# The SEC's Rules Governing Lawyers: Where to Go from Here?[1]

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Hearing on
The Role of Attorneys in Corporate Governance

## 1. Introduction

I have been asked to discuss the merits of the SEC's adopted and proposed Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer.[2] I will begin by providing some background information about the regulation of lawyers generally. I will then offer an assessment and critique of several of the SEC rules' more important provisions. I then discuss the SEC's noisy withdrawal proposal. Finally, I will recommend further steps Congress and the SEC might take to improve the effectiveness of corporate lawyer regulation.

I will state my conclusions up front. I strongly support section 307 of the Sarbanes-Oxley Act,[3] and applaud the SEC's careful and detailed efforts to implement Congress's directives. I am, however, concerned that the SEC's rules, as drafted, will be difficult to enforce and may wind up having far less effect on corporate lawyer behavior Congress might have hoped. Fixing the rules that the SEC has already promulgated should be the biggest priority. I also support the SEC's noisy withdrawal proposal and urge this Committee to encourage the SEC to adopt it.

I need not recount the sorry history of corporate wrongdoing we have witnessed in the opening years of the twenty-first century. We are still living with the consequences, unraveling

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[1]These remarks draw in large part on Roger C. Cramton, George M. Cohen, & Susan P. Koniak, Legal and Ethical Duties of Lawyers after Sarbanes-Oxley, Vill. L. Rev. (2004) (forthcoming). In the interests of brevity, I have omitted most footnotes and have not indicated which passages are quoted directly from the article.

[2]17 C.F.R., Part 205.

[3]15 U.S.C. §7245.

the causes, and punishing the perpetrators of Enron, Global Crossing, WorldCom, Tyco, Adelphia, and other scandals.  Not only that, new scandals continue to surface, even on a global scale (witness Parmalat).

These scandals have raised serious questions about the integrity, acuity, and prudence of lawyers who facilitate and document business transactions and approve required financial disclosures.  We have seen strong evidence that lawyers in these scandals structured bogus deals, vouched for nonexistent "sales," and whitewashed reports to keep regulators and potential plaintiffs at bay.  Yet lawyers have to date have largely escaped responsibility.  And they have received far less scrutiny for their role in recent corporate wrongdoing than accountants, corporate managers, and boards of directors.

But in enacting the Sarbanes-Oxley Act of 2002, Congress included section 307, a provision notable for its recognition of the important role corporate lawyers play in ensuring compliance with the law, as well as the need for federal oversight of this role to protect the investing public.  Section 307 directed the SEC to promulgate "minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of a issuers."  Section 307 went even farther.  It specified that one of those "minimum standards" require lawyers to "report evidence of a material violation of the securities laws or a breach of fiduciary duty or similar violation by the company or any of its agents to the chief legal officer or the chief executive officer of the company (or the equivalent thereof)."  If the chief legal officer or chief executive officer fails to provide an "appropriate response" to the evidence, the lawyer would be required to "report the evidence to the audit committee, another independent committee, or the full board of directors." Almost a year ago, on January 29, 2003, the SEC adopted rules pursuant to section 307, which became effective on August 5, 2003.

**2.  Lawyer Regulation: Form**

To evaluate the importance and the impact of the SEC rules, it is important to separate out two questions: who should regulate corporate lawyers, and what should the content of those regulations be.  I will briefly address both.

Lawyers have long been regulated by state disciplinary authorities run by state courts. The law that applies in disciplinary hearings is the ethics code adopted by that particular state. Typically, the ethics rules are based on the Model Rules of Professional Conduct or the Model Code of Professional Responsibility, both promulgated by the ABA.  But it is important to recognize that the ABA's version of the ethics rules has no force of law by itself.  The relevant state authority must adopt these rules, and need not follow the ABA's version.  That fact is particularly important for discussing corporate fraud, because until recently, the ABA's ethics rules on confidentiality have diverged from the actual ethics rules adopted by most states.

Although state disciplinary authorities handle some types of lawyer wrongdoing (particularly by sole practitioners and lawyers at small firms) fairly well, they are not effective regulators of the lawyers who do corporate transactional work at large firms for large, publicly traded corporate clients.  State disciplinary authorities lack the resources and the expertise to

successfully prosecute disciplinary actions against these lawyers, who are sophisticated, well-financed, and ready to defend their actions with a full and potent arsenal. As a result, we have seen few, if any, disciplinary actions brought in connection with large corporate scandals, either past or present. And that is true despite strong evidence of lawyer wrongdoing in a number of cases.

The impotence of state disciplinary authorities to regulate large firm corporate lawyers is an important, if underappreciated, fact, though Congress did recognize this fact in passing section 307.[4] One of the major objections lawyers have made to federal regulation, including section 307 and the SEC rules, is that lawyers are already regulated by state ethics rules. If, however, state disciplinary authorities cannot effectively reach corporate practice by lawyers in large firms, these objections ring hollow. Thus, when these lawyers argue for state disciplinary regulation, they are really arguing for no effective regulation at all.

Regulation by federal agencies of lawyers who practice before those agencies holds out at least some hope of effectively influencing large firm corporate lawyers. These agencies have better resources and greater expertise than state disciplinary authorities. Moreover, regulation by federal agencies provides another advantage over state regulation: uniformity. This advantage is particularly important when state rules diverge, as the state disciplinary rules on confidentiality do. In passing section 307, Congress recognized these advantages of regulating lawyers through federal agencies. But it is important to note, again because some lawyers seem to think otherwise, that securities lawyers are not the only lawyers who have been subject to federal regulation. Tax lawyers, patent lawyers, and others are also regulated by federal agencies. On the other hand, it is also important to note the limitations of regulation of lawyers by federal agencies.[5] These agencies often have numerous tasks they are required to perform besides regulating lawyers, and they are always battling budgetary restraints and personnel limitations. Moreover, in part because these agencies are staffed by lawyers who hope one day to enter, or return to, private practice, there is a good deal of sympathy for corporate lawyers.

