SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 205

[Release Nos. 33–8150; 34–46868; IC–25829; File No. S7–45 –02]

RIN 3235–AI72

Implementation of Standards of Professional Conduct for Attorneys

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is soliciting comments on a proposed rule that would establish 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 company or any agent thereof to the chief legal counsel or the chief executive officer of the company (or the equivalent); 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 do not ignore evidence of material misconduct.

DATES: Comments should be received on or before December 18, 2002.

ADDRESSES: To help us process and review your comments efficiently, comments should be sent by hard copy or by e-mail, but not by both methods.

Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Alternatively, comments may be submitted electronically to the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. 33–8150.wp; this file number should be included on the subject line if e-mail is used. All comment letters received will be available for public inspection and copying in the Commission's Public Reference Room at the same address. Electronically submitted comments will be posted on the Commission's internet Web site (*http://www.sec.gov*).[1]

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

SUPPLEMENTARY INFORMATION: The Commission is proposing to add a new Part 205 to Title 17, Chapter II, of the Code of Federal Regulations[2] establishing standards of professional conduct for attorneys who appear and practice before the Commission in the representation of issuers, under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Sarbanes-Oxley Act of 2002.

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I. Purpose of This Rule Proposal

The purpose of this release is to solicit comments on proposed Part 205,[3] which prescribes Standards of Professional Conduct for Attorneys who appear and practice before the Commission in any way in the representation of issuers.

Section 307 of the Sarbanes-Oxley Act of 2002 (the ''Act'') (15 U.S.C. 7201 *et seq.*) mandates that the Commission shall issue rules, 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.

The proposed rule responds to this directive.[4]

II. Commission Initiatives to Establish Professional Standards for Attorneys Appearing and Practicing Before the Commission

A. The Role of Attorneys Who Appear Before the Commission

Attorneys play a varied and crucial role in the Commission's processes. Attorneys prepare, or assist in the preparation of, materials that are filed with or submitted to the Commission by, or on behalf of, issuers. These materials are relied upon by public investors in making their investment decisions. Thus, the Commission, and the investing public, must be able to rely upon the integrity of in-house and retained lawyers who represent issuers.

Attorneys also play an important and expanding role in the internal processes and governance of issuers, ensuring compliance with applicable reporting and disclosure requirements (including, inter alia, requirements mandated by the federal securities laws). During the floor debate on the amendment that was subsequently adopted and enacted as Section 307 of the Act, Senator John Edwards emphasized the important function attorneys play at public companies. ''This amendment is about making sure those lawyers, in addition to the accountants and executives in the

[1] The Commission does not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. Interested persons submitting comments should only submit information that they wish to make publicly available.

[2] 17 CFR part 205.

[3] Proposal 17 CFR part 205.

[4] The Act mandates that the Commission issue a rule establishing such minimum standards of conduct for attorneys within 180 days of its enactment. The Act was signed into law by President Bush on July 30, 2002. Accordingly, the new rule must be issued by January 26, 2003. The Commission may, in the event it determines it appropriate in light of the mandate of Section 307, supplement the rule establishing minimum standards after that date.

company, don't violate the law and, in fact, more importantly, ensure that the law is being followed.'' [5] Unfortunately, the actions of some attorneys have drawn increasing scrutiny and criticism in light of recent events demonstrating that at least ''some lawyers have forgotten their responsibility.'' [6] Moreover, existing state ethical rules have not proven to be an effective deterrent to attorney misconduct.[7] The July 16, 2002 *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility* (hereinafter the ''Cheek Report'') noted that ''a disturbing series of recent lapses in corporations involving false or misleading financial statements and alleged misconduct by executive officers' has compromised investors' confidence in both the ''quality and the integrity'of the governance of public companies.[8] Indeed, the Task Force concluded that ''the system of corporate governance at many public companies has failed dramatically.'' Moreover, the Task Force's preliminary report acknowledges that attorneys representing and advising corporate clients bear some share of the blame for this failure.[9]

Moreover, foreign attorneys are playing an ever greater role in connection with their representation of issuers making Commission filings. With the globalization of the U.S. capital markets, there has been a marked increase in the number of companies from non-U.S. jurisdictions registering securities with the Commission.[10] At present, there are over 1,300 foreign private issuers from 59 countries that are filing reports with the Commission under the Exchange Act, as compared with approximately 400 issuers from less than 30 countries in 1990. As a result, it is important to address how the proposed rule would apply to these foreign attorneys.

B. The Commission's Ability To Discipline Attorneys Under Rule 102(e)

Rule 102(e) of the Commission's Rules of Practice has been the primary vehicle available to the Commission to protect its processes and ensure the competence of professionals (including attorneys) who appear and practice before it.[11] The Commission adopted Rule 102(e) as a ''means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence.'' [12] The rule permits the Commission to initiate disciplinary proceedings against attorneys who lack integrity or competence, engage in improper professional conduct,[13] or who are determined to have violated provisions of the federal securities laws. The sanctions available in those proceedings include censure, temporary suspension, and permanent bar.

Professionals against whom the Commission has instituted Rule 102(e) proceedings (particularly accountants) have challenged the Commission's authority to promulgate the rule. Every court that has ever considered the issue has concluded that the Commission possessed the authority to promulgate Rule 102(e), and the courts have recognized that it is appropriate for the Commission to use a disciplinary mechanism like Rule 102(e) to protect the integrity of its processes and to encourage professionals to adhere to minimum standards of competence.[14] Nevertheless, as noted below, the Commission's use of Rule 102(e) has proven to be controversial,[15] and until enactment of the Act, the Commission has never had express statutory authority to promulgate a rule establishing standards of conduct for attorneys representing issuers.[16]

C. Prior Commission Consideration of an Attorney's Obligation to Report Corporate Misconduct to Management Even before enactment of the Act, the Commission had addressed the responsibility of attorneys appearing and practicing before the Commission to report to management evidence of misconduct of which they become aware during the course of their representation of a public company.

In a 1981 decision, *In the Matter of William R. Carter, Charles J. Johnson, Jr.,* 22 S.E.C. Docket No. 292, 1981 WL 384414, the Commission reversed an initial decision by a Commission Administrative Law Judge that concluded that two attorneys who failed to correct misstatements contained in a client's press releases and Commission filings concerning earnings had aided and abetted their client's violation of the federal securities laws. The Commission

[5] *See* remarks by Senator John Edwards, 148 Cong. Rec. S6552 (July 10, 2002).

[6] *Id.* at S6551. *See also* Speech by SEC Chairman Harvey L. Pitt: Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002) (''recent events have refocused our attention on the need for the profession to assist us in ensuring that fundamental tenets of professionalism, ethics and integrity work to ensure investor confidence in public companies.''), available at http://www.sec.gov/news/speech/spch579.htm.

[7] *See* remarks by Senator Michael Enzi, 148 Cong. Rec. at S6555 (''I am usually in the camp that believes that [s]tates should regulate professionals within their jurisdiction. However, in this case, the [s]tate bars as a whole have failed. They have provided no specific ethical rule of conduct to remedy this kind of situation. Even if they do have a general rule that applies, it often goes unenforced.'').

[8] *See* Cheek Report at 3–4.

[9] *See* Cheek Report at 7 (''It is a clear failure of corporate responsibility if executive officers aware of potential accounting irregularities sell millions of dollars of stock to public investors who are unaware of [earnings misstatements and self-dealing by corporate officers]. It is a clear failure of corporate responsibility for insiders to borrow enormous amounts from their companies without adequate security beyond inflated stock of the company itself. And it is a clear failure of corporate responsibility when outside directors, auditors and lawyers, who have important roles in our system of independent checks on the corporation's management, fail to avert or even discover—and sometimes actually condone or contribute toward the creation of—the grossest of financial manipulations and fraud.'').

[10] The Commission realizes that the application of Section 307 and the rules we are proposing under Part 205 to foreign law firms, multijurisdictional law firms, and foreign lawyers employed by those law firms and foreign registrants, raises a number of significant and difficult issues. We are requesting comment on a broad range of questions in this area, including whether foreign law firms and foreign lawyers should be exempt from Part 205.

[11] Rule 2(e), the predecessor to Rule 102(e), was promulgated in 1935. Rule 2(e) was redesignated Rule 102(e) in 1995. For the sake of uniformity, the rule will be referred to throughout this release as Rule 102(e).

[12] *Touche Ross & Co.* v. *SEC,* 609 F.2d 570, 582 (2d Cir. 1979). The Commission's existing Rule 102 addresses the conduct of attorneys, accountants, engineers and other professionals or experts who appear or practice before the Commission. 17 CFR 201.102(e)(2) and (f)(2).

[13] Rule 102(e) does not establish professional standards. Rather, the rule enables the Commission to discipline professionals who have engaged in improper professional conduct by failing to satisfy the rules, regulations or standards to which they are already subject, including state ethical rules governing attorney conduct, or generally accepted accounting principles (GAAP) or generally accepted auditing standards (GAAS) governing the conduct of accountants.

[14] *See Touche Ross* v. *SEC,* 609 F.2d 570 (2d Cir. 1979) (Rule 2(e) was validly promulgated pursuant to the Commission's ''broad authority'' to adopt rules and regulations necessary to carry out the Commission's designated functions); *Davy* v. *SEC,* 792 F.2d 1418 (9th Cir. 1986)(concluding that the Commission had statutory authority to adopt Rule 102(e)); *Checkosky* v. *SEC,* 23 F.3d 452, 456 (D.C. Cir. 1994) ('''There can be little doubt that the Commission, like any other institution in which lawyers or other professionals participate, has authority to police the behavior of practitioners before it''') (Silberman, J., *quoting Polydoroff* v. *ICC,* 773 F.2d 372, 374 (D.C. Cir. 1985)).

[15] *Compare* Norman S. Johnson & Ross A. Albert, *''Deja Vu All Over Again'': The Securities and Exchange Commission Once More Attempts to Regulate the Accounting Profession Through Rule 102(e) of its Rules of Practice,* 1999 Utah L. Rev. 553, *with* Paul Gonson, *The 1998 Amendment to SEC Rule 102(e) Will Withstand Judicial Scrutiny,* 1999 Utah L. Rev. 609.

[16] In 1998, in response to the opinion from the U.S. Court of Appeals for the District of Columbia Circuit in *Checkosky* v. *SEC,* in which the Court criticized the Commission's interpretation of Rule 102(e) to the extent it was applied to accountants, the Commission amended Rule 102(e) to clarify the Commission's standard for determining when accountants engage in ''improper professional conduct''. The Commission did not at that time amend the rule to address how it would apply the rule to misconduct by attorneys.

concluded that existing ethical standards governing the conduct of attorneys did not unambiguously proscribe the behavior in question, and the Commission therefore did not sanction the attorneys. Nevertheless, the Commission announced that in the future it would interpret Rule 102(e) to require an attorney who learns that a client is ''engaged in a substantial and continuing failure to satisfy'' disclosure requirements prescribed by the federal securities laws to ''take[] prompt steps to end the client's noncompliance'' in order to avoid violating professional standards. 1981 WL 384414 at *29–*31.[17] The Commission indicated that the attorney can initially simply ''counsel[] accurate disclosure'' by the client. However, in the event the client does not cure the deficiency, the Commission stated that an attorney must take additional ''more affirmative steps'' including possibly a ''direct approach to the board of directors or one or more individuals or officers'' or an attempt ''to enlist the aid of other members of the firm's management'' to correct the deficiency. *Id.* at *31. ''What is required, in short, is some prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying problem, rather than having capitulated to the desires of a strong-willed, but misguided client.'' *Id.* at *31.

The Commission announced in its decision in *Carter and Johnson* that it would solicit comments from the public regarding whether the newly articulated interpretation of ''unethical or improper professional conduct'' should be expanded or modified. *Id.* at *28. The release doing so stated that, based on the comments received, the Commission might or might not expand or modify its interpretation of the phrase ''unethical or improper professional conduct'' in Rule 102(e). ''Until that time, the present interpretation will govern all similar circumstances for purposes of proceedings pursuant to Rule [102](e) if the conduct occurred after February 28, 1981''—the date on which the Commission announced its interpretation in *Carter and Johnson.*[18]

The Commission's announcement in *Carter and Johnson* of the standard to be applied to similar cases in the future and its request for written comments engendered strong opposition from the private bar. The Commission, however, never amended the interpretation of ''unethical or improper professional conduct'' articulated in *Carter and Johnson.*[19]

Subsequently, the Commission's then-General Counsel expressed concern in a speech regarding the Commission's lack of either ''the time or expertise'' to fashion a code of professional conduct for attorneys appearing and practicing before it.[20] He further suggested that the Commission should focus its attention on bringing Rule 102(e) proceedings against attorneys when the alleged misconduct represents ''a violation of established state law ethical or professional misconduct rules and has a direct impact on the Commission's internal processes,'' and indicated that the Commission generally should not institute Rule 102(e) proceedings against attorneys absent a judicial determination that the lawyer has violated the federal securities laws.[21]

In 1988, the Commission issued a release announcing adoption of an amendment to Rule 102(e) to provide for public proceedings initiated under the rule. *See Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission,* 1988 SEC LEXIS 1365 (July 7, 1988). The majority of the release discussed the basis for the Commission's conclusion that the benefit of conducting such proceedings in public outweighed the competing privacy concerns. The Commission noted in the release that it ''has generally utilized Rule [102(e)] proceedings against attorneys only where the attorney's conduct has already provided the basis for a judicial or administrative order finding a securities law violation in a non-rule [102(e)] proceeding'' and that it would continue to follow this policy. *Id.* at *22.

Nevertheless, the Commission has continued to assess the actions of attorneys who learn of misconduct by public company clients outside of the context of Rule 102(e). In a subsequent case, *In the Matter of George C. Kern, Jr.,* 50 S.E.C. 596, 1991 SEC LEXIS 1222 (June 21, 1991), a Commission Administrative Law Judge concluded that an attorney serving both as outside counsel and as a director of a company caused his client to violate the Exchange Act by failing to amend his client's prior filing with the Commission to reflect more recent developments during the course of a tender offer. The ALJ nevertheless concluded that he lacked authority to enter an order directing future compliance pursuant to Section 15(c)(4) of the Exchange Act, and discontinued the proceedings. The Commission affirmed the order discontinuing proceedings.

In another case, *In the Matter of John H. Gutfreund, Thomas W. Strauss and John W. Meriwether,* 51 S.E.C. 93 (Dec. 3, 1992), the Commission issued a report of investigation pursuant to its authority under Section 21(a) of the Exchange Act (15 U.S.C. 78u(a)) concerning the actions of the chief legal officer at a broker-dealer who was apprised of criminal wrongdoing by a corporate officer. While the chief legal officer was not named as a respondent, the Commission issued the report to emphasize its views on the supervisory responsibilities of legal and compliance officers who learn of misconduct by their employer or by a co-worker. The Commission concluded that such individuals are ''obligated to take affirmative steps to ensure that appropriate action is taken to address the misconduct,'' including ''disclosure of the matter to the entity's board of directors, resignation from the firm, or disclosure to regulatory authorities.'' *Id.* at 113–114.[22]

[17] The Commission specifically opined that ''[w]hen a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance.'' 1981 WL 384414 at *29.

[18] *Request for Comments on Standard of Conduct Constituting Unethical or Improper Professional Practice Before the Commission,* 1981 SEC LEXIS 730 at *3–*4 (Sept. 21, 1981).

[19] In a previous case, *In the Matter of Keating, Muething & Klekamp,* 1979 SEC LEXIS 1186 (July 2, 1979), the Commission instituted and settled a Rule 102(e) proceeding against a law firm which prepared Commission filings by a financial client. The Commission concluded that virtually every member of the firm knew that disclosures contained in the client's filings were inadequate and misleading, but that the internal procedures at the firm were inadequate to ensure that this information was properly evaluated in connection with the firm's preparation of Commission filings or reflected within the filings. The Commission specifically opined that ''[a] law firm has a duty to make sure that disclosure documents filed with the Commission include all material facts about a client of which it has knowledge as a result of its legal representation of that client.'' *Id.* at *27.

[20] *See* Edward F. Greene, Lawyer Disciplinary Proceedings before the Securities and Exchagne Commission, Remarks to the New York County Lawyers' Association, (Jan. 18, 1982), Fed. Sec. L. Rep. (CCH) ¶ 83,089.

[21] *See* Fed. Sec. L. Rep. (CCH) ¶ 83,089 (''When the attorney's alleged misconduct is predicated on theories of aiding and abetting liability, as it almost always is when the conduct involves the preparation and filing of documents, and the Commission is also proceeding against the principals in a simultaneous injunctive action, I believe that the wisest course for the Commission to follow is to add the attorney to the injunctive action as a co-defendant. If that is not possible for unusual reasons, then an administrative proceeding under Rule [102(e)] could be commenced. And in those administrative proceedings based upon violations of standards of ethical or professional conduct, I believe that the Commission should use existing state law standards.'').

[22] In 1997, the Commission issued another report of investigation in a matter involving officers and

In sum, while the Commission has opined on a case-by-case basis that lawyers appearing and practicing before the Commission have an obligation to report corporate misconduct to appropriate officers and directors, it has not adopted comprehensive standards directing attorneys to report instances of misconduct.

III. Section 307 of the Sarbanes-Oxley Act

In the wake of sensational revelations concerning Enron and other public companies, a group of legal academics forwarded a letter to Chairman Pitt urging the Commission to impose an ''up the ladder'' reporting requirement on attorneys that would oblige attorneys who learn of misconduct at public companies to report this information to the management of the company.[23] In a March 28, 2002 response, the Commission's then-General Counsel did not take issue with the academics' proposals but noted that there are good reasons why ''a significant change in established practice should be undertaken in the context of Congressional legislation, as opposed to agency rulemaking.''[24] Senator John Edwards, the sponsor of Section 307, learned of this exchange of letters and concluded that it was time for Congress to act to provide a context of Congressional legislation for Commission rules imposing an ''up the ladder'' reporting requirement on attorneys representing public companies.[25]

Section 307 of the Act requires the Commission to promulgate minimum ethical standards for attorneys representing issuers, including an ''up the ladder'' reporting requirement on attorneys as originally proposed by the Commission in *Carter and Johnson*[26] as a means of addressing the same types of concerns regarding attorney behavior and shareholder protection as were described in the Cheek Report. The provision directs the Commission to issue rules applicable to all attorneys appearing and practicing before the Commission in the representation of issuers that require attorneys initially to report evidence of a material violation 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.[27]

IV. Proposed Part 205

A. General Overview

Proposed Part 205 responds to Congress' mandate that the Commission adopt an effective ''up the ladder'' reporting system, and evidences the Commission's intention to implement a robust system in this regard. As set forth in greater detail in the discussion below, the proposed rule would adopt an expansive view of who is appearing and practicing before the Commission. This approach recognizes that attorneys interact with the Commission on behalf of issuer clients in a number of ways, and protects investors by reaching attorney conduct that may threaten the Commission's processes and harm shareholders.

In addition to a rigorous ''up the ladder'' reporting requirement, the proposed rule incorporates several corollary provisions that are not explicitly required by Section 307, but which the Commission believes are important components of an effective ''up the ladder'' reporting system. Under certain circumstances, these provisions permit or require attorneys to effect a so-called ''noisy withdrawal'' and to notify the Commission that they have done so and permit attorneys to report evidence of material violations to the Commission. These provisions embody ethical principles that legal commentators and the ABA have been considering for years,[28] and are similar in important respects to ethical rules that have already been enacted in a number of jurisdictions. At the same time, the proposed rule does not attempt to articulate a comprehensive set of standards regulating all aspects of the conduct of attorneys who appear and practice before the Commission. The Commission does not intend to supplant state ethics laws unnecessarily, particularly in areas (*e.g.*, safeguarding of client assets, escrow procedures, advertising) where the Commission lacks expertise. The Commission believes that the proposed rule will deter instances of attorney and issuer misconduct and where misconduct has occurred, minimize its impact upon issuers and their shareholders.

At the same time, the Commission does not want the rule to impair zealous advocacy, which is essential to the Commission's processes. The Commission also does not want the rule to discourage issuers from seeking and obtaining effective and creative legal advice. Finally, the Commission is cognizant of the ongoing efforts by the ABA and other organizations to address many of the same issues that are covered by the rule, and will continue to monitor those efforts and review the content and operation of the rule, particularly insofar as any measure adopted by the ABA or some other organization or entity extends beyond the scope of Section 307.

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directors of W.R. Grace Co. The Commission concluded that these individuals failed to take action to ensure full and prompt disclosure of substantial retirement benefits the company had agreed to pay to its former CEO in the company's annual report, a 10K filing, and a proxy statement. *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co.,* 1997 SEC LEXIS 2038 (Sep. 30, 1997). The Commission issued the report in order ''to emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the federal securities laws.'' 1997 SEC LEXIS 2038, *3. Although none of the officers and directors named in the matter were attorneys, the report emphasizes the affirmative duty of an issuer's management to correct misconduct and make full disclosure of relevant matters to investors. See also cases discussed infra in n.31 and accompanying text.

[23] *See* March 7, 2002 letter to Chairman Pitt from Richard Painter, *et al.*, at http://www.abanet.org/buslaw/corporateresponsibility/responsibility_relatedmat.html.

[24] *See* March 28 letter from David Becker to Painter, *et al.*, at http://www/abanet.org/buslaw/corporateresponsibility/responsibility_relatedmat.html.

[25] *See* 148 Cong. Rec. S6524–02, S6551–6552 (July 10, 2002).

[26] *See* 148 Cong. Rec. S6552 (July 10, 2002).

[27] Although legislative history for Section 307 is limited, comments made by its sponsors in speeches delivered on the Senate floor suggest that the sponsors' immediate goal was to impose an ''up the ladder'' reporting system upon lawyers representing issuers. *See* remarks by Senator John Edwards, 148 Cong. Rec. S6552 (July 10, 2002) (''This amendment is about making sure those lawyers, in addition to the accountants and executives in the company, don't violate the law and, in fact, more importantly, ensure that the law is being followed. * * * If you find out that the managers are breaking the law, you must tell them to stop. If they won't stop, you go to the board of directors, which represents the shareholders, and tell them what is going on. If they won't act responsibly and in compliance with the law, then you go to the board and say something has to be done; there is a violation of the law occurring. It is basically going up the ladder, up the chain of command. * * * This amendment acts in a very simple way. It basically instructs the SEC to start doing exactly what they were doing 20 years ago, to start enforcing this up-the-ladder principle.''). *See also id.* at S6555 (comments by Senator Enzi) (''When their counsel and advice is sought, attorneys should have an explicit, not just an implied, duty to advise the primary officer and then, if necessary, the auditing committee or the board of directors of any serious legal violation of the law by a corporate agent. Currently, there is no explicit mandate requiring this kind of conduct. It is clearly in the best interest of their client to disclose this type of information'') and S6556 (comments by Senator Corzine) (''The bottom line is this. Lawyers can and should play an important role in preventing and addressing corporate fraud. Our amendment seeks to ensure that. It seeks to go back to the old way: when lawyers know of illegal actions by a corporate agent, they should be required to report the violation to the corporation.'').

