"UP THE LADDER" AND OVER: REGULATING SECURITIES LAWYERS – PAST, PRESENT & FUTURE[*]

THEODORE SONDE
F. RYAN KEITH
Crowell & Moring LLP
Washington, D.C.

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[*] This article was prepared in late November 2002, shortly after the SEC announced its proposed rules under Section 307 of Sarbanes-Oxley, discussed at length herein. A finalized version will appear in a forthcoming issue of the *Washington and Lee Law Review*, and other excerpts or adaptations may appear elsewhere. Those versions will be revised to reflect the SEC's final rules, as well as other material developments on the topic.

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“UP THE LADDER” AND OVER: REGULATING SECURITIES LAWYERS – PAST, PRESENT & FUTURE

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INTRODUCTION

Over 30 years ago the Securities and Exchange Commission (“SEC” or “the Commission”) filed a complaint against two major law firms and charged them with violating the securities laws. Since that time, the legal profession, in one form or another, has tried to deny its responsibilities for client conduct that may be fraudulent or worse. At the same time, the profession has disputed, as have accountants, the authority of the SEC to discipline these professionals when they violate the securities laws, or assist their clients in doing so.

Fast forward to summer 2002. In the face of a growing scandal of arguably unprecedented dimensions in the corporate and securities world, Congress made clear that both lawyers and accountants have duties beyond those owing to their immediate clients and have obligations to their so-called “true clients,” to borrow a phrase from the Chairman of the SEC, Harvey Pitt.[1] In the law popularly known as “Sarbanes-Oxley,” after its primary sponsors, Congress further made clear that the SEC has both the power and now the duty to police both lawyers and accountants who practice before it.[2] This article will briefly review the events that have led the legal profession to become the subject of regulation by the Congress and the SEC, in an effort to illuminate the broader historical context in which this most recent regulation arose.

On November 21, 2002, the Commission issued the proposed rules Congress called for in Section 307 of the Sarbanes-Oxley bill.[3] The practical impact of these rules, discussed in more detail herein, cannot be understated. They threaten to revolutionize the contours of the attorney-client privilege, as well as the general corporate environment to which issuer clients and securities lawyers have become accustomed. Whether the rules are wise or prudent – and whether the statute even authorizes them all – are important issues to be thoroughly vetted in the legal community. These rules are also the latest development in a long struggle of wills between the SEC and the organized American Bar, and are sure to make that dialogue as robust as ever.

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[*] Mr. Sonde is Senior Counsel to the law firm of Crowell & Moring LLP in its Washington, D.C. office. He formerly was an Associate Director of the Securities and Exchange Commission’s Division of Enforcement, as well as Director of Enforcement of the Federal Energy Regulatory Commission. Mr. Keith is an Associate at Crowell & Moring LLP. The discussion in this article does not necessarily reflect the views of their law firm, its clients, or their colleagues in the firm.

[1] *See infra*, at __ (discussing passing of historic corporate reform legislation); *see also* 15 U.S.C. § 7201 *et seq.*; 15 U.S.C. § 7245.

[2] *See infra*, at __ (discussing new obligations of lawyers who practice before SEC, and SEC’s power to punish them if those obligations are breached).

[3] *See Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys*, Release No. 33-8250 (Nov. 21, 2002) (hereinafter “Proposed Rules”) (available at www.sec.gov/rules/proposed/33-8150.htm). These rules are scheduled to take effect on January 1, 2003, and will be codified at 17 C.F.R. Part 205.

The authors do not necessarily applaud regulation of the legal profession by any government entity, much less the national government, when historically (and for good reason) the legal profession has not been subject to regulation at any official level. Clearly, lawyers often stand to protect the rights of many people and institutions whose freedom and property are threatened by the government; sometimes that threat is for good reasons, sometimes for bad reasons. However, as will be apparent from our discussion, there are times when the profession itself has failed to act responsibly and, as a result, arguably bad law has arguably filled the void. This is not to justify the result. Rather, we aim to help impel a solution that may otherwise avoid further regulation of the legal profession; by not only the SEC, but also by other governmental entities who might likewise be tempted to act when members of the profession fail to act responsibly again.[4]

HOW WE GOT HERE: SOME HISTORY

The legislative history of the securities laws demonstrates that the legal profession has long been at the forefront of helping clients commit securities fraud. As Justice Douglas (a former Chairman of the SEC) noted in 1934, quoting a popular columnist of the day:

> But just as a fine, natural football player needs coaching in the fundamentals and schooling in the wiles of the sport, so, too, it takes a corporation lawyer with a heart for the game to organize a great stock swindle or income tax dodge and drill the financiers in all the precise details of their play.
>
> Otherwise, in their natural enthusiasm to rush in and grab everything that happens not to be nailed down and guarded with shotguns they would soon be caught offside and penalized, and some of the noted financiers who are now immortalized as all-time all-American larcenists never would have risen beyond the level of the petty thief or short-change man.

