

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

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

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

A. Benefits

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

Part 205 should protect investors by helping to prevent instances of significant corporate misconduct and

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

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

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

Part 205 may improve the governance of corporations that are subject to the rule. By mandating up-the-ladder reporting of violations, the rule helps to ensure that evidence of material violations will be addressed and remedied within the corporation, rather than misdirected or "swept under the rug." The formation of QLCCs may also serve to improve corporate governance.

The Commission believes that some issuers will choose to adopt QLCCs, and that they may prove to be a recognized and effective means of reviewing reported evidence of material violations. Because a QLCC must consist of at least two independent directors (as well as one member of the corporation's audit committee), it will give greater authority to independent directors. This should serve as an important check on corporate management.

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

B. Costs

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

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

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

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