

## Reflections Upon SEC Standards of Professional Conduct

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### I. INTRODUCTION

This article considers ambiguities and challenges faced by attorneys in meeting the requirements of the reporting and “appropriate response” rules of professional responsibility under the Sarbanes-Oxley Act<sup>1</sup> (SOX) section 307 and the Securities and Exchange Commission (SEC or Commission) Rules implementing that section.<sup>2</sup> It primarily focuses and reflects upon portions of Professor Marc I. Steinberg’s article, which appears in this issue, where he highlights some particularly knotty issues currently confronting practitioners.<sup>3</sup>

Section 307 provides:

Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—

- (1) requiring an attorney 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); and
- (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 [hereinafter SOX] (codified as amended in scattered sections of 15 U.S.C.).

2. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. pt. 205 (2006).

3. Marc I. Steinberg, *The Corporate/Securities Attorney as a “Moving Target” – Client Fraud Dilemmas*, 46 WASHBURN L.J. 1 (2006).

issuer, or to the board of directors.<sup>4</sup>

The reader should note that the SEC Rules (the Rules) contain important definitions of terms pertinent to the interpretation and implementation of section 307 such as, “appearing and practicing before the commission,” “appropriate response,” “breach of fiduciary duty,” “evidence of a material violation,” “issuer,” “material violation,” “qualified legal compliance committee,” “reasonable or reasonably,” “reasonably believes,” and “report.”<sup>5</sup> As elaborated below, applying some of these definitions is fraught with difficulty.

The reader should also note that the Rules express the important point that “[a]n attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization.”<sup>6</sup> They further state: “[t]hat the attorney may work with and advise the issuer’s officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney’s clients.”<sup>7</sup>

## II. THE REPORTING OBLIGATION

Under the Rules,

[i]f 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 (or the equivalent thereof).<sup>8</sup>

In the alternative, the attorney may report “to both the issuer’s chief legal officer [(CLO)] and its chief executive officer [(CEO)] (or the equivalents thereof) forthwith.”<sup>9</sup>

The reporting requirement applies to attorneys providing legal services for “an issuer[] regardless of whether [they are] employed or retained by the issuer.”<sup>10</sup> A covered attorney is restricted, however, to one “appearing and practicing before the commission.”<sup>11</sup> This latter phrase is broadly defined as follows:

(a) *Appearing and practicing* before the Commission:

(1) Means:

(i) Transacting any business with the Commission, including

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4. SOX § 307 (codified at 15 U.S.C. § 7245).

5. 17 C.F.R. § 205.2 (2006).

6. *Id.* § 205.3(a).

7. *Id.*

8. *Id.* § 205.3(b)(1).

9. *Id.* The Rules refer to the Chief Legal Officer (or the equivalent thereof). For convenience, this article refers to this position as “CLO.” The Rules also refer to the Chief Executive Officer (or equivalent thereof). For convenience, this article refers to this position as “CEO.”

10. *Id.* § 205.2(g).

11. *Id.* § 205.1.

communications in any form;

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2) Does not include an attorney who:

(i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii) Is a non-appearing foreign attorney.<sup>12</sup>

The Rules provide that if a covered attorney “becomes aware of evidence of a material violation” as described above,<sup>13</sup> the report is to be made forthwith.<sup>14</sup> Is the determination to be made by the covered attorney easy or difficult? At times it may be difficult—at other times easy. The Rules provide in an unhappily worded sentence that: “[e]vidence of a material violation means 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 ongoing, or is about to occur.”<sup>15</sup>

The meaning of various terms in the Rules point to numerous difficulties for a potentially-reporting attorney in determining his or her obligation. First, what is “credible evidence?” In the Adopting Release, the Commission states that the “attorney is not required (or expected) to report ‘gossip, hearsay, [or] innuendo.’”<sup>16</sup> However, reporting must occur if a material violation is reasonably likely and not only when it is

12. *Id.* § 205.2(a). For certain other limits on an attorney's reporting obligation, see section 205.3.

13. *Id.* § 205.3(b)(1); *see also supra* notes 8 and 9 and accompanying text.

14. *Id.* § 205.3(b)(1).

15. *Id.* § 205.2(e).