[28] Indeed, the ABA's ongoing evaluation of the Cheek Report focuses, in large measure, upon a provision which would impose a reporting obligation comparable to that in proposed Part 205. Cheek Report at 27–30.

B. Summary of Part 205

Section 205.3(b) of proposed Part 205 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.'' The rule's reporting obligation is triggered only when an attorney becomes aware of information that would lead a reasonable attorney to believe a *material* violation has occurred, is occurring, or is about to occur, thus limiting the instances in which the reporting duty prescribed by the rule will arise to those where it is appropriate to protect investors. The attorney is initially directed to make this report to the issuer's chief legal officer (''CLO''), or to the issuer's CLO and chief executive officer (''CEO''). Absent exigent circumstances, the attorney is also obligated to take reasonable steps to document his or her reports, as well as any response received from the CLO or CEO and retain the documentation for a reasonable time. Keeping such documentation will protect the attorney in the event his or her compliance with the proposed rule is put in issue in some future proceeding.

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 is about to occur. A CLO who reasonably concludes that there has been no material violation must notify 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 what remedial measures have been adopted or sanctions imposed and to advise the reporting attorney of his or her conclusions.

A reporting attorney who receives an appropriate response within a reasonable time and has taken reasonable steps to document his or her report and the response to it has satisfied his or her 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, or (if the issuer does not have an audit committee) to another committee of independent directors, or (if the issuer does not have another committee of independent directors) to the full board. 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, or (if the issuer does not have an audit committee) to another committee of independent directors, or (if the issuer does not have another committee of independent directors) to the full board. A reporting attorney who has reported a matter all the way ''up the ladder'' within the issuer and who reasonably believes that the issuer has not responded appropriately must take reasonable steps to document the response, or absence thereof.

The proposed rule would also provide an alternative system for reporting evidence of material violations. *See* Section 205.3(c). Issuers may, but are not required to, establish a qualified legal compliance committee (''QLCC'') composed 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. A QLCC must have the authority and the responsibility to conduct any necessary inquiry into the reported evidence, to require the issuer to adopt appropriate remedial measures to prevent an ongoing, or alleviate a past, material violation, and to notify the Commission of the material violation and disaffirm any tainted document submitted to the Commission. The QLCC would be required to notify the board, the CLO, and the CEO of the results of any inquiry and the remedial measures the QLCC decided were appropriate. In the event the issuer fails to take remedial measures as directed by the QLCC, each member of the QLCC, the CLO, and the CEO would each be individually responsible for notifying the Commission of the material violation and for disaffirming any tainted submission to the Commission. An attorney would satisfy his reporting obligation under the rule by reporting evidence of a material violation to a QLCC. Additionally, a CLO who receives a report of a material violation may refer the report to a QLCC in lieu of conducting his or her own inquiry.

Paragraph 205.3(d) discusses the obligations of an attorney who has not received an appropriate response from the issuer. The provision distinguishes between outside attorneys retained by the issuer and attorneys employed by the issuer. Outside attorneys who have made a report and have not received an appropriate response and who reasonably believe that the reported material violation is ongoing or is about to occur *and* is likely to result in substantial injury to the financial interest of the issuer or of investors are *required* to withdraw from the representation, notify the Commission of their withdrawal, and disaffirm any submission to the Commission that they have participated in preparing which is tainted by the violation. In-house attorneys employed by an issuer who reasonably believe that the reported violation is ongoing or is about to occur *and* is likely to result in substantial injury to the financial interest of the issuer or of investors are *required* to disaffirm any tainted submission they have participated in preparing, but are *not* required to resign. In the event an attorney reasonably believes that a material violation has already occurred and has no ongoing effect, the attorney is *permitted, but not required,* to take these steps, so long as he or she *also* reasonably believes that the reported material violation is likely to have caused substantial injury to the financial interest of the issuer or of investors. Finally, an attorney formerly employed or retained by an issuer who reasonably believes that he or she has been discharged because he or she fulfilled the reporting obligation imposed by the rule *may, but is not required* to, notify the Commission of his or her belief that he or she was discharged for reporting evidence of a material violation and also disaffirm in writing any submission to the Commission that he or she participated in preparing which is tainted by the violation. A notification to the Commission under this section does not breach the attorney-client privilege.

Paragraph 205.3(e) 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 the documentation he or she has prepared under the rule to defend against charges of attorney misconduct. Paragraph 205.3(e)(2) also allows an attorney to reveal confidential information to the extent necessary to prevent the commission of an illegal act which 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 illegal actions when such actions have been advanced by the issuer's use of the attorney's services.

Sections 205.4 and 205.5 detail the respective responsibilities of supervisory and subordinate attorneys, both those employed in-house by the issuer and those serving as outside counsel retained by the issuer. Collectively, these provisions broadly define who is serving as a supervisory attorney, specifically providing that an individual serving as the CLO of an issuer (or who serves in an equivalent role) is a supervisory attorney under the rule. The provision also places the responsibility for compliance with the rule's reporting requirements and documentation obligations upon the supervisory attorney after he or she has been informed of evidence of a material violation by a subordinate. Subordinate attorneys are not exempt from the rule, though they will have complied with it where they report evidence of material violations they learn about to their supervisory attorney. In addition, a subordinate attorney who has reported evidence of a material violation to a supervisory attorney, and who believes that the supervisory attorney has failed to comply with the reporting requirement under the rule is permitted, but not obligated, to report the evidence ''up the ladder'' within the issuer.

Section 205.6 describes the manner in which violations of the rule will be addressed by the Commission. Violation of the proposed rule will subject the violator to all the remedies and sanctions available under the Exchange Act, including injunctions, and cease and desist orders. An attorney who violates a provision of Part 205 will have engaged in improper professional conduct and may also be subject to administrative disciplinary proceedings that can result in a censure, or a suspension or bar from practicing before the agency. Paragraph 205.6(b) incorporates the same state of mind requirements that were adopted for accountants by the Commission in the 1998 amendment to Rule 102(e). Specifically, an attorney is subject to discipline for (1) intentional, including reckless, violations of the Part, and (2) negligent conduct in the form of a single instance of highly unreasonable conduct that results in a violation, or repeated instances of unreasonable conduct resulting in a violation of the Part. The rule provides that the Commission may impose discipline and sanction an attorney who violates the rule, even when the attorney is subject to discipline in the state where he or she practices or is admitted.

V. Section-by-Section Discussion of the Proposed Rule and Request for Comments

The proposing release invites interested persons to submit comments on a large number of specific issues. However, the Commission invites any interested person to submit comments on any aspect of the proposed rule, whether or not comments have been specifically solicited.

Section 205.1 Purpose and Scope

Section 307 of the Act expressly directs the Commission to adopt a rule imposing a reporting requirement upon attorneys ''appearing and practicing before the Commission in any way in the representation of issuers''. Section 307 mandates that the Commission ''shall issue rules * * * setting forth minimum standards of professional conduct * * * including a rule'' imposing an ''up the ladder'' reporting requirement. At the very least, this language directs the Commission to issue a rule requiring attorneys to report material misconduct within an issuer. The Commission may at some future date supplement or amend this rule to expand its scope and address additional ethical issues that are relevant to practice before the Commission.[29] Interested persons are invited to comment on whether the Commission should promulgate additional rules, the issues those rules should address, how, in what form, and why.

Section 205.2 Definitions

Proposed Part 205 includes a section defining a number of terms that appear in the statute and are used throughout the rule. Section 307 of the Act does not define any of its terms. The Act itself defines the term ''issuer,'' and that definition is incorporated into the rule. For several of the terms in the rule, the Commission has adopted the definitions contained in the ABA's Model Rules of Professional Conduct or a variation thereof. For others, the Commission has relied upon statutory definitions or adopted definitions from other sources, including the Restatement (Third) of the Law Governing Lawyers.

For those terms in Section 307 that are included in the proposed rule but not specifically defined in the proposed rule (*e.g.*, ''in any way'' and ''similar violations''), the Commission's intention is that their meaning shall be determined or interpreted according to Commission decisions. Interested persons are invited to comment on whether the Commission should leave these or other terms undefined in the rule or, alternatively, to propose definitions for these or other terms.

(a) *Appearing and practicing* before the Commission includes, but is not limited to, an attorney's:

(1) Transacting any business with the Commission, including communication with Commissioners, the Commission, or its staff;

(2) Representing any party to, or the subject of, or a witness in a Commission administrative proceeding;

(3) Representing any person in connection with any Commission investigation, inquiry, information request, or subpoena;

(4) Preparing, or participating in the process of preparing, any statement, opinion, or other writing which the attorney has reason to believe will be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the Commissioners, the Commission, or its staff; or

(5) Advising any party that:

(i) A statement, opinion, or other writing need not or should not be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the Commissioners, the Commission, or its staff; or

(ii) The party is not obligated to submit or file a registration statement, notification, application, report, communication or other document with the Commission or its staff.

The definition of the term ''appearing and practicing before'' the Commission is based upon Rule 102(f).[30] The wording of that definition has been modified to clarify and confirm that (as under existing Rule 102(f)) the term includes, among other things, representation of an issuer during the course of an investigation or inquiry conducted by the Commission and that an attorney appears and practices before the Commission if he or she advises an issuer either (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

[29] The Commission does not propose to create an ''SEC Bar'' with admission requirements, of which attorneys must be members to appear or practice before the Commission. *See* 5 U.S.C. 500(b) (prohibiting agencies from enacting their own supplemental admission requirements for duly admitted members of a state bar). However, the Commission ''like any other institution in which lawyers or other professionals participate, has authority to police the behavior of practitioners appearing before it.'' *Polydoroff* v. *ICC,* 773 F.2d 372, 374 (D.C. Cir. 1985). This authority is confirmed, of course, in the new Section 4C of the Exchange Act and Section 307 of the Sarbanes-Oxley Act.

[30] The definition prescribed in Rule 102(f) is unaffected by the proposed rule.

other document with the Commission or its staff.

Moreover, the definition of the term has also been drafted to make clear that it covers all communications (oral or written) with the Commission or its staff on behalf of an issuer, as well as conduct involving the preparation of any statement, opinion, or other writing which is submitted to Commissioners, the Commission, or its staff which is incorporated into materials submitted to the Commission—or participation in the process of preparing such a statement, opinion, or other writing. Participation in that process covers both adding and excluding information or a particular characterization of information. The definition also makes clear that an attorney who advises an issuer not to make a filing or submission to the Commission is also appearing and practicing before the Commission.

This broad definition is 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)) in which the Commission has argued that attorneys should be held responsible for materials which they have drafted, or participated in drafting, that they knew would be included in a document to be filed with the Commission but which have been submitted without attribution or under another individual's signature.[31] The modification also reflects 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.

An attorney ordinarily does not appear and practice before the Commission if his or her representation of an issuer involves no business or communication with the Commission, no participation in any way in a Commission process, and no assistance in the preparation of at least a portion of a document filed with or submitted to the Commission. The conduct of attorneys in practice specialties other than securities law will be covered by the proposed rule where their representation of an issuer involves contact with the Commission or where they have reason to believe they are assisting in the preparation of a document transmitted to the Commission, or where they supervise an attorney who does appear and practice before the Commission.

The proposed definition of ''appearing and practicing'' is broad enough to include attorneys who do not serve in the legal department of an issuer or do not act in their capacities as attorneys, but who either transact business with the Commission or assist in the preparation of documents filed with or submitted to the Commission.

Interested persons are invited to comment on any aspect of this definition, including its appropriate scope and whether the Commission should exclude any persons from the definition of ''appearing and practicing'' (*e.g.*, in-house corporate attorneys working outside of a legal department who assist in preparing a document to be filed with the Commission). Interested persons are specifically invited to comment on whether, and how, the definition of ''appearing and practicing'' will impact upon attorneys representing issuers during the course of Commission investigations, inquiries, administrative proceedings or civil litigation, and whether and how the definition should be modified in those contexts. Does the definition need to be modified to make clear that an attorney defending an issuer in a civil injunctive action by the Commission in a district court is not appearing and practicing before the Commission, because the issuer is not transacting business with the Commission, even though the defense attorney is in contact with the Commission's staff who are representing the Commission in that litigation? In the event an attorney representing an issuer in an administrative proceeding fails to receive an appropriate response to evidence of a material violation that the attorney has reported, should the attorney's response be governed by the proposed rule or by the Commission's Rules of Practice? Why? Comment is also particularly invited on the breadth of ''participating in the process of preparing'' in paragraph (a)(4) and whether the ''has reason to believe'' standard in that paragraph is too high or too low (*e.g.*, whether an attorney must have actual knowledge or give express consent for a document to be sent to the Commission in order to be appearing and practicing before the Commission).

The concept of ''appearing and practicing'' also raises issues regarding foreign attorneys employed or retained by foreign issuers. Such attorneys may, for example, be involved in the preparation of documents for use in a foreign jurisdiction that might subsequently be used as the basis for other documents prepared by others for filing with the Commission, with or without the knowledge of the foreign attorneys who prepared the original documents. Interested persons are invited to comment on whether such foreign attorneys are ''appearing and practicing'' before the Commission; if not, how the proposed definition might be modified to make that clear; whether an express exclusion for such foreign attorneys is necessary and, if so, how it might be crafted.

(b) *Appropriate response* means a response to evidence of a material violation reported to appropriate officers or directors of an issuer that provides a basis for an attorney reasonably to believe:

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

(2) That the issuer has, as necessary, adopted remedial measures, including appropriate disclosures, and/or imposed sanctions that can be expected to stop any material violation that is occurring, prevent any material violation that has yet to occur, and/or rectify any material violation that has already occurred.

The definition of the term ''appropriate response'' emphasizes that the actions of attorneys in evaluating possible instances of material violations and the appropriateness of the response made by an issuer apprised of possible instances of material violations will be evaluated against an objective 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 objectively reasonable.

For example, if an issuer responds to an attorney's report regarding the legality of a particular transaction by informing the attorney that a reputable law firm has reviewed the transaction and concluded that there has been no violation, and if the issuer provides a copy of the opinion to the attorney, the attorney could reasonably believe that the issuer's response was appropriate so long as the opinion satisfactorily addresses all of the reporting attorney's reasonable legal and factual concerns and is otherwise reasonable. Similarly, if an issuer responds to an attorney's report concerning another employee's potentially illegal conduct by, for example, disciplining or terminating the employee, and remedying any impact of the employee's misconduct, the attorney could reasonably believe that the issuer's response was appropriate. If, however, the issuer responds to the attorney's report by peremptorily

[31] The Commission has taken this position in several important recent cases, including Newby, *et al.* v. *Enron Corp.* (C.A. HO–13624) (S.D. Tex) (an ongoing private class action suit in which the Commission has submitted briefs as an amicus curiae) and *Klein* v. *Boyd,* 1998 U.S. App. LEXIS 2004 (3rd Cir. Feb. 12, 1998), *vacated* and *reh'g, en banc, granted,* 1998 U.S. App. LEXIS 4121 (3rd Cir. Mar. 9, 1998).

informing the attorney that the reported matter is not cause for concern, and fails to provide any factual or legal basis for the reporting attorney to conclude there was no violation, such a response may not reasonably be viewed as appropriate by the attorney.

An appropriate response where there has been a disclosure violation would include disclosure of the material information or the correction of any material misstatement. Further, it could include an express directive forbidding the unlawful conduct at issue or, if it has already commenced, ordering that it cease at once. The definition also clarifies that past instances of misconduct may not need to be reported further where that misconduct has been addressed, for example, through the imposition of sanctions or other means. A past instance of misconduct that nevertheless may have an ongoing impact (*e.g.*, a misstatement contained in a prior Commission filing that investors may continue to rely upon) will need to be rectified.

Interested persons are invited to comment on any aspect of what is an appropriate response. Should an attorney's reasonable belief determine whether a response is appropriate? What circumstances would permit an attorney reasonably to believe either that no violation has occurred or that any violation has been rectified? Is there a better objective test to measure whether a response is appropriate and, if so, what is it?

(c) *Attorney* refers to 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.

The term ''attorney'' is defined broadly so that the proposed rule applies equally to lawyers employed in-house by an issuer and attorneys retained to perform legal work on behalf of an issuer, and covers persons who hold themselves out as attorneys, even if they are not in fact admitted, licensed, or otherwise qualified to practice law. Interested persons are invited to comment on the impact this definition will have upon attorneys in particular positions, or performing particular functions, and to identify situations in which the definition may reach too broadly. In particular, the Commission requests comment on whether the definition should require, with respect to in-house counsel, that the attorney actually provide legal services to the issuer such that an attorney-client relationship exists, so as to exclude attorneys employed by issuers in non-legal capacities, even if they prepare portions of documents submitted to or filed with the Commission.

The proposed definition of ''attorney'' also covers lawyers licensed in foreign jurisdictions, whether or not they are also admitted to practice in the United States. Under the proposed definition, foreign attorneys who prepare filings or other materials that are submitted to the Commission would be covered by the rule to the extent they are appearing and practicing before the Commission within the meaning of the rule. Potential difficulties related to applying the term ''appearing and practicing'' to foreign attorneys have been discussed above. The Commission also recognizes that significant issues would be raised by application of the proposed rule to foreign attorneys, or attorneys representing or employed by multijurisdictional firms, who may be subject to statutes, rules, and ethical standards in these foreign jurisdictions that are different from, and potentially incompatible with, the requirements of this rule. As noted above, over 1,300 foreign private issuers from 59 countries are registered and reporting with the Commission. These foreign companies are represented by a wide-range of legal counsel. While U.S. lawyers at U.S. law firms often play the principal role in the preparation of disclosure documents filed with the Commission by foreign companies, foreign lawyers can also undertake significant roles in these filings. For example, foreign counsel is often called upon to file a legal or tax opinion as an exhibit to a registration statement filed by a foreign company. In addition, a number of non-U.S.-based law firms (principally firms based in the United Kingdom) have established significant legal practices under the U.S. federal securities laws, and may be the sole law firms representing a particular issuer before the Commission. Generally, such firms have attorneys who are licensed in the United States. Likewise, many U.S. law firms have expanded globally and now employ as partners, counsel and associates lawyers who are admitted to practice solely in jurisdictions outside the United States. These non-U.S. lawyers may play significant roles in connection with Commission filings by both foreign and U.S. issuers. Further, some non-U.S. registrants have employed U.S. or non-U.S. lawyers to serve as their in-house counsel with respect to federal securities law questions.

As proposed, Part 205 would cover lawyers who are licensed in foreign jurisdictions, although only to the extent they ''appear and practice'' before the Commission in the representation of issuers. The Commission recognizes that the application of Part 205 to foreign law firms, multijurisdictional law firms and foreign lawyers raises significant and difficult issues. Because of these issues, the Commission seeks comment on the application of Part 205 to these entities. In particular:

Are there statutes, rules and ethical standards in foreign jurisdictions that govern the conduct of foreign attorneys that are different from, and potentially incompatible with, the requirements of Part 205 and, if so, what foreign authority conflicts with what specific provisions of Part 205?

Are there provisions in Part 205 that could not be given effect (or would be nullified) under statutes, rules, or ethical standards in some foreign jurisdictions? If so, which provisions are affected, and how would this situation affect implementation of Part 205?

How would the ''up the ladder'' rule apply to in-house and retained attorneys in jurisdictions where issuers use different internal corporate structures not contemplated by Part 205?

What difficulties are likely to arise in applying the QLCC alternative to foreign issuers, and how, specifically, could the QLCC alternative be adapted to foreign private issuers?

What are the difficulties in applying Part 205 to law firms that operate in multiple jurisdictions or that have partners, counsel and associates who are admitted to practice law in a foreign jurisdiction but not admitted to practice law in the United States and who participate in the preparation of documents filed with the Commission (or documents that form the basis for documents filed with the Commission)? Are there different considerations in the application of Part 205 in this circumstance depending on whether the law firm in question is principally based in the United States or outside the United States?

What are the difficulties in applying Part 205 to an issuer's in-house attorneys who are admitted to practice law in a foreign jurisdiction but are not admitted to practice law in the United States and who participate in the preparation of documents filed with the Commission (or documents that form the basis for documents filed with the Commission)? Are there different considerations in the application of Part 205 in this circumstance whether the issuer is incorporated in the United States or in a foreign jurisdiction? Any such special difficulties and considerations should be discussed with specificity.

Are there mechanisms that satisfy the objectives of Part 205 that would apply the rule to a narrower category of foreign-licensed attorneys—for example, by employing a variation of the proposed definitions of supervisory and subordinate attorneys or by identifying attorneys in the United States who would have responsibility for compliance with U.S. securities laws? How, specifically, would such mechanisms work?

With respect to disciplinary proceedings, do foreign jurisdictions maintain procedures for disciplining attorneys for violations of statutes, rules or standards relating to ethical conduct and, if so, how do these procedures operate? Is a Commission proceeding against an attorney that violated Part 205 reconcilable with a disciplinary proceeding in the home jurisdiction?

Should foreign attorneys be exempted in whole or in part from the application of Part 205, and if so, why? Are there protections under foreign statutes, rules and standards relating to ethical conduct that serve as an adequate substitute for the various provisions of Part 205? Should the Commission establish a process under which foreign attorneys may apply for exemptions on a case-by-case basis, and if so, what should this process be (for example, the submission of a legal opinion as to the incompatibility of some or all of Part 205 with foreign statutes, rules and standards, and whether those statutes, rules and standards serve as an adequate substitute for the various provisions of Part 205)?

(d) *Breach of fiduciary duty* refers to any breach of fiduciary duty recognized at common law, including, but not limited to, misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

This definition is intended to identify typical common-law breaches of fiduciary duty. It is not intended to change the law.

Interested persons are invited to comment on any aspect of the definition of ''breach of fiduciary duty,'' including whether the examples given should be expanded or narrowed, and, if so, how.

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

This objective standard is intended to preclude reports based on mere suspicion of a material violation while providing reasonable flexibility to attorneys when evaluating their reporting obligations under the proposed rule. An individual attorney is not excused from reporting evidence of a material violation on the grounds that he or she does not personally believe that a material violation has occurred, is occurring, or is about to occur. Under the definition of ''reasonably believes'' in paragraph (l) of Section 205.2, any information that would lead an attorney, acting reasonably, to believe that a material violation has occurred, is occurring, or is about to occur must be reported—whether or not the reporting attorney subjectively believes it. An individual attorney is not, however, required to report within the issuer evidence of a material violation that the attorney thinks is insufficient to lead an attorney, acting reasonably, to believe that a material violation has occurred, is occurring, or is about to occur. The definition does not prescribe a process by which an attorney must evaluate evidence he or she learns about.

Interested persons are invited to comment on any aspect of the definition of ''evidence of a material violation.'' Should a different standard be adopted than that proposed by the Commission and, if so, what should that different standard be? Should the test be subjective rather than objective? Where along the spectrum from actual knowledge to mere suspicion should the line be drawn? Is the correct measure ''beyond a reasonable doubt,'' ''knows or should know,'' ''substantial credible information,'' a ''prima facie case,'' ''more likely than not,'' ''at least as likely as not,'' ''reason to believe,'' ''some credible information,'' ''a mere scintilla of information sufficient to raise suspicion,'' or another test and, if so, what? If reasonable belief is the appropriate standard, what should be reasonably believed: that a material violation has occurred, is occurring, or is about to occur or that a material violation may have occurred, may be occurring, or may be about to occur, or something else? Should the definition be revised to make clearer that the standard is objective rather than subjective and, if so, how?