In his own writings, Justice Stone found the root of this problem in the principle that "a man cannot serve two masters." Further, Justice Stone recognized that, in the separation of ownership from management, there exists an inherent conflict — a conflict that often has resulted in the ignoring of responsibilities by those who nominally serve as trustees. And in his view, that departure from fiduciary principles did not "usually occur without the active assistance of some member of our profession. . . ."[5]

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4 *See* Theodore Sonde, *Professional Responsibility – A New Religion, or the Old Gospel?*, 24 EMORY L.J. 827, 833-36 (1975) ("This author believes that the Commission is not seeking to establish new principles or new standards of conduct, but to establish professional independence by both accountants and lawyers, consistent with both professions' public responsibilities….”). Given these recent changes in the law, the then-recent admonition included in that article – "if confidence in the profession continues to wane, the public will demand an alternate and perhaps Draconian system of control by forces outside the profession" – also rings true today. *See id.*, at 843 (quoting Kaufman, *Attacking Anomie in the Legal Profession*, 1 LITIGATION 5 (Winter 1975)).

5 *See* Theodore Sonde, *The Responsibility of Professionals Under the Federal Securities Laws – Some Observations*, 68 NW. L. REV. 1, 7-8 (1973) (quoting Harlan Fiske Stone, *The Public Influence of the Bar*, 48 HARV. L.

(continued…)

With this guidance in mind, the SEC in 1972 did something nevertheless unheard of in the history of securities regulation: it sued two large law firms for securities fraud. Further, the SEC claimed, as it had never done before, that both of those law firms had a professional obligation to not only stop the consummation of a fraudulent merger, but, when their clients failed to heed what would have been sound legal advice under the circumstances, the firms had an additional obligation to report to the shareholders of the two companies or to the SEC the fraudulent nature of the transaction.[6] Although unprecedented, the complaint in that case, *SEC v. National Student Marketing*, at least on its face, did not seem so remarkable.

Indeed, the Bar's existing ethical rule on point precluded the conduct at the heart of the *National Student Marketing* case. At the time, the ABA Model Code of Professional Responsibility provided thus:

> A lawyer who receives information clearly establishing that
>
> (1) His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal.
>
> (2) A person other than his client has perpetrated a fraud upon a tribunal shall promptly reveal the fraud to the tribunal.

The Commission's theory in the case was consistent with this duty, as well as with the historical exemption of crime or fraud from attorney-client communications that enjoyed a privilege in the first place.[7]

Yet as the case moved forward, the Court noted that the litigation had, to mild surprise,

> generated significant interest and an almost overwhelming amount of comment within the legal profession on the scope of a

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(…continued)

REV. 1, 8 (1934) and William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1329 n.65 (1934)). These observations now seem prescient, largely because no one has ever done much to heed them; to the extent those have tried in any large-scale way, they have mostly been rebuffed. *See infra* ____.

6 One of the authors, Mr. Sonde, was one of the principal draftsmen of the SEC's complaint in *National Student Marketing* and principal trial counsel throughout that proceeding. At the same time, as in most SEC enforcement actions, the "blame" or "credit" for the case justly needs to be shared with many other staff members who were also instrumental in causing the Commission to take that step. These include Alan Levenson, Richard Rowe, and David Belkin, to name just a few. Their work is reported at 412 CCH – Federal Securities Law Reports ¶ 93,360 (Feb. 24, 1972).

7 This had been the rule in American law for at least 100 years, though, as a practical matter, was never enforced against large law firms, as in *National Student Marketing*. *See* 1928 ABA Canon of Professional Ethics 37 ("announced intentions of a client to commit a crime is not within the confidences which [the attorney] is bound to respect"); 1908 ABA Canon of Professional Ethics 41 (lawyer "should endeavor to rectify" fraud or deception, independent of client confidentiality); *see also Nix v. Whiteside*, 475 U.S. 157, 167-68 (1986) (these rules "articulate centuries of accepted standards of conduct"); *Queen v. Cox*, 14 Q.B.D. 153, 168 (1884) (quoted with approval in *Clark v. United States*, 289 U.S. 1, 15 (1932)). In fact, in 1969, when the conduct at issue in *National Student Marketing* occurred, the somewhat stricter Canon of Professional Ethics 37 remained the law in most states. *See generally* Sonde, *supra* note __, at 830-32.

> securities lawyer's obligations to his client and to the investing public.[8]

Consequently, the Court recognized,

> this action … has provided a necessary and worthwhile impetus for the profession's recognition and assessment of its responsibilities in this area.[9]

After watching the litigation continue for more than five years, the Bar's "comment" and "assessment" culminated in – to major surprise – the functional evisceration of the ethical rule on its books. By the decade's end, information "protected as a privileged communication,"[10] even if that information was perpetrating an unrectified fraud, purportedly no longer needed to be disclosed.[11] This move turned *National Student Marketing*, and, of course, the historical rule, on their heads.

