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Washington, D.C. 20549

Standards of Professional Conduct

Dear Mr. Eisenberg:

Under Section 307 of the Public Company Accounting Reform and Corporate Responsibility Act of 2002, 15 U.S.C. §7245, the Securities and Exchange Commission is required to issue, by January 24, 2003, "rules...setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers." This submission offers some views on what those rules should contain.

Section 307 explicitly imposes an obligation on the Commission to make and enforce national rules in an area that the Commission, deferring to the views of the organized bar, has in recent years viewed as presumptively committed to the control of state bar regulators and state courts. That presumption is now authoritatively rejected.

Section 307 also requires abandoning any presumption that the professional standards formulated by national and state bar organizations necessarily define the appropriate standard of practice for lawyers representing issuers before the Commission. This is, of course, implicit in the directive to formulate new rules, but it is also explicit in the language of the statute. Unlike the professional codes, which are famous, if not notorious, for privileging the interests of the private lawyer's client over those of non-clients and the general public, the Section 307 rules are expressly required to be "in the public interest and for the protection of investors"–that is, for the protection of non-clients. The rules adopted should be optimized to promote the investor protection goals of the Federal securities laws.

Finally, though Section 307 seeks to vindicate the public interest in compliance with laws protecting shareholders and other public investors, the language and context of the statute both indicate that the preferred mechanism for achieving compliance is to activate mechanisms, internal to the issuer, through which the issuer and its managers can fulfill their obligations to ensure compliance with governing law. The text of the statute makes this point through its explicit focus on the lawyer's obligation to ensure that violations of law are reported to senior corporate officials and, if necessary, to the issuer's board. Many other provisions of the statute share the same emphasis on creating both opportunities and incentives to encourage corporate directors and

officers to exercise their responsibilities to ensure the lawfulness of acts by the corporation and its agents.

Against this background, the Commission should consider the following issues.

1. Coverage of the Rules. The statute calls for coverage of any lawyer who participates "in any way" in the representation of an issuer in connection with the compliance of the issuer or its agents with federal securities laws, with state law of fiduciary duty, presumably including duties of competence and loyalty, and with related federal and state laws aimed at the protection of investors. The rules should explicitly specify that this coverage includes in-house lawyers directly employed by the issuer and partners and associates of law firms acting as counsel to the issuer. There may well be grounds, however, for imposing different obligations on different classes of lawyers, based upon their degree of involvement with the relevant transaction, their seniority or lack thereof, or the extent to which they have management responsibility for the conduct of other lawyers.

2. Reporting of Violations. The statute expressly requires the enactment of a rule spelling out the lawyer's obligation to ensure that the corporation and its Board fulfill their obligations to comply with the law. Some aspects of the rule are explicitly governed by the statutory language. Others require elaboration or fleshing out. In suggesting how the Commission's reporting rule should be drafted in light of the statute, it will be helpful at several points to contrast the statutory solution with the approach adopted by the American Bar Association in Rule 1.13 of the Model Rules of Professional Conduct and by the Commission itself in In re Carter and Johnson, Exchange Act Release No. 17,597 (1981).

A. Violations of What Laws? The statutory language lists violations of "securities law," breach of fiduciary duty, or a "similar violation" whether committed by an issuer or an agent. Clearly, this encompasses breaches of federal securities law and state law breaches of fiduciary duty. It should be noted that one of management's fiduciary obligations is to exercise a monitoring role to ensure the corporation is in compliance with law. Accordingly, management's failure to correct violations of laws other than the federal securities laws should, under appropriate circumstances, be considered a violation of fiduciary duty for purposes of the Commission's rule.

The argument that state securities law violations are covered also seems very strong. State securities law is encompassed within the meaning of the term "securities law." Moreover, the statute already contemplates the enforcement of state fiduciary duties. Finally, state securities violations would appear to be the classic example of a violation "similar" to those already expressly enumerated.

The final question is what else falls within the definition of "similar violation." The most probable candidates for inclusion here are the rules of the major stock exchanges, particularly when they parallel in their design the provisions of federal and state law that the clearly are covered by the statute. These organizations operate under the direct supervision of the Commission, and their rules are approved by the Commission, placing their rules in many ways on a par with the Commission's own rules.

