisions. Under certain circumstances, these provisions permitted or required attorneys to effect a so-called ''noisy withdrawal'' by notifying the Commission that they have withdrawn from the representation of the issuer, and permitted attorneys to report evidence of material violations to the Commission.

Our proposing release [3] generated significant comment and extensive debate. We received a total of 167 timely comment letters: 123 from domestic parties and 44 from foreign parties. In addition to soliciting comments, on December 17, 2002 the Commission hosted a Roundtable discussion concerning the impact of the rules upon foreign attorneys. Many of these comments focused on the following issues: The scope of the proposed rule (including, particularly, its application to attorneys who either are not admitted to practice in the United States, or are admitted in the United States but who do not practice in the field of securities law); the proposed rule's ''noisy withdrawal'' provision (including the Commission's authority to promulgate this portion of the rule and the provision's impact upon the attorney-client relationship); and the triggering standard for an attorney's duty to report evidence of wrongdoing. In light of the compressed time period resulting from the 180-day implementation deadline prescribed in the Act, a number of commenters requested that the Commission allow additional time for consideration of several aspects of the proposed rule, including the application of the rule to non-United States lawyers and the impact of the ''noisy withdrawal'' and related provisions.

The thoughtful and constructive suggestions we have received from a broad spectrum of commenters have enabled us better to understand interested parties' views concerning the operation and impact of the proposed rule. As more specifically discussed below, the final rule we adopt today has been significantly modified in light of these comments and suggestions. Thus, the triggering standard for reporting evidence of a material violation has been modified to clarify and confirm that an attorney's actions will be evaluated against an objective standard. The documentation requirements imposed upon attorneys and issuers under the proposed rule have been eliminated, and a ''safe harbor'' provision has been added to protect attorneys, law firms, issuers and officers and directors of issuers. In response to the large number of comments requesting that we defer the immediate implementation of a final rule to accord affected persons adequate time to assess the duties imposed thereunder, we have deferred the effective date of the rule until 180 days after publication in the **Federal Register**.

We believe that the final rule responds fully to the mandate of Section 307 to require reporting of evidence of material violations up-the-ladder within an issuer, thereby allowing issuers to take necessary remedial action expeditiously and reduce any adverse

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[1] Section 307 of the Sarbanes-Oxley Act of 2002 (the ''Act'') (15 U.S.C. 7245) mandates that the Commission: Shall issue rights, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—

(1) Requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) If the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

[2] President Bush signed the Act on July 30, 2002.

[3] *See* Release 33–8150 (Nov. 21, 2002), 67 FR 71669 (Dec. 2, 2002).

impact upon investors. The final rule strikes an appropriate balance between our initial rule proposal on up-the-ladder reporting and the various views expressed by commenters while still achieving this important goal.

At the same time, the Commission considers it important to move forward in its assessment of rules under Section 307 requiring attorney withdrawal and notice to the Commission in cases where an issuer's officers and directors fail to respond appropriately to violations that threaten substantial injury to the issuer or investors. Accordingly, we are extending the comment period on the ''noisy withdrawal'' and related provisions of the proposed rule and are issuing a separate release soliciting comment on this issue. In that release, we are also proposing and soliciting comment on an alternative procedure to the ''noisy withdrawal'' provisions. Under this proposed alternative, in the event that an attorney withdraws from representation of an issuer after failing to receive an appropriate response to reported evidence of a material violation, the issuer would be required to disclose its counsel's withdrawal to the Commission as a material event. In the same release, we are soliciting additional comment on the final rules we are adopting, particularly insofar as adoption of the ''noisy withdrawal'' provisions of the proposed alternative might require conforming changes to the final rule.

Interested parties should submit comments within 60 days of the date of publication of the proposing release in the **Federal Register**. This will provide additional time for interested parties to comment on the impact of these provisions while still allowing for their implementation as of the effective date of the final rule.

II. Section-by-Section Discussion of the Final Rule

Section 205.1—Purpose and Scope

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

Proposed Section 205.1 stated that this part will govern ''[w]here the standards of a state where an attorney is admitted or practices conflict with this part.'' In the proposing release, we specifically raised the question whether this part should ''preempt conflicting state ethical rules which impose a lower obligation'' upon attorneys.[4]

A number of commenters questioned the Commission's authority to preempt state ethics rules, at least without being explicitly authorized and directed to do so by Congress.[5] Another comment letter noted that the Constitution's Commerce Clause grants the federal government the power to regulate the securities industry, that the Sarbanes-Oxley Act requires the Commission to establish rules setting forth minimum standards of conduct for attorneys appearing and practicing before it, and that, under the Supremacy Clause, duly adopted Commission rules will preempt conflicting state rules.[6] Finally, several commenters questioned why the Commission would seek to supplant state ethical rules which impose a higher obligation upon attorneys.[7]

The language which we adopt today clarifies that this part does not preempt ethical rules in United States jurisdictions that establish more rigorous obligations than imposed by this part. At the same time, the Commission reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdiction in which an attorney is admitted or practices.

Section 205.2—Definitions

For purposes of this part, the following definitions apply:

(a) *Appearing and practicing* before the Commission:

(1) Means:

(i) Transacting any business with the Commission, including communications in any form;

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2) Does not include an attorney who:

(i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii) Is a non-appearing foreign attorney.

The definition of the term ''appearing and practicing'' included in the proposed rule was based upon Rule 102(f) of our Rules of Practice, and covered, *inter alia*, an attorney's advising a client (1) that a statement, opinion, or other writing does not need to be filed with or incorporated into any type of submission to the Commission or its staff, or (2) that the issuer is not required to submit or file any registration statement, notification, application, report, communication or other document with the Commission or its staff. This broad definition was intended to reflect the reality that materials filed with the Commission frequently contain information contributed, edited or prepared by individuals who are not necessarily responsible for the actual filing of the materials, and was consistent with the position the Commission has taken as *amicus curiae* in cases involving liability under Section 10(b) of the Exchange Act (15 U.S.C. 78j(b)).

A number of commenters argued that the proposed definition of ''appearing and practicing'' was overly broad. The American Bar Association (''ABA'') stated that the definition in the proposed rule would unfairly:

> subject to the rules attorneys who do not practice securities law and may have only limited or tangential involvement with particular SEC filings and documents. For example, it could inappropriately encompass non-securities specialists who do no more than prepare or review limited portions of a filing, lawyers who respond to auditors' letters or prepare work product in the ordinary course unrelated to securities matters that may be used for that purpose,

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[4] 67 FR 71670, 71697 (Dec. 2, 2002).

[5] See Comments of the Association of the Bar of the City of New York, at 28 (''There is nothing in Section 307 to suggest that Congress authorized the Commission to preempt state law and rules governing attorney conduct.''); *see also* Comments of the American Bar Association, at 32; Comments of 77 law firms, at 2. While questioning the Commission's authority in this area, the American Bar Association (''ABA'') nevertheless recognized that ''the federal system of the United States may provide an arguable basis for the pre-emption of attorney-client and confidentiality obligations applicable to United States attorneys.'' *See* Comments of the American Bar Association, at 37.

[6] *See* Comments of Susan P. Koniak *et al.*, at 28–29.

[7] *See*, *e.g.*, Comments of Susan P. Koniak *et al.*, at 32; Comments of Richard W. Painter, at 8; Comments of Nancy J. Moore, at 3.

and lawyers preparing documents that eventually may be filed as exhibits. * * * We also believe it is inappropriate for the Commission to include lawyers who simply advise on the availability of exemptions from registration.[8]

The ABA recommended that the definition be modified to apply ''only to those lawyers with significant responsibility for the company's compliance with United States securities law, including satisfaction of registration, filing and disclosure obligations, or with overall responsibility for advising on legal compliance and corporate governance matters under United States law.''[9]

On the other hand, several commenters supported the more expansive definition set forth in the proposed rule. A comment letter submitted by a group of 50 academics specifically affirmed their:

> support [for] the Commission's inclusion of lawyers who advise and/or draft, but do not sign, documents filed with the Commission, as well as lawyers who advise that documents need not be filed with the Commission. Any other rule would facilitate circumvention of these rules by encouraging corporate managers and corporate counsel to confine lawyer signatures on Commission documents or filings to a bare minimum to ensure no up-the-ladder reporting of wrongdoing. That would risk gutting these rules and § 307.[10]

The definition contained in the final rule addresses several of the concerns raised by commenters. Attorneys who advise that, under the federal securities laws, a particular document need not be incorporated into a filing, registration statement or other submission to the Commission will be covered by the revised definition. In addition, an attorney must have notice that a document he or she is preparing or assisting in preparing will be submitted to the Commission to be deemed to be ''appearing and practicing'' under the revised definition. The definition in the final rule thereby also clarifies that an attorney's preparation of a document (such as a contract) which he or she never intended or had notice would be submitted to the Commission, or incorporated into a document submitted to the Commission, but which subsequently is submitted to the Commission as an exhibit to or in connection with a filing, does not constitute ''appearing and practicing'' before the Commission.

As discussed below, commenters also raised concerns regarding the potential application of the rule to attorneys who, while admitted to practice in a state or other United States jurisdiction, were not providing legal services to an issuer. Under the final rule, attorneys need not serve in the legal department of an issuer to be covered by the final rule, but they must be providing legal services to an issuer within the context of an attorney-client relationship. An attorney-client relationship may exist even in the absence of a formal retainer or other agreement. Moreover, in some cases, an attorney and an issuer may have an attorney-client relationship within the meaning of the rule even though the attorney-client privilege would not be available with respect to communications between the attorney and the issuer.

The Commission intends that the issue whether an attorney-client relationship exists for purposes of this part will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer. Thus, whether the provision of legal services under particular circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under this part. This portion of the definition will also have the effect of excluding from coverage attorneys at public broker-dealers and other issuers who are licensed to practice law and who may transact business with the Commission, but who are not in the legal department and do not provide legal services within the context of an attorney-client relationship. Non-appearing foreign attorneys, as defined below, also are not covered by this definition.

205.2(b) provides:

> (b) *Appropriate response* means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:
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> (1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;
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> (2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or
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> (3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:
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> (i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or
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> (ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

The definition of ''appropriate response'' emphasizes that an attorney's evaluation of, and the appropriateness of an issuer's response to, evidence of material violations will be measured against a reasonableness standard. The Commission's intent is to permit attorneys to exercise their judgment as to whether a response to a report is appropriate, so long as their determination of what is an ''appropriate response'' is reasonable.

Many of the comments on this paragraph focused on the proposal's standard that an attorney has received an appropriate response when the attorney ''reasonably believes,'' based on the issuer's response, that there either is or was no material violation, or that the issuer has adopted appropriate remedial measures. They suggested, among other things, that the paragraph be amended to state that the attorney could rely upon the factual representations and legal determinations that a reasonable attorney would rely upon,[11] or that the Commission adopt the ABA's Model Rules' definition of ''reasonably believes.''[12] Others opined that the

[8] *See* Comments of the American Bar Association, at 12.

[9] *Id.; see also* Comments of Sullivan & Cromwell, at 12–14; Comments of 77 law firms, at 7 (arguing that the scope of the definition of the term may incite efforts by attorneys to limit their involvement in certain matters in an effort to avoid coming within the purview of the rule).

[10] *See* Comments on Susan P., Koniak *et al.,* at 33.

[11] Comments of Thomas D. Morgan, at 5–6; Comments of Morrison & Foerster and eight other law firms, at 14 (paragraph 205.2(b) should be revised to read that in all situations it would be an appropriate response for an issuer to assert a colorable defense to any claim of material violation).

[12] Comments of Palmer & Dodge, Attachment at 2 (''The Model Rules state that 'reasonable belief' or 'reasonably believes' when used in reference to a lawyer denotes that the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable.'' Model Rule 1.0(i)). ''Reasonable'' and ''reasonably,'' in turn, are defined as ''denot[ing] the conduct of a reasonably prudent and competent lawyer.'' Model Rule 1.0(h). Along similar lines, one group of commenters suggested that the paragraph include language paralleling the Model Rule definition, setting as the standard the conclusion of ''a prudent and competent attorney, acting reasonably under the same circumstances'' that a response was appropriate. Comments of Susan P. Koniak *et al.,* at 12–13, 15; *see also* Comments of the SIA/TBMA, at 18 (urging that the Commission modify this paragraph to protect an attorney whose judgment that an issuer's response was appropriate was ''reasonable under the circumstances'').

''reasonably believes'' standard was inappropriate because it would impose on lawyers who are not expert in the securities laws a standard based on the ''reasonable'' securities law expert.[13] Others opined that the standard should be modified to require the lawyer's ''actual understanding,'' rather than reasonable belief, regarding a ''clear'' material violation,[14] while others urged that the standard must be objective.[15]

Other commenters felt that the paragraph did not properly address situations, which the commenters felt would be frequent, where an issuer's inquiry into the report of a possible material violation would be ''inconclusive.''[16] Others expressed the belief that the rule did not give a reporting lawyer sufficient guidance ''such that a reporting attorney can with confidence, and without speculation, determine whether he or she has received an appropriate response.''[17] Some comments questioned whether reporting attorneys would be able to judge whether discipline or corrective measures were sufficient to constitute an appropriate response.[18] One suggested that the paragraph be modified to provide that an attorney has received an appropriate response when the chief legal officer (''CLO'') states that he or she has fulfilled the obligations set forth in Section 205.3(b)(3), unless the attorney is reasonably certain that the representations are untrue.[19] Some commenters found the term ''and/or'' in subparagraph (b)(2) of the proposed paragraph confusing.[20] Others questioned whether the provision that the issuer ''rectify'' the material violation should be read to contemplate restitution to injured parties, with one stating that it did not believe Congress intended to impose upon attorneys an obligation to require issuers to make restitution,[21] while others read the proposed rule as ''impl[ying] that the appropriateness of a response need not include compensation of injured parties,'' and accordingly supported this standard.[22] A few commenters noted that under subparagraph (b)(2) a response is appropriate only if the issuer has already ''adopted remedial measures,'' and thus apparently does not apply if the issuer is in the process of adopting them. They urged that the Commission provide that an appropriate response includes ongoing remedial measures.[23]

A few comments were directed at the discussion accompanying the proposed rule. One suggestion was that the Commission make clear that the factors it will consider in determining whether an outside law firm's response that no violation has occurred constitutes an appropriate response include a description of the scope of the investigation undertaken by the law firm and the relationship between the issuer and the firm. They also urged the Commission to expressly state that the greater or more credible the evidence that triggered the report, the more detailed an investigation into the matter must be.[24] One commenter also suggested that the Commission withdraw the statement in the release of the proposed rule that Section 205.2(b) ''permits'' attorneys ''to exercise their judgment,'' finding that language both superfluous and conveying a signal that the Commission will be loathe to second-guess a lawyer's judgment that a response is ''appropriate.'' [25]

Several commenters suggested that the proposed rule should exempt internal investigations of reported evidence of a material violation.[26] Commenters were concerned that the reporting and disclosure requirements in the proposed rules might discourage issuers from obtaining legal advice and undertaking internal investigations and that, as a result, some violations might not be discovered or resolved.[27] Thus, some commenters urged that an issuer must be permitted ''to retain counsel to investigate the claim and respond to it, including defense in litigation, without being at risk of violating the rule.''[28] Some commenters stated that ''counsel conducting an internal investigation'' should not be subject to the rule's reporting and disclosure requirements.[29]

The proposing release stated that ''[i]t would not be an inappropriate response to reported evidence of a material violation for an issuer's CLO to direct defense counsel to assert either a colorable defense or a colorable basis for contending that the staff should not prevail. Such directions from the CLO, therefore, would not require defense counsel to report any evidence of a material violation to the issuer's directors.''[30] Several commenters were concerned over a possible chilling effect on an attorney's representation of an issuer in a Commission investigation or administrative proceeding if the attorney were subject to reporting and disclosure requirements.[31] Some noted

[13] Comments of the American Corporate Counsel Association, at 10. This concern was also expressed by commenters who asserted that foreign lawyers, in particular, would not have sufficient practical knowledge of United States laws to determine what constitutes an appropriate response. See, *e.g.*, Comments of Nagashima Ohno & Tsunematsu, at 7; Comments of the SIA/TBMA, at 13 (reporting attorney's judgment should be evaluated in light of that attorney's training, experience and position).

[14] Comments of Covington & Burling, at 3.

[15] Comments of Susan P. Koniak *et al.*, at 12–13.

[16] Comments of Covington & Burling, at 3.

[17] Comments of Richard Hall, Cravath Swaine & Moore, at 6–7; Comments of the Association of the Bar of the City of New York, at 12; Comments of Carter, Ledyard & Milburn, at 3 (stating that requiring an attorney, in deciding whether an issuer has made an appropriate response, to determine whether a material violation is about to occur, is an ''impossibly predictive standard''); Comments of the Japan Federation of Bar Associations, at 3 (opining that the term ''appropriate response'' cannot be easily construed on its face).