A third form of lawyer regulation, and the one feared most by many corporate lawyers, is liability. Lawyers are subject not only to disciplinary rules, whether promulgated by states or federal agencies, but also to laws of general applicability. Most notably, state tort laws concerning fraud and federal laws establishing liability for securities fraud, apply to lawyers. Liability for both forms of fraud can be either civil (paying damages) or criminal (fines or prison sentences). Lawyers also face the possibility of malpractice actions by their corporate clients if

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[4]See the remarks by Senator Michael Enzi during the Senate's consideration of § 307:

> I am usually in the camp that believes that States should regulate professionals within their jurisdiction. However, in this case, the State 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.

148 Cong. Rec. at S6555 (Jul. 10, 2002).

[5]Michael A. Perino, How Vigorously Will the SEC Enforce Attorney Up-the-Ladder Reporting Rules? An Institutional Analysis of Constraints, Norms, and Biases at the Commission, Vill. L. Rev. (2004) (forthcoming).

they do not sufficiently protect their clients from misbehaving managers, though in practice such suits are generally brought only in bankruptcy proceedings by the trustee. Section 307 does not address liability and the SEC rules specifically disclaim any attempt to create new causes of action against lawyers. But the liability question always lurks in the background of any debates over other forms of regulation because even though in theory they are independent, lawyers always fear that the content of disciplinary rules affects their liability. In particular, one of the main justifications lawyers offer for strong confidentiality rules is the belief that such rules will successfully stave off liability. This belief often turns out to be a false hope, but many lawyers seem to be misled nonetheless.

A significant change in the potential for liability to regulate corporate lawyers occurred in 1994, when the Supreme Court, in the *Central Bank* case,[6] declared that private damage suits for aiding and abetting could not be brought under the federal securities laws. These suits had been important vehicles for "disciplining" lawyers in past instances of corporate fraud, particularly the savings and loan crisis. Congress had a chance to overturn *Central Bank* when it passed the Private Securities Litigation Reform Act. But Congress declined to do so, because the bigger concern at that time was with perceived abuses by plaintiffs' lawyers in bringing class action suits for securities fraud than with deterring such fraud. Congress did reaffirm the right of the SEC to bring aiding and abetting suits against lawyers and other professionals, but it changed the "recklessness" standard that had been used by many courts to an "actual knowledge" standard, which is more difficult to prove.

## 3. Lawyer Regulation: Content

The debate over the content of the rules governing corporate lawyers, whether disciplinary, regulatory, or general law, has focused on one distinction and one tension. The distinction is between so-called "up-the-ladder reporting" or "reporting up," and so-called "reporting out," which involves questions of withdrawal and disclosure. The tension is between the lawyer's duty not to counsel or assist a client in committing a crime or fraud and the lawyer's duty of confidentiality to the client. The distinction and the tension are related: both reporting up rules and reporting out rules are designed to flesh out how the lawyer is to navigate between the avoidance of aiding and abetting and the protection of confidentiality.

### a. Reporting Up

The SEC rules are directed primarily to reporting up, which was the one thing section 307 required the SEC to address. The purpose of reporting up is to implement the universally accepted "entity theory" of corporate representation, under which the corporate lawyer is supposed to represent the corporation as an entity rather than management when managers are breaching their fiduciary obligations to the corporation or leading the corporation to engage in wrongdoing. A lawyer who discovers a manager's misconduct, but continues to advise and assist the manager without stopping and redressing the misconduct, risks being deemed to have

[6]Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994).

assisted in the misconduct. Of course, reporting up is easier said than done, especially when the lawyer has a close working relationship with management, and management generally has the authority to direct the lawyer's actions, as well as to fire the lawyer.

Thus, corporate lawyers have accepted the reporting up obligation in principle, but grudgingly and often with numerous qualifications. In particular, they have argued that managers will hesitate to consult and confide in them if they fear that the lawyers might go over their heads to the board. Although corporate lawyers owe no duty of confidentiality to managers, this argument is the same argument lawyers make in favor of strict confidentiality rules. Model Rule 1.13, as it existed up until last summer, reflected these concerns by limiting the lawyer's obligations in several ways. In particular, Model Rule 1.13 does not require a lawyer to do anything unless a lawyer "knows" that a corporate agent is engaged in wrongdoing. Moreover, Model Rule 1.13 includes reporting up as merely one possible option in responding to a rogue manager, rather than (at least under the interpretation given the provision by many lawyers) making it mandatory. The idea was to preserve maximum lawyer discretion.

The main substantive goal of section 307 and the SEC rules was to make reporting up mandatory and to trigger the obligation by "evidence of a material violation" rather than actual knowledge. Congress determined, correctly in my view, that there was sufficient evidence that too many lawyers were throwing in their lot with rogue managers rather than protecting the interests of their corporate clients. How well the SEC succeeded is a point I will address below.

b. Reporting Out

Reporting out has engendered much more discussion, and much more controversy than reporting up. But the question involved is essentially the same. If the corporation's board turns out to be corrupt and in cahoots with the rogue managers, can the lawyers continue to advise and assist the corporate client without becoming complicit in the wrongdoing? If not, what may or must the lawyer do to extricate himself from the situation?