16. Securities and Exchange Commission, Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release Nos. 33-8185, 34-47276, 79 SEC Docket 1351 (Aug. 5, 2003), at ¶ 42, *available at* <http://www.sec.gov/rules/final/33-8185.htm> [hereinafter Prof. Conduct Release] (alteration in original) (quoting comments of the Association of the Bar of the City of New York).

more likely than not,<sup>17</sup> a fine point indeed. The circumstances referred to in the Rules include a range of factors existing at the time the attorney decides on his or her reporting obligation.<sup>18</sup> According to the adopting release, “circumstances may include, among others, the attorney’s professional skills, background and experience, the time constraints under which the attorney is acting, the attorney’s previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult.”<sup>19</sup> This definition of “circumstances” could broaden or ease the difficulties the attorney faces. For example, the availability of other lawyers with whom to consult may often increase the efforts to be made by the attorney. Furthermore, Professor Steinberg’s article points to a Rule 2(e) (now Rule 102(e)) “proceeding against a law firm” in which “the SEC pointed [to] the firm’s failure to maintain adequate . . . control mechanisms [to] ‘assure[] . . . knowledge of [its] members . . . was communicated to [] persons responsible for preparing disclosure documents so that adequate disclosure of material information . . . within the firm’s knowledge [] was made.’”<sup>20</sup> Such a requirement may result in an increase of information available in the reporting attorney’s assessment.

Additional difficulties for the potentially-reporting attorney arise from the definition of “material violation.” Section 205.2(i) of the Rules states that a “[m]aterial violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.”<sup>21</sup>

One difficulty in determining the existence of a material violation under section 205.2(i) is possible confusion over the phrase “breach of fiduciary duty.” That phrase in the Rules “refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable Federal or State statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.”<sup>22</sup> Since the reporting duty may turn on applicable state fiduciary standards, the application of a federal reporting law may depend on the degree of strictness of fiduciary duty imposed by the relevant state law. This would not seem to be a wise approach for determining the applicability of a federal reporting requirement under SOX where uniformity of law seems desirable. In addition, the absence

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17. *Id.* ¶ 43.

18. *Id.* ¶ 42.

19. *Id.*

20. Steinberg, *supra* note 3, at 10 (quoting *In re Keating*, Muething & Klekamp, Securities Exchange Act Release No. 15982, [1979 Transfer Binder] CCH Fed Sec. L. Rep. ¶ 82,124 (SEC 1979)).

21. 17 C.F.R. § 205.2(i) (2006).

22. *Id.* § 205.2(d).

or uncertainty of case or statutory law in a particular jurisdiction, or nuances in differing state approaches, may inject real difficulty into ascertaining the appropriate reporting responsibility.

The potential complexity of a reporting responsibility determination is illustrated by yet another factor: when is a violation “material?” According to the SEC adopting release, no rule defining “material” was included because the Commission intended for the “well-established meaning under the federal securities law[s] . . . to apply.”<sup>23</sup> The Commission referred to two cases in connection with that well-established meaning: *Basic Inc. v. Levinson*<sup>24</sup> and *TSC Industries v. Northway, Inc.*<sup>25</sup> The following passage from *Basic* should indicate the complexity of determining the materiality issue at least in some cases:

The Court also explicitly has defined a standard of materiality under the securities laws, concluding in the proxy-solicitation context that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” Acknowledging that certain information concerning corporate developments could well be of “dubious significance,” the Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management “simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making.” It further explained that to fulfill the materiality requirement “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context.<sup>26</sup>

In his article, Professor Steinberg refers to the assertion that an issue such as materiality may involve a problematic determination and the potential adverse repercussions that may flow from an incorrect judgment that a material violation has been committed.<sup>27</sup> He indicates that it may be prudent for “counsel who withdraws from representing a client [who is] committing fraud or [engaging in] illegal conduct . . . to do more than ‘quietly’ resign . . . . [I]t may be appropriate for the attorney to inform the SEC [and certain others] of counsel’s withdrawal based [up]on ‘professional reasons.’”<sup>28</sup> He also points to difficulties involved in a “noisy withdrawal.”<sup>29</sup>

Rather than a clear duty to disclose, variations in the “gray” zone often arise. Without the benefit of hindsight, an attorney’s good faith interpre-

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23. Prof. Conduct Release, *supra* note 16, at ¶ 53.

24. 485 U.S. 224 (1988).

25. 426 U.S. 438 (1976); Prof. Conduct Release, *supra* note 16, at ¶ 53 & n.59.

26. *Levinson*, 485 U.S. at 231-32 (citations omitted).