[18] Comments of the SIA/TBMA, at 18; Comments of the Association of the Bar of the City of New York, at 12 (''[o]nce an attorney has reported and documented a possible violation, the attorney should be assured that good faith reliance upon the response protects the attorney).

[19] Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 14; Comments of the American Bar Association, at 22 (''[w]e believe it is important that the Commission recognize that a reporting attorney may rely on the considered judgment of the CLO so long as that judgment is in the range of reasonableness even though the attorney would not necessarily come out that way''); Comments of Skadden, Arps, Slate, Meagher & Flom, at 9–10 (reporting attorney should be able to rely upon the stated belief of the officer to whom he has reported the evidence of material violation that no material violation has occurred).

[20] Comments of JP Morgan & Chase, at 10–11; Comments of Debevoise & Plimpton, at 5.

[21] Comments of JP Morgan & Chase, at 11; Comments of Debevoise & Plimpton, at 5–6.

[22] Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 14.

[23] Comments of Carter, Ledyard & Milburn, at 3; Comments of Skadden, Arps, Slate, Meagher & Flom, at 9–10 (appropriate response should include a timely response that adequate measures are being taken).

[24] Comments of Susan P. Koniak *et al.*, at 13; Comments of Schiff Hardin & Waite, at 4–5 (criticizing the examples in the release of the proposed rule as undercutting the proposition that attorneys will be permitted to exercise their reasonable judgment, and stating that the Commission should clarify that the reasonableness of an issuer's response will vary depending on the circumstances and will not necessarily depend on the existence of a written legal opinion from outside counsel to the issuer); Comments of the SIA/TBMA, at 18 (suggesting revisions to Section 205.2(b) that would state that an appropriate response should be reasonable under the circumstances, measured by the magnitude and quality of the evidence of the violation, the severity of the violation, and whether there is a potential for ongoing or recurring violation).

[25] Comments of Susan P. Koniak *et al.*, at 12.

[26] Comments of the SIA/TBMA, at 11 (stating that the Rules ''should exempt outside counsel whom securities firms retain to conduct internal investigations'').

[27] Comments of Carter, Ledyard & Milburn, at 6 (noting risk that proposed rules ''might discourage persons from seeking legal representation''); Comments of the SIA/TBMA, at 11.

[28] Comments of Weil Gotshal & Manges, at 7.

[29] Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 4; Comments of the American Bar Association, at 30.

[30] 67 FR 71683.

[31] Comments of Akin Gump Strauss Hauer & Feld, at 7–8; Comments of Cleary, Gottlieb, Steen &

Continued

that an issuer's disagreement in good faith with the Commission over a matter in litigation should not raise a reporting obligation under the rules.[32] Others suggested that the definition of ''appropriate response'' include the assertion of ''a colorable defense or the obligation of the Commission staff to bear the burden of proving its case.'' [33] Some commenters stressed that an attorney representing an issuer should be able to take any position for which there is an evidentiary foundation and a nonfrivolous legal basis.[34] The commenters did not want the final rules to impair an advocate's ability to present non-frivolous arguments. Some commenters noted that an issuer has no right to use an attorney to conceal ongoing violations or plan further violations of the law.[35]

The standard set forth in the final version of Section 205.2(b) requires the attorney to ''reasonably believe'' either that there is no material violation or that the issuer has taken proper remedial steps. The term ''reasonably believes'' is defined in Section 205.2(m). In providing that the attorney's belief that a response was appropriate be reasonable, the Commission is allowing the attorney to take into account, and the Commission to weigh, all attendant circumstances. The circumstances a reporting attorney might weigh in assessing whether he or she could reasonably believe that an issuer's response was appropriate would include the amount and weight of the evidence of a material violation, the severity of the apparent material violation and the scope of the investigation into the report. While some commenters suggested that a reporting attorney should be able to rely completely on the assurance of an issuer's CLO that there was no material violation or that the issuer was undertaking an appropriate response, the Commission believes that this information, while certainly relevant to the determination whether an attorney could reasonably believe that a response was appropriate, cannot be dispositive of the issue. Otherwise, an issuer could simply have its CLO reply to the reporting attorney that ''there is no material violation,'' without taking any steps to investigate and/or remedy material violations. Such a result would clearly be contrary to Congress' intent in enacting Section 307. On the other hand, it is anticipated that an attorney, in determining whether a response is appropriate, may rely on reasonable and appropriate factual representations and legal determinations of persons on whom a reasonable attorney would rely.

Some commenters expressed confusion over the ''and/or'' connectors in the proposed subparagraph (b)(2), and they have been eliminated in the final rule. The Commission believes that the revisions to this subparagraph make clear that the issuer must adopt appropriate remedial measures or sanctions to prevent future violations, redress past violations, and stop ongoing violations and consider the feasibility of restitution. The concern that under subparagraph (b)(2) any issuer's response to a reporting attorney that remedial measures are ongoing but not completed must be deemed to be inappropriate, thereby requiring reporting up-the-ladder, appears to be overstated. Many remedial measures, such as disclosures and the cessation of ongoing material violations, will occur in short order once the decision has been made to pursue them. Beyond this, the reasonable time period after which a reporting attorney is obligated to report further up-the-ladder would include a reasonable period of time for the issuer to complete its ongoing remediation.

By broadening the definition of ''appropriate response,'' subparagraph (b)(3) responds to a variety of concerns raised by commenters. Subparagraph (b)(3) permits an issuer to assert as an appropriate response that it has directed its attorney, whether employed or retained by it, to undertake an internal review of reported evidence of a material violation and has substantially implemented the recommendations made by an attorney after reasonable investigation and evaluation of the reported evidence. However, the attorney retained or directed to conduct the evaluation must have been retained or directed with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to 205.3(b)(3), or a qualified legal compliance committee.

Subparagraph (b)(3) also explicitly incorporates into the final rule our view, expressed in the proposing release, that ''[i]t would not be an inappropriate response to reported evidence of a material violation for an issuer's CLO to direct defense counsel to assert either a colorable defense or a colorable basis for contending that the staff should not prevail.''[36] Subparagraph (b)(3) incorporates this standard into the definition of ''appropriate response'' by permitting an issuer to respond to a report that it has been advised by its attorney that he or she may assert a colorable defense on behalf of the issuer in response to the reported evidence ''in any investigation or judicial or administrative proceeding,'' including by asserting a colorable basis that the Commission or other charging party should not prevail.[37] The provision would apply only where the defense could be asserted consistent with an attorney's professional obligation. Once again, the attorney opining that he or she may assert a colorable defense must have been retained or directed to evaluate the matter with the consent of the issuer's board of directors, a committee thereunder to whom a report could be made pursuant to Section 205(b)(3), or a qualified legal compliance committee.

We noted in our proposing release our intention that the rule not ''impair zealous advocacy, which is essential to the Commission's processes.''[38] The attorney conducting an internal investigation that is contemplated under subparagraph (b)(3) may engage in full and frank exchanges of information with the issuer he or she represents.

Hamilton, at 9 (''There would be an unavoidable chilling effect on the advocacy of lawyers who represent clients before the Commission in investigations and administrative proceedings if Rule 205 applies to them.''); Comments of the Association of the Bar of the City of New York, at 19–20 (stating that it would be ''unfair[] to include attorneys who are adverse parties in enforcement or administrative proceedings within the reporting and withdrawal requirements of the proposed rules''); Comments of Susan P. Koniak *et al.*, at 36 (final rules should ''avoid chilling legitimate and vigorous advocacy'').

[32] Comments of Richard Hall, Cravath, Swaine & Moore, at 3.

[33] Comments of Morrison & Foerster and eight other law firms, at 14.

[34] Comments of Securities Regulation Committee, Business Law Section, New York State Bar Association, at 6 (stating that ''a lawyer need not subjectively believe that he or she has the 'better side of the argument' or that it is a position likely to prevail. The attorney is permitted to undertake the representation if he or she, after a reasonable investigation, believes that there is (or will be) evidentiary support for the position and that the assertions of law are nonfrivolous. See, *e.g.*, Rule 11, Fed. R. Civ. P.''). *See also* Comments of Cleary, Gottlieb, Steen & Hamilton, at 9 (''Lawyers representing clients before the Commission must be free to make all non-frivolous arguments to the staff.'').

[35] Comments of Susan P. Koniak, *et al.*, at 37.

[36] The text of the final rule does not specifically include a reference to a ''colorable basis for contending that the staff [or other litigant] should not prevail,'' nor does it specifically refer to requiring the Commission staff or other litigant to bear the burden of its case. The Commission, however, considers these and related actions permitted to an attorney, consistent with his or her professional obligations, to be included within the reference to asserting a ''colorable defense.''

[37] Subparagraph (b)(3) thereby also addresses the concern of some commenters that an attorney representing an issuer in connection with a Commission investigation or administrative proceeding not be required to report the information. Under subparagraph (b)(3), asserting a colorable defense on an issuer's behalf in an investigation or administrative proceeding may constitute an appropriate response, and no further reporting would be required.

[38] 67 FR 71673.

Moreover, as noted above, subparagraph (b)(3) expressly provides that the assertion of colorable defenses in an investigation or judicial or administrative proceeding is an appropriate response to reported evidence of a material violation. Concerns over a chilling effect on advocacy should thus be allayed. At the same time, by including a requirement that this response be undertaken with the consent of the issuer's board of directors, or an appropriate committee thereof, the revised definition is intended to protect against the possibility that a chief legal officer would avoid further reporting ''up-the-ladder'' by merely retaining a new attorney to investigate so as to assert a colorable, but perhaps weak, defense.

The term ''colorable defense'' does not encompass all defenses, but rather is intended to incorporate standards governing the positions that an attorney appropriately may take before the tribunal before whom he or she is practicing. For example, in Commission administrative proceedings, existing Rule of Practice 153(b)(1)(ii), 17 CFR 201.153(b)(1)(ii), provides that by signing a filing with the Commission, the attorney certifies that ''to the best of his or her knowledge, information, and belief, formed after reasonable inquiry, the filing is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law.'' An issuer's right to counsel is thus not impaired where the attorney is restricted to presenting colorable defenses, including by requiring the Commission staff to bear the burden of proving its case. Of course, as some commenters noted, an issuer has no right to use an attorney to conceal ongoing violations or plan further violations of the law.

205.2(c) provides:

(c) *Attorney* means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.

Commenters suggested that the proposed rule's definition of the term ''attorney'' was unnecessarily broad. A number of commenters suggested that it was inappropriate to apply the rule to foreign attorneys, arguing that foreign attorneys, and attorneys representing or employed by multijurisdictional firms, are subject to statutes, rules, and ethical standards in those foreign jurisdictions that are different from, and potentially incompatible with, the requirements of this rule.[39] These points were amplified by foreign attorneys who attended a December 17, 2002 Roundtable discussion hosted by the Commission to address the issues raised by the application of the rule to foreign attorneys.

As noted above, and as set forth more fully below, the rule we adopt today adds a new defined term, ''non-appearing foreign attorney,'' which addresses many of the concerns expressed regarding the application of the rule to foreign attorneys. In addition, other commenters argued that the proposed rule's definition of ''attorney'' applied to a large number of individuals employed by issuers who are admitted to practice, but who do not serve in a legal capacity. By significantly narrowing the definition of the term ''appearing and practicing'' as set forth above, we have addressed many of the concerns expressed by commenters concerning the application of the rule to individuals admitted to practice who are employed in non-legal positions and do not provide legal services.

205.2(d) provides:

(d) *Breach of fiduciary duty* refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

The definition we adopt today has been slightly modified from the definition included in the proposing release. Several commenters suggested that the definition in the proposing release should be amended to include breaches of fiduciary duty arising under federal or state statutes.[40] The phrase ''under an applicable federal or state statute'' has been added to clarify that breaches of fiduciary duties imposed by federal and state statutes are covered by the rule.

205.2(e) provides:

(e) *Evidence of a material violation* means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.

This revised definition of ''evidence of a material violation'' clarifies aspects of the objective standard that the Commission sought to achieve in the definition originally proposed.[41] The definition of ''evidence of a material violation'' originally proposed prompted extensive comment because (read together with the rule's other definitions) it defines the trigger for an attorney's obligation under the rule to report up-the-ladder to an issuer's CLO or qualified legal compliance committee (''QLCC'') (in section 205.3(b)). Some commenters, including some practicing attorneys, found the proposed reporting trigger too high.[42] Many legal scholars endorsed the framework of increasingly higher triggers for reporting proposed by the Commission at successive stages in the reporting process but considered the Commission's attempt at articulating an objective standard unworkable and suggested changes to the language in the proposed rule.[43] Nearly all practicing lawyers who commented found the reporting trigger in the rule too low and called instead for a subjective standard, requiring ''actual belief'' that a material violation has occurred, is ongoing, or is about to occur before the attorney would be obligated to make an initial report within the client issuer.[44] The revised

[39] See, *e.g.*, Comments of Skadden, Arps, Slate, Meagher and Flom, at 16 (noting that foreign private issuers usually consult with United States counsel on securities matters, and suggesting that limiting the definition of ''attorney'' to lawyers licensed in United States jurisdictions ''will avoid the unfairness of subjecting foreign lawyers to the Proposed Rules without compromising the effectiveness of the rules.'').

[40] *See* Comments of Richard W. Painter, at 10–11 (''Breaches of fiduciary duty to pension funds under federal law such as ERISA, and other similar violations would thus clearly be covered, whereas arguably they are not under the current definition in the Proposed Rules.'').

[41] The proposed rule defines *evidence of a material violation* as ''information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur'' and *reasonable belief* as what ''an attorney, acting reasonably, would believe.''

[42] *E.g.,* Comments of John Bullock, at 1 (''the threshold for mandatory reporting by an attorney should be the level of evidence that a responsible corporate officer should want to know, so that the client can pursue an investigation and take appropriate action. The standard should therefore be 'some credible information that a material violation may have occurred, may be occurring, or may be about to occur.'''').

[43] Comments of Richard W. Painter, at 6 (suggesting that ''evidence that a violation is 'possible' could trigger the duty to report to the Chief Legal Officer, whereas evidence that a violation is ''likely'' could trigger the duty to report to the full board or to the QLCC. Evidence that a violation was 'highly likely' or a 'near certainty' could trigger the requirement of a noisy withdrawal.''); Comments of Susan P. Koniak *et al.*, at 9–11, 15–17 (emphasizing the importance of distinguishing between a violation and evidence of one and suggesting the use of the phrase ''credible evidence'').

[44] Comments of Skadden Arps, Slate, Meagher & Flom, at 10 (proposing to define ''*evidence of a material violation*'' as ''facts and circumstances known to an attorney which have caused the attorney to believe that a material violation has occurred, is occurring or is about to occur''); Comments of Chadbourne & Parke, at 7 (proposing ''a subjective standard that an attorney 'knows' that a material violation has occurred, is occurring or is about to occur''); Comments of Sullivan & Cromwell, at 11 (''Evidence of a material violation

Continued

definition incorporates suggested changes into an objective standard that is designed to facilitate the effective operation of the rule and to encourage the reporting of evidence of material violations.

Evidence of a material violation must first be credible evidence.[45] An attorney is obligated to report when, based upon that credible evidence, ''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.'' This formulation, while intended to adopt an objective standard, also recognizes that there is a range of conduct in which an attorney may engage without being unreasonable.[46] The ''circumstances'' are the circumstances at the time the attorney decides whether he or she is obligated to report the information. These circumstances may include, among others, the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult. Under the revised definition, an attorney is not required (or expected) to report ''gossip, hearsay, [or] innuendo.'' [47] Nor is the rule's reporting obligation triggered by ''a combination of circumstances from which the attorney, in retrospect, should have drawn an inference,'' as one commenter feared.

On the other hand, the rule's definition of ''evidence of a material violation'' makes clear that the initial duty to report up-the-ladder is not triggered only when the attorney ''knows'' that a material violation has occurred [48] or when the attorney ''conclude[s] there has been a violation, and no reasonable fact finder could conclude otherwise.''[49] That threshold for initial reporting within the issuer is too high. Under the Commission's rule, evidence of a material violation must be reported in all circumstances in which it would be unreasonable 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. To be ''reasonably likely'' a material violation must be more than a mere possibility, but it need not be ''more likely than not.''[50] If a material violation is reasonably likely, an attorney must report evidence of this violation. The term ''reasonably likely'' qualifies each of the three instances when a report must be made. Thus, a report is required when it is reasonably likely a violation has occurred, when it is reasonably likely a violation is ongoing or when reasonably likely a violation is about to occur.