Traditionally, the ethics codes and the other law regulating lawyer conduct have, for the most part, been consistent in their answers to these questions. If continued representation of a client constitutes illegal assistance, the lawyer must withdraw from the representation. A lawyer is permitted to disclose confidential information to prevent a client's prospective crime or fraud. And when the client in the course of the representation has used the lawyer's services to perpetrate a crime or fraud on a person or a tribunal, the lawyer is required to disclose confidential information to the extent necessary to rectify the consequences of the crime or fraud.

The reasons for these rules are straightforward. Neither the legal profession nor society as a whole should tolerate a regime in which lawyers may be used by clients as a means of carrying out a crime or fraud. The possibility of disclosure reinforces the lawyer's duty to provide only *lawful* assistance and advice to clients, and provides the lawyer with a last-resort weapon and increased leverage in dealing with a difficult client or one embarked on an unlawful or fraudulent course of conduct. Moreover, a lawyer's failure to take reasonable steps to prevent or rectify client fraud is likely to lead to civil liability of the lawyer. If insolvency and litigation occur as an aftermath of the fraud, a frequent occurrence, the client's confidentiality will

inevitably disappear. A public company often desires to cooperate with likely to waive any privileges in an effort to recover assets for the insolvent entity; and, if these events do not take place, the crime-fraud exception of the privilege may be successfully investigators and waiving the privilege is often part of successful cooperation; a successor in interest, such as a bankruptcy trustee, is invoked; finally, if the lawyer is charged by defrauded persons, the lawyer will use the self-defense exception to confidentiality.

Despite the traditional answers to the reporting out question and the arguments in favor of these answers, the ABA in its ethics rules abandoned mandatory disclosure of transactional fraud in 1974 and permissive disclosure of such fraud in 1983. The source of the professional concerns that led to the ABA's retrenchment is relevant to today's concern that professional advisers have failed to perform their functions of preventing corporate wrongdoing. The ABA's actions in 1974 and 1983 were heavily influenced by the hostility of important segments of the legal community to the SEC's efforts during the 1970's to apply the ethics rules on disclosure to securities lawyers who remained silent when they knew or should have known that their client was engaged in a course of conduct that violated federal securities laws. Those propositions had not been viewed as problematic when they were not enforced by state disciplinary authorities. But when SEC enforcement came into play with the *National Student Marketing* case,[7] the two propositions were attacked and drastically narrowed by the ABA.

The states, however, for the most part did not go along, creating a hodgepodge of rules on the subject of permissive and mandatory disclosure of client fraud. The current landscape may be briefly summarized as follows. Forty-one states permit (and four of those require) a lawyer to disclose confidential information to prevent a client's criminal fraud. Forty-four states *require* (and three permit) a lawyer to disclose confidential information relating to a client's ongoing criminal or fraudulent act. And eighteen states permit a lawyer to disclose confidential information to rectify or mitigate a past client fraud in which the lawyer's services were used.

The SEC rules as they currently stand contain a permissive disclosure provision, under which a lawyer may reveal to the SEC information that the lawyer reasonably believes necessary to prevent the issuer from committing a material violation or to rectify the consequences of a material violation, though disclosure for rectification purposes requires that the lawyer's services have been used.

After the enactment of section 307 and the promulgation of the SEC rules, the ABA last summer changed its confidentiality rule, Model Rule 1.6, to permit disclosure of information either to prevent the client from committing a crime or fraud or to rectify a past or ongoing fraud in which the lawyer's services were used. The ABA also changed Model Rule 1.13 to include permissive disclosure outside the organization, even if the lawyer's services are not being used to perpetrate wrongdoing by an organization, though the matter must be related to the lawyer's representation. The primary motivation for these changes was to stave off further regulation by the SEC, and in particular the noisy withdrawal requirement. It is important to note that by permitting disclosure of ongoing fraud in Model Rule 1.6, the ABA has effectively required disclosure in cases of ongoing fraud in which the lawyer's services have been used. Model Rule

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[7]SEC v. National Student Marketing Corp., 457 F.Supp. 682 (D.D.C. 1978).

4.1(b) says that a lawyer "shall not knowingly fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by rule 1.6."

One other point about reporting out is worth mentioning because there seems to be much misunderstanding about it. Sometimes press reports contain statements to the effect that lawyer disclosure of client confidences waives the client's attorney-client privilege. In fact, although some disclosures by lawyers may involve situations in which the crime-fraud exception to the privilege may apply, lawyer disclosure by itself, if not authorized by the client, does not generally waive the client's privilege, since the privilege belongs to the client.

**4. Advocates versus Counselors**

The SEC rules are largely addressed to lawyers acting in a counseling rather than an adversarial role. Their purpose is to enhance compliance with the law. Reporting evidence of misconduct and litigating are two very different legal events, even though they may involve the same conduct. Of course, the reporting of evidence of material violation may lead to litigation over whether a violation has occurred, but it need not.

The bar sometimes speaks as if every lawyer's job is to behave as lawyers in adversary adjudicatory proceedings are privileged to behave. But that is not so: lawyers who facilitate transactions or advise clients in private on complying with the law perform distinct functions in our democracy and operate in radically different environments from those inhabited by advocates engaged in adversary proceedings.