27. Steinberg, *supra* note 3, at 22-23.

28. Steinberg, *supra* note 3, at 19.

29. Noisy withdrawals are further discussed in a later portion of this article. See *infra* Part IV.

tation may prove erroneous. Indeed, public knowledge of an attorney's noisy withdrawal may cause the market price of the subject company's stock to plummet. If counsel is mistaken as to the commission of a material violation (when no such violation exists), claims for attorney malpractice, among others, may ensue.<sup>30</sup>

The reporting rules will result at times in serious challenges to interpersonal and business relations. To begin with, the attorney's report of a potential material violation by any person or persons is likely to be offensive and threatening to those reported on. In addition, the Rules call for a subordinate attorney (that is "an attorney [acting] . . . under the supervision or direction of another attorney [] other than . . . the issuer's [CLO]"<sup>31</sup>) to comply with reporting rules even if the subordinate "acted at the direction of or under the supervision of another person."<sup>32</sup> The subordinate attorney is to report evidence of a material violation to the supervising attorney.<sup>33</sup> Furthermore, if the "subordinate [] reasonably believes [the] supervisor[] . . . to whom he or she has reported evidence . . . failed to comply with [section] 205.3," the subordinate may report under section 205.3(b).<sup>34</sup> In addition, the reporting attorney who believes that the CLO or CEO of the issuer has not provided an appropriate response within a reasonable time has further reporting obligations to "[t]he audit committee of the issuer's board of directors"<sup>35</sup> (or another committee consisting of certain eligible directors),<sup>36</sup> or to "the issuer's board of directors [] if the" previously mentioned committee does not exist.<sup>37</sup> The Rules also allow for alternative reporting procedures to a "qualified legal compliance committee"<sup>38</sup> (QLCC) which may be estab-

30. Steinberg, *supra* note 3, at 19.

31. 17 C.F.R. § 205.5(a) (2006).

32. *Id.* § 205.5(b).

33. *Id.* § 205.5(c).

34. *Id.* § 205.5(d).

35. *Id.* § 205.3(b)(3)(i).

36. *Id.* § 205.3(b)(3)(ii).

37. *Id.* § 205.3(b)(3)(iii).

38. *Id.* § 205.3(c)(1). As defined in the SEC Rules, a qualified legal compliance committee refers to a committee of an issuer (which also may be an audit or other committee of the issuer) that:

(1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));

(2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under § 205.3;

(3) Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in § 205.3(b)(4));

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A) Notify the audit committee or the full board of directors;

lished by an issuer. If such a committee has been established, a reporting attorney would have the option of reporting evidence of a material violation to that committee. The pertinent rule states that the attorney who does so “is not required to assess the issuer’s response to the reported evidence of a material violation.”<sup>39</sup>

### III. APPROPRIATE RESPONSE

Where the reporting attorney has reported to the CLO, the latter “shall cause such inquiry into the” reported violation as the CLO reasonably believes appropriate to determine whether a violation has occurred.<sup>40</sup> If the CLO determines there is no violation, then the CLO shall advise the reporting attorney of the basis for that finding.<sup>41</sup> Unless the CLO reasonably believes there is no violation then “he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof.”<sup>42</sup> Alternatively, the CLO may refer the report to a QLCC.<sup>43</sup>

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(B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C) Retain such additional expert personnel as the committee deems necessary; and

(iii) At the conclusion of any such investigation, to:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

17 C.F.R. § 205.2(k).

39. *Id.* § 205.3(c)(1).

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 may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer’s response to the reported evidence of a material violation.

*Id.*

40. *Id.* § 205.3(b)(2).

41. *Id.*

42. *Id.*

43. *Id.*; see also *supra* note 38 and accompanying text for the definition of “qualified legal compliance committee” (QLCC). In connection with a referral:

A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements under § 205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material violation reported to it under this paragraph (c).