With this change, the legal profession was reacting to *National Student Marketing* with unabashed denial. Rather than accept any form of public responsibility, the organized Bar proceeded to weaken its ethical rules, and provided its members with many confusing notions and no guidance on how to act. In fact, the Bar actually provided so much misdirection that it may have actually caused many members of the profession to lose sight of their professional obligations.

Direct linkage is unclear, but, in 1978, the Commission staff brought *In re William B. Carter and Charles J. Johnson*,[12] charging that two more lawyers had concealed their knowledge of a client's true financial condition in order to ensure that a deal closed. Determining whether the respondents, again members of a prominent national firm, could continue practicing before the SEC, the Commission found no limits to the liability of lawyers per se. To the contrary, the "substantial assistance" element of aiding and abetting a securities law violation, one of the three bases on which practice privileges could be suspended, would be "generally satisfied" by nothing more than the routine practice of securities law, in the context of a fraudulent or deceptive deal. Almost always, the Commission recognized, the attorney "is inevitably deeply involved in his client's disclosure activities[;] often participates in the drafting of

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8 *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682, 714 (D. D.C. 1978); *see also, e.g.*, *The Troubled Professions*, BUS. WEEK (Aug. 16, 1976), at 126 (with *National Student Marketing*, the SEC "loosed a thunderbolt," spawned "fears that the SEC would make [lawyers] responsible for the securities violations of their clients," and began expecting lawyers to become the "corporate conscience"). Over ten years later, the then-General Counsel of the SEC remarked, almost wryly, that *National Student Marketing* "had the effect of crystallizing the bar's awareness of its relations with the Commission and the Commission's expectations of counsel's function." *See* Greene, *infra* note __.

9 *National Student Marketing Corp.*, 457 F. Supp. at 714.

10 ABA Model Code of Professional Responsibility 7-102(B)(1) (1981).

11 *See* ABA Code of Professional Responsibility 7-102(B)(1) (as amended in 1974).

12 In re *William R. Carter and Charles J. Johnson, Jr.*, 47 S.E.C. 471 (Feb. 28, 1981), *available at* 1981 SEC LEXIS 1940.

documents[;] … [and] does so knowing that he is participating in the preparation of disclosure documents – that is his job."[13]

The Commission also addressed whether these lawyers had engaged in "unethical or improper conduct," a standard it had not specifically defined before. On that front, the SEC "perceive[d] no unfairness whatsoever in holding … professionals … to generally recognized norms of professional conduct, *whether or not such norms had previously been explicitly adopted or endorsed by the Commission*."[14] In other words, the SEC recognized as a rule of decision a principle that otherwise lacked the force and effect of law, without formal notice that it would do so.[15] This was as aggressive a position as it appears – and indicates how determined the SEC was at the time to keep lawyers in line, recognizing their crucial role in preserving marketplace integrity, particularly if the nation's primary bar association would not. The Commission acknowledged the division, but was not restrained by it:

> While precise standards have not yet emerged, it is fair to say that there exists considerable acceptance of the proposition that a lawyer must, in order to discharge his professional responsibilities make all efforts within reason to persuade his client to avoid or terminate proposed illegal action. Such efforts could include, where appropriate, notification to the board of directors of a corporate client.
>
> * * *
>
> [In this case,] management … use[d] [the lawyers] as a shield to avoid the pressures exerted by the banks toward disclosure. Such a role is a perversion of the normal lawyer-client relationship, and no lawyer may claim that, in these circumstances, he need do no more than stubbornly continue to

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13 47 S.E.C. at 503.

14 47 S.E.C. at 508.

15 Noting that at the time of the conduct in question (more than five years before the SEC's opinion) the current ethical rules did not "unambiguously cover" Carter and Johnson's work, the Commission did not actually sanction the attorneys before it in that case. Yet it was firm about its plans moving forward:

> When 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.

47 S.E.C. at 511. Reflecting this philosophy, the Commission brought a series of cases against lawyers in this era. *See, e.g.*, *SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978); *SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973) ("The legal profession plays a unique and pivotal role in the effective implementation of the securities laws. … [T]he smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on … attorney[s]."); In re *Fields*, CCH Transfer Binder ¶79,407 (1973); *see also Meyerhofer v. Empire Fire & Marine Ins. Co.*, 497 F.2d 1190 (2d Cir. 1974). Even the SEC's investigation of the controversial financier Robert Vesco encompassed three lawyers at another large New York firm, who were also named in the SEC's complaint. *See SEC v. Vesco*, No. 72-5001 (S.D.N.Y. 1972). They eventually settled. *See* SEC Litigation Release No. 8413 (May 23, 1978), *available at* 1978 SEC LEXIS 1506.

