

## American University Law Review

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Volume 52 | Issue 3

Article 3

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2003

# Panel Two: The Evolution of Corporate Governance

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### Recommended Citation

Quinn, Randall, Richard W. Painter, Roberta S. Karmel, and Stuart Kaswell. "Panel Two: The Evolution of Corporate Governance." *American University Law Review* 52, no.3 (2003): 613-638.

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## Panel Two: The Evolution of Corporate Governance

THE EVOLVING LEGAL AND ETHICAL  
ROLE OF THE CORPORATE ATTORNEY AFTER  
THE SARBANES-OXLEY ACT OF 2002

PANEL 2: THE EVOLUTION OF CORPORATE GOVERNANCE  
Washington, D.C.  
Friday, November 22, 2002

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## PROCEEDINGS

PROFESSOR QUINN: Good morning and welcome to the second panel, "The Evolution of Corporate Governance." I am Randall Quinn. I'm an adjunct professor at the law school. For my day job, I work at the SEC as an assistant general counsel. So, before I go any further, I have to state that everything I say today is my personal view only and does not reflect the view of the SEC commissioners or of anyone on the staff of the Commission. Even though I'm the moderator, I don't expect to say anything controversial, just to make that clear.

Section 307 of the Sarbanes-Oxley Act is a remarkable step in the evolution of corporate governance. It requires the SEC to enact rules setting minimum standards of professional conduct for lawyers representing issuers.<sup>1</sup> Now traditionally, of course, state bar associations, not a federal agency, regulate attorney conduct.

Section 307 directs the SEC to include in its rules a requirement that attorneys report evidence of violations up the ladder within a corporation.<sup>2</sup> In other words, report violations to a corporation's chief legal officer, and if there is no appropriate response, then to go to the board of directors.

Section 307 leaves open whether the SEC rules should impose further requirements on lawyers. Well, there has been no shortage of controversy at the SEC recently, and these rules will continue that trend. Just let me tell you the headline of a recent *Legal Times* article, which is simply based on a press release summarizing the Commission's proposals: "SEC Rules on Lawyers Draw Flack, Plan Blasted by Corporate Bar and by Advocates of Reform."<sup>3</sup> The *National Law Journal* reports that attorneys from coast to coast criticize the SEC's proposals.<sup>4</sup> At least there is no regional divide among the bar

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1. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 749-50 (to be codified at 15 U.S.C. § 7245) (setting out the requisite elements of the standards to be set by the Commission in their rule-making capacity).

2. See *id.* § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245(1)-(2)) (delineating a process in which the attorney must report evidence of violations of securities law or other specified infractions to the chief legal counsel, the chief executive officer, or to another similarly situated entity, and if none of these parties appropriately responds to the reported violation, the attorney must refer the issue to the board of directors or to another qualifying body such as the audit committee).

3. Otis Bilodeau, *SEC Rules on Lawyers Draw Flak, Plan Blasted by Corporate Bar and by Advocates of Reform*, LEGAL TIMES, Nov. 11, 2002, at 1.

4. See *SEC Proposal Criticized*, NAT'L L.J., Nov. 11, 2002, at 12 (claiming this outcry stems from attorneys viewing the proposed new rules on disclosure as an assault on the attorney-client privilege).

2003]

PANEL 2

615

in being dissatisfied, or expressing disagreement.

Anyway, there is no dispute that Section 307 and the Commission's proposed rules raise a number of very interesting questions. We are fortunate, we are very fortunate this morning, to have a truly outstanding panel to discuss some of these issues.

Richard Painter is Professor of Law at the University of Illinois at Urbana-Champaign. He is a leading authority on the ethical obligations of securities lawyers, and he played a key role in Section 307 being enacted.

Next to him is Roberta Karmel, Professor of Law at Brooklyn Law School and Of Counsel at Kelly, Drye & Warren. Professor Karmel is a former SEC Commissioner and she has been a thoughtful critic of the SEC's past actions in the area of regulating attorneys.

Next to her is Stuart Kaswell. He is Senior Vice-President and General Counsel of the Securities Industry Association. He is well-positioned to provide insight into how the Commission's rules may affect the securities industry.

I thought that each panelist could speak for about ten minutes, and then we'll open things up to questions. Professor Painter will start, followed by Professor Karmel, and then Mr. Kaswell.

PROFESSOR PAINTER: I want to explain some of the background to how we got here to this seventy-eight pages of regulation because, in my view, it really is evidence of a failure of self-regulation in the legal profession.

For me, this goes back not to Enron, but to the savings and loan debacle of the late 1980s and early 1990s. I was on the Ethics Committee of the Association of the Bar of the City of New York, and we very quickly put out a statement condemning the seizure of the assets of the Kaye Scholer firm by the Office of Thrift Supervision (OTS).

I dissented. I think I was the only dissenting vote on the committee. I dissented not because I thought the seizure of the law firm's assets—attachment of the assets—by the OTS was proper; I think that was probably excessive. But I think that we also as a committee should be addressing the deficiencies in ethics rules that caused a law firm to get into that situation. We had a lot of law firms that were settling charges in connection with the savings and loan crisis in the twenty, thirty, and forty million dollar range.<sup>5</sup> These were

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5. See Jennifer E. Duggan & Richard W. Painter, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 238 (1996) (citing a \$48 million settlement in the American Continental/Lincoln Savings and Loan litigation as an example of one of the many large attorney settlements during the period of

law firms that assisted people such as Charles Keating with Lincoln Savings and Loan in connection with their conduct—or misconduct—in their thrift organizations.

The response of the American Bar Association to what happened with the savings and loans, and the role of lawyers in representing those savings and loans, I thought was far worse. They put together a committee to study the role of the lawyer for a regulated industry, such as an S & L, and came out with a working group report in 1993 to challenge the position that the Office of Thrift Supervision had taken in those cases. One of the things they said in that report was that the Office of Thrift Supervision was wrong to interpret Model Rule 1.13 of the ABA's Rules of Professional Conduct<sup>6</sup> to require a lawyer to report illegal acts all the way up to the chain of command, to the board of directors if need be, to rectify the client's conduct or at least to bring the conduct to the attention of the client.

This did not sit well with my understanding of corporate law. Delaware General Corporation Law 141(a) says that a corporation is run by or under its board of directors.<sup>7</sup> The directors are the people who get sued when there is a securities law violation or other illegal conduct, and I would think, if I'm a director, I would want to know about it. If lawyers had been hired to represent the company, it's one thing for them to go first to senior management and seek to have illegal conduct addressed. But those lawyers should be required, if they cannot get appropriate action at the lower levels, to go to the full board of directors of the corporation. The directors run the corporation, and they have a right to know.

I think the ABA, instead of clarifying its ethics rules to try and prevent future Kaye Scholer incidents, circled the wagons and tried to prove how the federal regulators were wrong. I think that's a large part of what has put us where we are today.

I subsequently wrote an article in 1996 in the *Southern Methodist University Law Review*<sup>8</sup> suggesting that because of the failures of self-regulation in this area and because the SEC had been informally backing off from the position it had taken in the *Carter and Johnson* case<sup>9</sup>—that a lawyer should take remedial action including possibly

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1989 through 1993).

6. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2000).

7. See DEL. CODE ANN., tit. 8, § 141(a) (2002) (stating that a corporation organized within Delaware shall be governed by its board of directors).