17 C.F.R. §205.3(c)(2).

In situations where the reporting attorney must determine whether the CLO or CEO of the company has provided an appropriate response within a reasonable time, issues to be resolved may prove difficult. If the answer to the question is negative, the reporting attorney must report further up the corporate ladder to the issuer audit committee of the board of directors, if there is one (or to another described committee),<sup>44</sup> or to the board of directors if neither the audit committee nor the other committee exists.<sup>45</sup> Furthermore, if the reporting “attorney reasonably believes . . . it would be futile to report” to the CEO or CLO then those officials can be bypassed in the up-the-ladder procedure.<sup>46</sup>

The potentially difficult issues for the reporting attorney should be evident from the up-the-ladder rules language. Uncertainty may cloud the futility issue relevant to the first step. Deciding if there has been an appropriate response may not only be difficult at times but the decision may have serious implications for future attorney-client relations. The Rules provide:

(b) *Appropriate response* means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3) That the issuer, with the consent of the issuer’s board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii) Has been advised that such attorney 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

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44. *Id.* § 205.3(b)(3)(ii). The other described committee is one composed “solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, ‘interested persons’ as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)).” *Id.* In the event that the issuer has both an audit committee as well as this committee, the Rules provide that the attorney report evidence of the material violation specifically to the audit committee. *Id.*

45. *Id.* § 205.3(b)(3).

46. *Id.* § 205.3(b)(4).

administrative proceeding relating to the reported evidence of a material violation.<sup>47</sup>

The SEC's guidance in this area is particularly problematic. Once again, sometimes difficult materiality determinations may be called for. In addition, assessing the appropriateness of remedial measures may not be easy. Furthermore, section 205.2(b)(3) poses judgment problems for the reporting attorney. The section contemplates two scenarios for the situation where the issuer, with consent from an appropriate body, retains or directs "an attorney to review the reported evidence of a material violation." In the first scenario, the reporting attorney must reasonably believe that the issuer "[h]as substantially implemented any remedial recommendations made by" the reviewing "attorney after a reasonable investigation and evaluation of the reported evidence."<sup>48</sup> A degree of uncertainty is often wrapped into the determinations of reasonableness or substantiality that must be made. In the second scenario, the issuer is advised by the reviewing attorney that the latter "may, consistent with his or her professional obligations, assert a colorable defense" relative to the reported evidence of violation.<sup>49</sup> The word "colorable" is not merely imprecise; it appears to foster minimal expectations with respect to issuer responsibilities. Nor does the Commission's explanation of "colorable defense" in the adopting rules encourage sufficient strictness in issuer behavior. The Commission states:

The term "colorable defense" does not encompass all defenses, but rather is intended to incorporate standards governing the positions that an attorney appropriately may take before the tribunal before whom he or she is practicing. For example, in Commission administrative proceedings, existing Rule of Practice 153(b)(1)(ii), 17 CFR 201.153(b)(1)(ii), provides that by signing a filing with the Commission, the attorney certifies that "to the best of his or her knowledge, information, and belief, formed after reasonable inquiry, the filing is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law." An issuer's right to counsel is thus not impaired where the attorney is restricted to presenting colorable defenses, including by requiring the Commission staff to bear the burden of proving its case. Of course, as some commenters noted, an issuer has no right to use an attorney to conceal ongoing violations or plan further violations of the law.<sup>50</sup>

In its adopting release, the Commission rationalized its "colorable defense" position on the ground that it does not impair zealous advocacy, which is essential to the Commission's processes.<sup>51</sup> The Commission sought to allay "[c]oncerns over a chilling effect on advocacy."<sup>52</sup>

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47. *Id.* § 205.2(b).

48. *Id.* § 205.2(b)(3)(i).

49. *Id.* § 205.2(b)(3)(ii).

50. Prof. Conduct Release, *supra* note 16, at ¶ 34.

51. *Id.* ¶ 33.

52. *Id.*

Professor Steinberg is right to refer to the “colorable defense” standard as vague, weak and seemingly counterproductive.<sup>53</sup> His reference to another source is telling:

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 requirement in the definition that the investigation be underway, pending or even likely to occur), a colorable defense would be available. 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.<sup>54</sup>

Undermining what may even be the courageous efforts of a reporting attorney to stop or prevent fraud on the basis of promoting zealous advocacy before the occasion for such advocacy has arisen is highly questionable policy.

The pressures on the reporting attorney who must decide the appropriateness of a response may at times be severe. Hopefully, the reporting requirements may prevent some violations from even reaching a reporting stage, and the filing of an actual report, should that be necessary, ought to have a good prophylactic effect by engendering an appropriate response.