> suggest disclosure when he knows his suggestions are falling on deaf ears.[16]

The Commission went on, invoking at length the

> [s]ignificant public benefits [that] flow from the effective performance of the securities lawyer's role. The exercise of independent, careful and informed legal judgment on difficult issues is critical to the flow of material information to the securities markets. … In the course of rendering securities law advice, the lawyer is called upon to make difficult judgments, often under great pressure and in areas where the legal signposts are far apart and only faintly discernible.
>
> If a securities lawyer is to bring his best independent judgment to bear on a disclosure problem, he must have the freedom to make innocent – or even, in certain cases, careless – mistakes without fear of legal liability….[17]

Notwithstanding these platitudes, however, *Carter and Johnson* appeared to embody a redoubling of the Commission's efforts to hold lawyers accountable for their roles in the securities transactions of their clients.

The Bar could not help but take notice, and did not do so quietly. When the SEC subsequently sought comments on a proposed rule formalizing the *Carter and Johnson* opinion, the ABA submitted a lengthy criticism of the SEC's position.[18] The SEC backed off. Not only did it never finalize the rule, within a year, its then-General Counsel announced a substantial change in the Commission's view.

In an important speech to the New York County Lawyers' Association, Edward Greene minimized the usefulness of the ethical standards promulgated by the ABA or any state disciplinary authority, and asserted that the SEC itself "ha[d] neither the time or the expertise to fashion an appropriate code of conduct."[19] As had the *Carter and Johnson* decision, Greene invoked the undesirability of "[l]awyers … view[ing] the Commission's disciplinary actions as requiring them to divide their loyalties"; the risk that "their clients may perceive that the threat of

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16 47 S.E.C. 510-12. The Commission expressly reserved "the additional question of when a lawyer, aware of his client's intention to commit fraud or an illegal act, has a professional duty to disclose that fact either publicly or to an affected third party," although it tacitly endorsed that the duty might stem from "other existing standards of professional conduct." *Id.* at ___ n.78 (citing ABA Disciplinary Rule 7-102(B)).

17 47 S.E.C. at 504.

18 *See* ABA, Response of the Section of Corporation, Banking, and Business Law (Sept. 21, 1981) (adopted by ABA Board of Governors, Nov. 20, 1981).

19 *See* Edward F. Greene, *SEC General Counsel's Remarks on Lawyer Disciplinary Proceedings*, January 13, 1982, *reprinted at* BNA Securities Regulation and Law Report, at 168 (Jan. 20, 1982). In his remarks, Greene incorrectly states that, in *National Student Marketing*, the Commission eventually withdrew its charge that the lawyers should have "blown the whistle" on their client. The Commission did no such thing. Indeed, it took three published opinions issued over five years to resolve just those charges against all the lawyers in the case. *See National Student Marketing*, 457 F. Supp. at 686 n.1 (detailing procedural history of litigation).

disciplinary actions interferes with effective representation"; and "the valuable function that counsel provides by vigorous advocacy of differing positions before the Commission." Greene, however, qualified the *Carter and Johnson* position, announcing his intent to "generally limit" SEC proceedings against attorneys "to those instances that pose the most direct threat of harm." This unfortunate position brought the Commission's momentum on this front to an abrupt halt.[20]

At about the same time as these developments, the ABA was again revising its ethical standards, enacting the Model Rules of Professional Conduct, and continuing to narrow the circumstances under which its members must "come clean" of their knowledge of their clients' designs. In the new Rule 1.6(b),

> A lawyer *may* reveal [information relating to representation of a client] to the extent the lawyer reasonably believes necessary:
>
> (1) to prevent the client from committing *a criminal act* that the lawyer believes is likely to result in *imminent death or substantial bodily harm*….

In two key ways, this rule constituted a substantial departure from even the relaxed rules adopted a decade before. First, any disclosure was put at the sole option of the lawyer involved (*i.e.*, "may reveal"). Second, it imposed a tremendous limitation on the occasions a lawyer could even confront the dilemma, eschewing the possibility unless the client was (a) poised to commit a *criminal* act; (b) certain consequences of that act were not merely possible, but *likely to result*; and (c) those consequences would be either *imminent death or substantial bodily harm*.[21] For the securities lawyer, it is not unreasonable to say that a single client situation will almost never present all three of these attributes. Suffice it to say, this did not escape the drafters of the rule.[22]