205.2(f) provides:

(f) *Foreign government issuer* means a foreign issuer as defined in 17 CFR 230.405 eligible to register securities on Schedule B of the Securities Act of 1933 (15 U.S.C. 77a *et seq.*, Schedule B).

We adopt the definition for this new term prescribed under Rule 405.

205.2(g) provides:

(g) *In the representation of an issuer* means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

The definition we adopt today has been modified from the definition included in the proposing release. The phrase ''providing legal services'' has been substituted for the term ''acting.'' Some commenters objected that the term ''acting'' was both imprecise and overly broad, and that the concept of ''representation of an issuer'' should ''apply only to attorneys who are rendering legal advice to the organizational client. * * * and therefore have the professional obligations of an attorney.''[51] The substitution of the term ''providing legal services'' responds to these concerns. We believe that this change, combined with the narrowing of the definition of the term ''appearing and practicing'' as set forth above, addresses the concerns expressed by the ABA and others.[52]

For the reasons explained in the proposing release,[53] an attorney employed by an investment adviser who prepares, or assists in preparing, materials for a registered investment company that the attorney has reason to believe will be submitted to or filed with the Commission by or on behalf of a registered investment company is appearing and practicing before the Commission under this definition.

Although some commenters objected to this construction of the definition of ''in the representation of an issuer,''[54] those commenters did not contest either the fact that such an attorney, though employed by the investment adviser rather than the investment company, is providing legal services for the investment company or the logical implication of that fact: that the attorney employed by the investment adviser is accordingly representing the investment company before the Commission.[55] Indeed, the Investment Company Institute (''ICI'') opposes the Commission's construction of its rule because, the ICI asserts, the Commission's construction might make investment advisers limit the participation of attorneys employed or retained by the investment adviser in preparing filings for investment companies, thereby forcing the investment companies ''to retain their own counsel'' to do exactly the same work now performed by attorneys for the investment adviser.[56]

means information of which the attorney is consciously aware that would, in the attorney's judgment, constitute a material violation that has occurred, is occurring, or is about to occur.''); Comments of the American Bar Association, at 17 (recommending use of ''the knowledge standard'').

[45] *See* Comments of Susan P. Koniak *et al.*, at 18.

[46] Comments of Richard W. Painter, at 5–6.

[47] Comments of the Association of the Bar of the City of New York, at 10.

[48] The standard was suggested, *e.g.*, in Comments of the American Bar Association, at 5, 16–17.

[49] Comments of Cleary, Gottlieb, Steen & Hamilton, at 5–6 (any lower trigger for reporting would be equivocal, would lead to disparate application of the rule, and would ''chill'' the attorney-client relationship).

[50] The Commission intends the definition of the term ''reasonably likely'' to be consistent with the discussion of the term included in the adopting release for the recently adopted final rule governing disclosure of off-balance sheet arrangements, enacted pursuant to § 401(a) of the Sarbanes-Oxley Act.

[51] Comments of the American Bar Association, at 14 (''It is not uncommon for persons who were attorneys and may still retain their license to move into other non-legal capacities in the organization. * * * These persons should be subject to no greater obligations to the organization than someone who is not an attorney.''). However, the ABA stated that it believed that the rule ''appropriately applied to any attorney for the issuer'' who renders legal advice to the issuer. *Id.*

[52] We also note that the change should address concerns expressed that counsel to underwriters or similar persons might be covered by the rule.

[53] 67 FR 71678–79.

[54] *See, e.g.*, Comments of the Investment Company Institute at 1–5 (asserting that the Commission's construction of its rule may cause investment advisers to ''limit or even eliminate the participation of their internal and outside lawyers in the preparation of fund filings and materials, and in providing day-to-day advice to advisory personnel responsible for managing funds, in order to ensure that such lawyers are not 'involved in the representation of an issuer' or 'practicing before the Commission' within the meaning of the proposed rule.'').

[55] On the correctness of this inference, *see, e.g.*, Comments of Thomas D. Morgan at 3–4 (pointing out that ''current law'' makes an attorney employed by an investment adviser the ''legal representative'' of an investment company under these circumstances, although one has to take ''a logical step'' to reach that conclusion) (citing *Restatement (Third) of the Law Governing Lawyers* section 51(4)(2000)). An attorney-client relationship does not depend on payment for legal services performed. However, the legal services provided by an investment adviser to an investment company are usually performed pursuant to an advisory contract along with other services (such as investment advice) and are covered by the overall investment advisory fee.

[56] Comments of the Investment Company Institute, at 4. As noted in the proposing release, 67

205.2(h) provides:

(h) *Issuer* means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78*l*), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term ''issuer'' includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

The definition for the term ''issuer'' we adopt today incorporates the definition set forth in Section 2(a)(7) of the Act, which in turn incorporates the definition contained in the Exchange Act. The definition has been modified to specifically exclude foreign government issuers, defined above.[57]

The definition also has been modified to make clear that, for purposes of the terms ''appearing and practicing'' before the Commission and ''in the representation of an issuer,'' the term ''issuer'' includes any person controlled by an issuer (*e.g.*, a wholly-owned subsidiary), where the attorney provides legal services to that person for the benefit of or on behalf of an issuer. We consider the change important to achieving the objectives of Section 307 in light of the statutory reference to appearing and practicing ''in any way'' in the representation of an issuer. Under the revised definition, an attorney employed or retained by a non-public subsidiary of a public parent issuer will be viewed as ''appearing and practicing'' before the Commission ''in the representation of an issuer'' whenever acting ''on behalf of, or at the behest, or for the benefit of'' the parent. This language, consistent with the Commission's comment in the proposing release (although now limited to persons controlled by an issuer) would encompass any subsidiary covered by an umbrella representation agreement or understanding, whether explicit or implicit, under which the attorney represents the parent company and its subsidiaries, and can invoke privilege claims with respect to all communications involving the parent and its subsidiaries. Similarly, an attorney at a non-public subsidiary appears and practices before the Commission in the representation of an issuer when he or she is assigned work by the parent (*e.g.*, preparation of a portion of a disclosure document) which will be consolidated into material submitted to the Commission by the parent, or if he or she is performing work at the direction of the parent and discovers evidence of misconduct which is material to the parent. The definition of the term is also intended to reflect the duty of an attorney retained by an issuer to report to the issuer evidence of misconduct by an agent of the issuer (*e.g.*, an underwriter) if the misconduct would have a material impact upon the issuer.[58]

205.2(i) provides:

(i) *Material violation* means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

The definition we adopt today modifies the definition set forth in the proposed rule by adding the phrases ''United States federal or state'' and ''arising under United States federal or state law.'' This modification clarifies that material violations must arise under United States law (federal or state), and do not include violations of foreign laws. The final rule does not define the word ''material,'' because that term has a well-established meaning under the federal securities laws [59] and the Commission intends for that same meaning to apply here.

205.2(j) provides:

(j) *Non-appearing foreign attorney* means an attorney:

(1) Who is admitted to practice law in a jurisdiction outside the United States;

(2) Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and

(3) Who:

(i) Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or

(ii) Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

The final rule provides that a ''non-appearing foreign attorney'' does not ''appear and practice before the Commission'' for purposes of the rule. In brief, the definition excludes from the rule those attorneys who: (1) Are admitted to practice law in a jurisdiction outside the United States; (2) do not hold themselves out as practicing, or giving legal advice regarding, United States law; and (3) conduct activities that would constitute appearing and practicing before the Commission only (i) incidentally to a foreign law practice, or (ii) in consultation with United States counsel. A non-United States attorney must satisfy all three criteria of the definition to be excluded from the rule.

The effect of this definition will be to exclude many, but not all, foreign attorneys from the rule's coverage. Foreign attorneys who provide legal advice regarding United States securities law, other than in consultation with United States counsel, are subject to the rule if they conduct activities that constitute appearing and practicing before the Commission. For example, an attorney licensed in Canada who independently advises an issuer regarding the application of Commission regulations to a periodic filing with the Commission is subject to the rule. Non-United States attorneys who do not hold themselves out as practicing United States law, but who engage in activities that constitute appearing and practicing before the Commission, are subject to the rule unless they appear and practice before the Commission only incidentally to a foreign law practice or in consultation with United States counsel.

Proposed Part 205 drew no distinction between the obligations of United States and foreign attorneys. The proposing release requested comment on the effects of the proposed rule on attorneys who are licensed in foreign jurisdictions or otherwise subject to foreign statutes, rules and ethical standards. The Commission recognized that the proposed rule could raise difficult issues for foreign lawyers and

FR 71678–79, and below in the discussion of Section 205.3(b), an attorney employed by an investment adviser who becomes aware of evidence of a material violation that is material to an investment company while thus representing that investment company before the Commission has a duty to report such evidence up-the-ladder within the investment company. For the reasons explained in the proposing release and noted below, however, such reporting does no violence to the attorney-client privilege. *See Restatement (Third) of the Law Governing Lawyers,* section 75 and cmt. d (explaining that in a subsequent proceeding in which the co-client's interests are adverse there is normally no attorney-client privilege regarding either co-client's communications with their attorney during the co-client relationship).

[57] We also note that the changes should address concerns expressed that counsel to underwriters or similar persons might be covered by the rule.

[58] An attorney who represents a subsidiary or other person controlled by an issuer at the behest, for the benefit, or on behalf of a parent issuer who becomes aware of evidence of a material violation that is material to the issuer should report the evidence up-the-ladder through the issuer, as set forth in Section 205.3(b) of the rule.

[59] *See Basic, Inc.* v. *Levinson*, 485 U.S. 224, 231–36 (1988); *TSC Indus.* v. *Northway, Inc*, 426 U.S. 438 (1976).

international law firms because applicable foreign standards might be incompatible with the proposed rule. The Commission also recognized that non-United States lawyers play significant roles in connection with Commission filings by both foreign and United States issuers.

On December 17, 2002, the Commission hosted a Roundtable on the International Impact of the Proposed Rules Regarding Attorney Conduct. The Roundtable offered foreign participants the opportunity to share their views on the application of the proposed rule outside of the United States. The participants consisted of international regulators, professional associations, and law firms, among others. Participants at the Roundtable expressed concern about many aspects of the proposed rule. Some objected to the scope of the proposed definition of ''appearing and practicing before the Commission,'' noting that a foreign attorney who prepares a contract or other document that subsequently is filed as an exhibit to a Commission filing might be covered by the rule. In addition, some of the participants stated that foreign attorneys with little or no experience or training in United States securities law may not be competent to determine whether a material violation has occurred that would trigger reporting requirements. Others stated that the ''noisy withdrawal'' and disaffirmation requirements of the proposed rule would conflict with the laws and principles of confidentiality and the attorney-client privilege recognized in certain foreign jurisdictions.

The Commission received more than 40 comment letters that addressed the international aspects of the proposed attorney conduct rule. Many suggested that non-United States attorneys should be exempt from the rule entirely, arguing that the Commission would violate principles of international comity by exercising jurisdiction over the legal profession outside of the United States. Others recommended that the Commission take additional time to consider these conflict issues, and provide a temporary exemption from the rule for non-United States attorneys. The majority of commenters asserted that the proposed rule's ''noisy withdrawal'' and disaffirmation requirements would conflict with their obligations under the laws of their home jurisdictions.

Section 205.2(j) and the final definition of ''appearing and practicing before the Commission'' under § 205.2(a) together address many of the concerns expressed by foreign lawyers. Foreign lawyers who are concerned that they may not have the expertise to identify material violations of United States law may avoid being subject to the rule by declining to advise their clients on United States law or by seeking the assistance of United States counsel when undertaking any activity that could constitute appearing and practicing before the Commission. Mere preparation of a document that may be included as an exhibit to a filing with the Commission does not constitute ''appearing and practicing before the Commission'' under the final rule, unless the attorney has notice that the document will be filed with or submitted to the Commission and he or she provides advice on United States securities law in preparing the document.

The Commission respects the views of the many commenters who expressed concerns about the extraterritorial effects of a rule regulating the conduct of attorneys licensed in foreign jurisdictions. The Commission considers it appropriate, however, to prescribe standards of conduct for an attorney who, although licensed to practice law in a foreign jurisdiction, appears and practices on behalf of his clients before the Commission in a manner that goes beyond the activities permitted to a non-appearing foreign attorney. Non-United States attorneys who believe that the requirements of the rule conflict with law or professional standards in their home jurisdiction may avoid being subject to the rule by consulting with United States counsel whenever they engage in any activity that constitutes appearing and practicing before the Commission. In addition, as discussed in Section 205.6(d) below, the Commission is also adopting a provision to protect a lawyer practicing outside the United States in circumstances where foreign law prohibits compliance with the Commission's rule.

205.2(k) provides:

(k) *Qualified legal compliance committee* means a committee of an issuer (which also may be an audit or other committee of the issuer) that:

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

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

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

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

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A) Notify the audit committee or the full board of directors;

(B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C) Retain such additional expert personnel as the committee deems necessary; and

(iii) At the conclusion of any such investigation, to:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

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

A QLCC, as here defined, is part of an alternative procedure for reporting evidence of a material violation. That alternative procedure is set out in § 205.3(c) of the rule.

The definition of a QLCC in § 205.2(k) of the final rule contains a few modifications from the definition in the proposed rule. In the first clause of the definition, the final rule provides that an audit or other committee of the issuer may serve as the QLCC. As a result, the issuer is not required to form a QLCC as a new corporate structure, unless it wishes to, so long as another committee of the issuer meets all of the requisite criteria for a QLCC and agrees to function as a QLCC in addition to its separate duties and responsibilities. This change responds to comments that issuers should not be required to create a new committee to serve as a QLCC, so long as an existing committee contains the required number of independent directors.[60]

[60] Comments of the American Corporate Counsel Association, at 9–10; Comments of Association of the Bar of the City of New York, at 42; Comments of Corporations Committee, Business Law Section,

Subsection 205.2(k)(1) of the final rule, which addresses the composition of the QLCC, provides that if an issuer has no audit committee, the requirement to appoint at least one member of the audit committee to the QLCC may be met by appointing instead a member from an equivalent committee of independent directors. The Commission does not intend to limit use of the QLCC mechanism only to those issuers that have an audit committee. However, the Commission believes that the requirement that the QLCC be comprised of members who are not employed directly or indirectly by the issuer is warranted and appropriate, and thus disagrees with a commenter's suggestion to permit non-independent board members to be on the QLCC.[61]

Subsection 205.2(k)(3)(iii)(A) has been modified to clarify that the QLCC shall have the authority and responsibility to recommend that an issuer implement an appropriate response to evidence of a material violation, but not to require the committee to direct the issuer to take action. This modification responds to comments that the proposed rule would be in conflict with established corporate governance models insofar as the QLCC would have the explicit authority to compel a board of directors to take certain remedial actions.[62]

The proposed rule did not specify whether the QLCC could act if its members did not all agree. In response to comments expressing concern over this point,[63] language has been included in subsections 205.2(k)(3) and (4) of the final rule to clarify that decisions and actions of the QLCC must be made and taken based upon majority vote. Unanimity is not required for a QLCC to operate; nor should an individual member of a QLCC act contrary to the collective decision of the QLCC. Accordingly, the final rule specifies that a QLCC may make its recommendations and take other actions by majority vote.

Commenters suggested both that issuers would have great difficulty finding qualified persons to serve on a QLCC because of the burdens and risks of such service,[64] and that many companies will utilize a QLCC because reporting evidence of a material violation to a QLCC relieves an attorney of responsibility to assess the issuer's response.[65] The Commission does not know how widespread adoption of the QLCC alternative will be, but encourages issuers to do so as a means of effective corporate governance. In any event, the Commission does not intend service on a QLCC to increase the liability of any member of a board of directors under state law and, indeed, expressly finds that it would be inconsistent with the public interest for a court to so conclude.

As in the proposed rule, the final rule provides that members of the QLCC may not be ''employed, directly or indirectly, by the issuer.'' This language, which is also included in Section 205.3(b)(3), is drawn directly from Section 307 of the Sarbanes-Oxley Act. The Commission considers it appropriate and consistent with the mandate of the Act to ensure a high degree of independence in QLCC members and members of committees to whom reports are made under Section 205.3(b)(3). Accordingly, the Commission anticipates that these provisions will be amended to conform to final rules defining who is an ''independent'' director under Section 301 of the Act, upon adoption of those rules.

205.2(l) provides:

(l) *Reasonable* or *reasonably* denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

The definition of ''reasonable'' or ''reasonably'' is based on Rule 1.0(h) of the ABA's Model Rules of Professional Conduct, modified to emphasize that a range of conduct may be reasonable.

205.2(m) provides:

(m) *Reasonably believes* means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.