There is nothing revolutionary in terms of legal theory or policy in requiring an attorney to report “evidence of a material violation” to corporate higher-ups. After all, the duty of the attorney is owed to the corporation and not to the individuals who may be breaking the law. Former SEC Commissioner Goldschmid put it this way:

Few things are more clear in the ethical codes of all of our states than that the entity is the client of a lawyer and not those who manage a corporation. As Bill Donaldson, the current [now former] Chairman of the SEC, recently put it: “The basic principle that [Section 307 and the SEC’s] rules build upon is unassailable and needed reinforcement—the client of a lawyer representing a corporation is the corporation—and not the CEO, or other members of management, or the company officer doing the deal on which the lawyer is working.” Another basic legal and ethical proposition should also be carefully remembered by the bar: a lawyer must not participate in, or assist a client in, the commission of a fraud.<sup>55</sup>

In fact, sound business policy and legal requirements necessitate a reporting system within a company that would bring violations of law to

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53. Steinberg, *supra* note 3, at 20 n.82.

54. Roger C. Cramton, George M. Cohen & Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 771 (2004); *see also* Steinberg, *supra* note 3, at 20 n.82.

55. Harvey J. Goldschmid, SEC Commissioner, A Lawyer’s Role in Corporate Governance: The Myth of Absolute Confidentiality and the Complexity of the Counseling Task, Address at the Orison S. Marden Lecture (Nov. 17, 2003), *in* CORPORATE GOVERNANCE 2006: BEST PRACTICES FOR GATEKEEPERS, 18-19 (Practising Law Inst. ed., 2006) (second alteration in original) (footnotes omitted) (quoting William H. Donaldson, Remarks to Practising Law Institute (Nov. 6, 2003)).

the attention of higher-ups in the company. Companies must protect themselves from economic losses arising from the misbehavior of their own agents, whether such misbehavior is perpetrated against the companies themselves or outsiders. Many violations of the law, which fall outside the technical reporting requirements of section 307 and its implementing rules, are of sufficient gravity, particularly on a cumulative basis to need to be monitored and dealt with by the company. Indeed, under state law, a leading Delaware case, *In re Caremark International Inc. Derivative Litigation*,<sup>56</sup> takes the position that directors have a certain monitoring responsibility in connection with violations of law. What section 307 and its implementing Rules do is carve out a special area for reporting up which is backed by prescribed federal consequences for those who fail to comply. One commentator states:

Most chief legal officers will expect to be notified of potentially material violations of law even if reasonable minds could disagree as to the implications of the evidence. Nothing, of course, prevents corporate counsel from establishing their own, lower, standards for reporting; it may well be that a fairly high standard such as this is the right approach when the power of the SEC enforcement division stands behind a failure to meet the standard.<sup>57</sup>

As a matter of policy, companies should go beyond section 307 and its implementing Rules to set up effective monitoring and reporting systems that reinforce the fulfillment of lawyer responsibilities to the real client, the corporation.

#### IV. MAKING NOISE

As Professor Steinberg states, the SEC did not adopt mandatory “noisy withdrawal” provisions under which, “if the corporate client refused to take appropriate . . . action after counsel . . . went ‘up the ladder,’” the attorney would be obligated to notify the SEC that he or she “disaffirmed documents . . . prepared during the course of the representation.”<sup>58</sup> However, the SEC did provide that the reporting attorney “may reveal to the Commission, without the issuer’s consent, confidential information related to the representation [of the issuer] to the extent the attorney reasonably believes necessary.”<sup>59</sup> The Rule provides that the necessity may be:

- (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the

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56. 698 A.2d 959, 967-70 (Del. Ch. 1996).

57. Simon M. Lorne, *An Issue-Annotated Version of the SOX Rules for Lawyer Conduct [A Work-in-Process]*, in GATEKEEPERS UNDER SCRUTINY: WHAT ATTORNEYS, ACCOUNTANTS AND DIRECTORS NEED TO KNOW NOW: PRE-CONFERENCE BRIEFING AT THE 37TH ANNUAL INSTITUTE ON SECURITIES REGULATION 585, 610 (Practising Law Inst. ed., 2005).