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20 Interestingly, however, other federal agencies attempted to pick up the SEC's baton. In the savings and loan scandals of the 1980's, both the Federal Deposit Insurance Commission and the Office of Thrift Supervision sued national law firms, asserting breaches of professional obligations. The Supreme Court rebuffed the former of these efforts, holding that the FDIC's receivership of a failed bank meant that it was unable to hold that bank's lawyers accountable for conduct that the bank itself could not. *See O'Melveny & Myers v. FDIC*, 512 U.S. 79, 86 (1994). But the OTS was markedly more successful in other cases. *See OTS v. Kaye, Scholer, Fierman, Hayes & Handler* (after freezing firm's assets, case was settled for $41 million); Rita Hanley Jensen, *Jones Day: Behind the Settlement*, NAT'L L.J. (July 5, 1993) (reporting $51 million settlement); *see also Lincoln Savs. & Loan Ass'n v. Wall*, 743 F. Supp. 901, 919 (D.D.C. 1990) ("What is difficult to understand is that with all the professional talent involved [in this case], why at least one … would not have blown the whistle….).

21 In 2001, the ABA again refused to allow disclosure of conduct "reasonably certain to result in substantial injury to the *financial interests or property* of another." *See* ABA/BNA Lawyers' Manual on Professional Conduct, Conference Report (Aug. 15, 2001) (emphasis added). A recent task force report, however, recommends the Bar reconsider this position. *See infra* ____.

22 To like effect, if somewhat less restrictive, is Section 67 of the Restatement of the Law Governing Lawyers, which puts the continued confidentiality of client information at the lawyers' discretion, whenever the lawyer knows that his services will be used in the commission of a future crime or fraud, or, if the crime or fraud has already occurred, whenever disclosure can "prevent, rectify, or mitigate" the loss. More restrictively, however, this provision requires the lawyer to first, "if feasible, make a good faith effort to persuade the client not to act," or "advise the client to warn the victim or to take other action to prevent, rectify, or mitigate the

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BACK TO THE FUTURE: SECTION 307

As the securities laws entered the twenty-first century,[23] they were presented almost immediately with the wave of scandals now no doubt intensely familiar to the reader: Enron, WorldCom, Adelphia, Xerox, and others. The investing public did not just come down from the booming market of the few years before, but crashed among reports of cooked books and renegade corporate officials. Lawyers were inevitably involved, and may have even aided the execution of their client's frauds. To date, the entirety of the facts has not yet been made public.

Sensing a need for action, a group of law professors proposed that Congress at last settle the ongoing score of the dispute between the Commission and the Bar. Sarbanes-Oxley was already under consideration when Senator Edwards proposed the addition of what is now Section 307, requiring the Commission to issue rules on the professional obligations of attorneys who practice before it. In so doing, Senator Edwards noted that

> it is time to remind corporate lawyers of their legal and moral obligations – as members of the bar, as officers of the courts, as citizens of this country. The American Bar Association ought to take a leading role here, something they have not done thus far.[24]

After its enactment (a total of three votes were cast against it, all in the House of Representatives), Chairman Pitt endorsed that purpose: "The underlying principle of Sarbanes-

(…continued)

loss." The Restatement also requires a disclosing lawyer to "if feasible, … advise the client of the … ability to use or disclose information."

23 Since *Carter and Johnson*, very few SEC cases against lawyers have been brought. One of the few was *SEC v. Fehn*, where the Commission sued an attorney for his role in filing incomplete quarterly reports, noting that "[a] lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand" and endorsing the *National Student Marketing* view that "[l]awyers are not free to ignore the commercial substance of a transaction which could obviously be misleading to stockholders and the investing public." *SEC v. Fehn*, 1994 U.S. Dist. LEXIS 8204, at *34-*35 (D. Nev. Apr. 6, 1994) (citing and quoting *SEC v. Frank*, 388 F.2d 486, 488 (2d Cir. 1968) and *SEC v. National Student Marketing Group*, 402 F. Supp. 641, 647-48 (D. D.C. 1975)). In another, the Commission affirmed an administrative law judge's finding that a prominent partner at a large New York firm was responsible for his client's failure to file a disclosure statement in accordance with law. *See* In re *George C. Kern, Jr.*, Exchange Act Rel. No. 29,356 (June 21, 1991); *Kern* Admin. Proceeding File No. 3-6869 (Nov. 14, 1988); *see also* In re *John H. Gutfreund*, 51 S.E.C. 93 (Dec. 3, 1992) (legal officers who learn of misconduct by their employer or co-worker are "obligated to take affirmative steps to ensure that appropriate action is taken to address the misconduct"). As these suits waned, an SEC commissioner opined that guiding principles on these questions remained "elusive" and "hard to come by." Norman A. Johnson, *Suits Against Lawyers* (ABA Federal Securities Law Committee Nov. 8, 1996).