Consistent with the regulatory focus of the 2002 Act, the subject matter coverage of the statute is narrower that Model Rule 1.13, which is drafted to cover all areas of corporate representation including some that have nothing to do with the Commission's jurisdiction. But the scope is markedly broader than the rule established in the Carter and Johnson matter, which extended only to violations of the "disclosure requirements of the federal securities laws."

B. How Serious Must the Violation Be to Trigger An Obligation to Report? The statute refers to "material violations." The statute thus adopts an external perspective–that of the investor. On this view, the obligation to report would be triggered by a violations of law or fiduciary duty when "there is a substantial likelihood that a reasonable shareholder would consider it important" in evaluating his investment. Cf. Basic Inc. v. Levinson, 485 U.S. 224 (1988).

Such a standard would cover all violations of relevant federal laws involving material misstatements or failures to disclose. But it would also provide a way of identifying a class of other violations that, if uncorrected, invariably merit discussion with senior management. The materiality of a violation in this second sense would be determined by factors to which an investor would be likely to give weight, including the gravity of the offense, the actual or threatened harm to the issuer, investors, or the general public, and the extent to which non-compliance is isolated or reflects a potentially recurring structural or cultural weakness in the corporation's internal compliance mechanisms.

This measure of severity reaches more broadly than that adopted in Rule 1.13 or in Carter and Johnson. Model Rule 1.13 imposes an obligation to report only those violations of law that are "likely to result in substantial injury to the organization." The implication is that even very serious violations of law do not trigger the violation if the only resulting injury is likely to be to outsiders. In contrast, the statute's coverage plainly includes violations which, though they do not meet Rule 1.13's standard for harm to the organization, are nonetheless "material" because of their importance to or impact upon investors. Carter and Johnson's reporting obligation extends only to "substantial and continuing failures" to comply with the law. On the analysis offered here, the Carter and Johnson standard would be abandoned for non-compliance with disclosure obligations, which would ipso facto be "material" in the sense envisioned in the statute. Moreover, while the Carter and Johnson factors would be relevant in deciding when other types of violation of law, such as breaches of fiduciary duty, are "material," they would not be necessary to establish such a violation: for example, a serious breach of fiduciary obligation would not have to be "continuing" in order to be "material" in the statutory sense.

C. What Standard of Scienter Should Trigger the Lawyer's Obligations under the Rule?

Under the statute the reporting obligation is triggered by the lawyer's having "evidence" of a violation. Left open is the degree of awareness of, and confidence of, the existence of a violation that the "evidence" must provide.

Prior law in this area has typically premised the lawyer's duty to act on "knowledge" of a violation. See, e.g., Model Rule 1.13 (lawyer "knows"); cf. Carter and Johnson (liability based on "awareness" of a "substantial and continuing" failure to comply). A knowledge standard suggests that the lawyer has a duty to act only when there is no non-frivolous factual or legal argument that

the conduct is lawful. The statute's use of the term "evidence" points to a lower standard of scienter. It would be a mistake, however, to read the statute as enacting a negligence or due diligence standard with respect to the underlying financial information. Such review would require lawyers to duplicate, though less effectively, the work already being done by accountants. Cf, Painter & Duggan, Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation, 50 S.M.U. L. Rev. 225, 260-61 (1996).

An intermediate position would interpret the term "evidence" to require lawyer action when the lawyer believes that it is more probable than not that a material violation is occurring, even though there is a non frivolous argument that the conduct is lawful. Such a standard would not prevent the corporation from testing the limits of the law by taking action on the basis of a legitimate, though probably ultimately losing, view of what the law requires. It would, however, ensure that before any such test occurs, actions which probably involve a material violation are reviewed by senior officials of the corporation. This result is consistent both with the investor protection goals of the statute and with corporate officials' fiduciary obligations to ensure that the corporation obeys the law. Indeed, one way of reading the statute is that it places the shared interest of investors and independent directors in compliance with the law ahead of the preference of lower level corporate managers to monopolize the power of decision.