Advocates operate in an environment designed to guard against abuses of that broad license to manipulate fact and law. First, there is an adversary party equipped (in almost every case) with a lawyer both armed with information sufficient to challenge vigorously every theory, far-fetched or standard, that the opposing lawyer can make. Second, there is a judge who is acting as legal umpire (and sometimes as a neutral fact finder) and frequently a separate fact finder, the jury, in addition to the judge – actors obligated to decide with objectivity and neutrality between the contrasting visions of law and fact presented by the battling lawyers. None of those checks is present when, in the privacy of the office and the protections of lawyer confidentiality, a legal advisor counsels a client or corporate manager that it can act based on some unprecedented vision of what the law requires or some barely plausible interpretation of facts. In short, advocates have much more license to manipulate law and facts than advisors do.

And that is how it should be. Lawyers as advisors are a private sector solution to intrusive government alternatives to ensure that corporations, other entities and individuals operate within and not without the law. It is simply not true that the advisor's job is to stand by the client's position, no matter how implausible as a matter of fact or law, and not judge the client, as lawyers often assert. Advocates should not judge because there are others charged with that role in the environment in which they operate and they are present to guarantee the clash of positions that our adversary system depends upon. But advisors are relied upon to give advice made on prudent judgments. How else are they to tell anyone what the law requires and what it does not? And that is the role for which they are retained and paid to perform. The SEC rules do not

change the traditional responsibility and role of lawyer-advisors; they just insist that lawyers properly fulfill that role and not act as advocates in situations where such behavior is not permitted or appropriate.

## 5. Problems with the SEC Rules as They Now Stand

In our comments to the SEC and in a forthcoming paper, Roger Cramton, Susan Koniak, and I offer a detailed critique of a number of the rules the SEC has adopted. For purposes of this testimony, I will discuss the three main problems we find with the SEC's rules.

### a. The Triggering Standard for the Lawyer's Duty to Report

The heart of §307, and of the SEC rules, is the lawyer's duty to report. The key question under the duty to report is what circumstances trigger that duty. Section 307 obligated the SEC to adopt a rule requiring a lawyer "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)." The rule implementing this requirement, §205.3(b), states: "If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (of the equivalent thereof) or both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith." The SEC rules define "evidence of a material violation" in §205.2(e) as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is occurring, or is about to occur."

In assessing how faithfully and well the SEC rules implement the Congressional mandate, it is important to keep in mind the goals of §307. In the wake of Enron and other corporate scandals, Congress was concerned that too many corporate lawyers were taking a "see no evil, report no evil" approach to their representations. Any lawyer worth his salt knows that assessing whether the law is actually being violated is no simple task. One extra fact, one nuance, one affirmative defense, one creative ambiguity, and a judgment of "illegality" is transformed into something more benign. Unfortunately, as lawyer behavior in the S & L scandal and countless other financial debacles demonstrates, the inevitable "grayness" or uncertainty of all law – a characteristic of all just legal regimes and not a flaw – has become an excuse for ignoring evidence of illegality, no matter how substantial the evidence or harm being wrought has been.

The purpose of §307 was to change this corporate legal culture and practice and encourage more reporting of dubious corporate activities. Thus, Congress abandoned the "subjective" approach of Model Rule 1.13(b), which imposes no obligations on a lawyer unless she "knows" that illegal activity is occurring or will occur. Instead, Congress mandated an objective trigger, while at the same time lowering the triggering standard from one of definitive violation to "evidence" of a violation. The hope was that an objective, probabilistic "evidence"

trigger would be less subject to manipulation by lawyers inclined not to notice evidence of wrongdoing or to explain such evidence away. The question, then, is whether the SEC rules further this objective. The answer, unfortunately, is no.

In deciding whether to act – whether to report what Congress wanted to encourage lawyers to report up the corporate ladder – the lawyer confronting the definition of "evidence of a material violation" in §205.2(e) must ask herself whether it would be *unreasonable not to conclude* that the evidence before her demonstrates a reasonable likelihood of a material violation of law. This definition, which triggers the "up-the-ladder" reporting duty, is troublesome because its use of a double-negative formulation makes the standard difficult to understand, interpret or apply. Law is intended to guide action in the world. Yet it is barely possible to read the SEC's definition out loud without tripping (or, as I have discovered when presenting this definition in various fora, chuckling) over the words, let alone trying to remember the definition without reading it or trying to work out its "logic."

Moreover, the SEC's standard fails another critical test of sound rulemaking. It would be a nightmare to enforce. The Commission has asked its staff to assume the burden of proving not just one negative, but two. To enforce this rule, the Commission would have to show that it was *unreasonable* for a lawyer *not* to conclude that a violation was reasonably likely. I do not believe that this burden is a realistic one to ask the staff to meet.

The SEC's defense of this definition in the Adopting Release is that it "recognizes that there is a range of conduct in which an attorney may engage without being unreasonable." The idea is that if *any* "prudent and competent" lawyer *might* conclude that the evidence did not support the conclusion that a material violation has occurred, up-the-ladder reporting is not required. But this standard renders the reporting requirement of §307 nearly an empty shell. Any good lawyer will almost always be able to conclude that it is not 'unreasonable' to conclude that the evidence before her demonstrates legal conduct. Lawyers are trained to re-imagine evidence of illegality as evidence of legality. Not only will lawyers be able to reach this conclusion, they have strong motives to do so. The ethos of lawyers is not to report up the corporate ladder, and to find any possible way to avoid doing so.