8. Duggan & Painter, *supra* note 5.

9. *In re Carter & Johnson*, No. 34-17597, [1981] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (Feb. 28, 1981).

reporting up the chain of command to the board of directors<sup>10</sup>—that it was necessary for Congress to step in and enact a statute that provided that a lawyer should first report illegal acts to the senior management of a corporation, and then if that is unsuccessful to the full board of directors.<sup>11</sup> Congress had in 1995 amended the 1934 Act to require an accountant to report illegal acts, not just to the board of directors but to the SEC.<sup>12</sup> I didn't think that was appropriate for lawyers. Lawyers should be only required to tell their own client's board of directors about illegal conduct. Since the SEC did not appear to be willing to clarify the standard in Carter and Johnson,<sup>13</sup> and since the ABA was in effect saying just the opposite in its working group report, I thought that it was time for Congress to step in.

I started to put pressure on the ABA to change Model Rule 1.13 when their Ethics 2000 Commission was redrafting the Model Rules. I made several proposals to amend Model Rule 1.13 to require a mandatory report up the chain of command to the board of directors, if necessary, to rectify illegal acts that the lawyer knew about. I think this is important because we're going to find that Section 307 of the Sarbanes-Oxley Act has a very different standard than the one that I've been proposing all along. My proposal was that, if a lawyer *knows* of *illegal* acts, the lawyer should be required to report those up the chain of command, to the directors if necessary, to put a stop to the illegal conduct.

That, of course, didn't go anywhere. They did not amend Model Rule 1.13. Not only that, but the ABA rejected the proposal that its own Commission did make to amend Model Rule 1.6 to allow a lawyer to disclose illegal conduct outside the client organization, if necessary to prevent a future crime.<sup>14</sup> The vast majority of the states

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10. See *id.* ¶ 84,163 (arguing further that lawyers help shield themselves from potential liability and discipline action by reporting to the board of directors).

11. See Duggan & Painter, *supra* note 5, at 262 (suggesting that Congress require lawyers to report illegal acts to either an appropriate officer or committee of the client-issuer, and if such action brings no sufficient remedy, the lawyers must refer the problem to the board of directors).

12. See *id.* at 255 (explaining the procedures an accountant must follow under the 1995 Reform Act, which include first reporting any illegal acts to an appropriate level of management, then to the full board of directors, and finally reporting directly to the SEC if the board of directors failed to respond appropriately to the accountant's report).

13. See *In re Carter & Johnson*, No. 34-17597, [1981] Fed. Sec. L. Rep. (CCH) ¶¶ 82,847, 84,166 (holding that an attorney could not be sanctioned under the securities law for "willfully aiding and abetting" a client's violations unless the attorney knew his participation in the violation "was improper or illegal").

14. See MODEL RULES OF PROF'L CONDUCT R. 1.6 (2002) (detailing Model Rule 1.6 as passed by the House of Delegates), available at <http://www.abanet.org/cpr/e2k-rule16h.html> (last visited Apr. 3, 2003); see also CHEEK REPORT, *infra* note 43, at 31-33 (discussing the ABA House of Delegation's rejection of the Commission's proposal

permit that, but the ABA didn't seem to even want to permit such disclosure.

So I saw ethics rules, at least as being promoted by the ABA, sinking to the lowest common denominator. There was also a great deal of controversy arising over the role of lawyers in Enron—although I think that's a much more complex situation. I wrote a letter<sup>15</sup> to Chairman Harvey Pitt and asked some other law professors, mostly in the ethics area and a few securities law professors such as Joel Seligman and Steve Bainbridge, to recommend that Chairman Pitt promulgate a rule requiring just this: that a lawyer who knows of securities law violations, which are material violations of the securities laws, report that information first to senior management. If that will not put a stop to the known violation, the lawyer for the issuer would be required to tell the client's board of directors.

David Becker, the General Counsel of the SEC, wrote me back—the letter that's cited here in the release.<sup>16</sup> The position the Commission took was that this was quite controversial and it, in effect, didn't want to get into this at the moment. If anybody is going to set rules of professional responsibility for attorneys in the securities area, Becker said it ought to be Congress; and he cited my 1996 *SMU Law Review* article for that proposition.<sup>17</sup> Well, I guess I had suggested that Congress should do it because the SEC wasn't doing it, but that didn't mean the SEC shouldn't do it.

This made its way up to the Hill. Senator Enzi of Wyoming and Senator Edwards of North Carolina, and I believe Senator Corzine of New Jersey, co-sponsored an amendment to the Sarbanes-Oxley Act. The ABA had lobbyists all over the Hill trying to convince Congress that lawyers should not have to tell their own clients' boards of directors about illegal conduct. Well, this is now the law. Congress required the Securities and Exchange Commission to promulgate rules of professional responsibility for attorneys representing issuers including a rule requiring up-the-ladder reporting of securities law

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to expand permissive disclosure under Model Rule 1.6).

15. Letter from Prof. Richard Painter and Several Professors of Securities Regulation and/or Professional Responsibility of Noted Law Schools, to Harvey L. Pitt, Chairman, U.S. Securities and Exchange Commission (Mar. 7, 2002) ("Expressing Concern About the Role of Professionals in the Enron Matter and Other Frauds on Investors"), <http://www.abanet.org/buslaw/corporateresponsibility/pitt.pdf> (last visited Mar. 4, 2003).

16. Letter from David Becker, General Counsel, U.S. Securities and Exchange Commission (Mar. 28, 2002) ("[I]n Response to Letter from Several Professors of Securities Regulation and/or Professional Responsibility of Noted Law Schools"), <http://www.abanet.org/buslaw/corporateresponsibility/becker.pdf> (last visited Mar. 4, 2003).

17. *Id.*



2003]

PANEL 2

619

violations.<sup>18</sup>

But what's interesting is that they broadened the language significantly. The statute now requires the lawyer to report evidence—not just known acts—but evidence.<sup>19</sup> So we've dropped the knowledge threshold down substantially in the statute. The knowledge threshold has been dropped down to evidence and includes not just securities law violations but breaches of fiduciary duty and other similar violations,<sup>20</sup> going substantially beyond the proposal in the law professors' letter and anything that had been perceived, I believe, to be under the SEC authority previously. We're now getting into state fiduciary duty breaches, breaches of duty to pension funds and a wide range of other conduct beyond the scope of the securities laws.

So what we end up with is a substantially broader rule coming from Congress than we probably would have gotten from the SEC back in March if people had been willing to work with the SEC in promulgating rules focused on known securities law violations. We also wouldn't have had the SEC involved in this if the American Bar Association and the states that promulgate rules of professional responsibility had zeroed in on what the problems were that caused past incidents such as the improper conduct of lawyers in the S&L crisis, and other cases before that, such as *National Student Marketing*.<sup>21</sup> But the position of the bar has just been to play defense and avoid taking proactive measures to tighten up rules of professional responsibility. So this is where we are today.

There are only two paragraphs in this statute that have to do with lawyers.<sup>22</sup> There are about forty pages on accountants. We're still very much self-regulated compared with broker-dealers, accountants, and other professions. But we are losing parts of that as we go along

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18. See Sarbanes-Oxley Act § 307, Pub. L. No. 107-204, 116 Stat. 745, 784 (to be codified at 15 U.S.C. § 7245(1)-(2)) (defining the first step as reporting to the CLO or CEO and the second step as reporting to the board of directors).

19. *Id.* (to be codified at 15 U.S.C. § 7245(1)) (evidence of a material violation of the securities laws).