D. Under What Circumstances Should The Lawyer Insist Upon Communicating with the Board of Directors?

The statute states that if the lawyer fails to obtain an appropriate response to his report from the General Counsel or the Chief Executive Officer, he must take the matter to either to a committee composed entirely of independent directors or to the Board as a whole.

What constitutes an appropriate response that would terminate the obligation to report short of the Board? A first possibility is that the person to whom the report is made may initiate further investigation, research or discussion which persuades the lawyer that the conduct with which he is concerned is more probably than not legal. A lawyer who is persuaded that conduct which he initially judged to be probably unlawful is instead probably lawful cannot properly be sanctioned for failing to pursue the matter further. Such changes of view are more defensible when advice leading to the change comes from lawyers who are more experienced or knowledgeable in the relevant area of practice than the lawyer who initially made the report. Cf. Model Rule 5.2 (permitting junior lawyers to defer in some circumstances to senior lawyers on issues of ethical judgment).

The statute also lists "appropriate remedial measures" as a possible response. The most important remedial measure, which should be listed explicitly in the rule, is an express directive forbidding the unlawful conduct at issue, or, if it has already commenced, ordering that it cease at once. If the lawyer fails to receive a response sufficient to provide him with reasonable confidence that the conduct in question is probably lawful or that the conduct has ceased or will promptly do so, the obligation to report to the Board should arise.

E. What if the Board Does Not Act?

Under well-accepted ethics principles, a lawyer whose advice that conduct is unlawful is rejected by a corporate client may resign, and must do so if continued service in the matter would necessarily entail unlawful assistance in a crime or fraud.

The harder question is whether the lawyer should be free to disclose the client's wrongful conduct when it threatens harm to innocent persons. This issue has been hotly contested for more than 20 years. Current state law in most states gives lawyers discretion to disclose ongoing or intended criminal conduct, including fraudulent conduct that can be punished as a crime, and a couple of states require such disclosure. At a minimum, the Commission should make clear its endorsement of such a power to disclose.

Conversely, most states do not permit the disclosure of a past or ongoing civil fraud, even if the harm is ongoing and the client has used the lawyer as an unwitting instrument in the commission of the fraud. And this is so even though the attorney-client privilege ordinarily would not protect against compelled disclosure of such information. Under the crime-fraud exception to the privilege, there is no protection against compelled disclosure for lawyer-client communications to or from a client who uses the lawyer's advice or services in order to engage in a crime or fraud. The result reached by most states is thus very difficult to defend in terms of an account of attorney client confidentiality that stresses its contribution to compliance with law and simply impossible to defend within the public interest/investor protection framework of Section 307.

The strong consensus among disinterested scholars and judges who have studied the problem, including at least three ABA Ethics Task Forces and the Reporters of the Restatement of the Law Governing Lawyers, is that discretionary disclosure of civil fraud should be permitted where the lawyer's services are being or have been used and the threatened financial harm is substantial. See, e.g. Restatement (Third) of the Law Governing Lawyers §67 (2000).

I believe that the proper course for the Commission is to adopt a federal rule that permits disclosure following the rejection of the lawyer's advice to the Board in the class of cases identified in Restatement §67. This would mean that on some occasions where the Board rejected the lawyer's advice the lawyer's only permitted response would be withdrawal. But in cases involving use of the lawyer's services and substantial avoidable harm, disclosure would be permitted. The law of the crime-fraud exception to the privilege, the weight of scholarly and judicial opinion, and the investor protection thrust of Section 307 all point in this direction.

Were the Commission to adopt such a rule, it would be necessary for the Commission also to spell out that the rule would preempt inconsistent state laws and state criminal civil, or disciplinary liability based upon those laws.

F. Measures to Encourage Compliance with the Reporting Rules.

The difficulty in making any duty to report effective is that it requires the lawyer to go over the heads of the businessmen and senior in-house lawyers who make the day to day management decisions on the hiring and compensation of both retained and in-house counsel. Correctly or

incorrectly, lawyers faced with a reporting obligation are likely to perceive that reporting a violation, to senior insiders or especially to the Board, creates a significant risk of getting no new business, or, in the case of an in-house lawyer, of being shunted aside or replaced as soon as a convenient pretext arises. The risk will seem larger in those states that do not allow attorneys to bring a cause of action for wrongful discharge. The danger, then, is that lawyers will report only in those cases where they think that the jig is already up for current managers and there is nothing to be gained by continuing to stand with them. By then, however, it will usually be too late to prevent harm to investors.