The SEC could easily have adopted a rule that a lawyer must report when confronted with information that a prudent and competent lawyer, acting reasonably under the circumstances, would conclude was credible evidence of a material violation. In fact, that is precisely the triggering standard that Roger Cramton, Susan Koniak, and I proposed in our comments to the SEC, and which we still support. This clearer and more straightforward definition, incorporating a standard conception of reasonableness, would provide ample recognition of a "range of conduct" and the need for lawyer discretion. It would also be consistent with Congress's intent by providing an objective standard (a "prudent and competent lawyer, acting reasonably under the circumstances") with respect to both the factual question ("credible evidence") and the legal question ("material violation"). The fact that the SEC opted for a more convoluted double-negative standard, rather than the more straightforward standard, will be read by many lawyers as an invitation to inaction. The bar needs no such invitation and Congress surely did not intend the Commission to offer one.

The triggering standard is the gateway to the entire set of obligations created by the rules. If that standard is so weak that lawyers inclined to do so can easily circumvent it, if it is so ambiguous, convoluted, and weak that the SEC cannot effectively enforce it, the rules will not have effectuated the statutory objective. I find it disappointing, then, that so little attention has been paid to the triggering standard compared to other issues, most notably noisy withdrawal.

I find it even more disappointing that many lawyers who did pay attention to the trigger, and the SEC which sympathized with their objections, so strongly resisted a simple, objective standard, stated in affirmative terms, which would fully implement Congressional intent that lawyers report evidence of a material violation, while at the same time preserving an appropriate degree of lawyer discretion. The resistance is all the more troubling when one considers how little is really being demanded of the lawyer at the initial stage. The lawyer must simply report "evidence of a material violation" to the corporation's chief legal officer. The "report" is not a formal, detailed document, but can be a simple phone call, e-mail, or even casual water cooler comment. More important, the lawyer is not required to take any further steps without an additional, more demanding trigger, being satisfied.

b. Colorable Defense as an Appropriate Response

Aside from the initial duty to report evidence of a material violation to the chief legal officer or chief executive officer, the other key component of §307 is the obligation of the reporting lawyer to report the evidence up the corporate ladder to the board or relevant board committee if the chief legal officer or chief executive officer does not "appropriately respond" to the reporting lawyer. The SEC implemented this directive in §205.3(b)(3), which states that the reporting lawyer "shall report evidence of a material violation" to the board or relevant board committee, unless the lawyer "reasonably believes that the chief legal officer or chief executive officer . . . has provided an appropriate response within a reasonable time."[8]

The effectiveness of the SEC's rule implementing the reporting up obligation thus depends crucially on the definition and meaning of "appropriate response." Section 205.2(b) defines "appropriate response" to mean one of three things: there is no material violation; there is a material violation but it is being addressed with "appropriate remedial measures"; or another lawyer has been retained or directed to investigate the matter further. One would expect that the third option would simply default to one of the first two scenarios (no violation, violation being remedied) once the investigating lawyer completes the investigation. But the SEC rules offer a new possibility: the corporation makes an "appropriate response" if the "investigatory lawyer" advises the corporation that he or she "may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation." Thus, the rule as adopted suggests that one alternative to stopping an ongoing fraud or abandoning plans to commit a new fraud is to get an opinion from a lawyer that should the issuer be investigated for the illegal conduct (there is no

[8] 17 C.F.R. §205.3(b)(3).

requirement in the definition that the investigation be underway, pending, or even likely to occur), a colorable defense would be available.

In my view, corporations will have a strong incentive to take advantage of this "colorable defense" option when faced with a report by a lawyer. And much like the confusing initial trigger, this option threatens to undermine Congress's intent in enacting §307. The colorable defense standard will result in too little reporting up of such evidence. The SEC should not be suggesting to anyone that the fact that a lawyer can (in good faith and/or reasonably) state that a "colorable" defense would be available, if the action is ever challenged, licenses an issuer to engage in activity that may more likely than not be illegal.

The problem with the colorable defense option is that it applies a standard appropriate to litigation to the quite different context of counseling and legal compliance, which is the primary concern of section 307 and the SEC rules. The existence of a colorable defense allows a lawyer when acting as an advocate, i.e., once conduct is challenged in a forum in which another party is arguing that the conduct is unlawful, the lawyer may argue that the conduct, even if very likely illegal, is legal. It has no other relevance.

It is of course true that there may be factual or legal uncertainty about the existence of a material violation, and this uncertainty may remain after an investigation of the initially reported evidence. But section 307 specifically requires that the reporting lawyer take "the evidence" to the board or relevant board committee if the chief legal officer or chief executive officer does not "appropriately respond." Thus, the statute itself mandates reporting up in at least some cases in which the violation is uncertain. This mandate makes sense because a concerned and prudent board would want to know about potential material violations of law.

The fact that a lawyer can advance arguments that would meet the minimum level of plausibility sufficient to avoid sanction in an adversary proceeding does not mean that the conduct is probably legal or somewhere near that middle ground. A public company subject to SEC regulation is guilty of a civil violation of the securities laws when the preponderance of evidence supports a finding of a violation. A lawyer acting as an adviser in transactions and filings subject to SEC disclosure requirements must advise the company on the basis of whether the available evidence indicates that a violation is more likely than not. The result of the SEC's rule is that both the firm and the lawyer potentially remain exposed to a significant risk of liability. The application of the "colorable defense" standard must be limited to the litigation context for which it is appropriate. The colorable defense standard certainly should not be used to permit lawyers to advise clients, particularly corporate clients with fiduciary obligations to their owner-shareholders, to proceed with conduct that is very likely illegal.