20. *Id.*

21. SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978) (concluding that counsel has a duty to disclose a company's violations of the securities laws and the breach of that duty constitutes a violation of the antifraud provisions through aiding and abetting the violation). The SEC's complaint alleged that two law firms failed to notify shareholders and the SEC of a fraudulent scheme involving an issuance of false opinions in connection with a merger and stock sales. *Id.* at 701. The Commission argued that in the event the Interstate directors failed to withdraw the opinions, the attorneys should withdraw from their representation and inform the shareholders or the Commission. *Id.*

22. See Sarbanes-Oxley Act of 2002 § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245) (describing the rules of professional responsibility for attorneys).

here, and I think we will continue to do so if we don't hold organizations such as the American Bar Association, such as our state and local bar associations, accountable to come up with rules that make sense and that avoid these types of problems in the future.

It's going to be an issue that the legal profession, just like the accounting profession, broker-dealers, and analysts, will face—do we want to be self-regulated? Or do we want to be regulated by outsiders? How that is decided is very much going to hinge on how we regulate ourselves. I think I'll end it there, and we can move on to the other panelists and have discussion on some of those points afterwards.

PROFESSOR QUINN: Thank you very much, Richard. Roberta?

PROFESSOR KARMEL: I have about fifteen minutes to go through a statute, a seventy-eight page release and my reactions to it, and about forty years of SEC history trying to regulate securities attorneys. I don't quite know how I'm going to do that; some of my views are going to have to be left to the question and answer session and thereafter.

I started my career as an enforcement attorney for the Securities and Exchange Commission in New York. This was in the 1960s, during the aftermath of the collapse of the 1959 hot issue market. We were chasing crooks or at least that's how most of us saw our jobs.

Some staff members at the SEC in the Division of Trading and Markets in Washington got started on what was an inchoate Rule 2(e), later 102(e), program bringing cases against lawyers as gatekeepers.<sup>23</sup> Actually, someone wanted me to work on one of these cases, and I had an immediate negative reaction. The case involved an attorney who had been representing a lot of clients that we were investigating and prosecuting. I said, "I don't think this is right." This is like a U.S. Attorney's office saying, "we're going to regulate the behavior and professional ethics of the criminal defense bar." That was just my spontaneous reaction. I said I didn't want to work on any of the Rule 2(e) cases, and I didn't.

That has really been my point of view ever since. Maybe, as I became more mature, I should have become wiser concerning this subject, but I've never changed my mind in thinking that it is a very poor policy to have a prosecutor—and the SEC is a prosecutorial agency—regulating the bar that practices before the agency. This was

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23. See, e.g., ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 173-83 (1982) (criticizing the "access" or "gatekeeper" theory and the Commission's increasing resort to enforcement actions against lawyers and accountants during the 1970s).

2003]

PANEL 2

621

the basis for my dissents in the Rule 2(e) area when I became a commissioner. At that time I also took the position that the SEC did not have the statutory authority for its Rule 2(e) program against attorneys.<sup>24</sup>

That part of the equation has been changed by the Sarbanes-Oxley Act, which requires the SEC to pass a rule by mid-January that would require “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).”<sup>25</sup> If those officers don’t take appropriate action, the attorney must go up the ladder and report evidence of securities law violations to the audit committee or another committee of independent directors.

This puts into statutory form two previously controversial proposals: first, it does give the SEC the authority to regulate the professional practice of securities attorneys and thereby federalizes the regulation of the bar in certain respects. As Professor Painter pointed out, this goes considerably beyond the securities laws. It appears to give the SEC authority to regulate attorneys who become aware of breaches of fiduciary duty under state law or similar violations. There was little debate on this provision; it was just tacked on to a bill that was basically directed at the re-regulation of the accounting profession.

The other thing the statute does is incorporate into legislation the SEC holding in *In re Carter and Johnson*<sup>26</sup> that attorneys learning of substantial and continuing disclosure violations by their clients must take prompt steps to end the client’s non-compliance.<sup>27</sup> However, the *Carter and Johnson* holding was never vigorously enforced by the SEC; shortly after that holding was articulated, the SEC’s General Counsel essentially said, because of all the questions as to the SEC’s authority

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24. See The Keating, Meuthing and Klekamp, Exchange Act Release No. 15,982 (July 2, 1979) (Karmel, Comm’r, dissenting); Darrel L. Nielson, Exchange Act Release No. 16,479 (Jan. 10, 1980) (Karmel, Comm’r, dissenting) (questioning the legitimacy of Rule 2(e) of the Commission’s Rules of Practice as “an enforcement tool against both attorneys and accountants”).

25. Sarbanes-Oxley Act of 2002 § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245).

26. *In re Carter & Johnson*, No. 34-17597, [1981] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (Feb. 28, 1981).

27. Compare Sarbanes-Oxley Act of 2002 § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245) (requiring attorneys to report material violations or other specified breaches to the CLO or CEO and if no remedial action is taken, to the board of directors), with *In re Carter & Johnson*, No. 34-17597, [1981] Fed. Sec. L. Rep. (CCH) ¶ 84,169-73 (requiring attorneys promptly to ensure clients end noncompliance with federal securities laws as soon as attorneys learn of the misconduct).

under Rule 102(e), we will bring cases against attorneys in the federal courts and not at the agency.

In trying to implement Sarbanes-Oxley, the SEC has proposed Rule 205. This is a political and bureaucratic reaction to an economic, political, and cultural problem—that is, the stock market bubble of the 1990s and its collapse.

Proposed Rule 205 goes considerably beyond the statute and returns to what the SEC tried to do in the early 1970s in the *National Student Marketing* case<sup>28</sup> and make lawyers into whistle-blowers. Under the proposal, an attorney would have to reasonably believe that a material violation has occurred.<sup>29</sup> I don't know what's a material violation and what's not a material violation of the securities laws. In fact, the word "materiality" is used throughout the securities laws.<sup>30</sup> It's usually a disclosure threshold. Is every line item in every SEC form that is not correctly disclosed a material violation? Is every disclosure that does not conform to Regulation S-K a material violation? I don't know. I think it would be hard to find a public company that has 100% compliance with every SEC form and every part of Regulation S-K.<sup>31</sup>

The attorney who reasonably believes there is a material violation has to report this violation up the ladder and document that reporting.<sup>32</sup> The chief legal officer has to respond appropriately and document his or her response.<sup>33</sup> If the reporting attorney does not receive an appropriate response, then that attorney has to go higher up the ladder.<sup>34</sup> Eventually someone has to go to the board of directors.<sup>35</sup> If the board of directors does not agree, and doesn't take action, then in certain situations, an attorney would be obligated to make a "noisy withdrawal."<sup>36</sup> That is, the attorney would be required

28. SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978).

29. See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71674 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. § 205.3(d)(2)) (providing that the discovery of materiality requires subsequent disaffirmation).

30. For example, the word appears in Sarbanes-Oxley §§ 7213(a)(2), 7245(1), and 7261(b)(1).

31. 17 C.F.R. § 229 (2002).

32. See Sarbanes-Oxley Act of 2002 § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245(1)) (requiring attorneys to present evidence of a material breach).

33. See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71685 (to be codified at 17 C.F.R. § 205.3(b)(3)) (stipulating remedies for the chief legal officer if material violations are discovered).

34. See Sarbanes-Oxley of 2002 § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245) (mandating two-step reporting).

35. See *id.* (to be codified at 15 U.S.C. § 7245(2)) (requiring that when a reporting attorney does not receive an appropriate response, the attorney must report the material violation to the board).