(f) *In the representation of an issuer* means acting in any way on behalf, at the behest, or for the benefit of an issuer, whether or not employed or retained by the issuer.

The proposed rule includes a broad definition of what constitutes ''in the representation of an issuer.'' A broad definition is essential to protect investors. Accordingly, the term is defined to cover attorneys providing any legal services at the request of, or for the benefit of, an issuer.

For example, an attorney employed or retained by a non-public subsidiary of a public parent issuer is appearing and practicing before the Commission in the representation of an issuer when the subsidiary is 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.

An attorney employed by a privately-held investment adviser who prepares, or assists in preparing, materials 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, or will be incorporated into any document filed with or submitted to the Commission, is appearing and practicing before the Commission. Such an attorney, though employed by a privately-held investment adviser, is representing the investment company before the Commission. Where such an attorney discovers evidence of a material violation by an officer of the investment adviser that is related to the investment company, the attorney is obliged to report that evidence to the CLO of the investment company under 205.3(b). The investment adviser is an agent of the investment company and owes the investment company a fiduciary duty under common law and under Section 36 of the Investment Company Act of 1940.[32] Section 307 of the Act requires an attorney to report evidence of a material violation by any agent of an issuer to the issuer's CLO or CEO.

This reporting obligation does no violence to the attorney-client privilege. Because the attorney is providing legal services for the registered investment company, the attorney is reporting to his or her client evidence of a material violation that is related to his or her

[32] 15 U.S.C. 80a–35.

representation of the client.[33] In effect, an attorney employed by the investment adviser and representing the investment company before the Commission has joint clients. Fairness and candor between co-clients regarding matters of common interest normally preclude any expectation of confidentiality regarding communications with their attorney, even regarding a communication of which one co-client was unaware at the time it was made.[34] That analysis must apply with special force where the co-clients are both organizations, with the investment adviser owing a fiduciary duty to the investment company, and where the attorney employed by the investment adviser, like any attorney employed by an organization, represents the investment adviser as an organization, not officers or employees who may have engaged in misconduct injuring the investment company.

Interested persons are invited to comment on the appropriate scope of the term, and its impact upon attorneys. Does the definition provide sufficient clarity and, if not, how could it be improved? Are there factual circumstances the definition would bring in that might better be excluded? Does the definition go far enough to protect investors?

(g) *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.

The definition for the term ''issuer'' adopts the definition set forth in Section 2(a)(7) of the Act, which in turn incorporates the definition contained in the Exchange Act. This definition raises a question regarding whether the rule should also apply to attorneys who represent various entities that are subject to comprehensive Commission regulation and oversight, and who regularly appear before the agency, but whose clients are not ''issuers.'' For example, many broker-dealers, investment advisers, self-regulatory organizations, transfer and clearing agents are, by law, required to register with the Commission. Attorneys for these entities prepare documents that are filed with the Commission and interact regularly with the Commission. As a regulated entity that is not an issuer presumably does not have a board of directors or an audit committee, and perhaps not even a chief legal officer, imposing the proposed rule on such entities may be inappropriate.

Certain foreign governments have listed debt securities that are registered under Section 12(b) of the Exchange Act. These foreign governments are thus issuers under the Act's definition. These foreign governments, however, may not have the organizational structure contemplated by the proposed rule in that the foreign governments may not have reasonable equivalents to a CEO, an audit committee, independent directors, or a board of directors. Thus, it may be difficult or inappropriate to apply the new Part 205 to such foreign issuers. It may be necessary for the Commission to create an exception or exemption for foreign governments that are issuers of listed debt securities.

The Commission invites interested persons to comment on any aspect of this definition, including: whether some form of ''up the ladder'' reporting should be implemented for attorneys employed by regulated entities that are not issuers; whether there is good reason or a legal basis to alter the definition in Section 2(7) of the Act; and whether the Commission should create an exemption for foreign issuers—providing, for example, that ''Part 205 shall not apply to foreign governments that are eligible to register [or ''that register''] securities under Schedule B of the Securities Act of 1933''—or should modify the definition of ''issuer'' to exclude foreign issuers—and, if so, how.

(h) *Material* refers to conduct or information about which a reasonable investor would want to be informed before making an investment decision.

The definition for the term ''material'' is derived from Supreme Court precedent, and is consistent with the remarks of Senator John Edwards, the sponsor of Section 307, who stated that ''the obligation to report is triggered only by violations that are material—violations that a reasonable investor would want to know about.''[35]

Interested persons are invited to comment on this definition, particularly whether it provides sufficient clarity or, alternatively, whether another formulation would be preferable.

(i) *Material violation* means a material violation of the securities laws, a material breach of fiduciary duty, or a similar material violation.

The rule defines the term ''material violation'' to clarify that the term ''material'' in Section 307(b) modifies all three succeeding references to violations (*i.e.*, ''violation of securities law,'' ''breach of fiduciary duty,'' and ''similar violation''), and that only evidence of material misconduct triggers the rule's reporting obligation.

The rule does not define what constitutes a ''violation of securities law'' since the term is well-understood. The Commission believes that the term covers violations of the federal securities laws, as defined in Section 2(a)(15) of the Act, as well as violations of state securities laws. The rule separately defines ''breach of fiduciary duty'' to cover those forms of breach of fiduciary duty recognized at common law, including misfeasance, nonfeasance, abdication of duty, abuse of trust and the approval of unlawful transactions.

The rule does not define the term ''similar violation.'' However, it appears from the context in which it is used in Section 307 that the term is intended to extend beyond a breach of fiduciary duty or a violation of the securities laws.

Interested persons are invited to comment on any aspect of the definition. Is there good reason to exempt violations of state securities laws from the definition? Should the term ''similar violation'' be defined and, if so, how? Does the definition encompass conduct about which the Commission should not be concerned? Would an alternate test be better? What test, and why?

(j) *Qualified legal compliance committee* means a committee of an issuer that:

(1) Consists of at least one member of the issuer's audit committee 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));

[33] *See Restatement (Third) of the Law Governing Lawyers,* section 14 and Comment c (''a client-lawyer relationship results when legal services are provided''), and Virginia Supreme Court Rule 6:1–1(B) (''Generally, the relation of attorney and client exists, and one is deemed to be practicing law whenever he furnishes to another advice or service under circumstances which imply his possession and use of legal knowledge or skill.''). *See also* 205.3(d)(2) (permitting an attorney appearing and practicing before the Commission in any way in the representation of an issuer to disclose client confidences to the Commission under specified circumstances).

[34] *See Restatement (Third) of the Law Governing Lawyers,* section 75 and Comment d (explaining that in a subsequent proceeding in which the co-clients' interests are adverse there is normally no attorney-client privilege regarding either co-client's communications with their attorney during the co-client relationship).

[35] *See* 148 Cong. Rec. at S6552 (July 10, 2002). *See also TSC Indus.* v. *Northway, Inc.,* 426 U.S. 438 (1976); *Basic, Inc.* v. *Levinson,* 485 U.S. 224 (1988); Staff Accounting Bulletin 99, 99 WL 1123037.

(2) Has been duly established by the issuer's board of directors and authorized to investigate any report of evidence of a material violation by the issuer, its officers, directors, employees or agents;

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

(4) Has 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)(5));

(ii) To decide whether an investigation is necessary to determine whether the material violation described in the report has occurred, is occurring, or is about to occur and, if so, 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 under paragraph (j)(4)(ii) of this section, to:

(A) Direct the issuer to adopt appropriate remedial measures, including appropriate disclosures, and/or to impose appropriate sanctions to stop any material violation that is occurring, prevent any material violation that is about to occur, and/or to rectify any material violation that has already occurred; 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 paragraph (j)(4)(ii) of this section and the appropriate remedial measures to be adopted; and

(5) Each member of which individually, together with the issuer's chief legal officer and chief executive officer (or the equivalents thereof) individually, has the authority and responsibility, in the event the issuer fails in any material respect to take any of the remedial measures that the qualified legal compliance committee has directed the issuer to take, to notify the Commission that a material violation has occurred, is occurring or is about to occur and to disaffirm in writing any document submitted to or filed with the Commission by the issuer that the individual member of the qualified legal compliance committee or the chief legal officer or the chief executive officer reasonably believes is false or materially misleading.

A ''qualified legal compliance committee'' (''QLCC''), as here defined, is part of an alternative procedure for reporting evidence of a material violation. That alternative procedure is set out in Section 205.3(c) of the proposed rule and is discussed below. Excluding ''interested persons'' of a registered investment company from the investment company's QLCC is intended to ensure that the members of such a QLCC will be truly independent, as explained further in the discussion of Section 205.3(b)(4) below.

Interested persons are invited to comment on any aspect of the definition of a QLCC, considered in light of Section 205.3(c), specifically including whether any changes should be made to the definition, either in light of Section 205.3(c) as proposed or in light of changes that the interested persons believe should be made to that section. Should the written procedures for the retention of reports, which a QLCC must establish pursuant to paragraph 205.2(j)(3), require the QLCC to retain paper or electronic copies of all reports submitted by attorneys? Should this requirement be expanded to obligate the QLCC to retain paper or electronic copies of responses to attorney reports?

(k) *Reasonable* or *reasonably* denotes the conduct of a reasonably prudent and competent attorney.

The definition of ''reasonable'' or ''reasonably'' is taken from Rule 1.0(h) of the ABA's Model Rules of Professional Conduct. Interested persons are invited to comment on whether this definition is sufficiently clear and whether alternative language would be an improvement.

(l) *Reasonably believes* means that an attorney, acting reasonably, would believe the matter in question.

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 eliminate any implied subjective element. It is intended to define when belief is objectively reasonable. Interested persons are invited to comment on whether this definition is sufficiently clear and whether alternative language would be an improvement and, if so, what alternative language interested persons would propose. Would the definition of ''reasonable belief'' by New Jersey's Supreme Court, for example, be clearer: ''Reasonable belief for purposes of R[ule of]P[rofessional] C[onduct] 1.6 is the belief or conclusion of a reasonable lawyer that is based upon information that has some foundation in fact and constitutes prima facie evidence of the matters referred to in paragraphs (b) or (c)''?

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

This definition emphasizes that an attorney who is obligated to report evidence of a material violation must do so directly rather than indirectly. Although the attorney is not required to communicate in person with the appropriate individual, the Commission believes that it is essential for any report to be made directly rather than through a third party to ensure clarity. In light of the report's importance, most attorneys would want to report directly in any event.

Interested persons are invited to comment on any aspect of this definition. Should the attorney be required to make a written report, or to memorialize the substance of the report in writing shortly after making it? Should the attorney be required to keep a record of the report, including all supporting documentation? Should the Commission require that the report be made in person? Should the Commission prescribe a format for the report? Should the Commission require that a witness be present for each report? Should an attorney be permitted to delegate his or her reporting requirement to another and, if so, under what circumstances?

Section 205.3 Issuer as Client

Section 205.3 is at the core of the Commission's proposed ''Standards of Professional Conduct for Attorneys.'' It sets out the rule on reporting ''evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof,'' as required by the Act. It also sets out related provisions addressing an attorney's obligations to the issuer.

Representing an Issuer

Section 205.3(a) provides:

(a) *Representing an issuer.* An attorney appearing and practicing before the Commission in the representation of an issuer represents the issuer as an organization and shall act in the best interest of the issuer and its shareholders. 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 paragraph of the proposed rule makes explicit that the client of an attorney representing an issuer before the Commission, in any way, is the issuer as an entity, not the issuer's individual officers or employees that the attorney regularly interacts with and advises on the issuer's behalf. Those officers and other employees, like the attorney, have a fiduciary duty to act in the best interests of the issuer and its shareholders.

This paragraph is grounded in a lawyer's well-established duty to act with reasonable competence and diligence in representing a client and to take steps to prevent reasonably foreseeable harm to the client—

including harm from persons who work for the client.[36] As the Cheek Report explains (at 27), the premise of the ABA's equivalent rule (Model Rule 1.13) is that, when a lawyer represents an organization (such as an issuer),

> the organization is the lawyer's client and * * * the lawyer owes that client an obligation of protection from harm. Harm can result when an officer breaches a duty to the corporation (*e.g.* wastes or misappropriates corporate assets), when the corporation will be caused to injure a third party who will then have a claim against the corporation or when the corporation will be exposed to a fine or penalty. In any such case the lawyer's duty to protect the corporate client from harm requires the lawyer to serve the interest of the corporation and its shareholders rather than the interests of the individual officers or employees who are acting for the corporation.

The attorney representing an issuer does not represent the issuer's officers and employees simply because the attorney necessarily interacts with them in representing the issuer, and the attorney should make that clear to those officers and employees. Any attorney-client privilege for information related to the issuer's affairs that the officers and employees communicate to the attorney belongs to the issuer.[37]

Interested persons are invited to comment on any aspect of this paragraph, including whether it should be expanded to address under what circumstances an attorney for the issuer may also represent officers, directors and employees, and, if an attorney does so, the related questions of: (1) The responsibilities of an attorney when there is a potential for a conflict of interest; (2) obtaining waivers from clients when there is a conflict of interest; and (3) terminating representation when an actual conflict arises.

Reporting Within the Issuer Evidence of a Material Violation

Section 205.3(b) of the proposed rule clarifies and codifies 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.

Paragraph (b)(1) provides:

> (b) *Duty to report evidence of a material violation.* (1) If, in appearing and practicing before the Commission in the representation of an issuer, an attorney becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report any evidence of a material violation to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or to the equivalents thereof) forthwith (unless the issuer has a qualified legal compliance committee and the attorney chooses instead to report the evidence of a material violation to that committee under paragraph (c) of this section). An attorney does not reveal client confidences or secrets by communicating information related to the attorney's representation of an issuer to the issuer's officers or directors.

Paragraph (b)(1) describes the first step that an attorney representing an issuer is required to take after he or she becomes aware of information that would lead an attorney reasonably to believe that a material violation by an issuer or by any of the issuer's officers, directors, employees, or agents has occurred, is occurring, or is about to occur (unless the issuer has a qualified legal compliance committee, and the attorney chooses to report to it).[38] In utilizing this standard, the rule seeks to balance the likelihood of increased compliance with the law as a result of having an appropriate triggering standard that prompts the bringing of potentially illegal conduct to the attention of the issuer's management against the likelihood of decreased compliance resulting from reduced consultation with an issuer's attorneys through adoption of too high a standard.

As paragraph (b)(1) itself expressly states, an attorney does not reveal client confidences or secrets (or breach the attorney-client privilege) by communicating to the issuer's officers or directors information related to the attorney's representation of the issuer. This legal principle is not controversial.[39] The Cheek Report, however, recommends incorporating into the ABA's Model Rule 1.13 a clear statement that Model Rule 1.6 does not prohibit communicating client confidences or secrets ''to higher authority *within* the corporation.''[40] The consensus of the Cheek Task Force was that the existing language of Model Rule 1.13(b) ''tends to discourage action by the lawyer to prevent or rectify corporate misconduct'' generally and to ''discourage[] a lawyer from seeking review by higher corporate authority,'' even though the lawyer's goal ought to be to ''minimiz[e] harm resulting from the misconduct.'' *Id.* The Commission has incorporated such an explicit statement of the legal principle into paragraph (b)(1) of this section.

The report required in Section 205.3(b) to prevent or minimize the harm to an issuer resulting from a material violation is internal. It involves no disclosure of confidential information outside the issuer.[41] The

[36] *See, e.g., Restatement (Third) of the Law Governing Lawyers* (2000) section 96; Model Rules 1.1 and 1.2; *FDIC* v. *O'Melveny & Myers,* 61 F.3d 17, 19 (9th Cir. 1995) (incorporating verbatim the applicable section of its earlier opinion); *FDIC* v. *O'Melveny & Myers,* 969 F.2d 744, 748–49 (9th Cir. 1992), *rev'd on other grounds,* 512 U.S. 79 (1994).

[37] *See, e.g., United States* v. *Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of America, AFL–CIO,* 119 F.3d 210, 215–17 (2d Cir. 1997).

[38] This appears to have been the expectation of the Senators who drafted Section 307 of the Act. *See* 148 Cong. Rec. S6552 (July 10, 2002) (statement of Sen. Edwards) (''the SEC shall make one rule in particular, and it is a simple rule with two parts. No. 1, a lawyer with evidence of a material violation has to report that evidence either to the chief legal counsel or the chief executive officer of the company. No. 2, if the person to whom that lawyer reports doesn't respond appropriately by remedying the violation, by doing something that makes sure it is cured, that lawyer has an obligation to go to the audit committee or to the board. It is that simple. * * * If the CEO can do a short investigation, for example, and figure out that no violation occurred, then the obligation stops there. But if there is a serious violation of the law, the appropriate response is clear: The CEO has to act promptly to remedy the violation. If he doesn't, the lawyer has to go to the board. It is that simple.''). *Accord id.* at S6555 (statement of Sen. Enzi) (''This amendment instructs the Commission to establish rules that require an attorney, with evidence of material legal violation by the corporation or its agent, to notify the chief legal counsel or the chief executive officer of such evidence and the appropriate response to correct it. If these officers do not promptly take action in response, the Commission is instructed to establish a rule that the attorney then has a duty to take further appropriate action, including notifying the audit committee of the board of directors or the board of directors themselves, of such evidence and the actions of the attorney and others regarding this evidence.''), S6556 (statement of Sen. Corzine) (''when lawyers are aware of a potential violation, they do have a duty to investigate. And if they determine there is a material violation of law—not some small violation, some insignificant rule—that violation should be remedied by the corporation. If it is not remedied, it is the duty of the lawyer, under our language, to report it to the board.'').

[39] Information related to the issuer's affairs communicated to the attorney is effectively communicated to the issuer. The officer or employee thus cannot have any reasonable expectation of confidentiality against the issuer regarding such information, and the attorney breaches no confidence in communicating the information to the issuer's CLO, CEO, or directors. *See, e.g., Int'l Bhd. of Teamsters,* 119 F.3d at 215–17.

[40] *Id.* at 28 (original emphasis). The Cheek Report is available at *http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.* It reflects the consensus of the task force appointed by the ABA's President in March 2002 to re-examine ''the framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants'' so that the ABA could contribute to legislative and regulatory reform aimed at improving corporate responsibility after the Enron bankruptcy; as the report notes, however, not every member of the task force endorses every recommendation. Cheek Report at 1–2. The Cheek Report recommends amending Model Rules 1.2, 1.6, 1.13, 1.16, and 4.1, especially Rules 1.6 and 1.13. *Id.* at 27–33, 45–46.

[41] *See also* discussion, above, of disclosure to the CLO, CEO, or directors of a registered investment company regarding misconduct by officers or

Continued

report, moreover, is intended to prevent, if possible, misconduct that would injure the issuer and its shareholders, or at least to limit the injury. Accordingly, awareness of information leading an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur appears to be the appropriate trigger for the obligation to make an internal report of the evidence of a material violation.

As the reporter for the ABA's Commission of Evaluation of Professional Standards (''Kutak Commission'') wrote in 1984, explaining why he considered the ABA's present Model Rule 1.6 (on disclosure of confidential information *to outsiders*) inadequate,

> there is an unavoidable tension between the proposition that the lawyer should act early, to prevent the fraud, and the requirement that he should act only on the basis of solid information. The longer the wait, the more solid the information, but also the greater the likelihood of the client's deeper *inculpation*.[42]

Requiring more than ''a reasonable basis'' for believing that a client intends to commit, or has committed, fraud before allowing the lawyer to reveal confidential client information *to outsiders* ''would virtually preclude the possibility of the lawyer's action except in most egregious situations.'' *Id.* at 285–86. That analysis would appear to apply with even greater force where the disclosure is within an issuer, as required by Section 205.3(b).

Proposed Section 205.3(b) would require an attorney representing an issuer to report within the issuer evidence of ''a material violation by the issuer or by any officer, director, employee, or agent of the issuer.'' The internal report of evidence of a material violation is not comparable to a judicial determination that a material violation actually occurred. There must, however, be some factual basis that would lead an attorney to reasonably believe that a material violation has occurred, is occurring, or is about to occur. The internal report then allows responsible officers of an issuer to consider the reported evidence, investigate where appropriate, and take actions necessary to prevent or minimize any threatened harm to the issuer.[43]

The ABA's Model Rule 1.13 includes a similar but narrower reporting requirement for attorneys representing an organization, applicable only when the attorney *knows* that a violation is occurring or going to occur that is likely to result in substantial injury to the organization:

> If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization.

Even though a securities lawyer ''may be taken as knowing what an alert lawyer would know upon looking with a professional eye at the totality of circumstances there to be seen,'' [44] the ABA's Model Rule appears to set too high a standard for reporting within an issuer evidence of a material violation, both in requiring an attorney to *know* that an officer, employee or other person associated with the issuer organization is engaged in or intends a material violation and in requiring that material violation to result in substantial injury to the issuer. Such a high threshold for internal reporting would be inconsistent with Section 307's emphasis on the public interest and protecting investors.

The proposed rule obligates an attorney to report information he or she has become aware of that would lead an attorney, acting reasonably, to believe that a material violation has occurred, is occurring or is about to occur. In the Commission's decision in *Carter and Johnson* and the order entered in *Keating, Muething & Klekamp,* the Commission addressed the responsibilities of an attorney who ''knows'' of a violation of law by the issuer or its officers. Because those cases dealt with situations where the attorneys knew, or should have known, about their client's misconduct, the Commission's discussion in both cases focused upon an attorney's obligation in that situation. Neither case, however, established actual knowledge of a client's misconduct as a minimum threshold for triggering an attorney's duty to report such misconduct. A rule which obligates an attorney to report only a material violation of which he or she ''knows'' could be interpreted as imposing an initial investigative obligation upon the attorney which he or she may be poorly situated to perform, and which section 307 indicates should be borne by appropriate personnel within the issuer after an attorney has made a report.

When an attorney ''becomes aware'' of information that would lead an attorney reasonably to believe in the existence of a material violation would turn, at least in part, on the attorney's training, experience, position and seniority. Attorneys are not necessarily expected to identify issues they are not equipped to see. What the reasonable, experienced securities lawyer might regard as a clear violation of the law may appear different—or not appear at all—to an unseasoned attorney with a different level of expertise.[45]

The evidence of a material violation that an attorney first becomes aware of may be the tip of an iceberg and, may, on its face, appear unlikely to result in substantial injury to the issuer. For example, evidence indicating that an issuer controls one or two of many special-purpose entities, which individually do not qualify for the off-balance-sheet treatment they have been given, might indicate a material misstatement in the issuer's financial statements, and a material violation of securities law, but not, without more, a material violation likely to result in substantial injury to the issuer.[46]

The proposed rule, however, is not intended to impose upon an attorney, whether employed or retained by the issuer, a duty to investigate evidence of a material violation or to determine whether in fact there is a material violation. Of course, nothing in the proposed rule is intended to discourage any such inquiry. On the other hand,

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employees of its investment adviser under Section 205.2(f).