This definition is based on the definition of ''reasonable belief'' or ''reasonably believes'' in Rule 1.0(i) of the ABA's Model Rules of Professional Conduct, modified to emphasize that the range of possible reasonable beliefs regarding a matter may be broad—limited for the purposes of this rule by beliefs that are unreasonable. Because the definition no longer is used in connection with the definition of ''evidence of a material violation,'' the proposed rule's attempt to exclude the subjective element in ''reasonable belief'' has been abandoned.

205.2(n) provides:

(n) *Report* means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

The definition for this term has not been changed from the one included in the proposed rule.

Section 205.3—Issuer as Client

205.3(a) provides:

(a) *Representing an Issuer.* An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.

This section makes explicit that the client of an attorney representing an issuer before the Commission is the issuer as an entity and not the issuer's individual officers or employees that the attorney regularly interacts with and advises on the issuer's behalf. Most commenters supported the second sentence of the subsection as it is consistent with a lawyer's recognized obligations under accepted notions of professional responsibility.[66] Thus, this sentence remains unchanged in the final rule.

The proposed rule provided that an attorney ''shall act in the best interest of the issuer and its shareholders.'' Commenters raised three principal concerns regarding that provision: It misstates an attorney's duty under traditional ethical standards in charging an attorney with acting in the ''best interest'' of the issuer; it suggests attorneys have a duty to shareholders creating a risk that the failure to observe that duty could form the basis for a private action against the attorney by any of these shareholders;[67] and it appears to contradict the view expressed by the Commission in the proposing release that ''nothing in Section 307 creates a private right of action against an attorney.'' [68] As the Commission agrees, in part, with these comments, it has modified language in the final rule.

As to the first concern, the Commission recognizes that it is the client issuer, acting through its management, who chooses the

State Bar of California, at 12; Comments of Skadden, Arps, Slate, Meagher & Flom, at 12, 20, 25.

[61] *See* Comments of America's Community Bankers, at 5–6.

[62] Comments of Business Law Section, New York State Bar Association, at 14–15; Comments of the Business Roundtable, at 2–3.

[63] Comments of the American Bar Association, at 27; Comments of Business Law Section, New York State Bar Association, at 15.

[64] Comments of Clifford Chance, at 4–5; Comments of Emerson Electric Co., at 5.

[65] Comments of Susan P. Koniak *et al.*, at 11; Comments of Richard W. Painter, at 5; Comments of Thomas D. Morgan, at 12.

[66] *See* ABA Model Rule 1.13, ''Organization as Client,'' at 1:139.

[67] *See, e.g.*, Comments of Cleary, Gottlieb, Steen & Hamilton, at 3–4; Comments of Corporations Committee, Business Law Section, The State Bar of California, at 7; Comments of the American Corporate Counsel Association, at 11; Comments of Task Force on Corporate Responsibility of the County of New York Lawyers' Association, at 2–3.

[68] *See* Comments of the Association of the Bar of the City of New York, at 47–50.

objectives the lawyer must pursue, even when unwise, so long as they are not illegal or unethical. However, we disagree with the comment to the extent it suggests counsel is never charged with acting in the best interests of the issuer. ABA Model Rule 1.13 provides that an attorney is obligated to act in the ''best interests'' of an issuer in circumstances contemplated by this rule: that is, when an individual associated with the organization is violating a legal duty, and the behavior ''is likely to result in substantial injury'' to the organization. In those situations, it is indeed appropriate for counsel to act in the best interests of the issuer by reporting up-the-ladder.[69] However, the Commission appreciates that, with respect to corporate decisions traditionally reserved for management, counsel is not obligated to act in the ''best interests'' of the issuer. Thus, the reference in the proposed rule to the attorney having a duty to act in the best interests of the issuer has been deleted from the final rule. The sentence has also been modified to make it clear the lawyer ''owes his or her professional and ethical duties to the issuer as an organization.''

As to the second concern, the courts have recognized that counsel to an issuer does not generally owe a legal obligation to the constituents of an issuer—including shareholders.[70] The Commission does not want the final rule to suggest it is creating a fiduciary duty to shareholders that does not currently exist. Accordingly, we have deleted from the final rule the reference to the attorney being obligated to act in the best interest of shareholders. This modification should also address the third concern as the Commission does not intend to create a private right of action against attorneys or any other person under any provision of this part. Indeed, the final rule contains a new provision, 205.7, that expressly provides that nothing in this part is intended to or does create a private right of action.

205.3(b) provides:

(b) *Duty to report evidence of a material violation.* (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

Section 205.3(b) clarifies an attorney's duty to protect the interests of the issuer the attorney represents by reporting within the issuer evidence of a material violation by any officer, director, employee, or agent of the issuer. The section was broadly approved by commenters. Paragraph (b)(1) describes the first step that an attorney representing an issuer is required to take after he or she becomes aware of evidence of a material violation, now defined in § 205.2. The definition of ''evidence of a material violation'' originally proposed was controversial and has been modified (as discussed above). Paragraph (b)(1), however, was otherwise generally approved.[71]

Section 205.3(b)(2) in Proposed Rule: Withdrawn

(2) The attorney reporting evidence of a material violation shall take steps reasonable under the circumstances to document the report and the response thereto and shall retain such documentation for a reasonable time.

The language set forth from proposed subsection 205.3(b)(2) of the proposed rule has been withdrawn.

In the final rules we have eliminated all requirements that reports and responses be documented and maintained for a reasonable period. Under the proposed rule, a lawyer would have been required to document his or her report of evidence of a material violation (205.3(b)(2)); the CLO would have been required to document any inquiry in response to a report (205.3(b)(3)); a reporting attorney would have been required to document when he or she received an appropriate response to a report (205.3(b)(2)); and an attorney who believed he or she did not receive an appropriate response to a report would have been required to document that response (205.3(b)(8)(ii)).

The Commission proposed the documentation requirements because it believed that up-the-ladder reporting would be handled more thoughtfully if those involved memorialized their decisions. It was also the Commission's view that documentation would benefit reporting attorneys as it would provide them with a contemporaneous written record of their actions that they could use in their defense if their up-the-ladder reporting subsequently became the subject of litigation. To that end, the Commission proposed 205.3(e)(1) (which is codified in the final rule as § 205.3(d)(1)) that specifically authorizes an attorney to use ''[a]ny report under this section * * * or any response thereto * * * in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.'' Moreover, the Commission noted (*see* note 52 to the proposing release) that in at least one reported judicial decision, an associate at a law firm who had memorialized his reasons for resigning from the firm over a dispute regarding the adequacy of disclosures in a registration statement, was dismissed as a defendant in subsequent litigation over the appropriateness of those disclosures because his contemporaneous record demonstrated he had not participated in the fraud.

Nevertheless, the comments that the Commission received to the proposed documentation requirements were almost unanimously in opposition to its inclusion in the final rule. A number of commenters expressed concern that the documentation requirement could be an impediment to open and candid discussions between attorneys and their issuer clients. Those commenters were of the view it would stultify the consultation process because if the client knows the lawyer is documenting discussions regarding a potential material violation, managers are less likely to be honest and forthcoming.[72]

Other commenters expressed concern that the documentation requirement has the potential to create a conflict of interest between the lawyer and his or her client. For example, one commenter

[69] *See* ABA Model Rule 1.13, at 1:139.

[70] Decisions in a number of states recognize that, under state law, an attorney for an issuer does not owe a fiduciary duty to shareholders. *See Pelletier* v. *Zweifel,* 921 F.2d 1465, 1491–92 n.60 (11th Cir.) *cert. denied,* 502 U.S. 955 (1991) (Under Georgia law ''[I]t is a black letter principle of corporation law that a corporation's counsel does not owe * * * [a] fiduciary duty to the corporation's shareholders''). *See also Skarbrevik* v. *Cohen, England & Whitfield,* 231 Cal. App. 3d 692, 703 (1991) (Under California law, ''[a]n attorney representing a corporation does not become the representative of its stockholders merely because the attorney's actions on behalf of the corporation also benefit the stockholders; as attorney for the corporation, counsel's first duty is to the corporation.''); *Egan* v. *McNamara,* 467 A.2d 733, 738 (DC 1983) (''According to the District of Columbia Code of Professional Responsibility (Code), an attorney represents, and therefore owes a duty to, the entity that retains him. * * * When retained to represent a corporation, he represents the entity, not its individual shareholders, officers, or directors.'').

[71] The Comment of Federal Bar Counsel, at 12–13, for example, objected to ''becomes aware'' in (b)(1) but appears to have done so in connection with the proposed definition of ''evidence of a material violation.'' The revisions made to that definition appear to address those objections.

[72] *See, e.g.*, Comments of the American Bar Association, at 22; Comments of the American Corporate Counsel Association, at 5; Comments of the Association of the Bar of the City of New York, at 16; Comments of Cleary, Gottlieb, Steen & Hamilton, at 6.

stated that it ''places counsel to the issuer in the untenable position of having to protect himself or herself while trying to advise his or her client.'' [73] Similarly, another commenter pointed out that documentation would ''occur at exactly the time when there was disagreement between an attorney and the client. At the very least, requiring the attorney to produce such product by virtue of his or her separate obligation to the Commission is bound to present potential for conflict of interest.'' [74] Indeed, it was pointed out, there may be occasions where the preparation of documentation is not in the best interests of the client.[75]

Additionally, commenters opined that the documentation requirement might increase the issuer's vulnerability in litigation. They noted that a report will be a ''treasure trove of selectively damning evidence'' [76] and, while the Commission may be of the view that such documentation should be protected by the attorney-client privilege, the applicability of the privilege will be decided by the courts. Thus, there is considerable uncertainty as to whether it will be protected. At a minimum, it was contended, assertions of privilege will be met with significant and prolonged legal challenges.[77]

At least at the present time, the potential harms from mandating documentation may not justify the potential benefits. In all likelihood, in the absence of an affirmative documentation requirement, prudent counsel will consider whether to advise a client in writing that it may be violating the law.[78] In other situations, responsible corporate officials may direct that such matters be documented. In those situations, the Commission's goal will be met, but not in an atmosphere where the issuer and the attorney may perceive that their interests are in conflict.

205.3(b)(2) provides:

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

Paragraph (b)(2) (corresponding to paragraph (b)(3) of the proposed rule, as revised) describes the responsibilities of the issuer's CLO (or the equivalent thereof) in handling reported evidence of a material violation. The final rule adds a provision expressly allowing the CLO to make use of an issuer's QLCC. The revision eliminates the CLO's documentation requirement and, for the time being, the CLO's obligation, as part of the QLCC process, to notify the Commission in the unlikely event that the issuer fails to take appropriate remedial actions recommended by the QLCC after a determination by the QLCC that there has been or is about to be a material violation. It also changes language that would have required a CLO who reasonably believed that a material violation had occurred, was ongoing, or was about to occur to ''take any necessary steps to ensure that the issuer adopts an appropriate response'' to language that would, under the same circumstances, require the CLO to ''take all reasonable steps to cause the issuer to adopt an appropriate response.'' These are the points on which the corresponding paragraph in the proposed rule was criticized.[79] Reporting up-the-ladder was otherwise consistently supported. The CLO is responsible for investigating the reported evidence of a material violation for the reasons set out in the proposing release.[80] The second sentence of this paragraph has been modified to clarify the circumstances under which the CLO must advise a reporting attorney that no violation has been found. Thus, the term ''determines'' has been substituted for ''reasonably believes'' in the second sentence. This change makes the second sentence consistent with the first sentence which requires the CLO to cause an inquiry to be conducted ''to determine'' whether a violation has occurred, is ongoing, or is about to occur. Other minor textual changes have been made to the paragraph that do not alter its substantive requirements.

205.3(b)(3) provides:

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

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

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

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

This paragraph describes the circumstances under which an attorney who has reported evidence of a material violation to the issuer's CLO and/or CEO is obliged to report that evidence further up-the-ladder within the client issuer. The paragraph tracks the statutory language in Section 307 of the Act, is not controversial, and is adopted without change from the corresponding paragraph in the proposed rule—(b)(4)—for the reasons set out in the proposing release.[81]

205.3(b)(4) provides:

(4) If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's chief legal officer and chief executive officer (or the equivalents thereof) under paragraph (b)(1) of this section, the attorney may report such

[73] Comments of Skadden, Arps, Slater, Meagher & Flom, at 23.

[74] Comments of Corporations Committee, Business Law Section, the State Bar of California, at 10.

[75] *Id.*

[76] Comments of the American Corporate Counsel Association, at 5.

[77] *See* Comments of Corporations Committee, Business Law Section, the State Bar of California, at 10.

[78] *See* Comments of Cleary, Gottlieb, Steen & Hamilton, at 6.

[79] *E.g.,* Comments of the SIA/TBMA, at 16 (CLO should be able to make use of the QLCC); Comments of J.P. Morgan Chase & Co., at 3 (CLO should not be required to notify the Commission that a material violation has occurred and disaffirm documents that the issuer has submitted to or filed with the Commission that the CLO believes are false or materially misleading); Comments of Compass Bancshares, at 2–3 (requiring CLO ''to issue a response in writing to the attorney creates an undue burden on the CLO [in] responding to an issue which the CLO may not feel is warranted''); Comments of Charles Schwab & Co., at 1–2 (CLO ''typically does not have authority to sanction employees outside of his or her chain of command, to require the business units to adopt new procedures, or even to make disclosure on behalf of the company without the concurrence of other executives'').

[80] 67 FR 71685–86.

[81] 67 FR 71686.

evidence as provided under paragraph (b)(3) of this section.

The basis for paragraph (b)(4) is implicit in Section 307 of the Act. This bypass provision, however, is not controversial, was not the subject of comment, and is adopted without any substantive change from the corresponding paragraph—(b)(5)—of the proposed rule for the reasons set out in the proposing release.[82]

205.3(b)(5) provides:

(5) An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(3), or (b)(4) of this section shall be deemed to be appearing and practicing before the Commission. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported under paragraph (b)(1), (b)(3), or (b)(4) of this section from a duty to respond to the reporting attorney.

Paragraph (b)(5) addresses circumstances in which those to whom evidence of a material violation is reported direct others, either in-house attorneys or outside attorneys retained for that purpose, to investigate the possible violation. It elicited only a few comments, all of them negative.[83] The thrust of these comments was that issuers would be reluctant to retain counsel to investigate reports if those attorneys might trigger up-the-ladder reporting that could result in reporting out to the Commission. The definition of ''appropriate response'' in section 205.2(b) of the final rule has been modified to address these comments. Further, the modifications to the proposed rule reflected in final rule §§ 205.3(b)(6) and (b)(7) below, will relieve attorneys retained or directed to investigate or litigate reports of violations from reporting up-the-ladder in a number of instances.

Paragraph (b)(5) is adopted essentially as proposed. This paragraph—numbered (b)(6) in the proposed rule '' makes two points: first, that the investigating attorneys are themselves appearing and practicing before the Commission and are accordingly bound by the requirements of the proposed rule; and, second, that the officers or directors who caused them to investigate remain obligated to respond to the attorney who initially reported the evidence of a material violation that other attorneys have been directed to investigate.

205.3(b)(6) and (b)(7) provide:

(6) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

(i) The attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof) to investigate such evidence of a material violation and:

(A) The attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof); and

(B) Except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee; or

(ii) The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee.

(7) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if such attorney was retained or directed by a qualified legal compliance committee:

(i) To investigate such evidence of a material violation; or

(ii) To assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

As noted above in our discussion of paragraph (b)(5) of the final rule, a number of commenters expressed the view that the final rule should eliminate any requirement that attorneys report up-the-ladder when they are retained or directed to investigate a report of a material violation or to litigate whether a violation has occurred. New paragraphs (b)(6) and (b)(7) respond to these legitimate comments, and narrow considerably the instances when it is likely to be necessary for such an attorney to report up-the-ladder. Paragraph (b)(6) addresses the responsibilities of attorneys retained or directed to investigate or litigate reported violations by the chief legal officer (or the equivalent thereof); paragraph (b)(7) addresses circumstances where attorneys are retained or directed to investigate or litigate reported violations by a qualified legal compliance committee. Where an attorney is retained to investigate by the chief legal officer, the attorney has no obligation to report where the results of the investigation are provided to the chief legal officer and the attorney and the chief legal officer agree no violation has occurred and report the results of the inquiry to the issuer's board of directors or to an independent committee of the board. An attorney retained or directed by the chief legal officer to litigate a reported violation does not have a reporting obligation so long as he or she is able to assert a colorable defense on behalf of the issuer and the chief legal officer provides reports on the progress and outcome of the litigation to the issuer's board of directors. An attorney retained or directed by a qualified legal compliance committee to investigate a reported violation has no reporting obligations. Similarly, an attorney retained or directed by a qualified legal compliance committee to litigate a reported violation has no reporting obligation provided he or she may assert a colorable defense on behalf of the issuer.