36. See Implementation of Standards of Professional Conduct for Attorneys, 67

to disaffirm a submission to the Commission, which the attorney believes has been tainted by a material violation.<sup>37</sup> The proposed rule says that notification to the Commission prescribed does not breach the attorney-client privilege.<sup>38</sup> Alternatively, the issuer can establish a Qualified Legal Compliance Committee referred to, of course, by its acronym QLCC, composed of one audit committee member and two independent board members, and that QLCC can take action instead of the general counsel.<sup>39</sup> Then the attorney would not have to make a noisy withdrawal.

There are a lot of problems with the rule. I can only mention a few of them. The rule applies to attorneys acting as attorneys, but it also applies to all other persons within a corporation who happen to be attorneys.<sup>40</sup> So if the head of a human resources department happens to be an attorney and becomes aware of a material securities law violation, that person is under the obligations of this statute. The rule applies to foreign attorneys, so it has world-wide application.<sup>41</sup> There are some distinctions between in-house and outside attorneys with regard to withdrawal. In-house attorneys don't have to resign under the same circumstances that an outside attorney has to resign<sup>42</sup> because, in my view of the SEC, this would be too harsh. The whistleblowing provisions, as I've already indicated, go beyond the requirements of Sarbanes-Oxley and are contrary to legal ethics in many states.<sup>43</sup> The SEC intends to determine attorney-client privilege

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Fed. Reg. at 71690 (to be codified at 17 C.F.R. § 205.3(d)(2)(ii)) (directing attorneys who are retained by the issuer to withdraw from representation and notify the Commission that they have done so). The noisy withdrawal provisions are triggered only when the issuer's response to evidence of a material violation is not appropriate. *See id.* at 71683 (explaining that an appropriate response depends on the particular circumstance).

37. *See id.* at 71690 (to be codified at 17 C.F.R. § 205.3(d)(2)(i)(C)) (enunciating the duty of an attorney to report evidence of material violations to the Commission thereby alerting the Commission to investigate the issuer).

38. *Id.* (to be codified at 17 C.F.R. § 205.3(d)(3)).

39. *See id.* at 71679-80 (to be codified at 17 C.F.R. § 205.2(j)(1)) (defining the Qualified Legal Compliance Committee and its responsibilities). Pursuant to 17 C.F.R. § 205.3(c), issuers may, but are not required to, establish a Qualified Legal Compliance Committee for the purpose of investigating reports of material violations issued by attorneys. *See id.* at 71673 (to be codified at 17 C.F.R. § 205.3(c)).

40. *See id.* at 71677 (to be codified at 17 C.F.R. pt. 205) (explaining that the term "attorney" is broadly defined so that it applies equally to lawyers employed in-house by an issuer and to lawyers serving as outside counsel).

41. *See id.* (to be codified at 17 C.F.R. § 202.5(c)) (covering lawyers licensed in foreign jurisdictions).

42. *See id.* at 71689-90 (to be codified at 17 C.F.R. pt. 205) (explaining that in-house attorneys are required to disaffirm any tainted submission they helped prepare but are not required to withdraw from representation, which is required of outside attorneys).

43. *See* ABA TASK FORCE, PRELIMINARY REPORT OF THE ABA TASK FORCE ON CORPORATE RESPONSIBILITY 32 (July 26, 2002) [hereinafter CHEEK REPORT] (listing the

questions.

To me, one of the more troublesome parts of this proposed rule is that the rule applies to situations where an attorney is representing a client in an investigation or enforcement action.<sup>44</sup> This doesn't just apply to attorneys working on SEC disclosure documents. Although the SEC says that it does not intend to impair zealous advocacy essential to the SEC's processes, or discourage issuers from seeking effective and creative legal advice, in my opinion, this is precisely what the rule is going to do. It is going to make securities attorneys into a band of policemen working partly for their clients and partly for the SEC.

Why? How has this happened? I think there are a lot of reasons, and Richard Painter said one reason this has happened is that the bar has not engaged in sufficient and adequate self-regulation. That's probably true. I think it also happened because attorneys were part of the bubble phenomenon. Attorneys made much larger amounts of money than they had ever previously made before. They became organized in much bigger law firms than had previously existed, and many of them acted as quasi-investment bankers for their clients, putting deals together, and taking payment in stock. That's why I say it's a political reaction to the bursting of the bubble. Americans don't like it when some group is perceived to have become very rich and powerful. This group, attorneys, was perceived to be part of the problem of the Enrons and other failures, the stock market bubble, and so Congress tacked on a provision to punish them along with companies and accountants.

We're all going to have to learn to live with this new regime to some extent but, in the process, attorneys working on SEC matters are going to have to endure a kind of bureaucratization that in the long run is going to be a very bad thing for business entrepreneurial activity and the zeal with which attorneys have traditionally represented their clients.

PROFESSOR QUINN: Thank you very much, Roberta. Stuart?

MR. KASWELL: Thank you. I'm going to try to bring this to a little more practical level having heard how we got here. I sort of

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states that permit disclosure of client confidences, *at* [http://www.abanet.org/buslaw/corporateresponsibility/preliminary\\_report.pdf](http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf) (last visited Mar. 4, 2003).

44. *See* Letter from Roberta Karmel, Professor at Brooklyn Law School, to Jonathan G. Katz, Secretary of the Securities and Exchange Commission (Dec. 12, 2002) (arguing that an attorney might have to disavow a Wells submission document, which could prevent a person who is a target of an SEC investigation from having effective legal representation), *at* <http://www.sec.gov/rules/proposed/s74502/karmel1.htm> (last visited Mar. 4, 2003).

2003]

PANEL 2

625

have to observe though, having found that lawyers were part of the problem, the solution seems to be more lawyers.

We now have a system that puts the general counsel of a public company in a vastly more powerful position, perhaps properly so. I find it interesting that rather than saying to lawyers, "We don't want you participating in this process because we think you screwed it up," in fact, lawyers' roles will be greater. I see this in the other part of the Sarbanes-Oxley, in the SRO rules on analysts,<sup>45</sup> but that's beyond the scope of today's program. Overall, lawyers seem to be the winners in all of this, rather than the losers.

The Securities Industry Association, which is the group I represent, has more than 600 member firms. Broker-dealers are members of the Association, and we filed a comment letter on this proposal even before it was published because we read the statute and knew that rule-making would be forthcoming.<sup>46</sup> We were concerned that the Commission would not adopt rules that would be sensible and practical. But we thought we'd offer some guidance in advance of the rule-making, something which we don't often do, primarily because the timetable here is so short. I think if you count on your fingers, it comes out to something like January 26, 2002 when these rules have to be in place.<sup>47</sup> We thought we'd get in early and often and make our points with the Commission, and we did that.

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45. See *Statement by SEC Chairman: Proposal of Regulation AC* (July 24, 2002) (stating that the SRO rules adopted in May made significant structural changes in how analysts do business), <http://www.sec.gov/news/speech/spch578.htm> (last visited Mar. 4, 2003). SRO rules guard against potential conflicts of interest and provide investors with better information about the analysts' and the firms' relationships with public companies while forbidding some of those relationships altogether. *Id.*

46. See Letter from Howard Steinberg, Chair of the SIA Ad Hoc Committee on Section 307 of the Sarbanes-Oxley Act, to Giovanni Prezioso, SEC General Counsel, and Meyer Eisenberg, SEC Deputy General Counsel (Oct. 22, 2002) (submitting preliminary expressions of opinion on Section 307 of the Sarbanes-Oxley Act in light of the Commission's upcoming proposals), at [http://www.sia.com/2002\\_comment\\_letters/pdf/Section307.pdf](http://www.sia.com/2002_comment_letters/pdf/Section307.pdf) (last visited Mar. 4, 2003); see also Letter from Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association, and Paul Saltzman, Executive Vice President and General Counsel, The Bond Market Association, to Jonathan Katz, Secretary, SEC (Dec. 18, 2002), at [http://www.sia.com/2002\\_comment\\_letters/pdf/conduct\\_attorneys.pdf](http://www.sia.com/2002_comment_letters/pdf/conduct_attorneys.pdf) (last visited Apr. 3, 2003) [hereinafter Kaswell/Saltzman Letter]; Letter from Robert Dinerstein, Chair, Securities Industry Association, Federal Regulation Committee, and Michael Stone, Securities Industry Association, Compliance and Legal Division (Dec. 20, 2002), at [http://www.sia.com/2002\\_comment\\_letters/pdf/FedRegCL.pdf](http://www.sia.com/2002_comment_letters/pdf/FedRegCL.pdf) (last visited Apr. 3, 2003).

