

C. Small Entities Subject to Part 205

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

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

D. Reporting, Recordkeeping and Other Compliance Requirements

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

When presented with a report of a possible material violation, the rule obligates the issuer’s CLO to conduct a reasonable inquiry to determine whether the reported material violation has occurred, is occurring or may occur. A CLO who reasonably concludes that there has been no material violation must advise the reporting attorney of this conclusion. A CLO who concludes that a material violation has occurred, is occurring or is about to occur must take reasonable steps to ensure that the

issuer adopts appropriate remedial measures and/or sanctions, including appropriate disclosures. Furthermore, the CLO is required to report up-the-ladder within the issuer and to the reporting attorney what remedial measures have been adopted.

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

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

Paragraph 205.3(d) sets forth the specific circumstances under which an attorney is authorized to disclose confidential information related to his or her appearance and practice before the Commission in the representation of an issuer. Pursuant to this provision, an attorney may use any contemporaneous records he or she creates to defend against charges of attorney misconduct. Paragraph 205.3(d)(2) also allows an attorney to reveal confidential information to the extent necessary to prevent the commission of a material

violation that the attorney reasonably believes will result either in perpetration of a fraud upon the Commission or in substantial injury to the financial or property interests of the issuer or investors. Similarly, the attorney may disclose confidential information to rectify an issuer’s material violations when such actions have been advanced by the issuer’s use of the attorney’s services.

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

E. Agency Action To Minimize Effect on Small Entities

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

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

¹⁴⁶ 17 CFR 270.0–10.

¹⁴⁷ 13 CFR 121.201.