205.3(b)(8) and (b)(9) provide:

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

(9) An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section shall explain his or her reasons therefor to the chief legal officer (or the equivalent thereof), the chief executive officer (or the equivalent thereof), and directors to whom the attorney reported the evidence of a material violation pursuant to

[82] 67 FR 71686.

[83] *See* Comments of Schiff Hardin & Waite, at 4 (paragraph (b)(5) as proposed goes ''too far'' in deeming a lawyer engaged by an issuer to conduct an internal investigation of a possible material violation of the securities laws to be appearing and practicing before the Commission and that issuers will be reluctant to retain independent counsel to investigate if the independent counsel have ''an obligation to effect a noisy withdrawal if they disagree with the client's response to the finding or recommendation resulting from the investigation''); Comments of the Chicago Bar Association, at 3 (paragraph as proposed is overbroad in requiring an outside lawyer engaged to investigate whether a violation has occurred to withdraw and notify the Commission if it disagrees with the issuer); Comments of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, at 4–5 (''attorneys conducting an internal investigation, and not otherwise interacting with the Commission or even known to the Commission at that point, do not have a sufficient nexus with the Commission's processes'' to be covered by the Commission's rules; making them subject to the Commission's rules will ''make issuers less willing to retain, and attorneys less willing to conduct, such investigations''; and is unnecessary because section 205.3(b)(2) requires an issuer's CLO ''to assess the timeliness and appropriateness of the issuer's response'').

paragraph (b)(1), (b)(3), or (b)(4) of this section.

As proposed, paragraphs (b)(8) and (b)(9)—numbered (b)(7) and (b)(8) in the proposed rule—elicited no comment (apart from negative comments on documentation provisions that have been eliminated in the final rule). They are adopted without any other substantive change for reasons explained in the proposing release.[84]

205.3(b)(10) provides:

(10) An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

Paragraph (b)(10) authorizes an attorney to notify an issuer's board of directors or any committee thereof if the attorney reasonably believes that he or she has been discharged for reporting evidence of a material violation under this section. This provision, an important corollary to the up-the-ladder reporting requirement, is designed to ensure that a chief legal officer (or the equivalent thereof) is not permitted to block a report to the issuer's board or other committee by discharging a reporting attorney.

This provision is similar in concept to paragraph (d)(4) of the proposed rule (as to which, as noted above, the Commission is seeking further comment), although it does not provide for reporting outside the issuer.

205.3(c) provides:

(c) *Alternative reporting procedures for attorneys retained or employed by an issuer that has established a qualified legal compliance committee.* (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

(2) A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements under § 205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c).

This alternative to the reporting requirements of § 205.3(b) would allow, though not require, an attorney to report evidence of a material violation directly to a committee of the board of directors that meets the definitional requirements for a QLCC. It would also relieve the reporting attorney of any further obligation once he or she had reported such evidence to an issuer's QLCC.

Under this alternative, the QLCC—itself a committee of the issuer's board of directors with special authority and special responsibility—would be responsible for carrying out the steps required by Section 307 of the Act: notifying the CLO of the report of evidence of a material violation (except where such notification would have been excused as futile under § 205.3(b)(4)); causing an investigation where appropriate; determining what remedial measures are appropriate where a material violation has occurred, is ongoing, or is about to occur; reporting the results of the investigation to the CLO, the CEO, and the full board of directors; and notifying the Commission if the issuer fails in any material respect to take any of those appropriate remedial measures.

More generally, the QLCC institutionalizes the process of reviewing reported evidence of a possible material violation. That would be a welcome development in itself. It may also produce broader synergistic benefits, such as heightening awareness of the importance of early reporting of possible material violations so that they can be prevented or stopped.

Probably the most important respect in which § 205.3(c) differs from § 205.3(b) is, as noted, that Section 205.3(c) relieves an attorney who has reported evidence of a material violation to a QLCC from any obligation ''to assess the issuer's response to the reported evidence of a material violation.'' If the issuer fails, in any material respect to take any remedial action that the QLCC has recommended, then the QLCC, as well as the CLO and the CEO, all have the authority to take appropriate action, including notifying the Commission if the issuer fails to implement an appropriate response recommended by the QLCC.

Commenters generally approved of the QLCC in concept, although several proposed changes in how it would work. The American Bar Association agreed with the need for corporate governance mechanisms to ensure legal compliance once a material violation is reported to an issuer's board, but suggested that existing corporate governance reforms should be given time before new reforms are added.[85] Another commenter suggested that the QLCC should be only one of a number of acceptable governance models, with issuers having freedom to craft techniques suitable to their own circumstances.[86] The Commission recognizes these concerns, but believes the benefits of the QLCC model, as described above, and the absence of any requirement that an issuer form or utilize a QLCC, justify inclusion of this alternative in the final rule.

One commenter suggested that the Commission's final rules should make clear that, for a matter to be referred to a QLCC, the issuer must have a QLCC in place and is not permitted simply to establish a QLCC to respond to a specific incident.[87] This comment has been addressed in § 205.3(c), which authorizes referral only to a QLCC that has been previously formed.

Commenters made a number of other suggestions regarding the QLCC provisions in the proposed rule. One commenter proposed that the Commission consider making creation of a QLCC mandatory for each issuer.[88] The Commission believes that keeping the QLCC as an alternative reporting mechanism is preferable, and that attorneys should be permitted to report up-the-ladder through their chief legal officers. Another commenter suggested that the QLCC proposal be modified to remove the ''noisy withdrawal'' provision.[89] The Commission has concluded that, in the extraordinary circumstance in which an appropriate response does not follow a QLCC's recommendation in response to evidence of a material violation, the QLCC should have the authority to take all appropriate action, including notifying the Commission, although it is not required to do so in every case. Another suggestion from a commentator was that the Commission offer a ''safe harbor'' for a chief legal officer who

[84] 67 FR 71687.

[85] Comments of the American Bar Association, at 27–28.

[86] Comments of the American Corporate Counsel Association, at 9–10.

[87] Comments of Richard W. Painter, at 5.

[88] Comments of Edward C. Brewer III, at 4.

[89] Comments of the Association of the Bar of the City of New York, at 41–42.

reports to a QLCC.[90] The Commission has provided a form of ''safe harbor'' against any inconsistent standard of a state or other United States jurisdiction in Section 205.6(c), and against a private action in Section 205.7.

Section 205.3(d) Issuer Confidences

205.3(d)(1) provides:

(1) Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

Paragraph (d)(1) makes clear that an attorney may use any records the attorney may have made in the course of fulfilling his or her reporting obligations under this part to defend himself or herself against charges of misconduct. It is effectively equivalent to the ABA's present Model Rule 1.6(b)(3) and corresponding ''self-defense'' exceptions to client-confidentiality rules in every state. The Commission believes that it is important to make clear in the rule that attorneys can use any records they may have prepared in complying with the rule to protect themselves.

One comment expressed concern that this provision would empower the Commission to use such records against the attorney. That concern misreads this paragraph, which expressly refers to the use of these records ''by an attorney'' in a proceeding where the attorney's compliance with this part is in issue.

205.3(d)(2) provides:

(2) An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

This paragraph thus permits, but does not require, an attorney to disclose, under specified circumstances, confidential information related to his appearing and practicing before the Commission in the representation of an issuer. It corresponds to the ABA's Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981–1982 and by the ABA's Commission of Evaluation of the Rules of Professional Conduct (''Ethics 2000 Commission'') in 2000,[91] and as adopted in the vast majority of states.[92] It provides additional protection for investors by allowing, though not requiring, an attorney to disclose confidential information relating to his appearing and practicing before the Commission in the representation of an issuer to the extent the attorney reasonably believes necessary (1) to prevent the issuer from committing a material violation that the lawyer reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer or investors; (2) to prevent the issuer from perpetrating a fraud upon the Commission; or (3) to rectify the consequences of an issuer's material violations that caused or may cause substantial injury to the issuer's financial interest or property in the furtherance of which the attorney's services were used.

The proposed version of this rule provided that the attorney appearing or practicing before the Commission could disclose information to the Commission:

(i) To prevent the issuer from committing an illegal act that the attorney reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer from committing an illegal act that the attorney reasonably believes is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of the issuer's illegal act in the furtherance of which the attorney's services had been used.

Several comments stated that permitting attorneys to disclose illegal acts to the Commission, in the situations delineated by the proposed rule, would undermine the relationship of trust and confidence between lawyer and client, and may impede the ability of lawyers to steer their clients away from unlawful acts.[93] Other comments expressed concern that this provision conflicts with, and would (in their eyes impermissibly) preempt, the rules of professional conduct of certain jurisdictions (such as the District of Columbia) which bar the disclosure of information which an attorney is permitted to disclose under this paragraph, particularly where it permits the disclosure of past client misconduct.[94] Some aver that ''it is not a lawyer's job'' in representing an issuer before the Commission ''to correct or rectify the consequences of [the issuer's] illegal actions, or even to prevent wrong-doing.'' [95]

Other commenters noted that these disclosure provisions should be limited to illegal acts that are likely to have a material impact on the market for the issuer's securities,[96] or to ongoing criminal or fraudulent conduct by the issuer,[97] while others suggest that attorneys should only be permitted to disclose information where there is a risk of death or bodily harm, and not where only ''monetary interests'' are

[90] *Id.,* at 42–43.

[91] ABA, *Report of the Commission on Evaluation of the Rules of Professional Conduct* (November 2000), recommended permitting a lawyer to disclose confidential ''information relating to the representation of a client to the extent the lawyer reasonably believes necessary . . . to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services.''

[92] Thirty-seven states permit an attorney to reveal confidential client information in order to prevent the client from committing criminal fraud. *See Restatement (Third) of the Law Governing Lawyers* (2000) section 67, Cmt. f, and Thomas D. Morgan & Ronald D. Rotunda, *Model Code of Professional Responsibility, Model Rules of Professional Conduct, and Other Selected Standards,* at 146 (reproducing the table prepared by the Attorneys' Liability Assurance Society (''ALAS'') cited in the Restatement). The ABA's Model Rule 1.6, which prohibits disclosure of confidential client information even to prevent a criminal fraud, is a minority rule. In its *Carter and Johnson* decision (1981 WL 384414, at n.78), the Commission expressly did not address an attorney's obligation to disclose a client's intention to commit fraud or an illegal act.

[93] See comments of Joseph T. McLaughlin, Heller Ehrman, at 2; Comments of the Los Angeles County Bar Association, at 2.

[94] Comments of Eleven Persons or Law Firms, at 8–9; Comments of the American Bar Association, at 33 (urging the Commission to refrain from considering the proposed disclosure provisions unless and until it receives express Congressional authority to preempt state privilege rules); Comments of 77 law firms, at 2; Comments of Latham & Watkins, at 5–6; Comments of Theodore Sonde, at 2; Comments of Schiff Hardin & Waite, at 7–8; Comments of Sheldon M. Jaffe, at 7–9; Comments of Emerson Electric, at 2; Comments of the Federal Bar Council, at 9–10 & n.9; Comments of JP Morgan & Chase, at 11 & n.3 (citing treatise for proposition that only six states permit disclosure to rectify past fraud).

[95] Comments of the Law Society of England and Wales, at 12.

[96] Comments of the Los Angeles County Bar Association, at 2; Comments of Edward C. Brewer, III at 8; see also Comments of the Association of the Bar of the City of New York at 5 (supporting attorney disclosure of materials facts to avoid assisting a criminal or fraudulent act by the client, or to correct prior representations made by the lawyer and believed by the lawyer still to be relied upon by a third person where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud).

[97] Comments of Theodore Sonde, at 2.

involved.[98] Many of the commenters voicing objections to this paragraph suggested that the Commission defer its promulgation until after further developments by state supreme courts[99] or further discussion.[100] Others, while criticizing the rule, noted that an attorney practicing before the Commission could comply with this permissive disclosure provision, but would have a duty to explain to the client at the outset this limitation on the ''normal'' duty of confidentiality.[101]

Commenters supporting the paragraph, however, noted that at least four-fifths of the states now permit or require such disclosures as pertain to ongoing conduct,[102] and that those states that follow the minority rule ''narrow[] the lawyer's options for responding to client conduct that could defraud investors and expose the lawyer to liability for legal work that the lawyer has already done.''[103] Several of these comments noted that the Commission could or should have required that lawyers make these disclosures to it when the client insists on continuing fraud or pursuing future illegal conduct,[104] and urged the Commission to make clear that this paragraph does not override state ethics rules that make such disclosures mandatory.[105] Many commenters also stated that it was proper for this paragraph to preempt any state ethics rule that does not permit disclosure.[106] They also noted that the confidentiality interests of a corporate client are not infringed by lawyer disclosure under the circumstances required by the paragraph, as the paragraph addresses a situation where the lawyer reasonably believes that agents of an issuer are engaged in serious illegality that the issuer has failed to remedy; in that situation, an instruction by an officer or even the board of the issuer to remain silent cannot be regarded as authorized.[107] Others generally supported the provision as injecting vitality into existing ethics rules, and stated that the Commission should not delay action on this provision.[108] One commenter emphasized the need to protect from retaliation attorneys who engage in the reporting mandated by Part 205.[109]

The final version of this paragraph contains modifications or clarifications of the paragraph as proposed. In paragraph (2), the description of when an attorney may disclose client confidences is limited ''to the extent the attorney reasonably believes necessary'' to accomplish one of the objectives in the rule. In subparagraph (i), the term ''material violation'' has been substituted for ''illegal act'' to conform to the statutory language in Section 307. In subparagraph (ii), the final version identifies the illegal acts that might perpetrate a fraud upon the Commission in an investigation or administrative proceeding; each of the statutes now referenced in subparagraph (ii) were referenced in the release accompanying the proposed rule.[110] The term ''perpetrate a fraud'' in this paragraph covers conduct involving the knowing misrepresentation of a material fact to, or the concealment of a material fact from, the Commission with the intent to induce the Commission to take, or to refrain from taking, a particular action. Subparagraph (iii) has been modified to cover only material violations by the issuer, and now this material violation must be one that has ''caused, or may cause, substantial injury to the financial interest or property of the issuer or investors'' before the provision may be invoked.

With regard to the issues raised by the comments on this paragraph, as explained below, the Commission either has addressed the concerns voiced by the commenters, believes that the concerns are adequately addressed by the paragraph, or has found the concerns to be insufficient to warrant further modification. Although commenters raised a concern that permitting attorneys to disclose information to the Commission without a client's consent would undermine the issuers' trust in their attorneys, the vast majority of states already permit (and some even require) disclosure of information in the limited situations covered by this paragraph,[111] and the Commission has seen no evidence that those already-existing disclosure obligations have undermined the attorney-client relationship. In addition, the existing state law ethics rules support the proposition that generalized concerns about impacting the attorney-client relationship must yield to the public interest where an issuer seeks to commit a material violation that will materially damage investors, seek to perpetrate a fraud upon the Commission in enforcement proceedings, or has used the attorney's services to commit a material violation.

With regard to the comments that this paragraph would preempt state law ethics rules that do not permit disclosure of information concerning such acts, or the concerns expressed by commenters at the other end of the spectrum that this paragraph could be misread to supplant state ethics rules that require rather than permit disclosure,[112] the Commission refers to Section 205.1 and the related discussion above. Section 205.1 makes clear that Part 205 supplements state ethics rules and is not intended to limit the ability of any jurisdiction to impose higher obligations upon an attorney not inconsistent with Part 205. A mandatory disclosure requirement imposed by a state would be an additional requirement consistent with the Commission's permissive disclosure rule. The Commission also notes that, as this paragraph in most situations follows the permissive disclosure rules already in place in most jurisdictions, the conflict raised by these commenters is unlikely to arise in practice.

As for the comments suggesting that attorneys be permitted to disclose only information that would appear to have a material impact on the value of the issuer's securities, the Commission has,

[98] Comments of the American College of Trial Lawyers, at 6.

[99] Comments of Conference of Chief Justices, at 4.

[100] Comments of the Federal Bar Council, at 14.

[101] Comments of the Law Society of England and Wales, at 12.

[102] Comments of Morrison & Foerster and eight other law firms, Exhibit B (listing jurisdictions whose ethics rules permit or require attorneys to disclose clients' past and/or require attorneys to disclose clients' past and/or ongoing fraud); Comments of Edward C. Brewer, III, at 8 (the proposed rule for permissive disclosure of an issuer's ''illegal act'' is essentially no different than the existing Model Code provision).

[103] Comments of Richard W. Painter, at 6.

[104] Comment of Edward C. Brewer, at 8.

[105] Comments of Susan P. Koniak *et al.*, at 26–27; Comments of Nancy J. Moore, at 2–3.

[106] Comments of Susan P. Koniak *et al.*, 27, 31–32.

[107] Comments of William H. Simon, at 3.

[108] See, *e.g.*, Comments of Manning G. Warren III, at 1; Comments of Douglas A. Schafer, Comment of Elaine J. Mittleman at 2; Comments of Thomas Ross *et al.*, at 6–8.