47. See Sarbanes-Oxley Act of 2002 § 3, Pub. L. No. 107-204, 116 Stat. 745, 749 (to be codified at 15 U.S.C. § 7245) (mandating the Commission to establish standards of professional conduct for attorneys who appear and practice before the Commission on behalf of issuers).

One of the things we were concerned about, in particular, is the member firms of SIA; some of them are small, privately held broker-dealers, but others are well-known public companies that also happen to be broker-dealers. You find that you kind of get caught twice—once because you're a broker-dealer and once because you're a public company. The general counsels of those firms have been paying more than a little bit of attention to this rule-making as it has gone forward.<sup>48</sup>

So we wrote what we thought was a very thoughtful letter and said, "please do this" and "please don't do that." We are convinced that the SEC read that letter very carefully because it seems they put it in a mirror and did exactly the opposite of almost everything we recommended.

The statute says if a reporting attorney finds a problem he should bring it to the general counsel. There should be a process there. If necessary, go to the CEO and to the board. You know, I always sort of mused—what would I do if I found myself in that situation? I think the answer is, I'd have gone to the board of directors. I don't think there is a whole lot of question about that. If I thought that my boss was doing something that was beyond the pale, I'd go to the board and that's just what I would see my role as a CLO to have to do.

The fact that the Congress saw fit to put that into statute I think, within reason, is sort of sensible. I don't think it goes wildly beyond what a responsible person should be doing in that setting. There are lots of opportunities for overriding the rule and reading it too broadly, and that was the reason for our submitting our letter to the SEC. But I think the basic premise of going within the company and going to the board, and saying that there is something terrible going on here, and you as members of the board have a responsibility to set it right—I don't have a problem with that.

But the SEC saw fit to propose something much further and that is to go, as Roberta noted, to the SEC. That turns the lawyers and the general counsel into basically cops for the SEC.<sup>49</sup> I think that is not well-founded. I think that it is *ultra-vires*<sup>50</sup> as far as the statute is concerned. It is sort of curious because, on other provisions when we have gone to the Commission staff and said, "We think you need to

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48. See Kaswell/Saltzman Letter, *supra* note 46.

49. The SEC deferred action on the "reporting out" provision, pending further comment. See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205 (2003)).

50. "Unauthorized; beyond the scope of power allowed or granted by a corporate charter or by law." BLACK'S LAW DICTIONARY 1525 (7th ed. 1999).



2003]

PANEL 2

627

adjust provisions of the Sarbanes-Oxley Act, use your exemptive authority because it doesn't quite hit the mark," we've been politely told, "Well, you know, the ink isn't even dry on this thing, and you're asking us to flex it and use our exemptive authority, we're not sure we can do that."

When it came to going well beyond what Congress decided it wanted to do, the SEC seems to have no problem proposing that, particularly when you compare it to Section 10(A) of the 1934 Act which was added in 1996.<sup>51</sup> Where Congress wanted to create a whistle-blowing provision, go to the SEC, file noisy withdrawal provisions for accountants, it had no problem doing that. In this case, Congress didn't see that as necessary. It just wanted to create a reporting mechanism within the company. Indeed there is legislative history where Senator Enzi says that it was not intended to change attorney-client privilege.<sup>52</sup>

I honestly think they have gone beyond the statute; and I think what will happen is the law of unintended consequences. The lawyers within the broker-dealers and the public companies will find themselves being viewed as the enemy, rather than as people you go to saying, "I'm not sure this is kosher. What do you think?" Or reviewing documents and saying, "Maybe there is a problem here, can you help me out?" It will turn into a fear relationship where they are afraid to view the lawyers as part of the team to keep the company out of trouble. I think that the net effect of that will backfire. I hope that the SEC will see the wisdom of that when it adopts final rules.

There are lots of other provisions in here, and we could go through them. I do sort of find the idea that once you're a lawyer that you're now sort of blessed with this responsibility. I have known firms where the CEO went to law school a little later in life. It was an investment banker who then decided to go to law school, so he could argue with the lawyers he was hiring. You will now find, as the rule is proposed, that the serendipity of that person happening to have gone to law school fundamentally changes that person's responsibility.<sup>53</sup>

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51. See Securities and Exchange Act of 1934, Pub. L. No. 104-67, tit. I, § 10(A), 109 Stat. 762 (amended 1995) (requiring accounting firms to report illegal acts).

52. See 148 CONG. REC. S6555 (daily ed. July 10, 2002) (statement of Senator Enzi) (proclaiming that the amendment would not require attorneys to report violations to the SEC and would not empower the SEC to cause attorneys to breach their attorney/client privilege).

53. The SEC accepted this advice and narrowed the definitions of "appearing and practicing" and "attorney." Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670 (to be codified at 17 C.F.R. pt. 205).

Now underwriters and issuers already have huge responsibilities and huge liabilities if they don't do the right thing. I don't think that this is going to be some sort of magic bullet that's going to change and make sure that nobody does anything wrong again. I do think it's just going to complicate the system, and if the SEC were to pare back and stick more within the original intentions of the statute, I think the outcome would be much more favorable.

PROFESSOR QUINN: Thank you very much. Why don't we now open things up to questions from the audience. Questions? Comments from the audience for any of our panel members? Yes.

SPEAKER: [question inaudible].

PROFESSOR PAINTER: I'm going to, in my comment letter to the Commission, point out Qualified Legal Compliance Committee, that an attorney ought to have some continuing obligation to discuss with the Qualified Legal Compliance Committee what it has done. As I understand the regulations, they require the committee to report what it does to the full board of directors. I think the attorney ought to at least make sure the committee has done that. I think at that point the attorney can step aside and let the committee do what it does. But the committee does have to report to the board under the rules as I see them here,<sup>54</sup> and the attorney ought to be in it insofar as making sure the committee has done that.

The issue of reporting to the Commission. The proposed rules require a noisy withdrawal, which is resigning from the representation of the client and renouncing work product that the lawyer has provided to the Commission or to the other parties.<sup>55</sup> The rules don't require you to disclose the client confidences to the Commission, but they do give you permission to do that, which is already the rule in over forty states.<sup>56</sup> The ABA position that you're prohibited from disclosing confidences to prevent a crime<sup>57</sup> is in my

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54. *See id.* at 71681 (to be codified at 17 C.F.R. § 205.2(j)(4)(1)) (recognizing that the QLCC would be required to notify the board, the CLO, and the CEO of the results of any inquiry, and the remedial measures deemed necessary by the QLCC).

55. *See id.* at 71690 (to be codified at 17 C.F.R. § 205.3(d)(2)(ii)) (discussing the noisy withdrawal process).