The better response to the problem of uncertain violation would be to adopt a graduated approach to reporting up, under which there would be a stricter standard for reporting evidence of a material violation to the board than for the initial duty to report, when the violation remained uncertain after investigation. Roger Cramton, Susan Koniak, and I supported such a graduated approach in our initial comments to the SEC. For example, the SEC could increase the quantum of evidence necessary by adopting a "substantial evidence" standard as triggering a duty to go to the board. The precise formulation could be debated.

My point is simply that the SEC could have adopted a graduated approach to the reporting up trigger without weakening the statutory mandate that "evidence of a material violation" be reported to the board. In particular, nothing in the statute required or even suggested that the SEC use a litigation standard – "colorable defense"– to handle the problem of uncertain violations. Requiring the reporting up of an uncertain violation in no way interferes with a subsequent decision by the board to litigate the issue, asserting all nonfrivolous defenses. Unfortunately, the colorable defense option falls far short of the statutory mandate. In short, the assertion of a colorable defense is not an appropriate response to a report of evidence of a material violation.

c. Law Firms

Section 307 refers to "standards of professional conduct for attorneys" without addressing the question whether firms in which attorneys practice are intended to be regulated. The SEC rules appear directed at individual attorneys. In my view, the rules should be revised to state explicitly that law firms, not just individual lawyers, "appear and practice" before the SEC. Similarly, the SEC should add a rule permitting the censure or reprimand of a law firm and the assessment of monetary fines when the firm has failed to conform to responsibilities required by the Commission. The SEC has sought to discipline law firms in the past in exercising its authority under Rule 2(e). It should renew these efforts under section 307.

The rationale for including law firms within the SEC rules is straightforward.[9] Corporate clients who hire outside counsel usually understand that they are represented by the law firm, not any one individual lawyer within the firm. And in matters of any size or complexity multiple lawyers in the firm, not just one partner and a few subordinates, are likely to be involved. Specialized corporate and securities practice involves the participation of a team of lawyers who bring differing skills and knowledge. Responsibility for decisions is often divided up or shared in ways that are uncertain or shifting. The diffusion of responsibility and knowledge leads to the argument that no one lawyer (or identified group of lawyers) can be held responsible for what was done.

The law of agency addresses these realities through rules of vicarious liability and imputed knowledge. If the SEC rules were to apply to law firms, the question would be whether a law firm might have "evidence of a material violation" as a result of information possessed by lawyers in the firm, even if those lawyers do not disclose the information to other lawyers in the firm who have authority to act for the firm. In particular, courts have adopted a doctrine of "composite knowledge," which attributes to an entity the collective knowledge of its individual agents even if no one agent had all the knowledge. The SEC has previously endorsed the composite knowledge idea in exercising its disciplinary authority against law firms under Rule 2(e).

[9]For a persuasive argument in favor of disciplining law firms, see Ted Schneyer, Professional Discipline for Law Firms?, 77 Cornell L.Rev. 1 (1991).

In my view, not only should the SEC rules apply to law firms, but the application to law firms should include the idea of composite knowledge. Absent such an imputation rule, law firms would have an incentive to decentralize legal work to minimize the number of lawyers with access to sufficient client information to bring them within the purview of these rules. As a result, the quality of legal work done in securities matters as well as compliance with the securities laws would decline, perhaps in dramatic ways. Moreover, I would not expect a composite knowledge rule to add significantly to legal costs. Firms often have good economic reasons for dividing up legal work (in particular, benefits from specialization), and so they already have a need to coordinate and monitor the work and information of various lawyers. A failure to coordinate is itself likely to result in duplication of legal work that itself would unnecessarily escalate fees, as well as an increased risk of malpractice. Finally, the increased risk on law firms as a result of the composite knowledge rule could be mitigated by adopting a system of reduced penalties for firms with effective compliance programs and procedures reasonably designed to prevent violations of the SEC rules.

**6. The Noisy Withdrawal Proposal**

Noisy withdrawal did not spring fully formed from the imagination of the SEC. It was a concept invented by the ABA to attempt to reconcile its (prior to last summer) absolute prohibition on disclosure of client fraud with its prohibition on aiding and abetting client wrongdoing. In a comment to Model Rule 1.6, the ABA stated that nothing in that rule would "prevent the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like." The ABA then endorsed the noisy withdrawal comment in an ethics opinion in 1992. Using reasoning only lawyers can appreciate, the ABA claimed that the noisy withdrawal was an exception to the confidentiality rule because it was not a "disclosure."

Not only did the ABA create the concept of noisy withdrawal, but the ABA itself has suggested that in certain circumstances noisy withdrawal might be required. Comment [10] to Model Rule 1.2 in the Ethics 2000 revisions to the Model Rules states: "In some cases, withdrawal alone might be insufficient. It may be *necessary* for the lawyer to give notice of the fact of withdrawal, and to disaffirm any opinion, document, affirmation or the like." A similar statement occurs in Comment [3] to Model Rule 4.1, which adds: "In extreme cases, substantive law may require a lawyer to disclose information relating to the representation to avoid being deemed to have assisted the client's crime or fraud."