[109] Comment of Elaine J. Mittleman at 2.

[110] See 67 FR at 71693.

[111] Comment of the American Corporate Counsel Association, at 7 (noting that permissive disclosure standards are ''more in line with a majority of state professional rules of conduct'').

[112] Specifically, New Jersey requires an attorney to reveal confidential ''information relating to the representation of a client to the proper authorities * * * to the extent the lawyer reasonably believes necessary to prevent the client: (1) [f]rom committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to result in * * * substantial injury to the financial interest or property of another'' or (2) such an act that ''the lawyer reasonably believes is likely to perpetrate a fraud upon a tribunal.'' New Jersey Rule of Professional Conduct 1.6(b). Wisconsin's corresponding rule is virtually identical to New Jersey's, except that it makes no reference to ''proper authorities.'' Wisconsin Supreme Court Rule 20:1.6. Florida requires a lawyer to reveal confidential information ''to the extent the lawyer reasonably believes necessary * * * to prevent a client from committing a crime.'' Florida Rule of Professional Conduct 4–1.6.

where appropriate, modified the paragraph in a manner that responds to that concern. Subparagraph (iii) has been limited to material violations, and subparagraph (i) limits its application to material violations that are likely to cause substantial injury to the financial interest or property of the issuer or investors.

Finally, the Commission concludes that it is not appropriate for it to wait for further developments. The Commission believes there has been ample discussion of this paragraph in the comments received, and that the major issues concerning this paragraph have been well identified. In addition, delay pending further developments does not promise to be fruitful: most state supreme courts already have rules in place that are consistent with this paragraph, and there is no evidence when, if ever, state supreme courts (or legislative bodies) will revisit these issues, and the public interest in allowing lawyers appearing and practicing before the Commission to disclose the acts covered by this paragraph counsels against waiting indefinitely for further refinement of state ethics rules.

Subsection 205.3(e)(3) in Proposed Rule: Withdrawn

The proposed paragraph read:

Where an issuer, through its attorney, shares with the Commission information related to a material violation, pursuant to a confidentiality agreement, such sharing of information shall not constitute a waiver of any otherwise applicable privilege or protection as to other persons.

Several commenters stated that it was uncertain if the Sarbanes-Oxley Act granted the Commission the authority to promulgate a rule that would control determinations by state and federal courts whether a disclosure to the Commission, even if conditioned on a confidentiality agreement, waives the attorney-client privilege or work product protection,[113] and a few suggested that the proposed paragraph would conflict with Federal Rule of Evidence 501.[114] They noted that this is an unsettled issue in the courts, or suggested that the Commission's proposed rule runs contrary to the bulk of decisional authority on this issue.[115] A few also noted that proposed legislation before Congress in 1974, supported by the Commission, that would have enacted a provision permitting issuers to selectively waive privileges in disclosures to the Commission was ultimately not passed by Congress.[116] The concern was expressed that attorneys might disclose information to the Commission in the belief that the evidentiary privileges for that information were preserved, only to have a court subsequently rule that the privilege was waived.[117]

The Commission has determined not to adopt the proposed rule on this ''selective waiver'' provision. The Commission is mindful of the concern that some courts might not adopt the Commission's analysis of this issue, and that this could lead to adverse consequences for the attorneys and issuers who disclose information to the Commission pursuant to a confidentiality agreement, believing that the evidentiary protections accorded that information remain preserved.

Nonetheless, the Commission finds that allowing issuers to produce internal reports to the Commission—including those prepared in response to reports under 205.3(b)—without waiving otherwise applicable privileges serves the public interest because it significantly enhances the Commission's ability to conduct expeditious investigations and obtain prompt relief, where appropriate, for defrauded investors. The Commission further finds that obtaining such otherwise protected reports advances the public interest, as the Commission only enters into confidentiality agreements when it has reason to believe that obtaining the reports will allow the Commission to save substantial time and resources in conducting investigations and/or provide more prompt monetary relief to investors. Although the Commission must verify that internal reports are accurate and complete and must conduct its own investigation, doing so is far less time consuming and less difficult than starting and conducting investigations without the internal reports. When the Commission can conduct expeditious and efficient investigations, it can then obtain appropriate remedies for investors more quickly. The public interest is thus clearly served when the Commission can promptly identify illegal conduct and provide compensation to victims of securities fraud.

The Commission also finds that preserving the privilege or protection for internal reports shared with the Commission does not harm private litigants or put them at any kind of strategic disadvantage. At worst, private litigants would be in exactly the same position that they would have been in if the Commission had not obtained the privileged or protected materials. Private litigants may even benefit from the Commission's ability to conduct more expeditious and thorough investigations. Indeed, many private securities actions follow the successful completion of a Commission investigation and enforcement action. Consequently, allowing the Commission access to otherwise privileged and inaccessible internal reports but denying access to others would not be unfair to private litigants but is appropriate in the public interest and for the protection of investors.

For these reasons, the Commission will continue to follow its policy of

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[113] Comments of Richard W. Painter, at 9 (''the only effective method'' of assuring lawyers that the attorney-client privilege is not waived by disclosure to the Commission ''is to seek an act of Congress establishing selective waiver and preempting inconsistent state law''); Comments of the American Bar Association, at 32; Comments of Susan P. Koniak *et al.*, at 44.

[114] Comments of Sheldon Jaffe, at 10. Fed. R. Evid. 501 provides that ''[e]xcept as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience. However, in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege of a witness, person, government, State, or political subdivision thereof shall be determined in accordance with State law.''

[115] Comments of the American Bar Association, at 32 n. 21; Comments of Sheldon M. Jaffe, at 9–11; Comments of Edward C. Brewer, III, at 11; Comments of Latham & Watkins, at 5; Comments of Morrison & Foerster and eight other law firms, at 19.

[116] Comments of the American Bar Association, at 32 n. 22; Comments of Morrison & Foerster and eight other law firms, at 19. The Commission notes that the proposal in Congress to which these commenters refer would have applied the selective waiver doctrine to all documents produced to the Commission, and was not limited to productions conditioned upon an express confidentiality agreement. *See Westinghouse Elec. Corp.* v. *Republic of the Philippines,* 951 F.2d 1414, 1425 (3d Cir. 1991). Also, Congress did not reject the Commission's proposal; rather, the House Committee to which the proposal was submitted took no action. *See* SEC Oversight and Technical Amendments: Hearing Before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, 98th Cong., 2d Sess 341 at 34, 51 (1984). Therefore, that the proposal before that House Committee in 1984 was not ultimately enacted carries no significance. *NAACP* v. *American Family Mut. Ins. Co.,* 978 F.2d 287, 299 (7th Cir. 1992) (''unsuccessful proposals to amend a law, in the years following passage, carry no significance'').

[117] Comments of Richard W. Painter, at 9; Comments of Susan P. Koniak *et al.*, at 6; Comments of Latham & Watkins, at 5 (''[g]iven the high stakes associated with waiver of privilege, uncertainty as to interpretation of [Paragraph 205.3(e)(3)'s] requirements in this regard is troubling''); Comments of the SIA/TBMA at 15 (''[a]lthough 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'').

entering into confidentiality agreements where it determines that its receipt of information pursuant to those agreements will ultimately further the public interest, and will vigorously argue in defense of those confidentiality agreements where litigants argue that the disclosure of information pursuant to such agreements waives any privilege or protection.

Section 205.4—Responsibilities of Supervisory Attorneys

(a) An attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer is a supervisory attorney. An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.

(b) A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a), that he or she supervises or directs conforms to this part. To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.

(c) A supervisory attorney is responsible for complying with the reporting requirements in § 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.

(d) A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under § 205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.

Section 205.4 prescribes the responsibilities of a supervisory attorney, and is based in part upon Rule 5.1 of the ABA's Model Rules, which (1) mandates that supervisory attorneys (including partners at law firms and attorneys exercising similar management responsibilities at law firms) must make reasonable efforts to ensure that attorneys at the firm conform to the Rules of Professional Conduct; and (2) provides that a supervisory attorney may be held liable for violative conduct by another attorney which he or she knowingly ratifies or which he or she fails to prevent when able to do so.

Several commenters objected that the articulation of the responsibilities of supervisory attorneys included in the proposed rule rendered senior attorneys responsible for the actions of more junior attorneys whose activities they might not actually supervise or direct. For example, the ABA argued that defining a supervisory attorney to include individuals ''who have supervisory authority over another attorney'' would unfairly cover ''all partners in a law firm and even senior associates,'' many of whom might not exercise actual supervisory authority regarding, or have any involvement with, the matter in question.[118] On the other hand, comments submitted by a distinguished group of academics stated that the sections of the proposed rule prescribing the responsibilities of supervisor and subordinate attorneys were ''necessary'' and appropriate.[119]

The language we adopt today confirms that a supervisory attorney to whom a subordinate attorney reports evidence of a material violation is responsible for complying with the reporting requirements prescribed under the rule. This language modifies the proposed rule by clarifying that only a senior attorney who actually directs or supervises the actions of a subordinate attorney appearing and practicing before the Commission is a supervisory attorney under the rule. A senior attorney who supervises or directs a subordinate on other matters unrelated to the subordinate's appearing and practicing before the Commission would not be a supervisory attorney under the final rule. Conversely, an attorney who typically does not exercise authority over a subordinate attorney but who does direct the subordinate attorney in the specific matter involving the subordinate's appearance and practice before the Commission is a supervisory attorney under the final rule. The final rule eliminates the proposed requirement that a supervisory attorney who believes that evidence of a material violation presented by a subordinate attorney need not be reported ''up-the-ladder'' document the basis for that conclusion. The final rule also eliminates the requirement that a supervisory attorney ensure a subordinate's compliance with the federal securities laws.

Section 205.5—Responsibilities of a Subordinate Attorney

(a) An attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)) is a subordinate attorney.

(b) A subordinate attorney shall comply with this part notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

(c) A subordinate attorney complies with § 205.3 if the subordinate attorney reports to his or her supervising attorney under § 205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.

(d) A subordinate attorney may take the steps permitted or required by § 205.3(b) or (c) if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation under § 205.3(b) has failed to comply with § 205.3.

Section 205.5 is based, in part, on Rule 5.2 of the ABA's Model Rules (which provides that subordinate attorneys remain bound by the Model Rules notwithstanding the fact that they acted at the direction of another person). This section confirms that a subordinate attorney is responsible for complying with the rule. We do not believe that a subordinate attorney should be exempted from the application of the rule merely because he or she operates under the supervision or at the direction of another person. We believe that creation of such an exemption would seriously undermine Congress' intent to provide for the reporting of evidence of material violations to issuers. Indeed, because subordinate attorneys frequently perform a significant amount of work on behalf of issuers, we believe that subordinate attorneys are at least as likely (indeed, potentially more likely) to learn about evidence of material violations as supervisory attorneys.

This section attracted far less comment than section 205.4, and those comments which were received typically supported the concept of allowing a subordinate attorney to satisfy his or her obligations under the rule by reporting evidence of a material violation to a supervisory attorney.[120] The language we adopt today clarifies that a subordinate attorney must be appearing and practicing before the Commission to come under the rule, and conforms this section to the language in section 205.4 by providing that a senior attorney must actually direct or supervise the actions of a subordinate attorney (rather than have

[118] *See* Comments of the American Bar Association, at 22–23. *See also* Comments of Skadden, Arps, Slate, Meagher & Flom, at 27 (arguing that the section should be eliminated entirely, or, alternatively, ''narrowed to apply only to the supervisory attorney within a law firm or a law department who is directly responsible for the supervision of a subordinate attorney in connection with the representation of the issuer in the specific matter, regardless of whether the attorney supervises such subordinate attorney in other unrelated matters.'').

[119] *See* Comments of Susan P. Koniak *et al.*, at 42.

[120] *See* Comments of the American Bar Association, at 22 (''We believe the Commission correctly approaches in Rule 205.5 the treatment of subordinate lawyers who report to a supervisory attorney and in Rule 205.4(c) the shifting of responsibility for compliance to the supervisory attorney to which the matter was reported'').

supervisory authority) to be a supervisory attorney under the rule.

New language has been added to this section to provide that an attorney who appears and practices before the Commission on a matter in the representation of an issuer under the supervision or direction of the issuer's CLO (or the equivalent thereto) is not a subordinate attorney. Accordingly, that person is required to comply with the reporting requirements of Section 205.3. For example, an issuer's Deputy General Counsel, who reports directly to the issuer's General Counsel (CLO) on a matter before the Commission, is not a subordinate attorney. Thus, the Deputy General Counsel is not relieved of any further reporting obligations by advising the CLO of evidence of a material violation. Further, in the event the Deputy General Counsel does not receive an appropriate response from the CLO, he or she is obligated to report further up-the-ladder within the issuer.

Section 205.6—Sanctions and Discipline

(a) A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.

(b) An attorney appearing and practicing before the Commission who violates any provision of this part is subject to the disciplinary authority of the Commission, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices. An administrative disciplinary proceeding initiated by the Commission for violation of this part may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the Commission.

(c) An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

(d) An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.

Paragraph 205.6(a) of the proposed rule tracked the language of Section 3(b) of the Act (which expressly states that a violation of the Act and rules promulgated thereunder shall be treated as a violation of the Exchange Act, subjecting any person committing such a violation to the same penalties as are prescribed for violations of the Exchange Act). Similarly, paragraph 205.6(b) of the proposed rule was based on Section 602 of the Act (adding Section 4C(a) to the Exchange Act, which incorporates that portion of Rule 102(e) of the Commission's Rules of Practice prescribing the state-of-mind requirements for Commission disciplinary actions against accountants who engage in improper professional conduct). Finally, paragraph 205.6(c) of the proposed rule stated that the Commission may discipline attorneys who violate the rule, regardless of whether the attorney is subject to prosecution or discipline for violation of a state ethical rule that applies to the same conduct.

Collectively, proposed section 205.6 (originally entitled ''Sanctions'') generated a number of comments. One commenter complained that sections 3(b) and 307 of the Act did not authorize Commission enforcement action against violators of the rule, and that violations should be handled in Commission disciplinary proceedings.[121] Several other commenters argued that paragraph 205.6(a) should specifically state that the Commission will not seek criminal penalties for violations of the rule.[122] Commenters also suggested that the juxtaposition of paragraphs 205.6(a) and (b) created confusion as to whether the Commission would treat violations of the rule as an Exchange Act violation or a violation of Rule 102(e). A number of commenters also suggested that the Commission should create a safe harbor, protecting attorneys who make a good faith attempt to comply with the rule and explicitly stating that the rule is only enforceable by the Commission and does not create a private right of action.[123]

The language we today adopt in § 205.6 has been extensively modified in light of these comments. The amended section is now titled ''Sanctions and Discipline,'' emphasizing that the Commission intends to proceed against individuals violating Part 205 as it would against other violators of the federal securities laws and, when appropriate, to initiate proceedings under this rule seeking an appropriate disciplinary sanction. Paragraph 205.6(a) has been amended to clarify that only the Commission may bring an action for violation of the part. Paragraph 205.6(b) incorporates the language of paragraph 205.6(c) of the proposed rule, and adds new language specifying the sanctions available to the Commission in administrative disciplinary proceedings against attorneys who violate the part.

New paragraph 205.6(c), consistent with § 205.1, provides that attorneys who comply in good faith with this part shall not be subject to discipline for violations of inconsistent standards imposed by a state or other United States jurisdiction. Paragraph 205.6(c) has been drafted to apply only to an attorney's liability for violating inconsistent standards of a state or other U.S. jurisdiction. Thus, it is not available where the state or other jurisdiction imposes additional requirements on the attorney that are consistent with the Commission's rules. Moreover, this paragraph has no application in actions or proceedings brought by the Commission relating to violations of the federal securities laws or the Commission's rules or regulations thereunder. Further, the fact that an attorney may assert or establish in a state professional disciplinary proceeding, or in a private action, that he or she complied with this part, and complied in good faith, does not affect the Commission's ability or authority to bring an enforcement action or disciplinary proceeding against an attorney for a violation of this part. Indeed, even if a state ethics board or a court were to determine in an action not brought by the Commission that an attorney complied with this part or complied in good faith with this part, that determination would not preclude the Commission from bringing either an enforcement action or a disciplinary proceeding against that attorney for a violation of this part based on the same conduct.

New paragraph 205.6(d) addresses the conduct of non-U.S. attorneys who are subject to this part, because they do not meet the definition of non-appearing foreign attorney. As noted above, the new definition of non-appearing foreign attorney in paragraph 205.2(j) responds to the large number of comments received from lawyers practicing in other jurisdictions stating that attorneys practicing in many foreign countries are subject to rules and regulations that render compliance with the part impossible. This point was also made at the December 17 Roundtable discussion. Several commenters also stated that attorneys who are admitted in United States jurisdictions but who practice in foreign countries are subject to similar restrictions. New paragraph 205.6(d) provides that attorneys in that situation must comply with the part to the

[121] *See* Comments of the Association of the Bar of the City of New York, at 43–44.