56. *See id.* at 71691 (to be codified at 17 C.F.R. pt. 205 ) (remarking that nearly forty states permit disclosure of confidential information); *see also* CHEEK REPORT, *supra* note 43, at 32 (stating that forty-one states either permit or require disclosure to prevent criminal fraud and eighteen either permit or require disclosure to rectify prior criminal fraud in which the attorney's services were used).

57. In February 2002, the ABA Commission on Evaluation of the Rules of Professional Conduct proposed three exceptions to be added to Model Rule 1.6. *See* CHEEK REPORT, *supra* note 43, at 31-32 (noting that the ABA House of Delegates rejected two of the proposals that would have expanded permissive disclosure to prevent or rectify the consequences of a crime or fraud under Model Rule 1.6). *But see id.* at 32 (explaining that the ABA Task Force recommends amending Model Rule

2003]

PANEL 2

629

view unconscionable, and in the view of over forty states unconscionable,<sup>58</sup> but the Commission is not requiring disclosure. That's an option. The noisy withdrawal is not an option. It is true that the Commission went significantly beyond any proposal I had ever made and beyond what they are required to do under the statute in putting in the noisy withdrawal. They certainly have the authority to do that under the statute, but they were not required to do that.<sup>59</sup>

But I think that does need to be clarified, the role of the lawyer in dealing with the Qualified Legal Compliance Committee.

PROFESSOR QUINN: Roberta or Stuart, any comments?

PROFESSOR KARMELE: Well, it's possible that some corporations will respond to this proposal in that fashion. The SEC is again going further than the statute does in federalizing corporate governance by suggesting that such a committee be created.

I don't really agree with Richard that this compelled whistleblowing is authorized by the statute. I don't think it is.

MR. KASWELL: Just to make one other point on the noisy withdrawal provision. The Commission asserts that the noisy withdrawal does not breach the attorney-client privilege.<sup>60</sup> Well, there are two points—and I don't know what the position is on the QLCC because I didn't get that far in the release last night.

I don't work for a public company. I work for an association whose members are broker-dealers, some of which are public companies. But I can just imagine saying to a guy on my board, "Don't worry I'm just telling the SEC," that they'll say, "Oh, that's fine."

Second, I think it is highly problematic as to whether or not state courts are going to say that they feel bound by the SEC. I don't see that the statute preempts the law of privilege in all fifty states. Therefore, just because the SEC says the privilege isn't waived, a state court might say, "too bad," and you might persuade the General Counsel's office at the SEC to file an amicus brief on your behalf. Again, I'm sure that that's not going to give the greatest amount of comfort to the mind of a CEO who says, "you're going to do what with this information?"

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1.6 to make disclosure mandatory, rather than permissive).

58. *See id.* at 31-32 (listing the forty-one states that either permit or require disclosure to prevent criminal fraud).

59. *See* Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71673 (to be codified at 17 C.F.R. pt. 205) (clarifying that the noisy withdrawal requirements are not mandated under § 307).

60. *Id.* at 71674 (to be codified at 17 C.F.R. pt. 205).

PROFESSOR KARMEL: I'd like to point out that this noisy withdrawal doesn't apply only to disclosure documents like a registration statement or a form 10K, but it also applies to documents sent into the SEC in the course of an investigation, for example, a Wells submission.<sup>61</sup> This is when the SEC is acting as a prosecutor.

PROFESSOR PAINTER: I just want to add that it is very important to keep the duty to keep confidences separate from the privilege. I think you're absolutely right. The SEC cannot establish selective waiver of the privilege as an evidentiary principle in the rules.

The noisy withdrawal, however, I don't think involves privileged information. I think that's right. On the other hand, the SEC can preempt, and I think Congress has given the authority to the SEC to preempt, those very few states that take the unconscionable position that a lawyer could be disciplined for disclosing a client's intent to commit fraud, such as California.<sup>62</sup> But that's a different issue than a privilege. We need to keep the two separate.

SPEAKER: [question inaudible].

PROFESSOR PAINTER: You're absolutely right. I didn't see that since I just got it this morning. The fact sheet seemed to be a little bit surer of their position on the selective waiver issue. I think in one of my comments to the press on this, I said, "I'm not so sure." The privilege could be lost, and I think that they now understand that.

PROFESSOR QUINN: Are there other—okay, yes, a question there.

SPEAKER: Will many companies form QLCCs?

PROFESSOR KARMEL: I'm not sure because what the Commission release says is that the Qualified Legal Compliance Committee has to be comprised of one audit committee member and two independent board members.<sup>63</sup> So it seems the SEC is mandating the creation of a

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61. *See id.* at 71693 (to be codified at 17 C.F.R. pt. 205) (advancing that § 205.3(e)(2)(ii) of the Proposed Rules applies to submissions or contracts with the Commission by issuers who try to induce the Commission to take or not to take a particular action); *see also* Joshua A. Naftalis, "Wells Submissions" to the SEC as Offers of Settlement Under Federal Rule of Evidence 408 and their Protection from Third-Party Discovery, 102 COLUM. L. REV. 1912, 1912 (2002) (declaring that Wells submissions provide prospective defendants the opportunity to discourage the SEC from bringing formal actions against them).

62. *See* Sarbanes-Oxley Act of 2002 § 101, Pub. L. No. 107-204, 116 Stat. 745, 750 (to be codified at 15 U.S.C. § 7245) (affording a clear basis for preemption of any conflicting state rule in cases of reporting "up the ladder"); *see, e.g.*, CAL. BUS. & PROF. CODE § 6068(e) (2002) (forbidding any disclosure of client confidences). *But see* Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 76917 (to be codified at 17 C.F.R. pt. 205) (noting that preemption is by no means certain in the case of the provisions of § 205.3(d) of the Proposed Rules).

63. *See* Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71689 (to be codified at 17 C.F.R. § 205.2(j)(4)) (explaining the

2003]

PANEL 2

631

new and special committee.

SPEAKER: Could an audit committee perform the function of a QLCC?

PROFESSOR KARMEL: It could. But the bureaucrats seem to want to create another committee, that is, a specialized committee for this purpose.

I agree with you that it would make sense for the audit committee to become the qualified legal compliance committee, except that, under Sarbanes-Oxley, every audit committee now has so much more work that the SEC is already creating a kind of two-tiered board structure where there is the audit committee and then the rest of the board.<sup>64</sup>

So I'm not sure of the wisdom of that.

PROFESSOR PAINTER: I'll tell you where it would be useful to have a different committee than the audit committee. Not all illegal acts breach a fiduciary duty. Everything that is covered by this statute has something to do with accounting. The audit committee has got to focus on accounting issues. Of course with Enron and so forth, that's what it was about.

But, as I said, there is a long history of lawyer involvement with securities law violations by clients—*National Student Marketing*<sup>65</sup> and so forth. Not all of those cases had anything to do with accounting. The audit committees are not necessarily the right place to go with every complaint. So maybe this committee serves a useful function.

MR. KASWELL: Maybe I can make one observation. The other provision that I think is alluded to is that the statute also has these other sort of catch-all breach of fiduciary duty provisions in it [portion of statement inaudible], and we had argued that it should be limited to securities law violations that would require disclosure both to build a fence around it in terms of which body of law we're talking about and what kind of violations we would be concerned with in that subset.

The Commission asks whether it is a good reason to exempt violation of state securities laws? Breach of fiduciary duty laws is another area. Now attorneys who work for issuers are in effect being charged with the knowledge of all the wrinkles of all of the different state securities laws and fiduciary laws where they might be

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composition and responsibilities of the Qualified Legal Compliance Committee).

64. See Sarbanes-Oxley Act of 2002 § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7201(a)(3)) (establishing a structure whereby the attorney who does not receive an appropriate response must report the violation to the audit committee or to the entire board of directors if the issuer has no such committee).

65. SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978).

operating.<sup>66</sup> That's a terrible burden for any practicing lawyer who is just simply trying to do the right thing—to now have this gun aimed at his head or her head. I think that it just goes well beyond what the idea of this original statute was, which was to say, when you're filing things at the SEC, they ought to be accurate, and you ought to have processes internally at your company to insure that they are.

PROFESSOR PAINTER: By original statute, you mean the 1933 and 1934 acts?

MR. KASWELL: I've already begun to use Sarbanes-Oxley as the original statute.

PROFESSOR PAINTER: I cited this example when I got here because this is substantially broader than the original proposals. I mean the statute now says securities law violations, breaches of fiduciary duty, or other similar violations, and it's all covered.<sup>67</sup>

PROFESSOR KARMEL: Yes, but is it breaches of fiduciary duty under all state laws or breaches of duty under the federal securities law?

PROFESSOR PAINTER: I think it's all state laws.

MR. KASWELL: No, I think it's all state laws under the Commission's release.

PROFESSOR PAINTER: There were reasonable, but narrower, proposals before this. The ABA simply could have amended their Model Rules to require a report to the board of directors as a matter of ethics, and they refused to do so and interpreted it to say exactly the opposite. The SEC could have had a proposal that known securities law violations, not evidence, have to be reported to the board of directors. No whistle-blowing. No noisy withdrawal. None of that.

There is now a flood of letters going into the SEC about that. Every step of the way, where there's resistance, however, what we're finding is this stuff gets up on the Hill, and there is a whole different view there of what the proper function is of a lawyer than what we have inside the bar associations. We've got to deal with that problem. If we don't, we're going to go the route that other professions have gone, auditors, broker-dealers, everyone else.

PROFESSOR QUINN: Yes.

SPEAKER: [question inaudible].

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66. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71679-80 (to be codified at 17 C.F.R. § 205.2(i)).

67. See Sarbanes-Oxley Act of 2002 § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245(1)) (discussing the material violations an attorney is required to report).

2003]

PANEL 2

633

MR. KASWELL: I think, if you violate the provision, the SEC has the authority to bring the full panoply of sanctions against you.<sup>68</sup>

SPEAKER: To bar you from practicing before the Commission?

PROFESSOR KARMEL: More than that. The SEC somewhere in this release says that a violation of these rules would be considered a violation of the federal securities laws.<sup>69</sup> So, presumably, the SEC could not only bar an attorney from practice, but also impose a fine.

SPEAKER: I understand that. But there is no private civil liability.

PROFESSOR PAINTER: Not expressed under the statute, but it doesn't preclude it. Of course, lawyers can't be sued as an aider or abettor under Section 10(b) by the investors.<sup>70</sup> But where you run into liability is when the company goes bankrupt, and you've got a trustee in there who looks around for people who breached their duty to the company. Those are just malpractice actions alleging that you were negligent.

There were a lot of those even before this new legislation. That's what's amazing to me. We've had cases recently settle in the \$20-25 million area over malpractice in securities law where the lawyers didn't tell the board of directors.<sup>71</sup> Then there was Kaye Scholer, all those millions of dollars,<sup>72</sup> and not one disciplinary case against the lawyers involved by the bar associations. That's, I think, the failure of the regulatory system. But I don't know if this is going to make lawyers any more liable than they were before. We've had, as I say, a lot of cases brought for just simple negligence. But absolutely, there is liability exposure.

SPEAKER: As I read the release, the potential scope of the law is huge that is, [portion of question inaudible] all you're doing is giving

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68. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71670 (to be codified at 17 C.F.R. § 205.6).

69. Sarbanes-Oxley Act of 2002 § 3, 116 Stat. at 749 (to be codified at 15 U.S.C. § 7202(b)(1)).

70. See *Cent. Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1455 (1994) (concluding that a private plaintiff may not maintain a lawsuit based upon aiding and abetting liability under 10(b)); see also *High Court Rules No Private Remedy for Section 10(b) Aiding, Abetting Violation*, 26 Sec. Reg. & L. Rep. (BNA) No. 16, 575, 575-76 (Apr. 22, 1994) (stating that the *Central Bank* decision reverses a line of lower court decisions and derails Section 10(b) cases against parties alleged to have had a secondary role in securities fraud).

71. See Eduardo Porter & Mitchell Pacelle, *Judge Increases Severance Pay To Former Enron Employees*, WALL ST. J., Aug. 29, 2002, at A3 (discussing a federal bankruptcy judge's ruling involved in the Enron proceedings who approved a settlement package affording laid-off employees \$28.8 million in additional severance pay).

72. See *In the Matter of Kaye, Scholer, Fierman, Hays & Handler: A Symposium on Government Regulation, Lawyers' Ethics, and the Rule of Law: Introduction*, 66 S. CAL. L. REV. 977, 977 (1993) (detailing the case of Kaye Scholer in the context of the savings and loan crisis and how the traditional rules of lawyer conduct apply in circumstances outside the courtroom).

an opinion that securities need not be registered [portion of question inaudible].

PROFESSOR KARMEL: I agree with that reading. It reminds me of a student I had many years ago. I failed the student in securities law, and he came around and said, "Oh, I really need these credits to graduate. You're preventing me from graduating. Can't you give me a makeup?" Then to try and persuade me, he said, "Professor Karmel, I promise, I'll never practice securities law." I said, "The trouble with you is that you won't know if you're practicing securities law or not." That's the kind of person that this rule could capture.

MR. KASWELL: I think the short answer is that violation of the provisions does subject you to all the remedies and sanctions available under the Exchange Act, including injunctions, cease and desist orders, officer and director bars for attorneys for officers or directors.<sup>73</sup> But I think the answer is yes, the full panoply is available.

Also, I think any of those things is the end of your professional life. If you're a securities lawyer, and you're now barred from practicing before the Commission, you had better figure out some other line of work.

PROFESSOR QUINN: I'd like to ask a question of the panel. If these proposed rules had been in place two years ago, do you think they would have had any impact in preventing any or some of the recent corporate scandals?

PROFESSOR PAINTER: I'm not so sure on Enron and WorldCom; we have yet to see from the investigations what comes forth with respect to the lawyers' conduct there.

The reason I got into this in the 1990s was the savings and loan scandals, where I think it was a lot clearer that, if outside directors had been told, some of those situations might have been avoided. In the *Carter and Johnson* case, the day the full board of directors was told by the lawyers, they shut the thing down and fired the CEO who was engaged in the fraud.<sup>74</sup>

PROFESSOR KARMEL: My answer is probably not. I mean the transactions in the most visible of these cases occurred at a time when everybody was irrationally exuberant: the companies, Wall Street, the lawyers, the accountants.

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73. See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 7169-97 (to be codified at 17 C.F.R. § 205.6) (describing the manner in which violations of the rule will be addressed by the Commission).

74. See *In re Carter & Johnson*, No. 34-17597, [1981] Fed. Sec. L. Rep. (CCH) ¶¶ 82,847, 84,163-64 (Feb. 28, 1981) (describing the events leading to Sheldon L. Hart's demise after his activities came to light).



2003]

PANEL 2

635

When you are dealing with that kind of a psychology in the stock market, I think it's unrealistic to think that lawyers who are really not principals in these transactions are going to be the ones to blow the whistle. Perhaps for one or two companies at the edges, it might have made a difference. But, I think it's unlikely. That's why I said before that I think Sarbanes-Oxley is a political response to what went on in the 1990s, which was partly caused by politics.