24 *See* Cong. Rec. S5652 (June 18, 2002). Mr. Van Hoey has recognized essentially the same problem, and outlined how the Commission might alternatively utilize theories of "causing" liability in this regard. *See* Gregory Van Hoey, Note, *Liability for "Causing" Violations of the Federal Securities Laws: Defining the SEC's Next Counterattack in the Battle of* Central Bank, __ WASH. & LEE L. REV. __ (2003). With Sarbanes-Oxley, Congress has endorsed the inclusion of law practice in the Commission's domain, putting his hypothesis on even firmer ground.

Oxley is unassailable – attorneys must be vigilant in protecting the interests of their true clients," or the shareholding public.[25]

The rules subsequently proposed by the SEC reflect a continuing debate. In large measure, they track the common law duties lawyers have arguably had for ages, even if not always acknowledged by the Bar.[26] If the rules take effect, lawyers for issuers will be obliged to:

- report "evidence of a material violation of the securities laws, a material breach of fiduciary duty, or a similar material violation," all the way "up the ladder" – to the company's chief counsel or the CEO, and, if those officials fail to "appropriately respond to the evidence," to the audit committee or, ultimately, to the full board of directors;[27]
- report the same violations to the Commission directly, if disregarded by all pertinent representatives of the client;[28] and
- effectuate, under some circumstances, a so-called "noisy withdrawal," whereby the lawyer publicly disaffirms his clients' submissions to the SEC.[29]

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25 *See Pitt Lauds Principle of New Mandate for Lawyers to Report Securities Violations*, 34 BNA Securities Regulation & Law 1374, 1374 (Aug. 19, 2002) (reporting August 12 ABA Business Law Section Meeting). In the same speech, Pitt also indicated that the SEC might use its new authority under Sarbanes-Oxley to require an attorney to disgorge fees, when those fees were earned in the course of some offending representation. *Id.*

26 *See infra*, at ___. The primary precedent the Commission cites for its actions is, of course, *Carter and Johnson*. *See* Proposed Rule, at ___.

27 *See* Proposed Rule § 205.3(b); *id.* § 205.2(i) (defining "material violation"). In preliminary reports, the Commission indicated that this duty would instead be triggered when a lawyer "reasonably believes" that a material violation of law has occurred, is occurring, or is about to occur. *See SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys*, SEC News Digest (Nov. 6, 2002). The Proposed Rules point out that either standard is more demanding than the parallel ABA rule, Model Rule 1.13, "applicable only when the attorney *knows* that a violation is occurring or going to occur…." Proposed Rule, at ___ (emphasis in original). According to the Commission, this "appears to set too high a standard for reporting." *See id.*

28 *See* Proposed Rule § 205.3(d)(1). This requirement assumes that the securities violation at issue "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 investors." *Id.* Other than the vague contemplation of "rules [] in the public interest and for the protection of investors," the statute itself does not authorize this particular requirement. *See* 15 U.S.C. § 7245. The proposed rules candidly acknowledge this, but the Commission justifies the addition as an "important component[] of an effective 'up the ladder' reporting system." *See* Proposed Rule, at ___ ("the proposed rule incorporates several corollary provisions that are not explicitly required by Section 307").

29 Although not all withdrawals will entail the disclosure of client information, the proposed rules indicate that those that do will not breach the attorney-client privilege. *See* Proposed Rule § 205.3(b)(1); *id.* § 205.3(e). The rules do not, however, indicate exactly how the Commission will persuade attorneys, clients, or state disciplinary agencies that is so. The proposed rules also threaten privilege in another alarming way, by requiring that a reporting attorney "take steps reasonable under the circumstances to document the report[s] and the response[s] thereto, and … retain such documentation for a reasonable time." *Id.* § 205.3(b)(2). The proposed rules contemplate that this documentation may be reviewed by third parties – specifically, the Commission itself. *See* Proposed Rules, at ___ ("documentation will protect the attorney in the event his or her compliance with the proposed rule is put at issue in some future proceeding").

Significantly, these rules extend to all lawyers who "appear[] and practic[e] before the Commission," very broadly defined. Not only will the standard reach all attorneys who deal with the Commission directly, it will also encompass those who "prepar[e], or participate in the process of preparing," to whatever extent, any material which the attorney has "reason to believe" will appear in any communication, oral or written, to the SEC or its staff.[30] Subordinate attorneys, as well as supervisory ones, are subject to the rules.[31]

SOME PRECEDENT: ACCOUNTANTS

However extensive, the pedigree of these various requirements is demonstrable and bona fide. A professional responsibility to disclose misdeeds has been long embraced by accountants. Many of the major corporations already discussed have announced "restatements" over the last year, despite that no express provision of the securities laws requires them. Nevertheless, it is generally recognized – and almost universally accepted – that each of these companies has acted out of an established legal obligation. Indeed, there is no appreciable body of law that even challenges that proposition. The lesson of restatements helps to show where lawyers have previously come up short.