58. Steinberg, *supra* note 3, at 16.

59. 17 C.F.R. § 205.3(d)(2) (2006).

issuer or investors;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.<sup>60</sup>

Furthermore, although an SEC Rule provides that its standards of professional conduct preempt conflicting standards of state law where an attorney is admitted or practices,<sup>61</sup> it also provides that it sets minimum standards and is "not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with" the SEC standards.<sup>62</sup> In this connection, it would be well to consider Professor Steinberg's discussion of noisy withdrawal problems faced by the corporate/securities practitioner. He states:

Regardless of the SEC's inaction, the noisy withdrawal dilemma continues to impact the corporate/securities practitioner. Depending on the circumstances, an attorney who discovers that a disclosure document that she drafted is materially false and is being relied upon by investors to their financial detriment may not simply withdraw from the representation. That alone may not be sufficient. In such situations, counsel may have to disaffirm her work product, hence making a noisy withdrawal, in order to effectuate the withdrawal.<sup>63</sup>

## V. AUDITORS' REQUESTS AND CONTINGENT LIABILITIES

The central imperative of federal securities law is proper disclosure to investors. A major contribution to proper disclosure should come from financial audits performed by those who are called independent auditors.<sup>64</sup> After all, a company's financial statements are normally of great interest and importance to investors. Professor Steinberg discusses the practice of auditors transmitting inquiry letters to client corporations, which, in turn, forward such requests to "counsel for assessment and response."<sup>65</sup> Among the items of inquiry are those relating to contingent liabilities.<sup>66</sup> Professor Steinberg lists points of tension arising

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60. *Id.*

61. Steinberg, *supra* note 3, at 18, 16 n.64 (summarizing 17 C.F.R. § 205.1).

62. 17 C.F.R. § 205.1.

63. Steinberg, *supra* note 3, at 18. For further discussion of the dilemmas created by a noisy withdrawal, see *id.* at 16-20.

64. The author has questioned the true "independence" of auditors and directors in another article. See Harvey Gelb, *Corporate Governance and the Independence Myth*, 6 WYO. L. REV. 129 (2006).

65. Steinberg, *supra* note 3, at 21.

66. *Id.* at 21.

from such requests,<sup>67</sup> and he also points to pronouncements made in an ABA Policy Statement regarding lawyers' responses to auditors' requests.<sup>68</sup> Referring to the ABA Policy Statement, Professor Steinberg states:

With respect to unasserted possible claims or assessments, where a potential claimant has not manifested an awareness of the potential claim, disclosure is required only if the client concludes that "(i) it is probable that a claim will be asserted, (ii) there is a reasonable possibility, if the claim is in fact asserted, that the outcome will be unfavorable, and (iii) the liability resulting from such unfavorable outcome would be material to [the company's] financial condition." Hence, by leaving the decision to reveal contingent liability for unasserted claims to the client, nondisclosure may well be the likely consequence.<sup>69</sup>

As noted by Professor Steinberg, there is a possible conflict between this ABA guidance and new SOX rules. Professor Steinberg refers specifically to SEC Rule 13b2-2(b) as amended by the SEC pursuant to SOX Section 303(a) as possibly raising "liability concerns for counsel who allegedly 'provide[] an auditor with an inaccurate or misleading legal analysis.'"<sup>70</sup>

Section 303(a) of SOX provides:

It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary and appropriate in the public interest or for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.<sup>71</sup>

SEC Rule 13b2-2(b) provides:

(1) No officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.

(2) For purposes of paragraphs (b)(1) and (c)(2) of this section, actions that, "if successful, could result in rendering the issuer's financial statements materially misleading" include, but are not limited to, actions taken at any time with respect to the professional engagement period to coerce,

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67. *Id.* at 21-22.

68. *Id.* at 22-23.

69. *Id.* at 23 (alteration in original) (footnote omitted) (quoting ABA, *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31 BUS. LAW. 1709, 1713 (1976)).

70. *Id.* at 22 (quoting *Improper Influence on Conduct of Audits*, Exchange Act Release No. 47890, [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,921, at 87,661 (May 20, 2003)).

71. SOX § 303(a) (codified at 15 U.S.C. § 7242 (2002)).

manipulate, mislead, or fraudulently influence an auditor:

- (i) To issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards, or other professional or regulatory standards);
- (ii) Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;
- (iii) Not to withdraw an issued report; or
- (iv) Not to communicate matters to an issuer's audit committee.<sup>72</sup>

Referring to the same ABA Policy Statement as did Professor Steinberg, former SEC General Counsel Lorne commented upon the impact of SOX 307 rules and SOX 303 amendments to Rule 13b2-2 as follows:

Finally, the SOx 307 rules, particularly in tandem with the SOx 303 amendments to Rule 13b2-2, may well threaten the audit letter accord ("Accord") between the legal profession (through the American Bar Association) and the auditing profession (through the American Institute of Certified Public Accountants) reached in 1975-76. It seems clear that a lawyer, in responding to an audit inquiry letter from a client's auditors, is acting at the direction of the client's officers and directors within the meaning of Rule 13b2-2, as newly revised in response to SOx 303. As such, while the dimensions of the Accord may be reasonably carefully circumscribed, the revised Rule 13b2-2 raises the question whether a response to auditors in careful consistency with the Accord might not, under at least some circumstances, be viewed as misleading to the auditors and hence violative. Such a possibility carries with it at least the risk that an accommodation that has worked, albeit with some misgivings, reasonably well for twenty-five years may dissolve.<sup>73</sup>

That the comforts of the practice under the Accord referred to above may be sacrificed by the new statute and Rules, should be of real concern to attorneys. The old practice of leaving matters to be disclosed regarding unasserted contingent claims to the discretion of clients seems untenable. If the client may be violating the law by withholding information from the auditors then the lawyer has difficult assessments to make regarding contingent claims in light of section 303(a) of SOX, SEC Rule 13b 2-2(b)(1) and section 307 of SOX and its implementing Rules.

A bad judgment call by an attorney that differs from the position of company officials could lead to dire consequences for the company, not only by awakening persons about possible claims they would not have asserted, but also by presenting a distorted and harmful financial picture

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72. Improper Influence on Conduct of Audits, Exchange Act Release No. 47890, [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,921, at 87,661 (May 20, 2003), available at [www.sec.gov/rules/final/34-47890.htm](http://www.sec.gov/rules/final/34-47890.htm); 17 C.F.R. § 240.13b2-2(b) (2006).

73. Lorne, *supra* note 57, at 597-98 (footnotes omitted).

of the company from giving such claims more than their due weight. The pressures on the attorney who must make such judgment calls are evident.<sup>74</sup>

## VI. CONCLUSION

By prescribing specific reporting procedures to follow, which the SEC has done, the reporting attorney may at least achieve a certain procedural comfort level, moral support and legal support in deciding where to go with “evidence of a material violation.” This is not to say that the reporting attorney will always be able to act with substantive and/or procedural certitude and this does not make the attorney’s reporting task a pleasant one.

What are some possible negative impacts which may flow from reporting requirements or noisy withdrawal possibilities? First, individuals may reduce consultation with lawyers for fear of exposure within or without the company. Because legal advice is often a bulwark against misbehavior, less consultation may result in more law-breaking. Second, lawyers in some situations may have too much influence on decisions made in the company. Former SEC General Counsel Lorne graphically explains the potential for such influence in perhaps too dire terms:

From the issuer’s perspective (as well as that of the broader society) it may be that the most important aspect of the new rules—particularly if a “dirty withdrawal” provision is adopted—is a reallocation of decision-making authority from clients to lawyers. With the threat of a lawyer’s withdrawal or public disclosure, few corporate boards of directors, particularly in a period of increased risk of governmental action and private litigation, will be willing to endorse activities counter to the judgment of counsel, no matter how strongly they believe—even with the advice of other, sophisticated counsel—that corporate counsel is in error. As a result, decisions in most close cases will effectively be made by the lawyers involved. Since lawyers face a very different risk-reward calculus than their clients, even if lawyers were not inherently more risk-averse than their clients (and they generally are), the different risk-reward analysis will lead at the margin to fewer risks being taken. At its most fundamental level, this removal of decision-making from those who bear the consequences of the decisions is counter to elemental principles of capitalism. It is nonetheless an issue.<sup>75</sup>

Third, when lawyers make the wrong calls about difficult issues involved in determining reporting or withdrawing actions, the consequences to the company may be needlessly yet severely negative.

In sum, as a general proposition, the harm to lawyer-client relations that may result from the SEC Rules implementing section 307 may be

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74. For further discussion of lawyer reporting challenges, see Steinberg, *supra* note 3, at 16-20.

75. Lorne, *supra* note 57, at 597.

significant, and modifications of such rules may be needed after the evidence is in on their virtues and defects. Former SEC Commissioner Harvey Goldschmid took an optimistic position in a 2003 speech where he stated: "I believe that it will be a most unusual circumstance . . . where reporting up to senior executives and independent directors will not stop wrongdoing or reckless behavior."<sup>76</sup> What will need to be determined in light of operational experience will be whether the benefits of the reporting and other rules under section 307 of SOX will outweigh their negative impacts, and what if any improvements can be made to the current system to make it more useful.

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76. Goldschmid, *supra* note 55.