What could have made a difference during the stock market bubble of the 1990s? Let's take two things that have nothing whatsoever to do with lawyers. One, the Federal Reserve Board could have raised margin rates to 100%. Maybe because of derivatives trading that wouldn't have mattered, but it sure would have been a signal that was never given by the Federal Reserve Board that stocks were overpriced. Two, stock options could have been expensed. Why wasn't that done? Because Congress said if the FASB passed a rule to expense stock options, Congress would abolish the FASB. This political passivity was all part of the same bubble psychology.

MR. KASWELL: You know, I also think this was a bubble psychology. Everybody was caught up into it. We all like to think that we were too smart, and we wouldn't fall victim to it. When somebody says "it's different this time," that's when it's time to reach for your wallet.

We have this idea that, if you just pass one more law, one more law will keep people from doing bad things. I just don't think that's the case. I think from what I've read in the newspapers ninety-nine and one-half percent of what went on at Enron and WorldCom and some of the others were violations of the 1933 and 1934 Acts; those Acts were written with the idea that if it's fraud, it's fraud. You can put any sort of new wrapper or bow on it, and it's still illegal. These cases will all be prosecuted under the law that existed before Sarbanes-Oxley, and I am confident that when all is said and done, the people who did bad things will go to jail and will be punished appropriately.

So, I don't believe having an attorney provision is necessarily the linchpin and that it would have made any difference. I think that the risk to the individuals in this setting, not just to the lawyers, but to all the participants, was plenty of reason already to do the right thing.

PROFESSOR PAINTER: I just want to emphasize that I think that it is true that existing law in many ways was sufficient. Lawyers who didn't do what this release requires before this release came out, before Sarbanes-Oxley, were exposing themselves to an enormous amount of liability and settling cases for millions of dollars. It was only the position of the bar associations that these lawyers did

nothing wrong. But that wasn't the legal liability rule even before this ever came along.

So, how much is it going to change good practice? Probably not much.

PROFESSOR QUINN: Yes?

SPEAKER: Why isn't it appropriate that those who are involved in the nuts and bolts of practice are involved in determining what rules ought to exist?

PROFESSOR QUINN: Would you like to comment?

PROFESSOR KARMEL: I think that if the SEC had proposed a rule implementing Sarbanes-Oxley that stuck to the logic of Sarbanes-Oxley, and which said that, in situations where lawyers draft documents that are going to be filed with the SEC, and they become aware that there are material violations of the federal securities laws involved in these documents, they have to go up the ladder,<sup>75</sup> they have to tell the general counsel, they have to go to the board or the audit committee, then yes, maybe that would be an appropriate rule because the state bar disciplinary committees are not very effective and securities law is a specialized area of practice.

The trouble is the rule goes so much beyond that and includes situations where the SEC is investigating and prosecuting a lawyer's clients. It is very troublesome to have a prosecutor regulating attorneys who are defending people who are being investigated and prosecuted by the government. It is just the same as the U.S. Attorney's Office trying to regulate the criminal defense bar and saying, "Your client is committing perjury, you have to turn him in." This SEC proposed rule isn't much different from that.

MR. KASWELL: There is a parallel provision, section 602 in the Act, that talks about appearance and practice before the Commission.<sup>76</sup> The Commission may censure any person and deny temporarily a privilege of appearance if the person doesn't have the requisite qualifications, lacks character or integrity, or willfully violated, aided and abetted violations of the Act.<sup>77</sup>

Now, I worry a little bit about that. If you robbed a bank, I think you probably shouldn't be practicing before the SEC. But part of my

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75. See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71675 (to be codified at 17 C.F.R. pt. 205) (requiring attorneys who learn of misconduct at public companies to report this information to management).

76. See Sarbanes-Oxley Act of 2002 § 3, Pub. L. No. 107-204, 116 Stat. 745, 749 (to be codified at 15 U.S.C. § 78d-3) (enabling the Commission to discipline professionals for improper conduct).

77. See *id.* (recognizing the reasons why the Commission may discipline attorneys who appear or practice before it).

2003]

PANEL 2

637

job is to get in the SEC's face a lot. I worry that, if you get too aggressive, could it be used to curtail the rights to petition the government? I don't think the SEC would actually do that, but I think it's not beyond the realm of at least musing about.

PROFESSOR PAINTER: Yes, I think you're right. There is a real problem of fifty state bar associations trying to regulate securities lawyers. It hasn't worked. We haven't had any disciplinary cases against these big-firm lawyers. It's the same pattern we see with broker-dealers, accountants, and every other gate-keeper profession—that self-regulation is lost gradually as people abuse it.

PROFESSOR QUINN: Okay. We're just about out of time. We have time for another short question.

SPEAKER: Well, I just wanted to say that to some extent this goes beyond the regulation of the profession. This is consistent with a long history of the SEC, which has insisted that when state law is insufficient that it's the role of the SEC to step in. It seems to me that this is part of a longstanding tradition.

PROFESSOR PAINTER: I would say that's absolutely right. But that's why we have the Commission too. State law doesn't work with respect to broker-dealers, and so we have the Commission. But lawyers were one of the few groups that were not being regulated. Well, self-regulation failed there as well.

PROFESSOR KARMEL: I would emphasize that the inadequacies of state law are as the Commission sees them. Is it for the SEC to rectify all of these problems? If the general discipline of lawyers under the soft regulatory process of state law isn't working, why should the SEC be the agency to fix this problem?

I wouldn't have the same criticisms if Congress decided, after a lot more deliberation than went into this provision of Sarbanes-Oxley, that we need to set up an independent federal agency to discipline attorneys who practice before federal agencies generally. There would be a federalism question there; you wouldn't have the same agency that attorneys are practicing before going after those attorneys and making them whistle-blowers for their clients, and using the leverage that the SEC has to make sure that the attorneys see the law in every case as the SEC sees it. This is exactly what compromises zealous advocacy.

MR. KASWELL: I guess my final thought is, as a practical matter, Congress has spoken, and I think the question now is to try to make this thing work in a sensible way. I do think, though, that it opens the question of more preemption. That as the SEC becomes more and more the dominant regulator, and the markets become more and

more dominant, national markets and international markets regulated at the federal level, I think it begs the question about the role of state regulation which has gotten a new lease on life lately. But I think that debate will still be joined.

PROFESSOR PAINTER: There is an ABA task force that has proposed revisions to the Rules of Professional Responsibility.<sup>78</sup> They are very sensible provisions, and I'm very much hoping the House of Delegates will make those amendments to 1.13 and 1.6 and some others.<sup>79</sup> That proposal was made, of course, while this bill was coming out of House-Senate conference—a Hail Mary pass if I've ever seen one.

But it's there, and I hope the House of Delegates takes it seriously. I think there is an opportunity to preserve what is left of self-regulation by looking carefully at what that task force of prominent securities lawyers had to say and not letting the process in the House of Delegates be taken over by the litigators, which is what happened the last time around.

PROFESSOR QUINN: Well, I think we'll have to leave it there, and I'd like to thank a truly great panel.

WHEREUPON, A RECESS WAS TAKEN.

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78. See CHEEK REPORT, *supra* note 43 (noting that the ABA Task Force was set up in March 2002 and appointed by the ABA's President to contribute to legislative and regulatory reform aimed at improving corporate responsibility after the Enron debacle).

79. The Task Force's proposed amendments address Model Rules 1.2, 1.6, 1.13, 1.16, and 4.1. See CHEEK REPORT, *supra* note 43, at 26-36 (proffering amendments to the Model Rules).