[122] *Id.* at 46–47. *See also* Comments of Morrison & Foerster and eight other law firms, at 21.

[123] *See* Comments of Skadden, Arps, Slate, Meagher and Flom, at 29; Comments of the SIA/TBMA, at 16; Comments of the American Bar Association, at 33; Comments of Sullivan & Cromwell, at 16–17.

maximum extent allowed by the regulations and laws to which they are subject.

Section 205.7—No Private Right of Action

(a) Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b) Authority to enforce compliance with this part is vested exclusively in the Commission.

In the proposing release, the Commission expressed its view that: ''nothing in Section 307 creates a private right of action against an attorney. * * * Similarly, the Commission does not intend that the provisions of Part 205 create any private right of action against an attorney based on his or her compliance or non-compliance with its provisions.''[124] Nevertheless, the Commission requested comments on whether it should provide in the final rule ''a 'safe harbor' from civil suits'' for attorneys who comply with the rule.[125] Numerous commenters agreed that the final rule should contain such a provision.

Several commenters suggested that the final rule contain a safe harbor similar to that provided for auditors in Section 10A(c) of the Exchange Act, 15 U.S.C. 78j–1(c), which provides that ''[n]o independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report'' to the Commission made by an issuer whose auditor has reported to its board a failure to take remedial action.[126] Other commenters recommended that the Commission adopt language similar to that in the Restatement (Third) of Law Governing Lawyers, Standards of Care section 52, which provides that ''[p]roof of a violation of a rule or statute regulating the conduct of lawyers * * * does not give rise to an implied cause of action for professional negligence or breach of fiduciary duty * * *.''[127] And others noted that the ABA Model Rules, Scope, ¶ 20, provides that ''[v]iolation of Rule should not itself give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty has been breached.''[128] Finally, numerous other commenters were of the view that a safe harbor should be created to protect lawyers from liability where they have attempted in good faith to comply with this part.[129]

The Commission is persuaded that it is appropriate to include an express safe harbor provision in the rule, which is set forth in new Section 205.7, No Private Right of Action. Paragraph (a) makes it clear that Part 205 does not create a private cause of action against an attorney, a law firm or an issuer, based upon their compliance or non-compliance with the part. The Commission is of the view that the protection of this provision should extend to any entity that might be compelled to take action under this part; thus it extends to law firms and issuers. The Commission is also of the opinion that, for the safe harbor to be truly effective, it must extend to both compliance and non-compliance under this part.

Paragraph (b) provides that only the Commission may enforce the requirements of this part. The provision is intended to preclude, among other things, private injunctive actions seeking to compel persons to take actions under this part and private damages actions against such persons. Once again, the protection extends to all entities that have obligations under this part.

III. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (''PRA'')[130] requires the agency to obtain approval from the Office of Management and Budget (''OMB'') if an agency's rule would require a ''collection of information,'' as defined by the PRA. As set forth in the proposing release, certain provisions of the rule, such as the requirement of written procedures for QLCCs, meet the ''collection of information'' requirement of the PRA. The information collection is necessary to implement the Standards of Professional Conduct for Attorneys prescribed by the proposed rule and required by Section 307 of the Sarbanes-Oxley Act of 2002. Specifically, the collection of information is intended to ensure that evidence of violations is communicated to appropriate officers and/or directors of issuers, so that they can adopt appropriate remedies and/or impose appropriate sanctions. In the rare cases in which a majority of a QLCC has concluded that an issuer did not act appropriately, the information may be communicated to the Commission. The collection of information is, therefore, an important component of the Commission's program to discourage violations of the federal securities laws and promote ethical behavior of attorneys appearing and practicing before the Commission.

The final rule would impose an up-the-ladder reporting requirement when attorneys appearing and practicing before the Commission become aware of evidence of a material violation by the issuer or any officer, director, employee, or agent of the issuer. An attorney must report such evidence to the issuer's CLO or to both the CLO and CEO. A subordinate attorney complies with the rule if he or she reports evidence of a material violation to his or her supervisory attorney (who is then responsible for complying with the rule's requirements). A subordinate attorney may also take the other steps described in the rule if the supervisor fails to comply.

If the CLO, after investigation, determines that there is no violation, he or she must so advise the reporting attorney. Unless the CLO reasonably believes that there is no violation, he or she must take reasonable steps to cause the issuer to adopt an appropriate response to stop, prevent or rectify any violation. The CLO must also report on the remedial measures or sanctions to the reporting attorney.

The rule also requires attorneys to take certain steps if the CLO or CEO does not provide an appropriate response to a report of evidence of a violation. These steps include reporting the evidence up-the-ladder to the audit committee, another committee consisting solely of independent directors if there is no audit committee, or to the board of directors if there is no such committee. If the attorney believes that the issuer has not made an appropriate response to the report, the attorney must explain the reasons for his or her belief to the CEO, CLO or directors to whom the report was made.

Alternatively, if an attorney other than a CLO reports the evidence to a QLCC, he or she need take no further action under the rule. The QLCC must have written procedures for the receipt, retention and consideration of reports of material violations, and must be authorized and responsible to notify the CLO and CEO of the report, determine whether an investigation is necessary and, if so, to notify the audit committee or the board of directors. The QLCC may also initiate an investigation to be

[124] 67 FR 71697.

[125] 67 FR 71691.

[126] *See* Comments of Attorney's Liability Assurance Society, Inc., at 20; Comments of the Association of the Bar of the City of New York, at 5.

[127] *See* Comments of the American Bar Association, at 33–34; Comments of Morrison & Foerster and eight other law firms, at 21.

[128] *Id.* Comments of the American Bar Association, at 33–34.

[129] *See, e.g.*, Comments of Skadden Arps Slate Meagher & Flom, at 29; Comments of the SIA/TBMA, at 21; Comments of the Investment Company Institute, at 7.

[130] 44 U.S.C. 3501 *et seq.*

conducted by the CLO or outside attorneys, and retain any necessary expert personnel. At the conclusion of the investigation, the QLCC may recommend that the issuer adopt appropriate remedial measures and/or impose sanctions, and notify the CLO, CEO, and board of directors of the results of the inquiry and appropriate remedial measures to be adopted. Where the QLCC decides, by a majority vote, that the issuer has failed to take any remedial measure that the QLCC has directed the issuer to take, the QLCC has the authority to notify the Commission. A CLO may also refer a report of evidence of a material violation to a QLCC, which then would have responsibility for taking the steps required by the rule.

The respondents to this collection of information would be attorneys who appear and practice before the Commission and, in certain cases, the issuer, and/or officers, directors and committees of the issuer. We proposed to require attorneys to document communications contemplated by the proposed rule. In response to commenters concerns, we are not specifying that the communications must be documented. We continue to believe that, in providing quality representation to issuers, attorneys report evidence of violations to others within the issuer, including the CLO, the CEO, and, where necessary, the directors. In addition, officers and directors already investigate evidence of violations and report within the issuer the results of the investigation and the remedial steps they have taken or sanctions they have imposed. Attorneys who believe that they were discharged for making a report under the proposed rule might notify the issuer of that fact. Except as discussed below, we therefore believe that the reporting requirements imposed by the rule are ''usual and customary'' activities that do not add to the burden that would be imposed by the collection of information.[131]

Certain aspects of the collection of information, however, impose a new burden. For an issuer to choose to establish a QLCC, the QLCC must adopt written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation. We are adopting this requirement and its collection of information requirement largely as proposed.

We estimate for purposes of the PRA that there are approximately 18,200 issuers that would be subject to the proposed rule.[132] We are unable to estimate precisely how many issuers will choose to form a QLCC. For these purposes, we estimate that approximately 20%, or 3,640, will choose to establish a QLCC. Establishing the written procedures required by the proposed rule should not impose a significant burden. We assume that an issuer would incur a greater burden in the year that it first establishes the procedures than in subsequent years, in which the burden would be incurred in updating, reviewing, or modifying the procedures. For purposes of the PRA, we assume that an issuer would spend six hours every three-year period on the procedures. This would result in an average burden of two hours per year. Thus, we estimate for purposes of the PRA that the total annual burden imposed by this collection of information would be 7,280 hours. We assume that half of those hours will be incurred by outside counsel at a rate of $300 per hour. Using these assumptions, we estimate the collection of information would result in a cost of $1,092,000.

We are not adopting at this time a requirement that attorneys make a ''noisy withdrawal.'' We have amended the PRA submission to remove any burden from that collection of information. We are still considering that provision and, in a separate proposing release, we are requesting additional comments on it. In addition, we are separately proposing an alternative that, along with the ''noisy withdrawal'' proposal, also constitutes a collection of information under the PRA.

The Commission received two comments regarding the Paperwork Reduction Act section of the proposing release. One commenter indicated that the Commission has not considered the paperwork burdens of Part 205 on attorneys who do not specialize in securities law, but who may be considered to be appearing and practicing before the Commission under the rule.[133] The Commission believes that as adopted, the rule imposes little, if any, paperwork burdens on attorneys regardless of whether they specialize in securities law, especially in light of clarification to the rule's scope in the definition of ''appearing and practicing.'' Another commenter suggested that the Commission's original estimate that one quarter of the 18,200 issuers subject to the rule will form QLCCs may be understated, but offered no alternate estimate.[134] The Commission estimated in the proposing release that one quarter of issuers would form QLCCs and received comments suggesting both that it would be difficult to find people to serve on QLCCs[135] and, on the other hand, many companies would use QLCCs.[136] Moreover, the Commission is not adopting at this time the ''noisy withdrawal'' proposal, which may tend to cause fewer companies to form QLCCs. Accordingly, the Commission estimates that under the rule, as adopted, 20% of issuers will form QLCCs.

The Commission submitted the collection of information to OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11, under the title of ''Reports of Evidence of Material Violations.'' Because of the changes to the nature of the information collected and because of the separate proposal for an alternative to ''noisy withdrawal,'' we have changed the name of the submission to ''QLCC and Other Internal Reporting.'' OMB has not yet approved the collection; we will separately publish the OMB control number. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Compliance with the collection of information requirements is in some cases mandatory and in some cases voluntary depending upon the circumstances. Responses to the requirements to make disclosures to the Commission will not be kept confidential.

IV. Costs and Benefits

Part 205 implements Section 307 of the Sarbanes-Oxley Act. Part 205 will affect all attorneys who appear and practice before the Commission in the representation of an issuer and who become aware of evidence that tends to show that a material violation of federal or state securities laws, a material breach of fiduciary duty, or a similar material violation by the issuer or an officer, director, agent, or employee of

[131] *See* 5 CFR 1320.3(b)(2).

[132] This estimate is based, in part, on the total number of operating companies that filed annual reports on Form 10–K (8,484), Form 10–KSB (3,820), Form 20–F (1,194) or Form 40–F (134) during the 2001 fiscal year, and an estimate of the average number of issuers that may have a registration statement filed under the Securities Act pending with the Commission at any time (100). In addition, we estimate that approximately 4,500 investment companies currently file periodic reports on Form N–SAR.

[133] Comments of the Mid-America Legal Foundation, at 3–4.

[134] Comments of Robert Eli Rosen, at 3.

[135] Comments of Clifford Chance, at 4–5; Comments of Emerson Electric Co., at 5.

[136] Comments of Susan P. Koniak *et al.*, at 11; Comments of Richard W. Painter, at 5; Comments of Thomas D. Morgan, at 12.

the issuer has occurred, is ongoing, or is about to occur. The rule we are issuing today implements a Congressional mandate to prescribe ''minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers * * * .'' Prior to passage of the Sarbanes-Oxley Act, attorneys appearing and practicing before the Commission were regulated as to their professional conduct primarily by the ethics standards of the various states where attorneys happened to practice. By passing the Sarbanes-Oxley Act, Congress has implicitly concluded that the benefits of setting such minimum federal standards justify their costs. We enumerate and discuss these costs and benefits below.

Part 205 implements an up-the-ladder reporting requirement upon attorneys representing an issuer before the Commission who become aware of a potential material violation about which a reasonably prudent investor would want to be informed. It is expected that, in the vast majority of instances of such reports, the situation will be addressed and remedied before it causes significant harm to investors.

In addition to these requirements, the rule would authorize a covered attorney to reveal to the Commission confidences or secrets relating to the attorney's representation of an issuer before the Commission to the extent the attorney reasonably believes it necessary to: (i) Prevent the issuer from committing a material violation likely to cause substantial harm to the financial interest or property of the issuer or investors; (ii) prevent the issuer from perpetrating a fraud upon the Commission; or (iii) rectify the consequences of the issuer's illegal act that the attorney's services had furthered.

A. Benefits

Part 205 is designed to protect investors and increase their confidence in public companies by ensuring that attorneys who represent issuers report up the corporate ladder evidence of material violations by their officers and employees. The Commission recognizes that some attorneys may already follow up-the-ladder reporting procedures, especially where the conduct at issue is directly related to the matter on which the attorney represents the issuer, but believes it will prove beneficial if all attorneys who appear and practice before the Commission comply with this requirement.

Part 205 should protect investors by helping to prevent instances of significant corporate misconduct and fraud. The rule requires that attorneys report up-the-ladder when they become aware of evidence of a material violation. Although many attorneys already do this, some may not, especially if the violation is unrelated to the purpose for which they were retained. The rule gives issuers the option of forming a QLCC, consisting of at least one member of the issuer's audit committee and two or more independent directors, which would investigate reports of material violations and would be authorized to recommend that the issuer adopt appropriate remedial measures. The Commission believes that these requirements will make it more likely that companies will address instances of misconduct internally, and act to remedy violations at earlier stages.

Part 205 is intended to increase investor confidence. By requiring attorneys to report potential misconduct up-the-ladder within a corporation, the rule provides a measure of comfort to investors that evidence of fraud will be known and evaluated by the top authorities in a corporation, including its board of directors, and not dismissed by lower-level employees. Furthermore, investors will know that a company that forms a QLCC will have reports of misconduct evaluated by at least one member of the company's audit committee as well as two or more of its independent directors. Investors will also know that if an issuer fails to implement a recommendation that the QLCC has recommended, the QLCC, after a majority vote, may notify the Commission.

Part 205 should serve to deter corporate misconduct and fraud. Corporate wrongdoers at the lower or middle levels of the corporate hierarchy will be aware that an attorney who becomes aware of their misconduct is obligated under the rule to report it up-the-ladder to the highest levels of the corporation. In the event that wrongdoing or fraud exists at the highest levels of a corporation, those committing the misconduct will similarly know that the corporation's attorneys are obligated to report any misconduct of which they become aware up-the-ladder to the corporation's board and its independent directors.

Part 205 may improve the governance of corporations that are subject to the rule. By mandating up-the-ladder reporting of violations, the rule helps to ensure that evidence of material violations will be addressed and remedied within the corporation, rather than misdirected or ''swept under the rug.'' The formation of QLCCs may also serve to improve corporate governance. The Commission believes that some issuers will choose to adopt QLCCs, and that they may prove to be a recognized and effective means of reviewing reported evidence of material violations. Because a QLCC must consist of at least two independent directors (as well as one member of the corporation's audit committee), it will give greater authority to independent directors. This should serve as an important check on corporate management.

Part 205 will give attorneys who appear and practice before the Commission guidance and clarity regarding their ethical obligations when confronted with evidence of wrongdoing by their clients. Part 205 requires that attorneys report up-the-ladder when they become aware of potential material violations and thus complies with an express Congressional directive to set minimum standards of professional conduct for attorneys who appear and practice before it. These benefits are difficult to quantify.

B. Costs

Part 205 will impose costs on issuers and law firms representing them. For issuers, the rule will require the chief legal officer of an issuer to investigate and, where necessary, cause remedial actions and/or sanctions to be taken and/or imposed. It also will cause the CEO, QLCC, and board of directors of the issuer to review evidence of material violations. We believe that most issuers already have procedures for reviewing evidence of misconduct. Similarly, we expect that most issuers already incur costs with investigating such reports.

Those companies that choose to form a QLCC to implement this provision will incur costs. These costs might include increased compensation and insurance for QLCC members, and administrative costs to establish the committee. Additionally, for purposes of the PRA, we assume that 20% of issuers will form such a committee and incur an annualized paperwork cost of two hours for a total annual burden of 7,280 hours. Assuming outside counsel accounts for half of these hours at a cost of $300 per hour,[137] and inside counsel accounts for the other half at $110 per hour,[138] this would result in a cost of $1,492,400.