The surprising origin of restatements is the literature and guidance that the accounting profession has voluntarily provided – in marked contrast to the organized Bar – to its own members.[32] Although the accounting profession has been justly criticized for failing to fulfill

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30 *See* Proposed Rule, at ___; Proposed Rule § 205.2(a); *see also Sarbanes-Oxley Act Question of the Week*, 36 BNA Corporate Counsel Weekly 285 (Sept. 18, 2002). The proposed rules ascribe somewhat different duties to in-house counsel than they do to outside lawyers, exhibiting the Commission's view that "attorneys employed by an issuer face greater potential obstacles to compliance, and [that] the personal cost of compliance to an attorney employed by the issuer is greater." *See SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys*, SEC News Digest (Nov. 6, 2002); *compare, e.g.*, Proposed Rule § 205.3(d)(i) *with* Proposed Rule § 205.3(d)(ii).

31 *See id.* §§ 205.4-205.5.

32 *See, e.g.*, AICPA No. 41 ¶9 (1967). When an accountant's client declines to restate its earnings, this provision provides that

> the auditor should take the following steps to the extent applicable: (a) Notification to the client that the auditor's report must no longer be associated with the financial statements; (b) Notification to regulatory agencies having jurisdiction over the client that the auditor's report should no longer be relied upon; (c) Notification to each person known to the auditor to be relying on the financial statements, that his report should no longer be relied upon.

It proceeds to recognize that

> [i]n many instances, it will not be practicable for the auditor to give appropriate individual notification to stockholders or investors at large, whose identities ordinarily are unknown to him; notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the auditor to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure. The Securities and Exchange Commission and the stock exchange are appropriate agencies for this purpose as to corporations within their jurisdictions.

Id.

many of its professional obligations in the last few years, one of the principles it can clearly take credit for is the notion that accountants must professionally *disassociate* themselves from any statement that might be attributed to them, or with which they might be professionally associated, if they know that the statement is no longer correct and that the public may still be relying on it.[33] An earlier series of court cases placed this duty in the "common law," as summarized in the important decision of *Fischer v. Kletz*:

> The common law has long required that a person that has made a representation must correct that representation if it becomes false and if he knows people are relying on it. This duty to disclose is imposed regardless of the interest of defendant in the representation and subsequent nondisclosure.[34]

Congress first confronted this notion in 1995, when it added Section 10A to the Securities Exchange Act of 1934. That provision, enacted as part of the Private Securities Litigation Reform Act, mandates that issuers' outside auditors work in compliance with standards issued by the SEC, in addition to Generally Accepted Accounting Principles; that the auditors report all but the most inconsequential illegal acts to the issuers' audit committee of the board of directors; and that the auditors resign, notifying the SEC of both the resignation and the reasons for it, if the issuer refuses to cease its illegal activity. In some ways, Section 307 of Sarbanes-Oxley extends Section 10A to lawyers.

Likewise, Section 307 also extends to lawyers the common law principle Section 10A reflects. To some extent, the ABA addressed these common law principles when it established standards guiding a "noisy withdrawal": while a noisy withdrawal is permitted when a lawyer knows her work is involved in a client's current or future commission of a fraud, it is prohibited if the fraud has ceased.[35] Section 307 and the proposed rules go a step further in removing this latter limitation.[36]

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33 *See National Student Marketing*, Compl. ¶48(h)-(i). After failing to "refuse to issue their opinions" about the actual transaction at hand, as well as failing to "insist that [their clients'] financial statements be revised and shareholders be resolicited" in light of the fraudulent deal, the lawyers named in the complaint allegedly violated the law by not "ceas[ing] representing their respective clients and, under the circumstances, notify the plaintiff Commission" what their clients had done. On the other hand, the case against the accountants was more concrete, as the complaint asserted that they breached "*their professional obligation* to insist that the [clients'] financial statements be revised …, and, failing that, to withdraw from the engagement and to come forward and notify plaintiff Commission *or the [clients'] shareholders*" about the fraud. *See id.* (emphases added).

34 *Fischer v. Kletz*, 266 F. Supp. 180, 188 (S.D.N.Y. 1967); *see also International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806 (4th Dist. 1986); *Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983); *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931).

35 *See* ABA Commission on Ethics and Professional Responsibility, Formal Op. No. 92-366 (1992).

36 *See supra*, at ___ (discussing noisy withdrawal under Section 307 and proposed rules).