The SEC made the mistake of taking the ABA at its word. Initially, the SEC proposed section 205.3(d)(1), which would require an issuer's attorney, in the rare situation in which the attorney reasonably believes that (1) an issuer has not made an appropriate response to the attorney's prior report of evidence of a material violation, and (2) "the 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 the investors:"

to withdraw forthwith from representing the issuer, indicating that the withdrawal is

based on professional considerations; . . . promptly disaffirm to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with 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.[10]

On January 29, 2003, when the Commission adopted its "reporting up" rule and permissive "reporting out," it also proposed an alternative to required "noisy withdrawal" which would require the issuer, rather than the reporting attorney, to notify the Commission of the reporting attorney's withdrawal and also report "the circumstances related thereto . . . ."[11]

The major argument against broadening exceptions to confidentiality is that clients will be deterred from confiding information to their lawyers. The lack of candor on the part of clients, it is said, will make it difficult for a lawyer to give informed advice. Moreover, the ability of the lawyer to disclose client information may diminish client trust and adversely affect the quality of the relationship and the single-mindedness with which the lawyer pursues the client's interests. If and when the lawyer informs the client that disclosure is desirable or contemplated, a serious conflict of interest arises between the lawyer and the client. The relationship ends in bitterness and a sense of betrayal.

The response to these arguments is several fold. First, some exceptions to both the professional duty and to the attorney-client privilege are longstanding and have not had the consequences that are feared. The people who might be engaged in wrongdoing (corporate managers who are violating fiduciary duties to the issuer or engaging in law violations that will harm the issuer as well as investors) have no privilege now and no legitimate claim of confidentiality. The privilege and the duty to keep confidences belong to the entity, not the managers or the directors. Either can be waived by future managers or trustees in bankruptcy.

Moreover, lawyers can disclose confidences in every state to defend themselves when necessary, even before the filing of actual charges or a complaint.[12] Lawyers can disclose confidences to collect a fee, when necessary. The crime-fraud exception to the privilege leaves unprivileged all communications of the client or its agents made in furtherance of illegality. And in most states, lawyers are already permitted, and in some cases required, to disclose client fraud. The self-defense and client-fraud exceptions involve situations that arise quite frequently and have limited lawyer secrecy from the very beginning.

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[10]An attorney employed by the issuer (an inside lawyer) would not be required to resign from employment but would have to stop working on the matter involved.

[11]SEC Release No. 33-8186, "Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys," Jan. 29, 2003.

[12]See Restatement of the Law Governing Lawyers §64, cmt. b (discussing the rationale for the "self-defense exception": disclosure of confidential information "to defend the lawyer . . . against a charge or threatened charge by any person that the lawyer . . . acted wrongfully in the course of representing a client."

With all these exceptions to confidentiality and the privilege extant, the idea that "noisy withdrawal" or the alternative's "circumstances" provision would suddenly result in clients not talking to their lawyers is untenable. Corporate clients (through their agents) confide in corporate lawyers (to the extent they do, which is now imperfect and always will be) because corporations need legal advice to carry on their business. Period. There is no evidence that those broad exceptions have had undesirable effects on the candor with which clients communicate to lawyers. There is no evidence whatsoever that corporate clients have avoided lawyers in those few states that now *require* disclosure of a client illegality (e.g., New Jersey) or those states that *permit* such disclosure (e.g., Pennsylvania), as distinct from the few that *prohibit* disclosure (e.g., District of Columbia). There is no evidence that lawyers in such states are told less than lawyers in other states. Corporate clients that function across state lines, as so many do, have a fairly wide choice of states from which they may secure outside lawyers. No evidence exists that lawyers in disclosure states have suffered at all or that the quality of representation or compliance with law in those states has been reduced. There is no reason to believe that a slight broadening of the exceptions in situations that arise less frequently will have any discernible effect.

Second, the available empirical evidence, albeit limited, suggests that most lawyers and clients expect that confidentiality will be breached when extremely important interests of third persons or courts would be impaired.[13] Nor is there any indication that clients are more candid with their lawyers in jurisdictions that have fewer exceptions to confidentiality than they are in jurisdictions with broader exceptions. Any objective observer must concede that there is insufficient solid empirical evidence to support firm conclusions in either direction. Do New Jersey lawyers, who are required to disclose to rectify a client's prior fraud on a third person, have an inferior relationship with their corporate clients than those in the District of Columbia, where such disclosure is prohibited? When severe harm is threatened that can be prevented by disclosure, the reality of that more certain interest should be preferred to dubious assumptions about effects on client candor.

Third, the confidentiality interests of public companies regulated by the SEC have a lesser moral claim for protection than those of private individuals who are suddenly confronted with a legal problem that requires a lawyer. Inexperienced individual clients, unfamiliar with legal matters and fearful of their predicament, have confidentiality interests that derive in part from constitutional provisions involving individual rights, especially the special protections given to criminal defendants. On the other hand, a public corporation "has neither a body that can be kicked or a soul that can be damned."

The public companies regulated by the SEC have many public obligations, operate in a goldfish bowl of scrutiny, and have large experience and sophistication concerning the hiring, supervision and firing of lawyers. They are sophisticated repeat-players who use law regularly in carrying on their business, entering into transactions, dealing with regulatory authorities, and participating in litigation. They are the major group of clients who are well informed about the details of the attorney-client privilege and the exceptions to it, the work-product immunity, and

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[13]See Fred C. Zacharias, Rethinking Confidentiality, 74 Iowa L.Rev. 351, ??? (1989).

the professional duty of confidentiality. They are also clients whose managers may have a large economic incentive to use lawyer secrecy to delay compliance with regulations or to conceal ongoing violations of them. This group of clients has many advantages in litigation over those with less resources, experience and staying power. The social value of secrecy versus disclosure is less when one is dealing, not with individual citizens encountering law for the first time, but with large and informed repeat-player, profit-making organizations that have strong incentives to delay or conceal compliance with regulatory requirements that impose substantial costs.