[42] Geoffrey C. Hazard, Jr., *Rectification of Client Fraud: Death and Revival of a Professional Norm,* 33 Emory L.J. 271, 286 (1984).

[43] Senator Edwards foresaw that a CEO to whom the evidence was reported might ''do a short investigation, for example, and figure out that no violation occurred.'' 148 Cong. Rec. S6552 (July 10, 2002).

[44] Hazard, *Rectification of Client Fraud,* 33 Emory L.J. at 283 (citing cases). *See also* Cheek Report at 33–35.

[45] *See* letter from SIA Ad Hoc Committee to Securities and Exchange Commission, dated Oct. 22, 2002.

[46] The massive fraud perpetrated by O.P.M. Leasing Services, Inc. in the 1970s and early 1980s unraveled after an attorney noticed that payments for computers leased from O.P.M. by one of O.P.M.''s largest customers were being paid directly to O.P.M., even though the lease agreement called for the payments to be made to the lender that was providing financing. Investigation over several months turned up no documentation for two of the many leases at issue. Copies of the missing documentation supplied by the lender revealed that O.P.M. had fabricated the leases and related title documents. O.P.M. had arranged to have the customer's relatively small payments channeled through O.P.M. so that O.P.M. could use its own funds to make the inflated payments due to the lender on the fabricated leases. *See* Report of the Trustee Concerning Fraud and Other Misconduct in the Management of the Affairs of the Debtor at 24–26, *In re O.P.M. Leasing Services, Inc.,* Reorg. No. 81–B–10533, (Bankr. S.D.N.Y., filed April 25, 1983). Clearly, even two fabricated leases were qualitatively material. However, they were arguably unlikely, by themselves, to result in substantial injury to O.P.M.

the attorney cannot ignore evidence of a material violation of which he or she is aware.

In proposing this rule, the Commission does not intend to inhibit the consultative process between an issuer and its attorney. The duty to report ''up the ladder'' under section 205.3(b)(2) does not arise from a consultation in which an attorney advises an officer or employee of an issuer that the law regarding a proposed course of action is unsettled and there is some possibility that a court might hold in the future that the action violated the securities laws. Nor does it arise where an officer actually pursues a course of action despite being advised by the attorney that the course of action has been held illegal by courts in three states, in none of which the issuer does business, even if the attorney thinks there is a reasonable argument that other courts would also be likely to find it illegal. The course of action is not clearly illegal, because its legality has not been addressed by courts in any state where the issuer does business. The duty to report does not even arise where the officer tells the attorney that he or she intends to pursue a course of action that the attorney thinks is clearly illegal where the issuer does business, because the officer might reconsider and not do what he or she said he or she would do. The attorney's reporting obligation is not triggered until the attorney can be sure that the officer or employee will actually pursue an illegal course of action.

Interested persons are invited to comment on: Whether the ''reasonably believes'' standard is an appropriate standard to trigger the requirement that an attorney make a report or whether the requirement should be triggered only in instances where the attorney ''knows'' or ''reasonably should know'' of a material violation; and whether the standard should also address the quantity and/or quality of evidence required to trigger a report.

The Commission also does not intend the proposed rule to chill zealous advocacy by an issuer's defense counsel. Under certain circumstances, however, the proposed rule would require an attorney defending an issuer to report ''up the ladder'' to the issuer's CLO evidence of any material violation that the attorney becomes aware of while defending the issuer. That reporting obligation exists whether or not the evidence of a material violation is directly related to a matter under inquiry or investigation by the Commission. Evidence of a material violation that an attorney learns about while defending an issuer does not pose any less a threat to the issuer and to investors than does evidence of a material violation that an attorney becomes aware of under other circumstances, and requiring defense counsel to report such evidence to the issuer-client's CLO—or even, under extraordinary circumstances, to appropriate directors of the issuer—should not chill an attorney's ability to provide effective representation to the issuer. Indeed, the intended deterrent effect of the proposed rule would be significantly compromised if the rule did not apply when an attorney appears and practices during Commission inquiries, investigations and administrative proceedings. (As a rule of reason, the proposed rule should not be construed to require defense counsel to report to the CLO evidence of a material violation that the CLO has made the defense counsel aware of.) [47]

Moreover, the rule's reporting obligation is consistent with defense counsel's ethical obligations to the issuer-client. ABA Model Rule 1.4 *requires* an attorney to ''keep a client reasonably informed about the status of a matter'' as ''reasonably necessary to permit the client to make informed decisions regarding the representation.'' [48] In the context of a Commission inquiry, investigation, or administrative proceeding, the issuer cannot make informed decisions without knowing about evidence that its officers or employees are responsible for a material violation and, if so, what steps would be required to rectify it. In such a context, the issuer's CLO needs to be aware of information indicating that a material violation has occurred, is occurring, or is about to occur in order to participate intelligently with defense counsel in making decisions about the objectives of the representation and how to pursue them. In the context of an inquiry, investigation, or administrative proceeding by the Commission, one of the affected issuer's objectives should be to determine whether there has been any violation and, if so, to decide how best to rectify it. Accordingly, it should be important to ensure that the issuer's CLO knows about any evidence of a material violation.

In an administrative proceeding, even where the Commission's staff asserts it has evidence of a material violation by an issuer, an attorney defending an issuer may assert any relevant and colorable affirmative defense on the issuer's behalf, and may require the Commission staff to prove its case against his or her client. It 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 under section 205.3(b)(4) of the proposed rule. On the other hand, if the CLO's *sole* response to reported evidence of a material violation from defense counsel is to direct defense counsel to argue in the proceeding that no violation has occurred and the CLO is conducting no internal inquiry and considering no remedial steps, defense counsel, acting reasonably, would probably believe that the CLO's response to the evidence of a material violation is inadequate and would be obligated to report the evidence of a material violation to the issuer's CEO under section 205.3(b)(1) or to appropriate directors under Section 205.3(b)(4) of the proposed rule.[49] Such reporting ''up the ladder,'' however, would constitute—not chill—zealous representation of the issuer's best interest. Responsible defense counsel should probably make such a report under those circumstances in any

[47] The fundamental purpose of reporting to the CLO, as Section 205.3(b)(3) makes clear, is to have the CLO ''cause such inquiry into the evidence of a material violation as he or she reasonably believes is necessary to determine whether the material violation described in the report has occurred, is occurring, or is about to occur.'' Defense counsel may be effectively part of the issuer's own investigation. Because the defense counsel is investigating, there should be no need for defense counsel to report separately each piece of evidence that the defense counsel becomes aware of. Moreover, the ''noisy withdrawal'' provisions in Section 205.3(d) are triggered only when the issuer's response to evidence of a material violation is not appropriate. What response is appropriate must depend on the particular circumstances. Circumstances in which the Commission is already investigating an issuer and the attorney is defending the issuer may well be fundamentally different from circumstances in which an issuer is preparing a filing with or submission to the Commission and the attorney is participating in preparing that filing or submission.

[48] As comment [1] to Model Rule 1.4 explains, ''[t]he client should have sufficient information to participate intelligently in decisions concerning the objectives of the representation and the means by which they are to be pursued, to the extent the client is willing and able to do so.''

[49] Moreover, if the attorney becomes aware during an administrative proceeding that the issuer intends to commit a fraud upon the Commission (*e.g.*, by offering testimony which the attorney knows to be false), then the attorney would be obligated to take appropriate remedial steps to prevent or correct such fraud. The attorney could also report to the Commission pursuant to Section 205.3(e)(2)(ii) of the proposed rule to prevent the client from committing an illegal act, such as suborning perjury, that would perpetrate a fraud on the Commission.

event.[50] The attorney's client is the issuer, not the issuer's CLO. A prudent defense counsel should report ''up the ladder'' in this situation to ensure that upper management is aware of the evidence and has an opportunity to take appropriate action. As the rule makes clear, reporting potential violations to officers and directors of the issuer does not reveal any client confidences.

If the attorney defending an issuer reports the matter all the way ''up the ladder'' within the issuer and does not receive an appropriate response even from the issuer's directors, and if the material violation is ongoing or about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investor, section 205.3(d)(1)(i) obligates an attorney retained by an issuer, even as an advocate, to withdraw from representation and notify the Commission that such withdrawal was for ''professional considerations.'' Section 205.3(d)(2)(i) permits, but does not require, an attorney retained by the issuer to take these steps if he or she reasonably believes the material violation has occurred and is not ongoing and is likely to have resulted in substantial injury to the financial interest or property of the issuer or of investors. The ABA's Model Rule 1.16 *requires* even an advocate in a criminal case to withdraw, unless ordered not to by a court, where continuing the representation ''will result in violation of the rules of professional conduct,'' as asserting frivolous defenses would, under Model Rule 3.4.

An attorney defending an issuer in a civil injunctive action by the Commission in a district court would not be appearing and practicing before the Commission, because the issuer would not be transacting business with the Commission, even though the attorney may be interacting with Commission staff assigned to the litigation. However, if that attorney is also appearing and practicing before the Commission by defending the issuer in a Commission inquiry or investigation and becomes aware of evidence of a material violation by the issuer, the attorney will have the reporting responsibilities under the proposed rule discussed above, whether or not the evidence is related to the subject matter of the litigation. If the evidence of a material violation relates to the subject of the litigation, the attorney should also observe his or her duty of candor to the court.

The Commission invites interested persons to comment on whether there is a potential chilling effect inherent in requiring an attorney to report within the issuer evidence of a material violation or make a ''noisy withdrawal'' while representing an issuer in an inquiry, investigation, or administrative proceeding by the Commission, and invites interested persons to suggest how to address this situation. Should the definition of the term ''appropriate response'' in 205.2(b) be modified to explicitly recognize an attorney's obligation to continue to defend an issuer client in a Commission administrative proceeding, even if the attorney does not believe the client has a meritorious defense? Should the definition be modified to state that an issuer's decision to require the Commission to establish its claims against the issuer in an administrative proceeding constitutes an ''appropriate response'' by an issuer, notwithstanding the fact that an attorney learns of evidence during the proceeding which indicates that the Commission's claims are valid? Should paragraphs 205.3(d)(1)(i) and 205.3(d)(2)(i) be revised to explicitly state that an attorney is not required, or even permitted, to effect a ''noisy withdrawal'' under these circumstances?

Maintaining a Contemporaneous Record

Paragraph (b)(2) of the proposed rule provides:

(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.

Absent exigent circumstances, the attorney retained or employed by an issuer who reports ''up the ladder'' within the issuer evidence of a material violation is required to take reasonable steps to make and retain a contemporaneous record of his or her report and the response it receives.[51] A subordinate attorney who reports evidence of a material violation to his or her supervising attorney is also required to take such steps. Such contemporaneous records would typically include the date, time, location, manner, and substance of the report and the response and the identity of witnesses to either. Much or all of this information would likely be included in the report or the response itself, if the report or the response is in written form. Requiring such a contemporaneous record of the report may protect the attorney in any proceeding in which his or her compliance with this rule is at issue by demonstrating that the attorney acted properly under the circumstances.[52] The rule does not establish any requirement for documentation of an attorney's determination that information does not constitute evidence of a material violation (except where a supervisory attorney believes the information reported to the supervisory attorney by a subordinate attorney is not evidence of a material

[50] *See* ABA Model Rules 3.1 (''A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law. A lawyer for the defendant in a criminal proceeding, or the respondent in a proceeding that could result in incarceration, may nevertheless so defend the proceeding as to require that every element of the case be established.'') and 1.4 (quoted above). As comments [1] and [2] to Model Rule 3.1 elaborate:

[1] The advocate has a duty to use legal procedure for the fullest benefit of the client's cause, but also a duty not to abuse legal procedure. The law, both procedural and substantive, establishes the limits within which an advocate may proceed. However, the law is not always clear and never is static. Accordingly, in determining the proper scope of advocacy, account must be taken of the law's ambiguities and potential for change.

[2] The filing of an action or defense or similar action taken for a client is not frivolous merely because the facts have not first been fully substantiated or because the lawyer expects to develop vital evidence only by discovery. What is required of lawyers, however, is that they inform themselves about the facts of their clients' cases and the applicable law and determine that they can make good faith arguments in support of their clients' positions. Such action is not frivolous even though the lawyer believes that the client's position ultimately will not prevail. The action is frivolous, however, if the lawyer is unable either to make a good faith argument on the merits of the action taken or to support the action taken by a good faith argument for an extension, modification or reversal of existing law.

[51] Section 205.4(d) of the proposed rule would require a supervisory attorney to document the subordinate attorney's report and the supervisory attorney's response to it only where the supervisory attorney believes the information reported by the subordinate attorney is not evidence of a material violation.

[52] *See* Section 205.3(d)(1) of the proposed rule and *Meyerhofer* v. *Empire Fire & Marine Ins. Co.,* 497 F.2d 1190, 1192–93 (2d Cir. 1974) (Friendly, J.), *cert. denied,* 419 U.S. 998 (1974) (associate attorney who had resigned from a law firm because the partners ignored his concerns about the adequacy of disclosures in registration statements, parts of which the associate had worked on, was entitled to disclose to plaintiffs in a subsequent law suit, claiming that one of those registration statements was fraudulent and naming the former associate as a defendant, an affidavit that the associate had previously given to the SEC and that contained confidential client information; the affidavit convinced the plaintiffs' attorney that the associate had not participated in the fraud, and the associate was dropped as a defendant); Hazard, *Rectification of Client Fraud,* 33 Emory L.J. at 283–85 (explaining why ''an innocent lawyer—however competent and however watchful—is inevitably at risk in any transaction where the client could commit fraud'' and why ''the notion that competent lawyers can take care of themselves under a confidentiality rule that does not have an exception concerning client fraud'' cannot be taken seriously).

violation). In close cases, it would be prudent for an attorney to do so.

In certain limited circumstances it may not be practicable or reasonable for the attorney to prepare a written record at the time. The attorney, for example, may learn of possible misconduct in the course of a fast-moving corporate deal. In this situation, it may appear more important to bring the evidence to the CLO's attention immediately than to memorialize it. Other exigent or extenuating circumstances also may result in the lack of a contemporaneous record, although the Commission believes that such cases will be rare. In some cases, the CLO's or management's written response may provide adequate documentation of the report as well as the response. Where it does provide adequate documentation, retaining a copy of the CLO's report would satisfy the requirements of (b)(2) and (7). Where it does not, the reporting attorney should endeavor to make a record of his or her report as soon as possible.

Where a report is directed to an issuer's audit committee, to some other committee of the issuer's board of directors, or to the full board—either because the reporting attorney considered it necessary to bypass the CLO and CEO or because the response from the CLO or CEO was inappropriate or was unreasonably delayed—those circumstances may make it important for the reporting attorney to make and retain a contemporaneous record of his or her report.

In the extreme and unlikely event that the issuer's audit committee, some other committee of the issuer's board of directors, or the full board of directors does not provide an appropriate response within a reasonable time, it may be essential for the reporting attorney to prepare and retain a contemporaneous written record documenting those circumstances. Accordingly, in that unlikely event, paragraph (b)(8) of the proposed rule would require the reporting attorney to take reasonable steps to document the response—typically preserving a copy of a written response—the attorney believes inappropriate, and to retain that documentation for a reasonable time. What is a reasonable time will depend on the circumstances but would probably not be shorter than the statute of limitations applicable to the material violation at issue.

A prudent attorney is likely to make such a contemporaneous record whether or not the Commission requires it, and all attorneys should do so under the circumstances covered by Sections 205.3 (b)(1), (4), and (5) and 205.5(c). Section 205.3(d)(1) expressly authorizes an attorney who has made and retained such contemporaneous records under the proposed rule to use them in self-defense in the event his or her conduct is called into question.

Interested persons are invited to comment on: (1) Whether the rule should require the attorney making a report to maintain a written record of that report; (2) whether the rule should prescribe in detail the form and content of the report, and if so, what form and content should or should not be prescribed; and (3) whether the rule should prescribe specific time deadlines for the preparation of the report, and if so, what time deadlines would or would not be appropriate.

Chief Legal Officer's Duty To Investigate

Paragraph (b)(3) of the proposed rule would provide:

(3) 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 necessary to determine whether the material violation described in the report has occurred, is occurring, or is about to occur. If the chief legal officer reasonably believes no material violation has occurred, is occurring, or is about to occur, he or she shall so advise the reporting attorney. If the chief legal officer reasonably believes that a material violation has occurred, is occurring, or is about to occur, he or she shall take any necessary steps to ensure that the issuer adopts appropriate remedial measures, including appropriate disclosures, and/or imposes appropriate sanctions to stop any material violation that is occurring, prevent any material violation that is about to occur, and/or to rectify any material violation that has already occurred. The chief legal officer shall promptly report the remedial measures adopted and/or sanctions imposed to the chief executive officer, to the audit committee of the issuer's board of directors, or to the issuer's board of directors, and to the reporting attorney. The chief legal officer shall take reasonable steps to document his or her inquiry and to retain such documentation for a reasonable time. 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 fails in any material respect to take any remedial measure that the qualified legal compliance committee directs the issuer to take in order to stop any material violation that is occurring, prevent any material violation that is about to occur, and/or to rectify any material violation that has already occurred, the chief legal officer shall notify the Commission that a material violation has occurred, is occurring or is about to occur and shall disaffirm in writing any documents submitted to or filed with the Commission by the issuer that the chief legal officer reasonably believes are false or materially misleading.

Paragraph (b)(3) would clarify the obligations of the issuer's CLO (or equivalent) under the proposed rule. The Commission has not imposed on attorneys making reports under Section 205.3(b) a duty to investigate independently the evidence before making their reports. Attorneys employed by the issuer or retained as outside counsel are often not in a position to conduct such an inquiry. In many cases, attorneys may lack the experience, resources, and access to records and other employees necessary to conduct an appropriate inquiry. Such an inquiry may be beyond the scope of outside counsel's representation. The issuer's CLO, however, is in a position to conduct an internal inquiry when appropriate. Moreover, a CLO has a clear duty to protect the issuer—as opposed to its other officers and employees—in every possible way.[53] The proposed rule, accordingly, would expressly make the CLO responsible for having an inquiry conducted in response to a report under paragraph (b), unless the CLO makes a reasonable determination that it is not necessary to do so.

Where an issuer has no general counsel or chief legal officer, the ''equivalent'' would be the chief executive officer, who would, under the proposed rule, be responsible for having an inquiry conducted in response to a report under 205.3(b), unless he or she makes a reasonable determination that it is not necessary to do so. In most such cases, the CEO would probably authorize whatever attorneys the issuer normally uses for its legal work to conduct the inquiry or retain another law firm to do so.

Interested persons are invited to comment on whether: (1) The chief legal officer should have an obligation to conduct an inquiry in response to a report and, if so, whether he or she should be permitted to retain or assign other counsel to conduct the inquiry; (2) the ''reasonably believes'' standard is appropriate for determining whether the chief legal officer must cause an inquiry to be conducted; (3) the ''reasonably believes'' standard is an appropriate guide for the chief legal officer's determination regarding whether a material violation has occurred: (4) the rule should further address when it is necessary for the issuer to take ''necessary steps'' in response to a material violation; (5) the rule should further address when remedial measures and/or sanctions are appropriate and the kinds of sanctions and remedial

[53] See O'Melveny & Myers, 969 F.2d at 748–49 (holding that outside counsel had such a duty).

measures that are acceptable under different circumstances; and (6) the rule should address what steps by an issuer are sufficient to ''stop,'' ''prevent'' or ''rectify'' a material violation.

Reporting a Material Violation to the Issuer's Directors

Paragraph (b)(4) of the proposed rule would provide:

(4) If 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 not provided an appropriate response, or has not responded 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 applies where the issuer's CLO and/or CEO fail to respond appropriately to the reported evidence of a material violation, requiring the reporting attorney to report the evidence to the issuer's audit committee, another committee of independent directors, or to the full board of directors. The term ''appropriate response'' is defined in Section 205.2(b) and identifies the steps a CLO or CEO must take in responding to a report of evidence of a material violation, including making appropriate disclosures when the reported evidence demonstrates the existence of a disclosure violation.

The statutory language refers to situations in which a CLO or CEO ''does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation).'' The proposed rule makes clear that providing no response at all within a reasonable time may be equivalent to not providing an appropriate response and no response may, under certain circumstances, require the attorney to report to a higher level of authority within the issuer—when, for example, a filing or submission that the attorney reasonably believes contains a misstatement of material fact is to be made the next day.

The direction that the attorney must report ''up the ladder'' to the audit committee of the issuer's board of directors, if there is one; if there is no audit committee, then to another committee of the issuer's board of directors consisting solely of independent directors, if there is one; and if there is no committee of independent directors, then to the full board of directors is intended to implement the statutory language on reporting ''up the ladder'' [54] while avoiding a situation in which one attorney might report some evidence of a material violation to one committee of directors while another attorney might report other evidence of a material violation to a second committee, obscuring the full, cumulative significance of reported evidence.

Requiring that the committee of a registered investment company's board of directors to which an attorney is allowed to report evidence of a material violation—here and in paragraph (b)(5) of this section—must exclude ''interested persons'' is intended to assure that the report will go to independent directors. That exclusion has the same rationale here as does excluding ''interested persons'' from an investment company's QLCC, as defined in Section 205.2(j). Usually, a director who is *not* ''employed directly or indirectly by the issuer'' is an independent director of the issuer. However, registered investment companies (including mutual funds) constitute an important group of issuers that typically are managed externally. As a result, a director of a registered investment who is ''not employed directly or indirectly'' by the investment company but is employed by the investment company's investment advisor may well not be independent. Independent directors of a registered investment company thus cannot include any ''interested person'' of the investment company as defined in Section 2(a)(19) of the Investment Company Act of 1940.

The Commission solicits comment on any aspect of this section, including whether: (1) The ''reasonably believes'' standard is appropriate for the reporting attorney to determine whether he or she has received an ''appropriate response'' and, if not, what alternative standard should be used; (2) the ''reasonable time'' standard is appropriate or whether the rule should contain a more specific deadline (or deadlines) or one that is linked to the complexity of the issues presented by the report; and (3) the rule should specifically prescribe the form and content of any report to the audit committee or the board of directors and, if so, what form and content would or would not be appropriate.

Paragraph (b)(5) of the proposed rule would provide for circumstances under which it may be appropriate to bypass the CLO and CEO:

(5) 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 the evidence of a material violation as provided under paragraph (b)(4) of this section.