[137] Estimate of outside counsel rate was obtained by contacting a number of law firms regularly involved in completing Commission documents. *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33–8138 (Oct. 22, 2002) and 33–8177 at n.69 (Jan. 23, 2003).

[138] Estimate of inside counsel rate is derived from the Securities Industry Association ''Report on Management & Professional Earnings in the

Continued

For lawyers, the rule could have an effect upon malpractice insurance premiums, which could, in turn, increase the cost of attorney services to issuers. The Commission received three comments suggesting that the rule, and particularly the provisions requiring mandatory withdrawal and reporting to the Commission, would lead to an increase in the number of malpractice suits brought against attorneys.[139] One of these comments, from an insurance carrier, indicated that the rule could cause malpractice insurance premiums for attorneys to rise by 10% to 50%.[140] The Commission has made a number of changes to the rule in light of these comments. The Commission has clarified and made explicit in Section 205.7 that no private right of action exists based on compliance or non-compliance with the rule. In addition, the Commission has made it clear in Section 205.6(c) that an attorney who complies in good faith with the rule will not be subject to discipline or otherwise liable under an inconsistent state standard. Moreover, the rule, as adopted, will not require attorneys to withdraw or report to the Commission, but will only require reporting to the Commission in the very limited circumstances occurring when a majority of a QLCC determines that an issuer has failed to take remedial action that was directed by the QLCC. Accordingly, the Commission believes that the rule will not have as great an effect on malpractice insurance premiums as suggested by commenters in response to the proposed rule.

Part 205 may also encourage some issuers to handle more legal matters in-house and may cause other issuers to limit the use of in-house counsel and rely more heavily on outside counsel, possibly increasing the cost of legal services. The Commission received one comment indicating that issuers would refer more matters to in-house counsel[141] and four comments indicating that the rule would result in more matters referred to outside counsel.[142] None of the commenters attempted to quantify the costs associated with these shifts. To the extent that the rule, as originally proposed, provided some perceived incentives to transfer functions to or from outside counsel, principally because of the ''noisy withdrawal'' requirements, we believe that those perceived incentives are not present in the rule as adopted.

There may also be some additional costs of the rule imposed on the market that are exceedingly difficult to predict or quantify. The Commission received comments indicating that the rule, and particularly the proposal regarding ''noisy withdrawal,'' would cause issuers to be less willing to seek legal advice and would result in issuers being less forthcoming with their counsel.[143] However, no commenters presented data or attempted to quantify any costs associated with this effect. The Commission also received comments indicating that the rule would not cause any decrease in attorney-client communication.[144] Since the rule, as adopted, will not require mandatory withdrawal or disclosure to the Commission, we believe that Part 205 will not have any adverse impact on attorney-client communications.

V. Effect on Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act (15 U.S.C. 78w(a)(2)) requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. In addition, Section 2(b) of the Securities Act (15 U.S.C. 77b(b)), Section 3(f) of the Exchange Act (15 U.S.C. 78c(f)), and Section 2(c) of the Investment Company Act (15 U.S.C. 80a–2(c)), require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

Part 205 is intended to ensure that attorneys representing issuers before the Commission are governed by standards of conduct that increase disclosure of potential impropriety within an issuer so that prompt intervention and remediation can take place. Doing so should boost investor confidence in the financial markets. We anticipate that this rule will enhance the proper functioning of the capital markets and promote efficiency by reducing the likelihood that illegal behavior would remain undetected and unremedied for long periods of time. Part 205 will apply to all issuers and attorneys appearing before the Commission and is therefore unlikely to affect competition.

The Commission invited comment on this analysis, and received one comment on it.[145] The commenter suggested that the rule could result in a large quantity of information being sent to a CLO or QLCC, which would be expensive and unwieldy to process, and would thus conflict with the goal of promoting efficiency, competition and capital formation. The Commission believes that Part 205 is consistent with the statutory goals and will substantially assist in attaining them by preventing corporate misconduct, restoring investor confidence and lowering the cost of capital.

VI. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis (''FRFA'') has been prepared in accordance with the Regulatory Flexibility Act, 5 U.S.C. 601. An Initial Regulatory Flexibility Analysis (''IRFA'') was prepared in accordance with 5 U.S.C. 603 and was made available to the public.

A. Need for the Rule

Part 205 complies with Section 307 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7245), which requires the Commission to prescribe ''minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers. * * *'' The standards must include a rule ''requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof'' to the CLO or the CEO of the company (or the equivalent thereof); and, if they do not respond appropriately to the evidence, requiring the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors.

B. Significant Issues Raised by Public Comment

The Commission received no comments in response to the IRFA.

Securities Industry 2002,'' and represents the SIA value for an Assistant General Counsel in New York City.

[139] Comments of Chubb Specialty Insurance, at 2–3; Comments of the American Bar Association, at 26–7; Comments of Attorneys' Liability Assurance Society, Inc., at 8, 11.

[140] Comments of Chubb Specialty Insurance, at 5.

[141] Comments of Carter, Ledyard & Milburn, at 2.

[142] Comments of Committee on Investment Management Regulation, Association of the Bar of the City of New York, at 4; Comments of the American Corporate Counsel Association, at 4–5; Comments of Investment Company Institute, at 4; Comments of Debra M. Brown, at 2.

[143] *See, e.g.*, Comments of the American Bar Association, at 26.

[144] *See, e.g.*, Comments of Susan P. Koniak *et al.*, at 24.

[145] Comments of Los Angeles County Bar Association, at 7–8.

C. Small Entities Subject to Part 205

Part 205 would affect issuers and law firms that are small entities. Exchange Act Rule 0–10(a) (17 CFR 240.0–10(a)) defines an issuer, other than an investment company, to be a ''small business'' or ''small organization'' if it had total assets of $5 million or less on the last day of its most recent fiscal year. As of October 23, 2002, we estimated that there were approximately 2,500 issuers, other than investment companies, that may be considered small entities. For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[146] We estimate that there are 211 small investment companies that would be subject to the rule. The revisions would apply to any small entity that is subject to Exchange Act reporting requirements.

Part 205 also would affect law firms that are small entities. The Small Business Administration has defined small business for purposes of ''offices of lawyers'' as those with under $6 million in annual revenue.[147] Because we do not directly regulate law firms appearing before the Commission, we do not have data to estimate the number of small law firms that practice before the Commission or, of those, how many have revenue of less than $6 million. We sought comment on the number of small law firms affected by the rules, but received none.

D. Reporting, Recordkeeping and Other Compliance Requirements

Paragraph 205.3(b) prescribes the duty of an attorney who appears or practices before the Commission in the representation of an issuer to report evidence of a material violation that has occurred, is ongoing, or is about to occur. The attorney is initially directed to make this report to the issuer's CLO, or to the issuer's CLO and CEO.

When presented with a report of a possible material violation, the rule obligates the issuer's CLO to conduct a reasonable inquiry to determine whether the reported material violation has occurred, is occurring or may occur. A CLO who reasonably concludes that there has been no material violation must advise the reporting attorney of this conclusion. A CLO who concludes that a material violation has occurred, is occurring or is about to occur must take reasonable steps to ensure that the issuer adopts appropriate remedial measures and/or sanctions, including appropriate disclosures. Furthermore, the CLO is required to report up-the-ladder within the issuer and to the reporting attorney what remedial measures have been adopted.

A reporting attorney who receives an appropriate response within a reasonable time has satisfied all obligations under the rule. In the event a reporting attorney does not receive an appropriate response within a reasonable time, he or she must report the evidence of a material violation to the issuer's audit committee, to another committee of independent directors if the issuer has no audit committee, or to the full board if the issuer has no such committee. Similarly, if the attorney reasonably believes that it would be futile to report evidence of a material violation to the CLO and CEO, the attorney may report directly to the issuer's audit committee, another committee of independent directors, or to the full board.

Alternatively, pursuant to paragraph 205.3(c), issuers may (but are not required to) establish a QLCC, consisting of at least one member of the issuer's audit committee and two or more independent members of the issuer's board, for the purpose of investigating reports of material violations made by attorneys. Such a QLCC would be authorized to recommend to the issuer that it adopt appropriate remedial measures to prevent ongoing or alleviate past material violations, and empowered to notify the Commission of the material violation if the QLCC decides, by a majority vote, that the issuer has failed to take any remedial measure that the QLCC has directed the issuer to take. The QLCC would be required to notify the board of the results of any inquiry. An attorney other than a CLO may satisfy entirely his or her reporting obligations under the rule by reporting evidence of a material violation to a QLCC. Further, a CLO to whom a report of a material violation has been made may refer the matter to a QLCC.

Paragraph 205.3(d) sets forth the specific circumstances under which an attorney is authorized to disclose confidential information related to his or her appearance and practice before the Commission in the representation of an issuer. Pursuant to this provision, an attorney may use any contemporaneous records he or she creates to defend against charges of attorney misconduct. Paragraph 205.3(d)(2) also allows an attorney to reveal confidential information to the extent necessary to prevent the commission of a material violation that the attorney reasonably believes will result either in perpetration of a fraud upon the Commission or in substantial injury to the financial or property interests of the issuer or investors. Similarly, the attorney may disclose confidential information to rectify an issuer's material violations when such actions have been advanced by the issuer's use of the attorney's services.

We expect that the various reporting requirements required by Part 205 would, at least to a limited extent, increase costs incurred by both small issuers and law firms. We believe that many of these reports are, however, already being made by those affected by the rule. We are unable to estimate the frequency with which reports would have to be prepared by small entities. The time required for the actual preparation of a report would vary, but should not be extensive. Small issuers and law firms may bolster, and in some instances institute, internal procedures to ensure compliance—although the rule does not dictate how these procedures should be implemented.

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the rule, we considered the following alternatives: (a) The establishment of differing compliance or reporting requirements that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of the reporting requirements for small entities; (c) an exemption from coverage of the requirements, or any part thereof, for small entities; and (d) the use of performance rather than design standards. As discussed above, the Sarbanes-Oxley Act directs the Commission to implement rules requiring up-the-ladder reporting. The Act does not contain any exemption or other limitation for small entities. Small business issuers may have some difficulty staffing a QLCC, as we presume that they may have fewer independent directors. We note that issuers are not required to have a QLCC under the rule.

The rule uses some performance standards and some design standards. While the rule establishes a framework for reporting evidence of material violations up-the-ladder, it does not set specific standards for how to comply with the rule's requirements. For the

[146] 17 CFR 270.0–10.

[147] 13 CFR 121.201.

most part, rather than requiring reports to contain specific, detailed disclosures, the rule prescribes general requirements for reporting. This should give small entities flexibility in complying with the rule.

By permitting issuers to establish QLCCs as an alternative mechanism for attorneys to report evidence of misconduct or fraud, the rule presents a performance standard (as opposed to a design standard). A performance standard is characterized by the provision for alternative means of fulfilling the regulatory standard. It has the advantage of permitting market participants to choose the method of meeting the standard that presents the least cost to them. The provision of alternative reporting mechanisms within this rule should serve to lower overall costs to issuers attributable to the rule in precisely this manner.

We believe that utilizing different reporting or other compliance requirements for small entities would undermine the effective functioning of the reporting regime. The rule is designed to restore investor confidence in the reliability of the financial statements of the companies they invest in—if small entities were not subject to such requirements, investors might be less inclined to invest in their securities. Further, we see no valid justification for imposing different standards of conduct upon small law firms than would apply to others who choose to appear and practice before the Commission. We also believe that the reporting requirements will be at least as well understood by small entities as would be any alternate formulation we might formulate to apply to them. Therefore, it does not seem necessary or appropriate to develop separate requirements for small entities.

VII. Statutory Authority

The Commission is adding a new Part 205 to Title 17, Chapter II, of the Code of Federal Regulations under the authority in Sections 3, 307, and 404 of the Sarbanes-Oxley Act of 2002,[148] Section 19 of the Securities Act of 1933,[149] Sections 3(b), 4C, 13, and 23 of the Securities Exchange Act of 1934,[150] Sections 38 and 39 of the Investment Company Act of 1940,[151] and Section 211 of the Investment Advisers Act of 1940.[152]

[148] 15 U.S.C. 7202, 7245, 7262.

[149] 15 U.S.C. 77s.

[150] 15 U.S.C. 78c(b), 78d–3, 78m, 78w.

[151] 15 U.S.C. 80a–37, 80a–38.

[152] 15 U.S.C. 80b–11.

Text of Rule

List of Subjects in 17 CFR Part 205

Standards of conduct for attorneys.

For the reasons set out in the preamble, the Commission amends Title 17, Chapter II, of the Code of Federal Regulations by adding Part 205 to read as follows:

PART 205—STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS APPEARING AND PRACTICING BEFORE THE COMMISSION IN THE REPRESENTATION OF AN ISSUER

Sec.

Authority: 15 U.S.C. 77s, 78d–3, 78w, 80a–37, 80a–38, 80b–11, 7202, 7245, and 7262.

§ 205.1 Purpose and scope.

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

§ 205.2 Definitions.

For purposes of this part, the following definitions apply:

(a) *Appearing and practicing* before the Commission:

(1) Means:

(i) Transacting any business with the Commission, including communications in any form;

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2) Does not include an attorney who:

(i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii) Is a non-appearing foreign attorney.

(b) *Appropriate response* means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

(c) *Attorney* means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who

holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.

(d) *Breach of fiduciary duty* refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable Federal or State statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

(e) *Evidence of a material violation* means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.

(f) *Foreign government issuer* means a foreign issuer as defined in 17 CFR 230.405 eligible to register securities on Schedule B of the Securities Act of 1933 (15 U.S.C. 77a *et seq.*, Schedule B).

(g) *In the representation of an issuer* means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

(h) *Issuer* means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term ''issuer'' includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

(i) *Material violation* means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

(j) *Non-appearing foreign attorney* means an attorney:

(1) Who is admitted to practice law in a jurisdiction outside the United States;

(2) Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and

(3) Who:

(i) Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or

(ii) Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

(k) *Qualified legal compliance committee* means a committee of an issuer (which also may be an audit or other committee of the issuer) that:

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

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

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

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

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A) Notify the audit committee or the full board of directors;

(B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C) Retain such additional expert personnel as the committee deems necessary; and

(iii) At the conclusion of any such investigation, to:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

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

(l) *Reasonable* or *reasonably* denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

(m) *Reasonably believes* means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.

(n) *Report* means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

§ 205.3 Issuer as client.

(a) *Representing an issuer.* An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.

(b) *Duty to report evidence of a material violation.* (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

(2) The chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the

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

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

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

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

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

(4) If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's chief legal officer and chief executive officer (or the equivalents thereof) under paragraph (b)(1) of this section, the attorney may report such evidence as provided under paragraph (b)(3) of this section.

(5) An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(3), or (b)(4) of this section shall be deemed to be appearing and practicing before the Commission. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported under paragraph (b)(1), (b)(3), or (b)(4) of this section from a duty to respond to the reporting attorney.

(6) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

(i) The attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof) to investigate such evidence of a material violation and:

(A) The attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof); and

(B) Except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee; or

(ii) The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee.

(7) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if such attorney was retained or directed by a qualified legal compliance committee:

(i) To investigate such evidence of a material violation; or

(ii) To assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

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

(9) An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section shall explain his or her reasons therefor to the chief legal officer (or the equivalent thereof), the chief executive officer (or the equivalent thereof), and directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section.

(10) An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

(c) *Alternative reporting procedures for attorneys retained or employed by an issuer that has established a qualified legal compliance committee.* (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

(2) A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements under § 205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c).

(d) *Issuer confidences.* (1) Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

(2) An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

§ 205.4 Responsibilities of supervisory attorneys.

(a) An attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer is a supervisory attorney. An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.

(b) A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a), that he or she supervises or directs conforms to this part. To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.

(c) A supervisory attorney is responsible for complying with the reporting requirements in § 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.

(d) A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under § 205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.

§ 205.5 Responsibilities of a subordinate attorney.

(a) An attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)) is a subordinate attorney.

(b) A subordinate attorney shall comply with this part notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

(c) A subordinate attorney complies with § 205.3 if the subordinate attorney reports to his or her supervising attorney under § 205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.

(d) A subordinate attorney may take the steps permitted or required by § 205.3(b) or (c) if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation under § 205.3(b) has failed to comply with § 205.3.

§ 205.6 Sanctions and discipline.

(a) A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.

(b) An attorney appearing and practicing before the Commission who violates any provision of this part is subject to the disciplinary authority of the Commission, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices. An administrative disciplinary proceeding initiated by the Commission for violation of this part may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the Commission.

(c) An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

(d) An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.

§ 205.7 No private right of action.

(a) Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b) Authority to enforce compliance with this part is vested exclusively in the Commission.

By the Commission.

Dated: January 29, 2003.

Jill M. Peterson,

Assistant Secretary.

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