Fourth, there is no evidence that exceptions to confidentiality have led or will lead to frequent whistle-blowing on the part of lawyers. Indeed, it is clear that the incidence of whistle-blowing by lawyers is astonishingly low given the fact that most or all states require disclosure when a crime or fraud has been perpetrated on a tribunal; thirty-seven states permit disclosure to prevent a client criminal fraud; and four populous states require disclosure in that situation. Disciplinary proceedings for failing to disclose information when required to do so are virtually non-existent and the same is true for failure to withdraw when withdrawal is required. On the other hand, law firms that learn that a client has used their services to defraud others and who have taken no action to prevent or stop the fraud have frequently settled malpractice and third-party liability claims for large and sometimes huge amounts. Available evidence indicates that lawyers who have discretion to disclose almost always decide not to do so, even when that course of action risks civil liability. The objection to rules permitting or requiring disclosure is not that they will lead to professional discipline, but the effect of the existence of such rules on the likelihood and success of the malpractice and third-party liability claims that are the real risk and, prior to the SEC's implementation of the Sarbanes-Oxley Act, the principal deterrent force.

Fifth, a lawyer's public disclosure of the fact of withdrawal and the general nature of the matter involved, does not waive the client's attorney-client privilege. The attorney-client privilege applies only to communications between lawyers and clients. It does not privilege the underlying facts. Thus the privilege allows a client (or its lawyer) to refuse to answer a question in this form: What did your lawyer tell you? Or, what did you tell your lawyer? The privilege does not allow a client to refuse to answer questions about a matter simply because the matter was discussed between lawyer and client.

In particular, a request that the circumstances of withdrawal be revealed, as the SEC's alternative proposal requires, is similar to a discovery request for certain underlying facts. The SEC is not asking issuers to hand over its lawyer's written reports or summarize the oral advice the lawyer gave. The SEC is not asking issuers to describe the back and forth between lawyer and client on the matter that was the subject of the report. What the Commission wants from issuers is two things: One, a statement that the lawyer has resigned, whenever a resignation is required by the SEC rules; and two, a statement that the lawyer's resignation was in connection with the following matter, including a brief description of the matter, with no requirement that the issuer repeat or disclose any of what the lawyer actually said about the matter.

Does this disclosure threaten the attorney-client privilege because it amounts to requiring the issuer to make this implicit statement: "My lawyer said that there is evidence that a material violation of law occurred (is occurring or will occur) in connection with this matter?" We think not. Courts do not treat the privilege so lightly as to find waiver based on "implicit" references to

lawyer-client communications. The “circumstances” portion of the Commission’s proposed alternative should not be changed in the absence of a convincing showing that the current law of attorney-client privilege adopts the proposition that “implicit” statements amount to waiver of the privilege. We know of no such authority and do not believe that any outlier authority that might exist for such a proposition would be followed by other courts. The Restatement (Third) of the Law Governing Lawyers §79, Comment *e,* states that “[k]nowledge by the nonprivileged person that the client consulted a lawyer does not result in waiver, nor does disclosure of nonprivileged portions of a communication *or its general subject matter*. Public disclosure of facts that were discussed in confidence with a lawyer does not waive the privilege if the disclosure does not also reveal that they were communicated to the lawyer.” (Emphasis added.)

Finally, securities laws now require issuers to disclose a contingent liability when that liability is likely to be significant enough to be of concern to investors. Any such disclosure involves as much of an implicit statement about what a lawyer told the issuer as the “circumstances” provision of the alternative proposal of a report by the issuer to the SEC would require. In sum, eliminating the “circumstances” provision would render the alternative less protective than the original proposal. It should not be eliminated. If it is, the original proposal requiring the reporting lawyer to notify the Commission should be adopted. Whatever version of the rule is adopted should include the requirement that the lawyer disaffirm any opinions or representations that the lawyer reasonably believes are or may be materially false or misleading. That additional step is required to ensure that these “minimum” standards are not lower than the fraud provisions of the securities laws or the ethics rules of most states.

## 6. Recommendations

My recommendations for Congress and the SEC are the following:

a. Fix the flaws and omissions in the SEC’s current rules on reporting up. In particular, the initial trigger should eliminate the double negative formulation; the “colorable defense” option should be eliminated from the list of “appropriate responses”; and the rules should make clear that they are applicable to law firms.

b. Adopt the SEC’s noisy withdrawal proposal. I have no strong views about which version should be adopted. If the issuer reporting standard is adopted, however, it should include the requirement that the issuer report the “circumstances” of the withdrawal. It should also add a requirement that the reporting lawyer inform the SEC if the issuer does not.

c. Restore private suits for aiding and abetting. The threat of liability is in many ways the most effective regulator of lawyer behavior. I would gladly trade the SEC rules for the overturning of *Central Bank*. Although securities class actions have many problems, those problems should be addressed directly, not by eliminating causes of action that may have the best chance of deterring corporate fraud. In addition, Congress should restore the recklessness standard of knowledge that was eliminated in the Private Securities Litigation Reform Act.

d. Consider adopting rules similar to the SEC’s rules for other agencies. The problem of corporate wrongdoing is of course not limited to securities fraud. The approach taken by the

SEC could easily be applied to lawyers who practice before other federal agencies. That would not only help deter more corporate wrongdoing, it would further the goal of providing more uniform standards of conduct for lawyers.