In the interest of expediting any required corrective action within the issuer, paragraph (b)(5) permits, but does not require, an attorney to bypass the CLO or CEO of an issuer and report evidence of a material violation directly to appropriate directors of an issuer—to the audit committee of the issuer's board of directors, if there is one; if there is no audit committee, then to another committee of the issuer's board of directors consisting solely of independent directors, if there is one; and if there is no committee of independent directors, then to the full board of directors—where the attorney reasonably believes that it is likely to be futile to report the evidence to the CLO or CEO. It provides a shortcut under the circumstances implicit in paragraph (b)(4), where the inappropriate response of a CLO and/or CEO can reasonably be anticipated. Reporting to the CLO or CEO might appear futile where those officers appear to be involved in the wrongdoing to be reported. Indeed, a report to participants in the wrongdoing might enable them to destroy relevant evidence. This is an amendment that the Cheek Report (at 29–30) recommends to Model Rule 1.13.

Interested persons are invited to comment on any aspect of this section, including whether: (1) The rule should contain a bypass provision, such as this, allowing a reporting attorney to forego reporting evidence to the chief legal officer and, if so, what its advantages and disadvantages would be; (2) a reporting attorney's ability to bypass the chief legal officer should be limited to instances where it is ''futile'' or whether it should be expanded to other situations, what those other situations should be, and why; (3) the ''reasonably

[54] Section 307 of the Act calls for a rule requiring an 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.''

believes'' standard is appropriate and, if not, what standard or standards would be appropriate; and (4) the rule should provide that the reporting attorney ''may'' bypass the chief legal officer or should it require that he or she do so under certain circumstances.

Attorneys Retained or Directed To Investigate a Reported Material Violation

Paragraph (b)(6) of the proposed rule would address 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:

(6) An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(4), or (b)(5) 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 the officers or directors of the issuer to whom the evidence of a material violation has been reported under paragraph (b)(1), (b)(4), or (b)(5) of this section of the duty to respond to the reporting attorney.

Paragraph (b)(6) makes two points. First, the investigating attorneys would themselves be appearing and practicing before the Commission. They would therefore be bound by the requirements of the proposed rule. Second, the officer or directors who caused them to investigate remain obligated to respond to the attorney who initially reported the evidence of a material violation. Either the issuer's officer or directors or, under the officer's or directors' instructions, the investigating attorneys would make the reporting attorney aware of the inquiry, to keep the reporting attorney from concluding mistakenly that the required response was unreasonably delayed.

Interested persons are invited to comment on all aspects of this section, including: (1) Whether it is appropriate for an attorney retained or directed to investigate a report to be deemed to be appearing and practicing before the Commission; and (2) to what extent, if any, the rule should permit the retained or directed attorney to fulfill the issuer's obligation to respond to the reporting attorney.

Assessment of the Issuer's Response to the Reported Evidence of a Material Violation

Paragraph (b)(7) of the proposed rule would provide for circumstances in which the attorney receives an appropriate and timely response to the evidence he has reported:

(7) 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)(4), or (b)(5) of this section from the issuer's chief legal officer, chief executive officer, audit committee, another committee of the issuer's board of directors consisting solely of directors not employed, directly or indirectly, by the issuer, or the issuer's board of directors and who has taken reasonable steps to document his or her report and the response thereto under paragraph (b)(2) of this section need do nothing more under this section regarding the evidence of a material violation.

This paragraph confirms that the attorney would fully comply with proposed Section 205.3 once the attorney has reported evidence of a material violation and reasonably believes that the issuer's response to that reported evidence is appropriate, so long as there is a record of the report and the response.

Interested persons are invited to comment on any aspect of this section, including whether the rule should have such a ''safe harbor'' and, if so, its scope.

Paragraph (b)(8) of the proposed rule would provide for circumstances in which the attorney does not receive an appropriate response to the evidence he has reported or does not receive any response in a reasonable time:

(8) If the attorney reasonably believes that the issuer has not made an appropriate response to the report or reports made pursuant to paragraph (b)(1), (b)(4), or (b)(5) of this section, or the attorney has not received a response in a reasonable time, the attorney shall:

(i) Explain his or her reasons for so believing to the chief legal officer, chief executive officer, or directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(4), or (b)(5); and

(ii) Take reasonable steps to document the response, or absence thereof, and to retain such documentation for a reasonable time.

It should be truly extraordinary for an attorney reporting evidence of a material violation to receive an inappropriate response—one, for example, that simply asserted that the reported evidence is no cause for concern without any hint of evaluation or inquiry—or to receive no response at all within a reasonable time. Any attorney who believes that the response to evidence of a material violation is not appropriate or is unreasonably delayed is obligated to the client-issuer to explain to the responsible officers or directors why he or she so believes. Where the attorney's explanation is unavailing and the attorney continues to believe that the issuer's response is not appropriate, that extraordinary event should be documented, and the attorney should retain that documentation for a reasonable time.[55]

Interested persons are invited to comment on any aspect of the rule, including: (1) Whether the ''reasonably believes'' standard is appropriate and, if not, what is an appropriate standard; (2) whether the rule should prescribe what is a ''reasonable time'' to permit the issuer to respond to a report; and (3) whether it is important to provide a ''safe harbor'' from civil suits for the attorney who reports evidence of a material violation under paragraph (b) or paragraph (c).

Section 205.3(c) of the proposed rule would provide an alternative to the reporting requirements of paragraphs 205.3(b) and to requirements under 205.3(d) that become applicable where an attorney reporting evidence of a material violation under 205.3(b) does not receive an appropriate response:

(c) *Alternative reporting procedures for attorneys retained or employed by an issuer with a qualified legal compliance committee.* (1) If, in appearing and practicing before the Commission in the representation of an issuer, an attorney 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 of a material violation to a qualified legal compliance committee, if the issuer has duly formed such a committee. Except as provided in paragraph (b)(3) of this section, an attorney who reports evidence of a material violation to a qualified legal compliance committee has satisfied his or her obligation to report evidence of a material violation within the issuer, is not required to assess the issuer's response to the reported evidence of a material violation, and is not

[55] *See* Cheek Report at 28 (characterizing situations in which directors within a corporate client fail to act under such circumstances as ''extreme''); Thomas Riesenberg, *Trying to Hear the Whistle Blowing: The Widely Misunderstood ''Illegal Act'' Reporting Requirements of Exchange Act Section 10A*, 56 Business Lawyer 1417, 1444–45 (2001) (noting that SEC received less than a dozen reports that an issuer had failed to take appropriate remedial action under Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j–1, in four years). Statements by Senators Edwards, Enzi, and Corzine in the floor debate regarding Section 307 of the Act indicate that they believed that an issuer's directors, once notified of evidence of a material violation, could be counted on to remedy it. *E.g.,* 148 Cong. Rec. S6552 (July 10, 2002) (statement of Sen. Edwards), S6555 (statement of Sen. Enzi), S6556 (statement of Sen. Corzine). If that assumption is correct, Section 205.3(d) would never be applicable. *But see Lincoln Savings & Loan Ass'n* v. *Wall,* 743 F. Supp. 901, 910 (D.D.C.1990) (Sporkin, J.) (finding that the directors of Lincoln Savings & Loan ''completely abdicated their duties to Lincoln'' by paying $94 million of Lincoln's assets to Lincoln's corporate parent, payments that the parent was ''under no circumstances'' entitled to and that ''led to a substantial dissipation of Lincoln's assets'').

required to take any action under paragraph (d) of this section regarding the 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 qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(3) of this section. Thereafter, pursuant to the requirements under § 205.2(j), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c) of this section.

This alternative to the reporting requirements of paragraphs Sections 205.3(b) and (d) would allow, though not require, an attorney to seek expedited assessment of reported evidence of a material violation. It would also relieve the reporting attorney of any further obligation once he or she had reported such evidence to an issuer's QLCC. Such a provision may well encourage attorneys to report evidence of a material violation more promptly, since the reporting attorney would not have to worry that he or she might ultimately be obliged to decide whether the issuer's response was ''appropriate,'' and, if the attorney concluded the issuer's response was not appropriate, to go outside the issuer and provide notice of ''noisy withdrawal'' to the Commission. Junior attorneys employed by an issuer might be especially concerned about having to second-guess their superiors, and yet those junior attorneys might also be the first to find evidence of a material violation that the issuer would want to know about.

The QLCC—itself a committee of the issuer's board of directors with special authority and special responsibility—is responsible for carrying out all 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)(5)); causing an investigation where appropriate; determining what remedial measures are appropriate where a material violation has occurred, is occurring, 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.[56] 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 respects in which Section 205.3(c) differs from Sections 205.3(b) and 205.3(d) taken together is 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,'' to alert the Commission as to the material violations, or even to withdraw silently. If the issuer fails, in any material respect to take any remedial action that the QLCC has directed it to take, each member of the QLCC, as well as the CLO and the CEO, is individually responsible for notifying the Commission that a material violation has occurred, is occurring or is about to occur and for disaffirming any document submitted to or filed with the Commission by the issuer that the individual member considers false or materially misleading.

Unlike Sections 205.3(b) and (d), Section 205.3(c) does not address a situation where an issuer's directors fail to stop, prevent, or rectify a material violation, or where it might be reasonable to consider an investigation unreasonably prolonged. On the other hand, Congress itself did not explicitly direct the Commission to address by rule what an attorney who had reported evidence of a material violation should do in the event that an issuer's directors did not respond appropriately. It might thus be argued that Section 205.3(c) of the proposed rule more accurately reflects Congressional intent than do Sections 205.3(b) and (d).

Interested persons are invited to comment on any aspect of this section, including whether: (1) Section 205.3(c) better implements Congressional intent than do Sections 205.3(b) and (d) taken together; (2) Section 205.3(c) reasonably incorporates the two-step process for review of evidence of a material violation described in Section 307 of the Act; (3) Section 205.3(c) is a valuable alternative to Sections 205.3(b) and (d), as it does not impose a requirement beyond reporting evidence of a material violation to an issuer's audit committee, a committee of independent directors, or its full board of directors; (4) Section 205.3(c) should specify circumstances under which an attorney may or should use that alternative and, if so, what would be appropriate circumstances; (5) Section 205.3(c) should indicate circumstances, if any, under which an attorney must *not* or should *not* use that alternative and, if so, what such circumstances should be; (6) an issuer's CLO should be able to make the same use of a QLCC as any other attorney employed by an issuer, with no obligation to assess the results of an investigation by outside attorneys who might be retained specifically to investigate evidence of a material violation; and (7) the QLCC alternative can be reasonably adapted to small issuers and, if so, how.

Notification to the Commission Where There Is No Appropriate Response

Section 205.3(d) of the proposed rule would address the rare situation in which an attorney reasonably believes an issuer's directors have either made no response (within a reasonable time) to reported evidence of a material violation or have not made an appropriate response. That section of the proposed rule is broadly based on the ABA's Model Rules 1.13 and 1.16 and on Section 10A of the Exchange Act. It distinguishes between material violations that have already occurred and are not ongoing and material violations that are either ongoing or have not yet occurred and between outside attorneys retained by an issuer and in-house attorneys employed by an issuer.

Section 205.3(d)(1) of the proposed rule would provide:

(d) *Notice to the Commission where there is no appropriate response within a reasonable time.* (1) Where an attorney who has reported evidence of a material violation under paragraph 3(b) of this section rather than paragraph 3(c) of this section does not receive an appropriate response, or has not received a response in a reasonable time, to his or her report, and the attorney reasonably believes that a material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors:

(i) An attorney retained by the issuer shall:

(A) Withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations;

(B) Within one business day of withdrawing, give written notice to the Commission of the attorney's withdrawal, indicating that the withdrawal was based on professional considerations; and

(C) Promptly disaffirm to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading;

(ii) An attorney employed by the issuer shall:

[56] *See, e.g.*, Cheek Report at 37–41 (encouraging institutional changes providing for regular communications between a company's general counsel, outside counsel, and directors that would facilitate early disclosure of possible misconduct).

(A) Within one business day, notify the Commission in writing that he or she intends to disaffirm some opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading; and

(B) Promptly disaffirm to the Commission, in writing, any such opinion, document, affirmation, representation, characterization, or the like; and

(iii) The issuer's chief legal officer (or the equivalent) shall inform any attorney retained or employed to replace the attorney who has withdrawn that the previous attorney's withdrawal was based on professional considerations.

Although such extreme situations should be rare, the proposed rule would probably be incomplete if it did not provide for them. Providing notification to the Commission, however, goes beyond what the Act expressly directed the Commission to do. The proposed rule, accordingly, sets a higher standard for notifying the Commission than for reporting ''up the ladder'' within the issuer. Paragraph (d)(1) addresses material violations that are ongoing or have yet to occur and distinguishes between in-house attorneys employed by an issuer and outside attorneys retained by the issuer. It requires the reporting attorney to take certain actions that paragraph (d)(2)—addressing past material violations that have no continuing effect—merely permits. Paragraph (d)(1), however, does not require even an outside attorney retained by the issuer to disclose evidence of the reported material violation, only to make a ''noisy withdrawal.''[57] An attorney would not be obligated to withdraw and notify the Commission unless paragraph (d)'s higher threshold is met.

The Commission is aware that the ABA is currently addressing the issues raised by this section and the Commission will be monitoring the progress of the ABA's efforts in assessing whether there is a need for the Commission's rule to reach this issue.

Outside Attorneys

Where the material violation at issue is ongoing or has yet to occur, Section 205.3(d)(1) of the proposed rule would require an outside attorney appearing and practicing before the Commission in the representation of the issuer to give notice to the Commission of the issuer's inappropriate response to the reported evidence through the ''signal'' or ''flag waving'' of ''noisy withdrawal'' that has long been recognized as a compromise between silent withdrawal and disclosure of specific confidential information.[58] It requires that signal, however, only when the attorney actually believes that the material violation of which the attorney reported evidence is occurring or is about to occur and is, *in addition*, likely to result in substantial injury to the financial interest or property of the issuer or of investors.

That is, where the issuer's directors have responded inappropriately to evidence of a material violation that is ongoing or has yet to occur, *and* this additional threshold is met, an attorney retained by the issuer is required, under paragraph (d)(1)(i), to withdraw from representing the issuer, in all matters, ''forthwith.'' Within one business day after withdrawing, the attorney is required to notify the Commission that he or she has withdrawn and was required to do so for ''professional considerations.'' Use of the phrase ''professional considerations'' to explain the withdrawal keeps confidential the particular facts underlying the withdrawal while signaling that the withdrawal reflects substantially more than a disagreement about the best legal strategy or a dispute over the cost of representation.[59] A purely silent withdrawal would be likely to assist an issuer in carrying out an ongoing or intended violation.

Under these circumstances, the attorney retained by an issuer is also required, ''promptly,'' to disaffirm in writing to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.

The distinction between ''forthwith'' in 205.3(d)(i)(A), ''within one business day'' in 205.3(d)(i)(B), and ''promptly'' in 205.3(d)(i)(C) recognizes that it may be impractical for an attorney to accomplish withdrawal, notification thereof, and disaffirmance of false or misleading statements in filings with or submissions to the Commission in a single day.

The limited disclosure involved in the ''noisy withdrawal'' required by Section 205.3(d) should provide such a powerful incentive for an issuer to take actions appropriate to prevent or rectify a material violation that such ''noisy withdrawals'' should be rare. Requiring such ''noisy withdrawal'' appears appropriate to protect shareholders and investors, where the reported material violation appears likely to result in substantial financial injury to the issuer or investors, by effectively requiring an issuer's directors to act and by virtually ensuring an immediate inquiry by the Commission if they do not.

In-House Attorneys

Even where the higher threshold under 205.3(d)(1) has been met and the material violation at issue is ongoing or has yet to occur, an attorney employed by the issuer is *not* required to resign. The in-house attorney is, however, required to notify the Commission that he or she intends to disaffirm an opinion or document within one business day of concluding that the issuer's response to the evidence reported by the attorney is inappropriate or unreasonably delayed, and is thereafter required to disaffirm in writing to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading. If the in-house attorney has not prepared or assisted in preparing any such submission or filing, the in-house attorney is not required to notify the

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[57] Senator Enzi stated in the floor debate over Section 307 of the Act that ''[t]he amendment [he] support[ed] would not require the attorneys to report violations to the SEC, only to corporate legal counsel or the CEO, and ultimately, to the board of directors.'' 148 Cong. Rec. S6555 (July 10, 2002). He was, however, contrasting the reporting requirement in what would be Section 205.3(b) of the proposed rule with the reporting requirement in Section 10A(3) of the Exchange Act. As Senator Enzi explained, requiring an attorney to report evidence of a material violation first to senior officers of an issuer, and then, if they do not rectify the violation, to the board of directors, as Section 205.3(b) would, is ''less onerous'' than Section 10A's requirement that an accountant must, as the Senator put it, ''report, *both to the client's directors and simultaneously to the SEC*, an[] illegal act if management fails to take remedial action.'' *Id.* (emphasis added). Senator Enzi nowhere suggested that an attorney representing an issuer should not be required (1) to withdraw in the unlikely and extreme event that the issuer's board of directors failed to prevent an ongoing material violation and (2) to notify the Commission that he had withdrawn for ''professional considerations.''

[58] *See* Comment [14] to the ABA's Model Rule 1.6, Comment [3] to Model Rule 1.16, and the discussion of the history of the ''signal'' of ''noisy withdrawal'' in Hazard, *Rectification of Client Fraud*, 33 Emory L.J. at 301–07. *See also* ABA Standing Committee on Ethics and Professional Responsibility, Formal Opinion 92–366 (explaining that the ABA's Model Rules permit ''noisy'' withdrawal, which involves disavowing work product, only when the client's fraud is continuing or intended, not when it is past).

[59] *See* Comment [2] to Model Rule 1.16, Comment [10] to Model Rule 1.2 and Comment [3] to Model Rule 4.1.

Commission. Requiring an in-house attorney employed by the issuer to resign when that attorney receives an inappropriate response to the attorney's reported evidence of an ongoing or impending material violation appears to be unreasonably harsh.

Notice to Successor Attorneys

Paragraph (d)(1)(iii) of this section would require the issuer to notify any attorneys retained or employed to replace the attorney who has withdrawn that the previous attorney withdrew based on professional considerations. The purpose of this paragraph is to avoid a situation in which successor attorneys are unaware that the previous attorney waved a red flag in withdrawing. Under such circumstances, an issuer engaged in fraud may shift work previously done by outside attorneys to its own in-house legal staff, over which it has more control, and it may take the successor attorneys some time to become aware of the evidence of material violations that led the previous attorneys to withdraw.[60] To provide substantial assurance that successor attorneys will be alerted to a potential material violation, the proposed paragraph (d)(1)(iii) would require the issuer's chief legal officer to inform any attorney retained or employed to replace the attorney who has withdrawn that the previous attorney's withdrawal was based on professional considerations.[61] Proposed paragraph (d)(2)(iii) would impose the same obligation on the issuer's chief legal officer where an attorney has chosen to withdraw based on professional considerations regarding the issuer's response to evidence of a past material violation.

Past Material Violations

Section 205.3(d)(2) of the proposed rule would provide for situations in which the reported material violation has already occurred and is not ongoing. Here too, the threshold for action by the attorney is higher than for reporting ''up the ladder'' within the issuer and corresponds to the higher threshold in 205.3(d)(1):

(2) Where an attorney who has reported evidence of a material violation under paragraph (b) rather than paragraph (c) of this section does not receive an appropriate response, or has not received a response in a reasonable time, to his or her report under paragraph (b) of this section, and the attorney reasonably believes that a material violation has occurred and is likely to have resulted in substantial injury to the financial interest or property of the issuer or of investors but is not ongoing:

(i) An attorney retained by the issuer may:

(A) Withdraw forthwith from representing the issuer, indicating that the withdrawal was based on professional considerations;

(B) Give written notice to the Commission of the attorney's withdrawal, indicating that the withdrawal was based on professional considerations; and

(C) Disaffirm to the Commission, in writing, any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading; and

(ii) An attorney employed by the issuer may:

(A) Notify the Commission in writing that he or she intends to disaffirm some opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading; and

(B) Disaffirm to the Commission, in writing, any such opinion, document, affirmation, representation, characterization, or the like; and

(iii) The issuer's chief legal officer (or the equivalent) shall inform any attorney retained or employed to replace the attorney who has so withdrawn that the previous attorney's withdrawal was based on professional considerations.

If the material violation at issue has already occurred and is not ongoing, the actions required of the attorney are more limited than if the violation is ongoing or has yet to occur. Under the proposed rule, an ongoing violation includes an inaccurate disclosure in a filing with or submission to the Commission that has not been corrected and may be relied on by investors. If the past material violation at issue has already occurred and is not ongoing and is likely to have resulted in substantial financial injury to the issuer, Section 205.3(d)(2)(ii) of the proposed rule would allow, but not require, the reporting attorney to withdraw, notify the Commission, and disaffirm false or misleading filings or submissions the attorney has prepared or assisted in preparing. The attorney's silence, under those circumstances, would not assist the violation. To the extent investors may continue to rely upon false or misleading statements in earlier filings or submissions, which have not been disaffirmed, the material violation would be ongoing and Section 205.3(d)(1) would apply.

The Commission once again distinguishes between the obligations of outside attorneys retained by an issuer and in-house attorneys employed by an issuer because it believes that in-house attorneys, as a practical matter, have less freedom of action than outside attorneys and that requiring an attorney to resign is more severe than requiring an attorney to withdraw from a particular representation.

Paragraph (d)(3) restates what is largely settled law:

(3) The notification to the Commission prescribed by this paragraph (d) does not breach the attorney-client privilege.

''Noisy withdrawal'' signals that something is wrong *without* revealing any privileged communication between attorney and client.[62] ''Noisy withdrawal'' under Section 205.3(d), moreover, presupposes that the attorney actually believes that the material violation of which the attorney reported evidence has occurred, is occurring, or is about to occur and, *in addition,* likely resulted or will result in substantial injury to the financial interest of the issuer or of investors. Under such circumstances, nearly forty states, adopting the 1981 recommendation of the Kutak Commission, permit disclosure of confidential information to the extent an attorney reasonably believes necessary to prevent a criminal or fraudulent act or to rectify the

[60] When the law firm representing O.P.M. Leasing Services finally withdrew because of O.P.M.''s continuing fraud, after being informed by the attorney for the head of O.P.M.''s in-house accounting department that O.P.M. ''could not survive without continuing wrongdoing,'' the law firm agreed to characterize its withdrawal as a ''mutual determination'' to terminate the relationship. Report of the Trustee Concerning Fraud and Other Misconduct in the Management of the Affairs of the Debtor at 33–35, *In re O.P.M. Leasing Services, Inc.,* Reorg. No. 81–B–10533, (Bankr. S.D.N.Y., filed April 25, 1983). As the law firm anticipated, O.P.M. retained replacement outside counsel and relied more heavily on its in-house legal staff, but neither the new CLO or the new outside counsel had any inkling of the reasons for the previous attorneys' withdrawal. *Id.* at 405–06, 411–13, 417–188. Those successor attorneys, in-house and outside, handled over $15 million in fraudulent transactions in last months of 1981, after O.P.M.''s original law firm withdrew. *Id.* at 405, 408.

[61] Both O.P.M.''s new outside law firm and its new chief legal officer wanted to know why the previous law firm had withdrawn. O.P.M. told both its new outside law firm and its new CLO that it had agreed not to discuss the reasons for the withdrawal but nevertheless led both to believe that it was the previous law firm's reputation that would be damaged by discussion because the parting of the ways had resulted from the law firm's exorbitant fees and its inability (because it was too small) to handle the ''peaks and valleys'' of work for O.P.M. *Id.* at 413, 418.