One way to deal with this problem would be to set and enforce extremely severe penalties for failure to report. But if detection of failures to report occurs only infrequently (for example, only after major financial debacles), it may be difficult to set sanctions high enough to offset the perceived risk of losing one's job. Moreover, there is a natural limit on the ability to pursue this strategy. It would be unfair, and inconsistent with doctrine in other areas of law, to punish lawyers who fail to prevent wrongdoing more severely than those who have actively engaged in it.

A number of steps to minimize this problem are worth considering. A first step would ensure that the rules regulating reporting of material unlawful conduct are harmonized with those relating to reporting of financial irregularities. Thus, at both the senior corporate and the board level, the issuer should be required to establish procedures for "receipt, reception and treatment" of Section 307 reports and for preserving confidentiality with respect to those reports comparable to that which issuers are already required to establish for financial complaints under Section 301 of the Act, 15 U.S.C. §78f(m)(4)(A)(B). In addition, the rules should make clear that attorney reports under Section 307 are fully covered by the anti-retaliation provisions of Section 806, 18 U.S.C. §1514(A). Finally, it would make sense for the issuer to be required to include some discussion of legal controls in the annual management discussion of internal controls required by Section 404 of the Act.

A second step, consistent with the approach taken by many states in regulating lawyer conduct, would be to include a rule requiring that supervisory lawyers in relevant organizations make reasonable efforts to ensure the organization has in effect measures giving reasonable assurance that lawyers will comply with their obligations under the reporting rules (as well as under any other rules the Commission should choose to promulgate.) Cf. ABA Model Rule 5.1. Such obligations should be imposed both on in house counsel for issuers and on partners or other managerial lawyers in outside law firms practicing before the Commission. There is much to be said for a further requirement that in-house counsel of issuers and managing partners of law firms certify to the Commission, on an annual basis, that such efforts have been undertaken and such measures are in place.

More generally, the Commission should consider what other steps might be taken to strengthen the independence of lawyers advising on compliance issues, and in particular of in-house general counsel. Among the measures worth considering is a requirement that the audit committee be consulted with respect to personnel and compensation decisions for senior in-house lawyers.

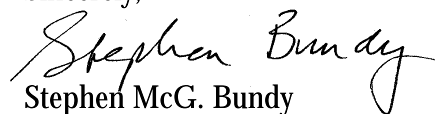
3. Other Rules. The statute does not specify what other professional rules the Commission should consider adopting. One valuable additional step the Commission could take would be to rationalize the conflicting judicial pronouncements on aiding and abetting liability for attorneys.

Concern on the part of some courts that federal aiding and abetting liability would lead to catastrophic financial liabilities or unwarranted reshaping of state ethics rules has produced some indefensible results. Since private damage liability for aiding and abetting is effectively shelved, at least for now, and since Congress has given the Commission twin mandates to enforce Federal aiding and abetting standards and to make ethical rules of national application, there is good reason for the Commission to clarify the standards that it will apply in enforcement actions and professional discipline. In particular, there would be real value in setting out the Commission's approach as contrasted with the views expressed in cases like Schatz v. Rosenberg, 943 F.2d 485 (4th Cir. 1991) and SEC v. National Student Marketing Corp., 457 F.Supp. 682 (D.D.C. 1978).

I would suggest the following formulation for the disciplinary offense: a lawyer may not knowingly or recklessly provide significant assistance in conduct violating the federal securities laws. The rule should make clear, as Schatz and National Student Marketing do not, that drafting papers or issuing an opinion that is contractually required to close the transaction are both forms of prohibited assistance. The rule should also make clear that failure to advise explicitly that conduct is illegal, in circumstances where the lawyer has a professional duty to do so, can also constitute forbidden assistance.

I wish the Commission the best in this important effort. Please do not hesitate to contact me if I can provide clarification or further assistance.

Sincerely,



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