WHAT IT ALL MEANS AND WHAT MIGHT COME

The additional duties codified by Sarbanes-Oxley are also significant in light of the current model ethical rules, in that they are independent of the potential consequences of a violation, as well as the probability that those consequences might occur. In addition, Section 307 eliminates a great deal of discretion on the part of attorneys involved.[37] It appears that, with the passage of Sarbanes-Oxley, at last Congress has lost its patience with the Bar; with its expansive rules, the same is assuredly true of the Commission as well.[38] As the president of the District of Columbia Bar has already observed, Section 307 is truly a "wake-up call to the profession."[39]

To its credit, the ABA has recently formed a "Task Force on Corporate Responsibility," which, about the time Sarbanes-Oxley was emerging, issued its preliminary report.[40] In the main, this task force was charged with "examin[ing] the framework of laws and regulations and ethical principles governing the roles of lawyers." The report recognized the need to "significantly enhance corporate governance practices and ethical principles." And that report has made firm proposals in that regard, including proposed amendments to Rule 1.6 and three other related Rules of Professional Conduct. Encouraging the ABA to finally "permit disclosure to prevent or rectify the consequences of a crime or fraud in which the client had used or was using the lawyer's services," the task force

> further recommends … mak[ing] disclosure mandatory, rather than permissive, in order to prevent client conduct known to the lawyer to involve a crime, including violations of federal securities laws and regulation, in furtherance of which the client has used or is using the lawyer's services, and which is reasonably certain to result in substantial injury to the financial interests or property of another.

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37 The Commission has already asserted that its proposed rules "embody standards of conduct that legal commentators and the American Bar Association have been considering for years, and are similar in important respects to ethical rules that have already been enacted in a number of jurisdictions." *See SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys*, SEC News Digest (Nov. 6, 2002).

38 *See* George W. Jones, Jr., *Federal Regulation of the Practice of Law: Unthinkable?*, WASH. LAWYER (Oct. 2002), at 6. This "wake-up call" will have the valuable practical benefit of harmonizing ethical standards across jurisdictions, especially those where there is a substantial securities practice. Prominently, conduct that has been required in New Jersey – a state which has, on its own initiative, rejected the limits of the ABA's recommended rules – has as a result been forbidden in New York. *Compare* N.J. Rule of Professional Conduct 1.6(b) ("shall disclose") *with* N.Y. Code of Professional Responsibility § 1200.33(b)(1) ("shall … [not] reveal"). As a result, as Mr. Jones also points out, "Section 307 … suggests that federal preemption of legal ethics rules is no longer unthinkable." Jones, at 6. While a fascinating and important topic (and another one the SEC would be wise to consider in the months ahead), a long discussion of the consequences of a federal common law of ethics is, unfortunately, beyond the scope of this piece.

39 *Id.*

40 *See Preliminary Report of the American Bar Association Task Force on Corporate Reponsibility* (July 16, 2002).

These recommendations condemn the current rules as "more out of step" with public policy than ever before, and herald a "public demand that lawyers play a greater role in promoting corporate responsibility."[41]

This task force report is a sign of progress. As this article has detailed, the Bar has a long track record of simply ignoring efforts by the SEC (or, less frequently, other government agencies or organizations) to prod its members to accept standards of conduct that not only fellow professions have long assumed they have, but that are in fact not as unfamiliar to lawyers as they have often thought. Perhaps Section 307 has reduced some negotiating room the Bar has had in the past, finally forcing the Bar's hand.

Regardless, Section 307 and the proposed rules will sharply test the Bar's resolve. They put both the Bar and the Commission at a crossroads, and the reaction of both will be telling. Will the Bar again "defend itself against the emerging trends by reliance upon old shibboleths and axioms"?[42] Will, perhaps, "doing nothing seem[] the least imperfect course"?[43] Will the Bar embrace, and perhaps even expand, the principles of Sarbanes-Oxley? Or will it resist them at every turn? To be sure, the Commission has obligations as well. Will it administer its rules judiciously? Will it, as it promises, ensure that its rules neither "impair zealous advocacy" nor "discourage issuers from seeking and obtaining effective and creative legal advice"?[44] Clearly, the "documentation" requirement of the new rules does not suggest that the SEC will jealously guard the heart of the attorney-client privilege. Further, it appears the Commission has too lightly considered the implications of its rules on maintaining the privilege in any manor of contexts; this complicated concept is not easily reconciled with the SEC's proposals. Whether the SEC's chosen approach can avoid inhibiting a free and trusting attorney-client relationship remains an open – and fundamental – question.

Such persistent issues ensure that this saga will not soon end. The obligations of attorneys promise to remain a sharp focus for heated continuing debate. The judgment and discretion of the SEC and its staff will be critical to any meaningful step forward.

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41 In this vein, the task force also recommends that the prohibition against lawyers "knowingly" assisting criminal or fraudulent behavior include a "reasonably should know" standard as well.

42 A.A. Sommer, *The Emerging Responsibilities of the Securities Lawyer*, CCH Transfer Binder ¶79,361 (Feb. 6, 1974). Sommer characterized this response as "serious error," and predicted at the time that "[s]ociety will not stand for it." *Id.*

43 2 American Law Inst., Federal Securities Code 832 (1980).

44 Proposed Rules, at ___.