[62] *See* Comment [14] to the ABA's Model Rule 1.6, Comment [3] to Model Rule 1.16, and the discussion of the history of the ''signal'' of ''noisy withdrawal'' in Hazard, *Rectification of Client Fraud,* 33 Emory L.J. at 301–07. *But see* ABA Standing Committee on Ethics and Professional Responsibility, Formal Opinion 92–366 (explaining that the ABA's Model Rules permit ''noisy'' withdrawal, which involves disavowing work product, only when the client's fraud is continuing or intended, not when it is past).

consequences of a criminal or fraudulent act in which the attorney's services were used.[63] The Commission's proposed rule would make clear that the attorney thus does not violate the attorney-client privilege in making the disclosures at issue here. Moreover, the attorney is not acting as the issuer's agent and accordingly also does not waive the issuer's attorney-client privilege in the information disclosed or any other privilege or protection that the issuer is entitled to assert regarding that information.[64] These disclosures should in most cases also be covered by the whistleblower protections of 18 U.S.C. 1514A.

Interested persons are invited to comment on any aspect of Section 205.3(d)(1)–(3), including:

(1) Whether the proposed rule should include any provision permitting or requiring notification to the Commission when an attorney receives an inappropriate response or whether this is a matter best left to the ABA or state bar associations;

(2) Whether a higher standard should apply to notification to the Commission than to reporting ''up the ladder'' within the issuer and, if so, how much higher it should be;

(3) Whether ''noisy withdrawal'' should be mandatory under some circumstances but permissive under others and, if so, what circumstances should make ''noisy withdrawal'' mandatory and what circumstances should make ''noisy withdrawal'' permissive, or whether ''noisy withdrawal'' should be mandatory under all circumstances covered by Section 205.3(d) or should be permissive under all such circumstances;

(4) Whether it is appropriate to distinguish between material violations that are ongoing or impending and material violations that are past and have no continuing effect;

(5) Whether a distinction between material violations that are ongoing or impending and material violations that are past and have no continuing effect is meaningful regarding investors;

(6) Whether the attorney who has reported evidence of a material violation to which the issuer has not made an appropriate response must know that the reported material violation has occurred, is occurring, or is about to occur before the attorney is required, or allowed, to make a ''noisy withdrawal'';

(7) Whether an attorney should be required, or permitted, to make a ''noisy withdrawal'' where the attorney has not received an appropriate response to reported evidence of a material violation, and the attorney reasonably believes that the reported material violation has occurred, is occurring, or is about to occur;

(8) Whether there is a sufficient basis for a ''noisy withdrawal,'' under those circumstances, where the attorney believes that the reported material violation is likely to have occurred, to be occurring, or to be about to occur;

(9) Whether there is a sufficient basis for a ''noisy withdrawal,'' under those circumstances, where the attorney believes that the reported material violation may have occurred, may be occurring, or may be about to occur;

(10) Whether substantial injury to the financial interest of investors is an appropriate prerequisite to a ''noisy withdrawal'';

(11) Whether substantial injury to the financial interest of the issuer-client is an appropriate prerequisite to a ''noisy withdrawal'' and, if so, whether such substantial injury to a financial interest must be certain, or likely, or merely possible;

(12) Whether the rule should distinguish between outside attorneys and those employed by the issuer and, if so, under what circumstances, how, and why;

(13) Whether an attorney who is employed by an investment adviser and who is appearing and practicing before the Commission in the representation of the investment company should be treated as an outside attorney retained by the investment company under paragraph (d)(1)(i) or should be treated as an in-house attorney under paragraph (d)(1)(ii);

(14) Whether the rule should distinguish between United States and foreign attorneys;

(15) Whether the rule should specify the content of a disaffirmance of an opinion or representation;

(16) Whether the rule should require that any disaffirmance be in writing;

(17) Whether there are any actions the rule should require an attorney to take when the attorney does not receive an appropriate response to his or her report of evidence of a material violation and, if so, which and why;

(18) Whether it would be reasonable to require an attorney making a ''noisy withdrawal'' to take all required steps within one business day;

(19) Whether it is important to require any successor attorney to be notified that the previous attorney withdrew based on ''professional considerations'' and, if so, whether there is a better way to require such notification be made than is proposed in paragraph (d)(1)(iii);

(20) Whether such notification should be required where ''noisy withdrawal'' is merely permissive; and

(21) Whether it is important to provide a ''safe harbor'' from civil suits for the attorney who notifies the Commission that he or she has withdrawn based on professional considerations under paragraph (d).

Discharge of an Attorney for Reporting a Material Violation

Section 205.3(d)(4) of the proposed rule addresses the situation where an issuer attempts to obstruct the proposed rule's notification requirements by discharging an attorney after the attorney had reported evidence of a material violation under 205.3(b) but before the attorney was obligated to notify the Commission under 205.3(d)(1) or allowed to do so under 205.3(d)(2). Under such circumstances, paragraph (d)(4) permits but does not require an attorney who reasonably believes he or she has been discharged for reporting evidence of a material violation to notify the Commission:

(4) An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this section and reasonably believes that he or she has been discharged for so doing may notify the Commission that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section and may disaffirm in writing to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.

The Commission was prompted to add this provision to Section 205.3 by a decision of the Board of Governors of the Florida Bar Association in August 2002, holding, by a vote of 22–15, that a Florida attorney who had been discharged by a large corporation could not report his concerns about improper accounting to the SEC.[65] The attorney

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[63] *See* Kutak Commission's Final Draft of the Model Rules of Professional Conduct, Rule 1.6 and related discussion of ''Disclosure Adverse to Client''; Thomas D. Morgan & Ronald D. Rotunda, *Model Code of Professional Responsibility, Model Rules of Professional Conduct, and Other Selected Standards* (2001), at 146 (stating that 41 states either permit or require disclosure to prevent criminal fraud; 18 either permit or require disclosure to rectify prior criminal fraud in which the attorney's services were used; and 40 require disclosure to rectify a prior fraud on a tribunal).

[64] *See, e.g., Restatement (Third) of the Law Governing Lawyers* (2000) Section 67 and comment c.

[65] Gary Blankenship, *May Lawyers Report Past Corporate Misconduct?,* Florida Bar News, September 15, 2002, at 1. From the reported

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believed that the profits of the corporation he worked for had been inflated by several million dollars, preventing a slump in the price of its publicly-traded stock, when the company amortized over several years an expense that should have been recognized immediately. After taking his concerns to the company's ''top executives''—in effect reporting evidence of a material violation ''up the ladder'' as in proposed Section 205.3(b)—the attorney was fired. The Ethics Department of the Florida Bar decided that the attorney was prohibited from revealing confidential information about these improper accounting practices because it viewed them as past misconduct by a company that the attorney had learned about in connection with his prior representation of that company (even though the past misconduct had an ongoing effect). The Professional Ethics Committee agreed with the Ethics Department. The Board Review Committee on Professional Ethics voted 4–1 to endorse that opinion (because the continuing crime could not be disclosed without also disclosing the past crime). And the Board of Governors voted to bar disclosure.

There is no reason to think such a scenario would not recur. Almost twenty years ago, the Reporter for the ABA's Kutak Commission wrote that ''an innocent lawyer—however competent and however watchful—is inevitably at risk in any transaction where the client could commit fraud.'' [66]

Interested persons are invited to comment on any aspect of this section of the rule, including: (1) Whether the reporting attorney's reasonable belief that he or she has been discharged for making a report is an appropriate standard and, if not, what alternative standard would be more appropriate; (2) Whether the permissive disclosure to the Commission should be limited to ongoing or future violations or should extend to past violations.

Disclosure of Issuer Confidences

Section 205.3(e) would allow an attorney to disclose, under specified circumstances, confidential information related to his appearing and practicing before the Commission in the representation of an issuer. Paragraph (e)(1) would provide:

(e) *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.

Paragraph (e)(1) would make clear that an attorney may use the contemporaneous records required by Sections 205.3(b) and 205.4(d) 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 its proposed rule that the contemporaneous records that the rule would require attorneys to prepare can be used to protect honest attorneys, and are meant to be so used.

Interested persons are invited to comment on any aspect of this section, including whether: (1) The rule should have a provision allowing the attorney to use documents generated under this rule in self-defense; and (2) the types of proceedings in which the documents may be used should be expanded or limited and, if so, why and in what way.

Paragraph (e)(2) would provide:

(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 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.

Paragraph (e)(2) corresponds to the ABA's Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981–1982 [67] and by the ABA's Commission of Evaluation of the Rules of Professional Conduct (''Ethics 2000 Commission'') in 2000,[68] and as adopted in the vast majority of states.[69] It would provide 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 an illegal act 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 committing an illegal act that the lawyer reasonably believes is likely to perpetrate a fraud upon the Commission; or (3) to rectify the consequences of the issuer's illegal act in the furtherance of which the attorney's services were used.

New Jersey's Rule of Professional Conduct 1.6(b) *requires* an attorney to reveal confidential ''information relating to the representation of a client''

to the proper authorities, as soon as, and to the extent the lawyer reasonably believes necessary, to prevent the client:

(1) From 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;

(2) From committing a criminal, illegal or fraudulent act that the lawyer reasonably

decision, it is not clear that the Florida attorney would be covered by the proposed rule, because it is not clear that the Florida attorney was appearing and practicing before the Commission.

[66] Hazard, *Rectification of Client Fraud,* 33 Emory L.J. at 283–84. Section 806 of the Act foresaw that employees of an issuer might be discharged for providing information, or causing information to be provided, regarding fraudulent misconduct by an issuer's employees or agents and sought to protect such a discharged employee by adding 18 U.S.C. 1514A to provide for a civil action to obtain relief.

[67] *Final Draft: Model Rules of Professional Conduct,* pullout supplement to the November 1982 issue of the *American Bar Association Journal,* proposed a version of Model Rule 1.6(b)—ultimately rejected by the House of Delegates—providing that a lawyer may reveal confidential information relating to the representation of a client ''to the extent the lawyer reasonably believes necessary:

(1) to prevent the client from committing a criminal or fraudulent act that the lawyer reasonably believes is likely to result in * * * substantial injury to the financial interests or property of another;

(2) to rectify the consequences of a client's criminal or fraudulent act in the furtherance of which the lawyer's services had been used. * * * '' Law Governing Lawyers (2000) section 67 and comment c.

[68] *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.''

[69] 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, Comment 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.

believes is likely to perpetrate a fraud upon a tribunal.

(Emphasis added.) The corresponding rule in Wisconsin is virtually identical to New Jersey's, though it makes no reference to ''proper authorities.''[70] Florida's Rule of Professional Conduct 4–1.6 requires a lawyer to reveal confidential information ''to the extent the lawyer reasonably believes necessary * * * to prevent a client from committing a crime.''[71]

The ABA's Cheek Task Force recommended making such disclosures mandatory in 2002.[72] Even the ABA's Canons of Professional Ethics, in effect until 1970, provided in Canon 37:

The announced intention of a client to commit a crime is not included within the confidences [a lawyer] is bound to respect. He may properly make such disclosures as may be necessary to prevent the act or protect those against whom it is threatened;

and in Canon 41:

When a lawyer discovers that some fraud or deception has been practiced, which has unjustly imposed upon the court or a party, he should endeavor to rectify it; at first by advising his client, and if his client refuses to forego the advantage thus unjustly gained, he should promptly inform the injured person or his counsel, so that they may take appropriate steps.[73]

The ''noisy withdrawal'' provision in Section 205.3(d) probably makes permissive disclosure of confidential information under the circumstances in Section 205.3(e) sufficient to protect investors.

Moreover, the rules requiring disclosure in New Jersey, Wisconsin, and Florida raise a question about ''conflicts'' between such states' rules and the permissive disclosure provisions in the proposed rule. So do the rules forbidding disclosure in jurisdictions such as the District of Columbia.

In theory, an attorney could simultaneously comply with the Commission's proposed rule permitting disclosure of confidential information and a state's rule forbidding disclosure by not disclosing the information, just as an attorney could simultaneously comply with the Commission's proposed rule permitting disclosure of confidential information and a state's rule requiring disclosure by disclosing the information. However, a Commission rule permitting disclosure would appear to preempt a state's rule forbidding disclosure. Accordingly, an attorney appearing and practicing before the Commission who is admitted in a jurisdiction that forbids disclosure of confidential information under circumstances where the proposed rule would permit disclosure, may disclose the information to the Commission, notwithstanding the contrary state rule.

A different case exists when a state rule requires disclosure in a case where the proposed rule would merely allow it. In such a case there will likely be no conflict between the Commission rule and the state rule, and the attorney should thus be bound by the state rule requiring disclosure.[74] The Commission, however, invites comments on whether an attorney appearing and practicing before the Commission and admitted in a jurisdiction that requires disclosure of confidential information under circumstances where the proposed rule would merely permit disclosure is required to disclose the information to the Commission.

Paragraph 205.3(e)(2)(ii) permits an attorney to reveal client information to the Commission to the extent the attorney reasonably believes necessary to prevent an issuer from committing ''an illegal act'' likely to ''perpetrate a fraud'' upon the Commission. The term ''illegal acts'' in this paragraph refers to acts proscribed in 18 U.S.C. 1001, as well the commission and subornation of perjury (proscribed, respectively, in 18 U.S.C. 1621 and 1622). The term ''perpetrate a fraud'' in this paragraph is intended to cover 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 not to take, a particular action. Therefore, this paragraph would not apply to filings or submissions to the Commission which satisfy a general requirement imposed upon issuers by the Commission (*e.g.*, 10-K or 10-Q filings). Rather, this paragraph is intended to apply to more specific submissions or contacts with the Commission by issuers which attempt to persuade the Commission to take, or not to take, particular actions, including, among other things, Wells submissions, applications for relief, and requests for ''no action'' letters.

Interested persons are invited to comment on any aspect of this section, including whether: (1) The rule should permit an attorney to disclose client confidences in any circumstances or only in some, or all, of the instances in the proposed rule; (2) the Commission should delay any action on this section until the ABA has had an opportunity to determine its position on Model Rule 1.6 in connection with its current reconsideration of the Ethics 2000 proposal; (3) an attorney should be permitted to act under (e)(2)(i) to prevent other misconduct besides that which is ''illegal'; (4) ''substantial injury to the financial interest or property'' is an appropriate standard and, if not, what is an appropriate standard; (5) the rule should be limited to instances where only the issuer may be financially harmed; (6) the rule should specify when and in what way an attorney may rely upon the rule ''to rectify'' the consequences of an illegal act; and (7) the rule should provide that disclosures to the Commission under this section are protected by the whistleblower provisions of 18 U.S.C. 1514A, added by the Act.

Paragraph (e)(3) would provide:

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

This paragraph would set forth the Commission's position on an unsettled question: whether an issuer waives attorney-client privilege and/or other protection (such as work-product protection) by sharing with the Commission, pursuant to a confidentiality agreement, confidential information regarding misconduct by the issuer's employees or officers?[75]

[70] Wisconsin Supreme Court Rule 20:1.6 (available at *http://www.courts.state.wi.us/supreme/sc_rules.asp).*

[71] Available at *http://www.flabar.org/* under ''Regulation.''

[72] The Kutak Commission and the Ethics 2000 Commission, in their proposed versions of Rule 1.6(b)(2), both recommended permitting a lawyer to disclose confidential information to outsiders under similar circumstances. The Kutak Commission recommended permitting an attorney to reveal confidential information relating to representation of a client where New Jersey and Wisconsin require disclosure. The Ethics 2000 Commission recommended permitting disclosure ''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.'' The Ethics 2000 Commission considered the ABA's Model Rule 1.6 to be ''out of step with public policy and the values of the legal profession as reflected in the rules currently in force in most jurisdictions.'' Reporter's Explanation of Changes.

[73] Reprinted in Morgan & Rotunda, Selected Standards, at 811–12.

[74] *See* the general discussion of preemption under Section 205.6 below.

[75] *See In re Columbia/HCA Healthcare Corp. Billing Practices Litigation,* 293 F.3d 289, 294–95 (case law on selective waiver of attorney-client privilege ''in a state of hopeless confusion'') (citation and internal quotation marks omitted), 304–05 (work-product protection may survive where attorney-client privilege has been waived) (Moore & Russell, JJ.), 307–08 (case law both limited

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Allowing issuers to produce internal reports to the Commission—including, but not limited to, those prepared in response to reports under 205.3(b)—without waiving otherwise applicable privilege or protection 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.[76] Even cooperative issuers are generally reluctant to produce internal reports to the Commission for fear that production will waive otherwise applicable privilege or protection as to third parties. Some parties to Commission investigations, however, have produced otherwise privileged or protected reports where they believe only the government—and not adversaries in private litigation—will have access to them.

Obtaining such otherwise privileged or protected reports furthers the public interest—and does not circumvent courts' rejection of the selective waiver doctrine—because the Commission enters into confidentiality agreements only 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.[77] Limiting those instances where producing documents to the Commission will not waive privilege or protection to circumstances where the Commission enters into a confidentiality agreement, as the proposed rule would, should curtail any abuse of this provision by issuers, because the Commission intends to abide by its current practice of entering into confidentiality agreements only when it is in the public interest to do so.

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 clearly served when the Commission can promptly identify illegal conduct and provide compensation to victims of securities fraud.[78]

Moreover, 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.[79] 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. ''Without the exception, much otherwise disclosed material would stay completely in the dark, under the absolute cover of privilege.'' *Columbia/HCA,* 293 F.3d at 312 (Boggs, J., dissenting). 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.

These arguments apply with special force to internal reports and responses to them that the Commission would require under the proposed rule.

The Commission believes that Congress authorized it to adopt a regulation providing for such an exception, by directing the Commission to ''promulgate such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of this Act''—as the Commission believes such an exception is. Moreover, such a rule would be consistent with the confidentiality provisions that Congress itself enacted regarding investigations by the Public Company Accounting Oversight Board (the ''Board'') in Section 105 of the Act, 15 U.S.C. 7215.

Section 105(b)(1) of the Act authorizes the Board to ''conduct an investigation of any act or practice, or omission to act, by a registered public accounting firm * * * regardless of how the act, practice, or omission is brought to the attention of the Board.'' Section 105(b)(5)(A) of the Act further provides that documents and information ''received by * * * the Board * * * shall be confidential and privileged'' until the documents or information are used in a public proceeding. Section 105(b)(5)(B) of the Act provides that documents and information received by the Board continue to be confidential and privileged, even if the Board shares them with the Commission—and even if the Board discloses them to the Attorney General of the United States, an appropriate Federal regulator, state attorneys general, or any ''appropriate State regulatory authority''—so long as the Board determines that those disclosures are ''necessary to accomplish the purposes of this Act or to protect investors.'' The Attorney General, appropriate Federal regulators, state attorneys general, and appropriate State regulatory authorities with which the Board shares confidential information are required to keep it confidential. *Id.*

The Commission's proposed rule would establish a provision for attorneys and the officers and directors of an issuer consistent with Section 105(b)(5)'s provision for accountants and accounting firms. Like Section 105(b)(5) of the Act, proposed section 205.3(e)(3) would facilitate investigations by the Commission and protect investors by maintaining the

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and conflicting, with circuit courts of appeals ''deeply split on whether a disclosure of privileged information to the government, in the course of an investigation, waives the privilege as to all other parties'') (Boggs, J., dissenting) (6th Cir. 2002); *Saito* v. *McKesson HBOC, Inc.,* No. 18553, 2002 WL 31458233, at *6-*11 (adopting a selective waiver rule for disclosures made to law enforcement agencies pursuant to a confidentiality agreement because such a rule ''encourages cooperation with law enforcement agencies without any negative cost to society or to private plaintiffs'') (Del. Ch. Oct. 25, 2002).

[76] *See, e.g., amicus* briefs filed by the Commission during the last two years in *Saito* v. *McKesson HBOC, Inc.*, No. 18553 (Del. Ch.); *United States* v. *Bergonzi & Gilbertson,* No. CR–00–05050MJJ (N.D. Cal.); *Adler* v. *McKesson HBOC, Inc.,* No. 99–C–7980–3 (Gwinnett County, Georgia) (S–01–347-GC); *McKesson HBOC, Inc.* v. *Adler*, No. A01A1836 (Ga. Ct. App.) (all arguing that sharing with the Commission, pursuant to confidentiality agreements, reports of internal investigations by outside lawyers does not waive work-product protection). In these briefs, the Commission has taken no position on selective waiver of the attorney-client privilege.

[77] *Cf. SEC* v. *Jerry T. O'Brien, Inc.*, 467 U.S. 735, 745–46, 750–51 (1984) (recognizing the importance of speed in the Commission's enforcement of the securities laws).

[78] In one case, the Commission subpoenaed over forty boxes of documents related to a complex scheme that had defrauded investors. Through a confidentiality agreement, it also obtained notes and interview memoranda from an internal investigation that had cost the company over $9 million, and Commission staff benefitted from presentations by the internal investigators that explained the scheme and helped the staff understand the subpoenaed materials more quickly. That otherwise protected work product allowed the Commission to file civil enforcement actions and obtain disgorgement of millions of dollars (ultimately distributed to investors and other injured parties) sooner than it otherwise could have.

[79] *See Westinghouse Electric Corp.* v. *Republic of the Philippines,* 951 F.2d 1414, 1426 (3d Cir. 1991) (refusing to adopt the rationale that ''it is inherently unfair for a party to selectively disclose privileged information in one proceeding but not another'' when rejecting the selective waiver theory because ''when a client discloses privileged information to a government agency, the private litigant in subsequent proceedings is no worse off than it would have been had the disclosure to the agency not occurred'').

privileged or protected status of internal reports shared with the Commission.[80]

Interested persons are invited to comment on any aspect of this section, including: (1) Whether the rule should contain such a provision; (2) the disadvantages and advantages of such a provision and its potential impact on private securities litigation where plaintiffs may seek to discover such documents from the issuer or the Commission; (3) whether the rule should reflect the Commission's long-standing policy of not entering into confidentiality agreements covering purportedly privileged materials except where it believes it would be in the public interest to do so; (4) whether the rule should reflect that even where the Commission enters into such confidentiality agreements, such agreements do not impact the Commission's ability to use the privileged materials in performing its statutory responsibilities; and (5) whether the rule should be limited to certain types of privileged or protected information and, if so, which ones.

Section 205.4 Responsibilities of Supervisory Attorneys

Section 205.4 would provide:

(a) An attorney supervising, directing, or having supervisory authority over another attorney is a supervisory attorney. An issuer's chief legal officer (or the equivalent) is a supervisory attorney under this rule.

(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, directs, or has supervisory authority over in appearing and practicing before the Commission conforms to this rule and complies with the statutes and other rules administered by the Commission. To the extent a subordinate attorney appears and practices before the Commission on behalf 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 reasonably believes that information reported to him or her by a subordinate attorney under § 205.5(c) is not evidence of a material violation shall take reasonable steps to document the basis for the supervisory attorney's belief.

Proposed Section 205.4 is based, in part, on 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.

Paragraphs 205.4(a) and (b) of the proposed rule are similar in concept in that they define who is a supervisory attorney, and obligate a supervisory attorney to make reasonable efforts to ensure compliance with the rule by subordinate attorneys. However, these paragraphs broaden the formulation from Rule 5.1 beyond attorneys who are actually supervising other attorneys to include attorneys ''directing or having supervisory authority over another attorney''. This expansion was intended to clarify that individuals who may exercise authority over subordinate attorneys for a particular matter, but who do not routinely supervise that attorney, are supervisory attorneys under the proposed rule. Paragraph 205.4(a) also states that an issuer's chief legal officer is a supervisory attorney, and cannot avoid responsibility under the rule by claiming a lack of knowledge of, or supervision over, the actions of subordinate attorneys.

Paragraph 205.4(b) obligates a supervisory attorney to take affirmative steps to ensure that subordinates comply with the proposed rule. While the rule imposes an obligation on the supervisory attorney to take affirmative steps, it leaves to the professional judgment of the supervisory attorney how best to accomplish that goal. Particularly in a large organization, the Commission would expect that these steps would include the creation of procedures for subordinate attorneys to report evidence of material misconduct they learn about and, perhaps, periodic meetings for the purpose of discussing how to address such matters. In addition, the provision affirms that the supervisory attorney of a subordinate attorney who appears and practices before the Commission also appears and practices before the Commission. Sections 205.4 and 205.5 place the burden of compliance with Section 205.3's reporting requirement on the supervisory attorney once he or she has received a report of a material violation from a subordinate.

Paragraph 205.4(c) affirmatively states that a supervisory attorney assumes the responsibility for compliance with section 205.3's reporting requirement when a subordinate attorney reports evidence of a possible material violation. The Commission believes that this provision is consistent with common practice. A supervisory attorney is expected to be in a better position (as a result of a presumed higher level of experience and/or expertise) than a subordinate attorney to evaluate whether the evidence of potential wrongdoing obtained by the subordinate needs to be reported. Moreover, the issuer (either a client or the employer of the supervisory attorney) is likely to assume (and, indeed, may reasonably expect) that a subordinate attorney will discuss the evidence of potential wrongdoing with the supervisor before reporting it to the issuer. Finally, an issuer is probably more likely to respond diligently to a report of potential wrongdoing under section 205.3 received from a supervisory attorney than from a subordinate attorney.

Finally, paragraph 205.4(d) obligates a supervisory attorney who believes that evidence of potential wrongdoing presented by a subordinate does not need to be reported under Section 205.3 to take reasonable steps to document the basis for that belief. The reporting requirement under section 205.3 will be weakened, if not entirely undermined, unless a supervisory attorney is required to memorialize a unilaterally arrived at conclusion that evidence of purported wrongdoing does not need to be reported to an issuer. Moreover, a supervisory attorney to whom a subordinate attorney presents evidence of potential wrongdoing will as a matter of good practice typically memorialize his or her conclusion that the evidence does not need to be reported, and the bases for that conclusion. Accordingly, as with the prior paragraph, this requirement is consistent with how responsible attorneys will conduct themselves.

Interested persons are invited to comment on any aspect of this section of the proposed rule including: (1) Whether the definition of a ''supervisory attorney'' in 205.4(a) is too broad and should be curtailed, or whether it is too narrow and should be expanded, and, if so, how; (2) whether the rule imposes too much responsibility upon supervisory attorneys for the actions of subordinate attorneys and, if so, how the rule should be revised; (3) whether

[80] Section 307 of the Act does not contain a similar confidentiality provision, but the Act's treatment of attorneys is much briefer and much less detailed than its treatment of accountants, we believe in part because the treatment of accountants in Section 10A of the Exchange Act is much more detailed than the treatment of attorneys. (*Compare, e.g.*, the treatment of accountants and attorneys in 17 CFR 201.102.) Section 105(b)(5) of the Act indicates that a similar confidentiality provision is an appropriate part of proposed Part 205, which elaborates on standards of conduct that attorneys appearing and practicing before the Commission must meet.

the responsibility for complying with the rule's reporting obligation should be placed upon supervisory attorneys at all and, if not, why imposing that responsibility upon supervisory attorneys is inappropriate, and how the rule should be amended to insure that the reporting obligation is satisfied; (4) whether the Commission's premise that supervisory attorneys are in a better position to report evidence of material violations ''up the ladder'' with the issuer than subordinate attorneys is correct; and (5) whether supervisory attorneys should be required to document their conclusion that evidence presented by a subordinate does not need to be reported.

Section 205.5 Responsibilities of a Subordinate Attorney

Section 205.5 would provide:

(a) An attorney under the supervision, direction, or supervisory authority of another attorney is a subordinate attorney.

(b) A subordinate attorney is bound by this rule 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 of this rule if the subordinate attorney reports to his or her supervising attorney under paragraph (3)(b) of that section evidence of a material violation that the subordinate attorney becomes aware of in the course of appearing and practicing before the Commission.

(d) A subordinate attorney may take the steps permitted or required by § 205.3(b), (c), and (d) 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.

Paragraphs 205.5 (a) and (b) of the proposed rule are based 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). These proposed paragraphs define who is a subordinate attorney, and confirm that subordinate attorneys are responsible for complying with section 205.3. The Commission believes that subordinate attorneys should not be exempted from the application of the rule merely because they operate under the supervision or at the direction of another person (who may or may not be an attorney), and 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, the Commission believes that subordinate attorneys are at least as likely (indeed, potentially more likely) to learn about evidence of material violations as supervisory attorneys.

Paragraph 205.5(c), which obligates subordinate attorneys to report evidence indicating a material violation to their supervisor, is related to paragraph 205.4(c), which provides that a supervisory attorney is charged with the responsibility for compliance with Section 205.3(b)'s reporting requirement when a subordinate attorney reports evidence of a material violation. As with paragraph 205.4(c), paragraph 205.5(c) is premised upon the concept that supervisory attorneys are in a better position than subordinate attorneys to report instances of possible material violations to appropriate individuals in the issuer.

A subordinate attorney is obligated under Section 205.3(b)(2) to maintain a record of a report made to the supervisory attorney, as supervisory attorneys are by paragraph 205.4(d). The Commission believes that the requirement imposed by this provision simply replicates the practice which responsible attorneys would adopt in any event.

Paragraph 205.5(d) provides that a subordinate attorney who reasonably believes that a supervisory attorney to whom he or she has reported evidence of a possible material violation has failed to comply with the reporting requirements of section 205.3 may report the evidence to appropriate officers and directors of the issuer pursuant to paragraph 205.3(b) or to the issuer's QLCC, if the issuer has established such a committee, and may carry out a ''noisy withdrawal'' under the circumstances specified in paragraph 205.3(d). The Commission is confident that supervisory attorneys will satisfy their reporting obligations under the rule, and that instances when a subordinate attorney disagrees with the supervisory attorney's actions will be exceedingly rare. The Commission also notes that this paragraph is permissive rather than mandatory. Nevertheless, the Commission believes that inclusion of such a provision is both appropriate and necessary to address those situations where it is clear that a supervisory attorney has neither made the report permitted by paragraph 205.3(c) nor complied with the reporting obligations imposed by paragraphs 205.3(b) and (d), and the subordinate attorney believes he or she must act to prevent harm to the issuer and its shareholders.

Interested persons are invited to comment on any aspect of this section of the proposed rule, including whether: (1) The definition of who is a subordinate attorney in 205.5(a) is too broad (or too narrow) and should be curtailed (or expanded); (2) the rule should distinguish between supervisory attorneys and subordinate attorneys at all or should do so in some other ways and, if so, what those other ways should be; (3) both subordinate and supervisory attorneys should be held to the same obligation to report evidence of material violations ''up the ladder'' within the issuer, and if so, why; (4) subordinate attorneys should have any obligations under the rule; (5) the rule should permit subordinate attorneys to report evidence of material violations if they reasonably believe that a supervisory attorney has failed to comply with the rule.

Section 205.6 Sanctions

Section 205.6 would provide:

(a) A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*), and any such attorney shall be subject to the same penalties and remedies, and to the same extent, as for a violation of that Act.

(b) With respect to attorneys appearing and practicing before the Commission on behalf of an issuer, ''improper professional conduct'' under section 4C(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78d-3(a)) includes:

(1) Intentional or knowing conduct, including reckless conduct, that results in a violation of any provision of this part; and

(2) Negligent conduct in the form of:

(i) A single instance of highly unreasonable conduct that results in a violation of any provision of this part; or

(ii) Repeated instances of unreasonable conduct, each resulting in a violation of a provision of this part.

(c) 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.

Part 205 sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers. As discussed above, some of the provisions of the proposed rule are permissive; others are mandatory. When an attorney fails to comply with a mandatory provision of the proposed rule, that failure will be treated as a violation of a substantive rule and will subject the attorney to enforcement and/or disciplinary action by the Commission.

Proposed paragraph 205.6(a), which tracks the language of Section 3(b) of the

Act, expressly states that a violation of the proposed rule 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. Thus, if an attorney violates the proposed rule, the Commission may commence a civil action seeking injunctive and other appropriate equitable relief, as well as civil money penalties, pursuant to Section 21(d) of the Exchange Act. Alternatively, the Commission may commence a cease-and-desist proceeding against the violator, and any other person who was a cause of the violation, pursuant to Section 21C of the Exchange Act.

The Commission does not believe, however, that violations of the proposed rule would, without more, meet the standard prescribed in Section 32(a) of the Exchange Act (15 U.S.C. 78ff), which provides for the imposition of criminal penalties.

In the event that an injunction is entered against an attorney for violating this rule, the Commission may initiate administrative proceedings to determine an appropriate disciplinary sanction. Even when no injunctive action is brought against an attorney under this rule, the Commission may bring an original administrative proceeding for a cease-and-desist order and/or seeking an appropriate disciplinary sanction for a violation of this rule.

The Commission notes that nothing in Section 307 creates a private right of action against an attorney. Indeed, statements by the sponsors of the provision unequivocally demonstrate that there was never an intention to create a right of action by third parties for violation of the rule. [81] 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.

Paragraph (b) of this section reflects the fact that Section 602 of the Act amends the Exchange Act by adding Section 4C(a), which incorporates that portion of the text of Rule 102(e) which provides that the Commission may discipline professionals for improper professional conduct. Accordingly, an attorney who violates any provision of Part 205 engages in improper professional conduct. The Commission may proceed against such an attorney in the manner described above.

Paragraph (b) of this section incorporates the state-of-mind requirements prescribed in Section 4C(b)(2). The ''[i]ntentional or knowing conduct, including reckless conduct'' standard articulated in 205.6(b)(1) is the standard which has been applied by the Commission in Rule 102(e) cases brought against accountants since the amendment to the rule in 1998. The ''negligent conduct'' standard prescribed in 205.6(b)(2) is similar to the standard adopted by the Commission in the 1998 amendment to Rule 102(e).[82] Accordingly, a single, highly unreasonable instance of attorney misconduct, or repeated instances of unreasonable attorney misconduct which result in violation of the rule will constitute improper professional conduct. Paragraph 205.6(b) evidences that the Commission will not proceed against attorneys when conduct that amounts to no more than simple negligence results in a failure to comply with a provision of Rule 205.

In proposing Part 205, the Commission does not intend to rescind Rule 102(e). While the Commission has employed Rule 102(e) as a disciplinary tool to protect the Commission's processes from improper professional conduct, Part 205 may serve both an enforcement and a disciplinary function. As noted, the Commission intends to proceed against individuals violating Part 205 as it would against other violators of the Exchange Act. In addition, when appropriate, the Commission may initiate proceedings under this rule seeking the imposition of an appropriate disciplinary sanction. At present, the Commission intends to limit its use of Part 205 to address only misconduct arising under that rule. Rule 102(e) will continue to be used to address the same types of misconduct it has been traditionally relied upon for, except those that would now fall under Part 205. The Commission intends to revisit this issue at such time as it determines whether to promulgate more comprehensive standards of professional conduct. In the event it does implement such rules, it may be necessary to reconsider whether it is appropriate to continue prosecuting disciplinary actions under Rule 102(e).

Interested persons are invited to comment on (1) the interaction between Part 205 and Rule 102(e), and (2) whether (and if so, how) the Commission should amend Rule 102(e) in light of the adoption of Part 205.

Paragraph (c) of the Act recognizes that the Commission may discipline attorneys who violate the rule, regardless whether the attorney is subject to prosecution or discipline for violation of a state ethical rule which applies to the same conduct. Accordingly, in the event that an attorney's conduct violates Part 205 as well a state ethical rule, the Commission may bring proceedings against the attorney regardless of whether the state proceeds against the attorney.

The prospect of simultaneous Commission and state disciplinary proceedings for the same misconduct raises the question of the impact of the rule upon state ethical rules and regulations. Due to the breadth and specificity of the Congressional mandate to the Commission to implement an ''up the ladder'' reporting system applicable to attorneys representing issuers, the Commission is considering whether Congress intended for the agency's rule to ''occupy the field'' on this issue, and whether Part 205 would preempt any state rules governing the reporting of evidence of a material violation by attorneys representing issuers before the Commission. Commission preemption of any state ethical rules as topics covered by Part 205 would have the salutary benefit of creating a single uniform standard which attorneys in all jurisdictions must satisfy; and it would also resolve the dilemma faced by attorneys who practice in multiple jurisdictions, and thereby subject themselves to different (and potentially conflicting) standards prescribed in the ethical rules adopted by those jurisdictions. Alternatively, the Commission is considering whether those provisions of the rule which are necessary to effectively implement an ''up the ladder'' reporting system may preempt conflicting state ethical rules which impose a lower obligation upon the attorney (or impose no obligation at all).[83] In those limited circumstances in which a state rule actually imposes a higher obligation than Part 205 (*e.g.*, by requiring an attorney to take some step

[81] See statement by Senator Edwards, 148 Cong. Rec. S6552 (''Nothing in this bill gives anybody a right to file a private lawsuit against anybody. The only people who can enforce this amendment are the people at the SEC.''); see also statement by Senator Enzi, *id.* at S6555 (''[T]his amendment creates a duty of professional conduct and does not create a right of action by third parties.'').

[82] Exchange Act Section 4C(b)(2) defines the term ''improper professional conduct'' to include negligent conduct by an accountant in the form either of a single instance of highly unreasonable behavior or repeated instances of unreasonable conduct which results in a violation of applicable professional standards and indicates a lack of competence.

[83] *See Crosby* v. *National Foreign Trade Council,* 530 U.S. 363, 372 (2000) (Court will find preemption ''when it is impossible for a private party to comply with both state and federal law, and where under the circumstances of a particular case, the challenged state law stands as an obstacle to the accomplishment and execution of the full purpose and objectives of Congress''); *City of New York* v. *FCC,* 486 U.S. 57, 64 (1989) (agency regulations can preempt state laws).

which Part 205 does not mandate), the attorney would remain free to comply with the state rule.

Interested persons are invited to comment on any aspect of this section of the rule. With respect to state-of-mind requirements, parties are invited to comment on the following issues: (1) What the state-of-mind requirement for violations of the rule should be; (2) what the required mental state should be in an injunctive action for violation of the rule; (3) whether attorneys who violate the rule should also be subject to disciplinary proceedings under Rule 102(e) for improper professional conduct; (4) whether the state-of-mind requirements for disciplinary proceedings set forth in paragraph 205.6(b) provide adequate guidance to attorneys, and whether they are appropriate; (5) whether the same state of mind requirements for accountants should also apply to attorneys and, if not, why.

With respect to the issue of preemption, interested persons are invited to comment on: (1) whether the internal reporting requirements within the issuer proposed by Section 307 and Part 205 should be interpreted to ''occupy the field'' so as to preempt all state regulation of an attorney's internal reporting evidence of a material violation; and (2) whether the reporting requirements preempt only conflicting state ethical rules.

The Commission has not established a ''safe harbor'' provision within the rule similar to Section 10A(3)(c) of the Exchange Act (15 U.S.C. 78j–1(3)(c)), which proscribes private suits against auditor's for statements or conclusions expressed in notices to the Commission mandated by Section 10A(b)(3). Interested persons are invited to comment on whether the Commission should include a similar provision within the proposed rule prohibiting private actions challenging an attorney's decision to take, or not to take, action under the proposed rule, when taken in good faith. Would inclusion of such a provision promote effective operation of the proposed rule by protecting attorneys who make a good faith effort to comply with the rule, and preventing ancillary litigation for alleged violations of the rule? Why or why not?

VI. Paperwork Reduction Act

The proposed rule contains a ''collection of information'' requirement within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[84] The title for this collection of information is ''Reports of Evidence of Material Violations.'' We have submitted the collection of information to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.

The proposed 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. As discussed in greater detail elsewhere in this release, an attorney must report such evidence to the issuer's chief legal officer (''CLO'') or to both the chief legal officer and chief executive officer (''CEO''), and must take reasonable steps to document his or her report and the response received, and retain this documentation for a reasonable time. A subordinate attorney complies with the proposed 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 proposed rule's requirements). A subordinate attorney may also take the other steps described in the proposed rule if the supervisor fails to comply. Additionally, when a supervisory attorney believes that information reported to him or her by a subordinate attorney is not evidence of a material violation, the supervisory attorney must take reasonable steps to document the basis for his or her belief.

If the CLO, after investigation, reasonably believes that there is no violation, he or she must so advise the reporting attorney. If the CLO reasonably believes that there is a violation, he or she must ensure that the issuer adopts remedial measures and/or imposes sanctions appropriate to stop, prevent or rectify any violation. The CLO must also promptly report on the remedial measures or sanctions to the CEO, the audit committee or the board of directors, and the reporting attorney. The CLO must take reasonable steps to document his or her inquiry and to retain such documentation for a reasonable time.

As described in detail elsewhere in this release, the proposed 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 outside directors if there is no audit committee, or to the board of directors if there is no such committee, and taking reasonable steps to document the report and response and to retain the documentation for a reasonable time. 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, and take reasonable steps to document the response, or absence thereof, and retain the documentation for a reasonable time. In addition, outside counsel must, if the violation is ongoing or about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or investors (or may, if the violation is not ongoing and is likely to have resulted in substantial injury to the financial interest or property of the issuer or investors): (1) Withdraw from the representation and notify the issuer that the withdrawal is based on professional considerations, (2) notify the Commission in writing of the withdrawal indicating that the withdrawal was based on professional considerations, and (3) disaffirm in writing any tainted documents filed with the Commission. In these circumstances, in-house attorneys must or may, depending on whether the violation is ongoing or not, notify the Commission in writing that they intend to make a disaffirmation and make the disaffirmation. The issuer's CLO must also inform any attorney retained or employed to replace an attorney who withdrew under these circumstances that the withdrawal was based on professional considerations. An attorney who reasonably believes that he or she has been discharged for making a report covered by the proposed rule may notify the Commission of this belief and may also disaffirm in writing any tainted documents.

Alternatively, if an attorney other than a CLO reports the evidence to a qualified legal compliance committee (''QLCC''), he or she need take no further action under the proposed rule. The QLCC would have written procedures for the receipt, retention, and consideration of reports of material violations, and would 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 would also initiate an investigation to be conducted by the CLO or outside attorneys, and retain any necessary additional expert personnel. At the conclusion of the investigation, the QLCC would direct the issuer to adopt appropriate remedial measures and/or impose sanctions, and would notify the CLO, CEO, and board of directors of the results of the inquiry and appropriate remedial measures to

[84] 44 U.S.C. 3501 *et seq.*

be adopted. Where an issuer failed to take the remedial measures directed by the QLCC, each member of the QLCC, along with the CEO and CLO, would have the authority and responsibility to notify the Commission of the material violation and disaffirm in writing any false or misleading documents. 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. In the case of such a referral from the CLO, if the issuer fails to take any remedial measures directed by the QLCC, the CLO must notify the Commission of the violation and disaffirm in writing any tainted documents.

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 issuers do not act appropriately, the information would be communicated to the Commission, so that the Commission could take appropriate action. 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.

We believe that the burden imposed by the proposed collection of information would be minimal. The respondents to this proposed 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. For the most part, and except as described below, we believe that these respondents are already making the types of reports and retaining the records contemplated by the proposed rule. In providing quality representation to issuers, attorneys already report evidence of violations to others within the issuer, including the CLO, the CEO, and, where necessary, the directors. We believe that attorneys also generally document their advice to clients and the responses to that advice that they receive. 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. Officers and directors generally also document these actions. Except as discussed below, we therefore believe that the reporting and recordkeeping requirements imposed by the proposed rule are ''usual and customary'' activities that do not add to the burden that would be imposed by the collection of information.[85]

Certain aspects of the collection of information would, however, impose a new burden. As described above, if an issuer chooses to establish a QLCC, the QLCC would have to establish written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation. Additionally, outside attorneys might, in certain cases, notify the Commission and the issuer that their withdrawal from representation is based on professional considerations, and disaffirm any tainted filings. Similarly, in-house attorneys might, in certain cases, notify the Commission that they must make a disaffirmation and make a disaffirmation. CEOs, CLOs and QLCCs, as well as attorneys who believe that they were discharged for making a report under the proposed rule, might, depending on the circumstances, notify the Commission of a violation and make a disaffirmation. Finally, in cases of an ongoing violation, a CLO would notify any successor attorneys retained or employed to replace an attorney who withdrew that the withdrawal was based on professional considerations.

We estimate for purposes of the PRA that there are approximately 18,200 issuers that would be subject to the proposed rule.[86] Of these, we estimate that approximately one quarter, or 4,550 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 6 hours every three-year period on the procedures. This would result in an average burden of 2 hours per year. Thus, we estimate for purposes of the PRA that the total annual burden imposed by this aspect of the collection of information would be 9,100 hours.

We cannot estimate with precision how many attorneys will be subject to the rule's requirements or how frequently they will be required to make the ''up the ladder'' reports required by the proposed rule. There are approximately 18,200 issuers that may employ or retain attorneys that would be subject to the rule. These issuers may employ in-house attorneys, outside counsel, or a combination of both. We believe, however, that it will be the rare occasion when, as a last resort, a disclosure will be made to the Commission. In the vast majority of cases, we expect that problems will be resolved at the corporate level, and the Commission will not be notified. We therefore estimate for the purposes of the PRA that approximately 10 attorneys, CLOs, CEOs, or QLCCs per year will make one disclosure to the Commission per year. Depending on the circumstances, the disclosure could consist of a notice of withdrawal (and a similar notice to the issuer and a CLO's notice to successor attorneys), a notice of material violations, a notice of discharge, a notice of disaffirmation, a disaffirmation, or some combination thereof. The burden hours for the disclosure will obviously vary depending on the circumstances. None of the components of the disclosure would, however, require a significant amount of time to compile. We therefore estimate, for purposes of the PRA that, on average, each disclosure would require 10 burden hours. Under these assumptions, this aspect of the collection of information would impose approximately 100 annual burden hours.

The total annual burden hours imposed by the collection of information would therefore be 9,200. Assuming half of the burden hours will be incurred by outside counsel at a rate of $300 per hour would result in a cost of $1,380,000.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those

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

[86] 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.

who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirement should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, with reference to File No. 33–8150.wp. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. 33–8150.wp, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning its review of the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

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, as described above, in some cases mandatory and in some cases voluntary depending upon the circumstances. As described above, in certain cases, records must be retained for a reasonable time; in other cases, there is no mandatory retention period. Responses to the requirements to make disclosures to the Commission will not be kept confidential.

VII. Costs and Benefits

We are proposing Part 205 to implement 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 learn of evidence that tends to show that a material violation of the federal securities laws, a material breach of fiduciary duty, or a similar material violation by the issuer or an officer, director, agent, or employee of the issuer has or may have occurred or may occur. The rule that we are proposing today implements a Congressional mandate. We recognize that any implementation of the Sarbanes-Oxley Act will likely result in costs as well as benefits and have an effect on the economy. We are sensitive to the costs and benefits of our proposal. We discuss these costs and benefits below.

Part 205 would implement an ''up the ladder'' reporting requirement upon attorneys representing an issuer before the Commission who become aware of potential misconduct of which a reasonably prudent investor in the issuer 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. Where the potential impropriety is ongoing and not taken care of internally following a report mandated by the rule, Part 205 mandates that the covered attorney, if retained by the issuer, effectuate a ''noisy withdrawal'' from representation of the issuer and disaffirm to the Commission any tainted documents, which will alert the Commission to investigate the issuer. In the same circumstance, if the attorney is employed by the issuer, the attorney must disaffirm to the Commission any tainted documents.

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 an illegal act likely to cause substantial financial harm to 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 improve the accuracy and reliability of corporate disclosures made pursuant to the securities laws and foster investor confidence in the securities markets. This may lower the cost of capital. In addition, Part 205 should, in some instances, prevent or mitigate illegal conduct and hasten the apprehension of wrongdoers whose misconduct injures investors and others. These benefits are difficult to quantify.

Interested persons are invited to comment upon this benefits analysis. Are there other foreseeable benefits? What is the likely economic impact of these benefits? Can the benefits be quantified in any meaningful way? If so, how and what conclusions should be drawn?

B. Costs

Part 205 will impose costs on issuers and law firms representing them. For issuers, the proposed 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 chief executive officer, qualified legal compliance committee, and board of directors of the issuer to review evidence of possible impropriety. For the most part, we believe that most issuers already have procedures for reviewing evidence of reports of misconduct. Similarly, we expect that most issuers already incur costs with investigating and documenting such reports.

Those companies that choose to form a qualified legal compliance committee to implement this provision will incur a cost. These might include increased compensation for QLCC members, and administrative costs to establish the committee. Additionally, for purposes of the PRA, we assume that one-quarter of issuers will form such a committee and incur an annualized paperwork cost of 2 hours for a total annual burden of 9,100 hours. Assuming outside counsel accounts for half of these hours at a cost of $300 per hour, and inside counsel accounts for the other half at $110 per hour would result in a cost of $1,865,500.

For lawyers, the proposal could have an effect upon malpractice insurance premiums, which could, in turn, increase the cost of attorney services to issuers. It may also encourage issuers to handle more legal matters in-house to avoid the possibility of a noisy withdrawal. The proposal will also impose some costs to make and document required reports and responses. For purposes of the Paperwork Reduction Act, we assume that attorneys already document most important legal advice given to corporate clients. We also assume that the number of times an attorney, CEO, CLO or QLCC will report potential illegal conduct outside the issuer will be rare—for purposes of that analysis we estimate a total of ten times a year (although we cannot, of course predict how many will actually be submitted). Further, we estimate in that analysis that preparing the various notices and disaffirmations will on average take 10 hours to prepare. We assume for the purposes of the PRA that half of these hours would be incurred by in-house counsel, QLCCs, CEOs and CLOs, and half would be incurred by outside counsel. Assuming an outside attorney charges $300 an hour, and the cost of in-house personnel is $110 an hour, these reporting requirements would impose a cost of $20,500.

There may also be some additional costs of the proposal imposed on the market that are exceedingly difficult to predict or quantify. To the extent the obligation to report some illegal conduct outside the issuer creates an incentive on issuers not to share confidences with a lawyer, the lawyer may not be able to avoid, remedy or report illegal conduct. While we recognize that such an effect would decrease the rule's effectiveness, we have no data to suggest that the rule would create such an incentive. We request data on this issue. In addition, there may also be some incentives to maximize use of inside counsel rather than retained attorneys, or small firms rather than large firms, or the reverse, for issuers that presently have no attorney employees to hire at least one attorney, and for issuers to reduce or eliminate reliance upon attorneys in some circumstances. Additionally, there may be economic consequences of ''noisy withdrawals'' that may occur under the rule.

Interested persons are invited to comment upon this costs analysis. Are there other foreseeable costs? What is the likely economic impact of these costs? Can the costs be quantified in any meaningful way? If so, how and what conclusions should be drawn? Interested persons are invited to address all aspects of costs and benefits attributable to proposed Part 205. The Commission requests data to quantify the expected costs and the value of the anticipated benefits.

VIII. 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, Section 3(f) of the Exchange Act, and Section 2(c) of the Investment Company Act 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 assure 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 these proposals would 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 would apply to all issuers and attorneys appearing before the Commission and is therefore unlikely to affect competition.

Interested persons are invited to comment upon any aspect of this analysis. We request comment on whether Part 205, if adopted, would impose a burden on competition. Commenters are requested to provide empirical data and other factual support for their views if possible.

IX. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603.

A. Reasons for the Proposed Action

We are proposing Part 205 to comply with Section 307 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*)(''the Act'').

B. Objectives

Section 307 of the Act 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 company or any agent thereof'' to the chief legal counsel or the chief executive officer of the company (or the equivalent); 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.

C. Legal Basis

We are proposing Part 205 under the authority set forth in Section 19 of the Securities Act of 1933, Sections 3(b), 4C, 13, and 23(a) of the Securities Exchange Act of 1934, Sections 38 and 39 of the Investment Company Act of 1940, Section 211 of the Investment Advisers Act of 1940, and Sections 3(a), 307 and 404 of the Sarbanes-Oxley Act of 2002.

D. Small Entities Subject to Proposed Part 205

Proposed 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.[87] We estimate that there are 211 small investment companies that would be subject to the proposed rule. The proposed revisions would apply to any small entity that is subject to Exchange Act reporting requirements.

Proposed 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.[88] 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 request data on that issue.

E. Reporting, Recordkeeping, and Other Compliance Requirements

Paragraph 205.3(b) of proposed Part 205 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 or may have occurred, or may occur. The attorney is initially directed to make this report to the issuer's chief legal officer (''CLO''), or to the issuer's CLO and chief executive officer (''CEO''). Absent exigent circumstances, the attorney is also obligated to take reasonable steps to make and retain a contemporaneous written record of his or her reports, as well as any response received from the CLO or CEO. Requiring the attorney to keep a contemporaneous written record will protect the attorney in the event his or her compliance with the proposed rule is put in issue at some future proceeding.

[87] 17 CFR 270.0–10.

[88] 13 CFR 121.201.

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, and must also preserve all relevant documentary evidence that supports that 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. A reporting attorney who has reported a matter all the way ''up the ladder'' within the issuer and who reasonably believes that the issuer has not responded appropriately must take reasonable steps to document and retain the response or lack thereof.

Alternatively, 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 require the issuer to adopt appropriate remedial measures to prevent ongoing, or alleviate past, material violations, and empowered to notify the Commission of the material violation and disaffirm any document submitted to the Commission which has been tainted by the material violation. 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 reporting obligation under the rule by reporting evidence of a material violation to a QLCC. Further, a chief legal officer to whom a report of a material violation has been made may refer the matter to a QLCC.

Paragraph 205.3(d) discusses the obligation of an attorney who has not received an appropriate response from the issuer and, in certain instances, requires or permits a ''noisy withdrawal.'' The provision distinguishes between outside attorneys retained by the issuer and attorneys employed by the issuer. A provision which obligates a reporting attorney under certain circumstances to disaffirm a submission to the Commission which the attorney believes has been tainted by a material violation (and permits the attorney to disaffirm under other circumstances) is also important to the effective operation of the reporting obligation in those instances where an issuer does not respond appropriately. The provision imposes an affirmative obligation on attorneys to disaffirm a document or filing where they believe a violation is ongoing or prospective because of the greater potential of harm to investors inherent in such violations. Pursuant to this provision, outside attorneys who have reported a material violation which they believe has occurred, is ongoing or is about to occur that is likely to result in substantial injury to the financial interest or property of the issuer or investors, and who have not received an appropriate response, are *required* to withdraw from representation, notify the Commission and the issuer that their withdrawal is based on professional considerations, and disaffirm any submission to the Commission which is tainted by the violation (unless, as noted above, they have reported the information to a QLCC). Attorneys employed by an issuer who have reported a material violation which they believe is ongoing or about to occur that is likely to result in substantial injury to the financial interest or property of the issuer or investors and have not received an appropriate response are *required* to disaffirm any tainted submission, but are not required to resign. Attorneys are *permitted, but not required,* to take these steps in the event they believe that the violation has already occurred and has no ongoing effect and is likely to have resulted in substantial injury to the financial interest or property of the issuer or investors. Issuers must also, in certain cases, notify an attorney who is employed or retained to replace an attorney who withdrew, that the withdrawal was based on professional considerations. Finally, an attorney formerly employed or retained by an issuer who reasonably believes that he or she has been discharged because he or she fulfilled the reporting obligation imposed by the rule *may, but is not required to,* notify the Commission of his or her belief and disaffirm in writing any submission to the Commission which is tainted by the violation.

Paragraph 205.3(e) 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 the contemporaneous records he or she is required to create by the rule to defend against charges of attorney misconduct. Paragraph 205.3(e)(2) also allows an attorney to reveal confidential information to the extent necessary to prevent the commission of an illegal act which the attorney reasonably believes will result either in perpetration of 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 illegal actions when such actions have been advanced by the issuer's use of the attorney's services.

We expect that the various reporting and recordkeeping requirements required by proposed 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 and retained by those affected by the proposed rule. We are unable to estimate the frequency with which reports would have to be prepared and retained 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.

F. Duplicative, Overlapping, or Conflicting Federal Rules

Proposed Part 205 would not duplicate, overlap, or conflict with other federal rules. There are no other statutory federal requirements that small entities make similar reports or provide similar information.

G. 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 proposed 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 proposal, but we nevertheless seek comment on whether the QLCC should be modified for small issuers or if another committee or procedure could accomplish the same regulatory purpose. We do not believe that the rule will impose any significant increased costs on small law firms.

The proposed 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 most part, rather than requiring reports to contain specific, detailed disclosures, the proposed rule prescribes general requirements for reporting and recordkeeping. It does not dictate the time period that records need to be kept, but directs only that they be retained for a reasonable time. This should give small entities flexibility in complying with the proposed rule.

We believe that utilizing different reporting or other compliance requirements for small entities would seriously undermine the effective functioning of the proposed reporting regime. The proposed 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 shun 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 proposed reporting and recordkeeping 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. We solicit comment on whether small entities should be subject to different requirements.

H. Solicitation of Comments

Interested persons are invited to comment upon any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments concerning: (i) The number of law practices that constitute small entities; (ii) the number of small entities that may be affected by proposed Part 205; (iii) the existence or nature of the potential impact of the proposed rule on small entities; and (iv) how to quantify the impact of the proposed revisions. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule is adopted, and will be placed in the same public file as comments on the proposed rule itself.

X. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (''SBREFA''), we must advise the OMB as to whether the proposed rule constitutes a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results or is likely to result in:

—An annual effect on the economy of $ 100 million or more (either in the form of an increase or a decrease);
—A major increase in costs or prices for consumers or individual industries; or
—Significant adverse effects on competition, investment, or innovation. Where a rule is ''major,'' its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed rule on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

XI. Statutory Basis and Text of Proposed Part 205

We propose to add 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,[89] Section 19 of the Securities Act of 1933,[90] Sections 3(b), 4C, 13, and 23 of the Securities Exchange Act of 1934,[91] Sections 38 and 39 of the Investment Company Act of 1940,[92] and Section 211 of the Investment Advisers Act of 1940.[93]

List of Subjects in 17 CFR Part 205

Standards of conduct for attorneys.

For the reasons set out in the preamble, the Commission proposes to amend 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.

Consistent with Section 307 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7245, the Commission is adopting rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before it in any way in the representation of an issuer. Where the standards of a state 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 includes, but is not limited to, an attorney's:

(1) Transacting any business with the Commission, including communication with Commissioners, the Commission, or its staff;

(2) Representing any party to, or the subject of, or a witness in a Commission administrative proceeding;

(3) Representing any person in connection with any Commission investigation, inquiry, information request, or subpoena;

[89] 15 U.S.C. 7202, 7245, 7262.

[90] 15 U.S.C. 77S.

[91] 15 U.S.C. 78c(b), 78d–3, 78m, 78w.

[92] 15 U.S.C. 80a–37, 80a–38.

[93] 15 U.S.C. 80b–11.

(4) Preparing, or participating in the process of preparing, any statement, opinion, or other writing which the attorney has reason to believe will be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the Commissioners, the Commission, or its staff; or

(5) Advising any party that:

(i) A statement, opinion, or other writing need not or should not be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the Commissioners, the Commission, or its staff; or

(ii) The party is not obligated to submit or file a registration statement, notification, application, report, communication or other document with the Commission or its staff.

(b) *Appropriate response* means a response to evidence of a material violation reported to appropriate officers or directors of an issuer that provides a basis for an attorney reasonably to believe:

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

(2) That the issuer has, as necessary, adopted remedial measures, including appropriate disclosures, and/or imposed sanctions that can be expected to stop any material violation that is occurring, prevent any material violation that has yet to occur, and/or rectify any material violation that has already occurred.

(c) *Attorney* refers to 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 duty recognized 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 information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur.

(f) *In the representation of an issuer* means acting in any way on behalf, at the behest, or for the benefit of an issuer, whether or not employed or retained by the issuer.

(g) *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.

(h) *Material* refers to conduct or information about which a reasonable investor would want to be informed before making an investment decision.

(i) *Material violation* means a material violation of the securities laws, a material breach of fiduciary duty, or a similar material violation.

(j) *Qualified legal compliance committee* means a committee of an issuer that:

(1) Consists of at least one member of the issuer's audit committee 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 been duly established by the issuer's board of directors and authorized to investigate any report of evidence of a material violation by the issuer, its officers, directors, employees or agents;

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

(4) Has 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)(5));

(ii) To decide whether an investigation is necessary to determine whether the material violation described in the report has occurred, is occurring, or is about to occur and, if so, 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 under paragraph (j)(4)(ii) of this section, to:

(A) Direct the issuer to adopt appropriate remedial measures, including appropriate disclosures, and/or to impose appropriate sanctions to stop any material violation that is occurring, prevent any material violation that is about to occur, and/or to rectify any material violation that has already occurred; 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 paragraph (j)(4)(ii) of this section and the appropriate remedial measures to be adopted; and

(5) Each member of which individually, together with the issuer's chief legal officer and chief executive officer (or the equivalents thereof) individually, has the authority and responsibility, in the event the issuer fails in any material respect to take any of the remedial measures that the qualified legal compliance committee has directed the issuer to take, to notify the Commission that a material violation has occurred, is occurring or is about to occur and to disaffirm in writing any document submitted to or filed with the Commission by the issuer that the individual member of the qualified legal compliance committee or the chief legal officer or the chief executive officer reasonably believes is false or materially misleading.

(k) *Reasonable* or *reasonably* denotes the conduct of a reasonably prudent and competent attorney.

(l) *Reasonably believes* means that an attorney, acting reasonably, would believe the matter in question.

(m) *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 represents the issuer as an organization and shall act in the best interest of the issuer and its shareholders. 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, in appearing and practicing before the Commission in the representation of an issuer, an attorney 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 any evidence of a material violation to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or to the equivalents thereof) forthwith (unless the issuer has a qualified legal compliance committee and the attorney chooses instead to report the evidence of a material violation to that committee under paragraph (c) of this section). An attorney does not reveal client confidences or secrets or privileged or otherwise protected information by communicating such information related to the attorney's representation of an issuer to the issuer's officers or directors.

(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.

(3) 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 necessary to determine whether the material violation described in the report has occurred, is occurring, or is about to occur. If the chief legal officer reasonably believes no material violation has occurred, is occurring, or is about to occur, he or she shall so advise the reporting attorney. If the chief legal officer reasonably believes that a material violation has occurred, is occurring, or is about to occur, he or she shall take any necessary steps to ensure that the issuer adopts appropriate remedial measures, including appropriate disclosures, and/or imposes appropriate sanctions to stop any material violation that is occurring, prevent any material violation that is about to occur, and/or to rectify any material violation that has already occurred. The chief legal officer shall promptly report the remedial measures adopted and/or sanctions imposed to the chief executive officer, to the audit committee of the issuer's board of directors, or to the issuer's board of directors, and to the reporting attorney. The chief legal officer shall take reasonable steps to document his or her inquiry and to retain such documentation for a reasonable time. 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 fails in any material respect to take any remedial measure that the qualified legal compliance committee directs the issuer to take in order to stop any material violation that is occurring, prevent any material violation that is about to occur, and/or to rectify any material violation that has already occurred, the chief legal officer shall notify the Commission that a material violation has occurred, is occurring or is about to occur and shall disaffirm in writing any documents submitted to or filed with the Commission by the issuer that the chief legal officer reasonably believes are false or materially misleading.

(4) If 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 not provided an appropriate response, or has not responded 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))).

(5) 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 the evidence of a material violation as provided under paragraph (b)(4) of this section.

(6) An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(4), or (b)(5) 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 the officers or directors of the issuer to whom the evidence of a material violation has been reported under paragraph (b)(1), (b)(4), or (b)(5) of this section of the duty to respond to the reporting attorney.

(7) 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)(4), or (b)(5) of this section and who has taken reasonable steps to document his or her report and the response thereto under paragraph (b)(2) of this section need do nothing more under this section regarding the evidence of a material violation.

(8) If the attorney reasonably believes that the issuer has not made an appropriate response to the report or reports made pursuant to paragraph (b)(1), (b)(4), or (b)(5) of this section, or the attorney has not received a response in a reasonable time, the attorney shall:

(i) Explain his or her reasons for so believing to the chief legal officer, chief executive officer, or directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(4), or (b)(5) of this section; and

(ii) Take reasonable steps to document the response, or absence thereof, and to retain such documentation for a reasonable time.

(c) *Alternative reporting procedures for attorneys retained or employed by an issuer with a qualified legal compliance committee.* (1) If, in appearing and practicing before the Commission in the representation of an issuer, an attorney 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 of a material violation to a qualified legal compliance committee, if the issuer has duly formed such a committee. Except as provided in paragraph (b)(3) of this section, an attorney who reports evidence of a material violation to a qualified legal compliance committee has satisfied his or her obligation to report evidence of a material violation within the issuer, is not required to assess the issuer's response to the reported evidence of a material violation, and is not required to take any action under paragraph (d) of this section regarding the 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 qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(3) of this section. Thereafter, pursuant to the requirements under § 205.2(j), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c) of this section.

(d) *Notice to the Commission where there is no appropriate response within a reasonable time.* (1) Where an attorney who has reported evidence of a material violation under paragraph 3(b) of this section rather than paragraph 3(c) of this section does not receive an appropriate response, or has not received a response in a reasonable time, to his or her report, and the attorney reasonably believes that a material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors:

(i) An attorney retained by the issuer shall:

(A) Withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations;

(B) Within one business day of withdrawing, give written notice to the Commission of the attorney's withdrawal, indicating that the withdrawal was based on professional considerations; and

(C) Promptly disaffirm to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading;

(ii) An attorney employed by the issuer shall:

(A) Within one business day, notify the Commission in writing that he or she intends to disaffirm some opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading; and

(B) Promptly disaffirm to the Commission, in writing, any such opinion, document, affirmation, representation, characterization, or the like; and

(iii) The issuer's chief legal officer (or the equivalent) shall inform any attorney retained or employed to replace the attorney who has so withdrawn that the previous attorney's withdrawal was based on professional considerations.

(2) Where an attorney who has reported evidence of a material violation under paragraph (b) rather than paragraph (c) of this section does not receive an appropriate response, or has not received a response in a reasonable time, to his or her report under paragraph (b) of this section, and the attorney reasonably believes that a material violation has occurred and is likely to have resulted in substantial injury to the financial interest or property of the issuer or of investors but is not ongoing:

(i) An attorney retained by the issuer may:

(A) Withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations;

(B) Give written notice to the Commission of the attorney's withdrawal, indicating that the withdrawal was based on professional considerations; and

(C) Disaffirm to the Commission, in writing, any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading;

(ii) An attorney employed by the issuer may:

(A) Notify the Commission in writing that he or she intends to disaffirm some opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading; and

(B) Disaffirm to the Commission, in writing, any such opinion, document, affirmation, representation, characterization, or the like; and

(iii) The issuer's chief legal officer (or the equivalent) shall inform any attorney retained or employed to replace the attorney who has so withdrawn that the previous attorney's withdrawal was based on professional considerations.

(3) The notification to the Commission prescribed by this paragraph (d) does not breach the attorney-client privilege.

(4) An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this section and reasonably believes that he or she has been discharged for so doing may notify the Commission that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section and may disaffirm in writing to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.

(e) *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 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.

(3) 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.

§ 205.4 Responsibilities of supervisory attorneys.

(a) An attorney supervising, directing, or having supervisory authority over another attorney is a supervisory attorney. An issuer's chief legal officer (or the equivalent) 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, directs, or has supervisory authority over is appearing and practicing before the Commission conforms to this part and complies with the statutes and other rules administered by the Commission. To the extent a subordinate attorney appears and practices before the Commission on behalf 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 reasonably believes that information reported to him or her by a subordinate attorney under § 205.5(c) is not evidence of a material violation shall take reasonable steps to document the basis for the supervisory attorney's belief.

§ 205.5 Responsibilities of a subordinate attorney.

(a) An attorney under the supervision, direction, or supervisory authority of another attorney is a subordinate attorney.

(b) A subordinate attorney is bound by 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 that the subordinate attorney becomes aware of in the course of appearing and practicing before the Commission.

(d) A subordinate attorney may take the steps permitted or required by § 205.3(b), (c), and (d) 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.

(a) A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*), and any such attorney shall be subject to the same penalties and remedies, and to the same extent, as for a violation of that Act.

(b) With respect to attorneys appearing and practicing before the Commission on behalf of an issuer, ''improper professional conduct'' under section 4C(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78d—3(a)) includes:

(1) Intentional or knowing conduct, including reckless conduct, that results in a violation of any provision of this part; and

(2) Negligent conduct in the form of:

(i) A single instance of highly unreasonable conduct that results in a violation of any provision of this part; or

(ii) Repeated instances of unreasonable conduct, each resulting in a violation of a provision of this part.

(c) 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.

Dated: November 21, 2002.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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