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PRELIMINARY STATEMENT

In response to a series of recent disclosures of corporate misconduct and with the goal of restoring investor confidence, Congress enacted the Sarbanes-Oxley Act of 2002 (the "Act"). Section 307 of the Act required the Securities and Exchange Commission to establish rules within 180 days which would set forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers of securities. The rules were to require an attorney to report evidence of material violations of securities law or breaches of fiduciary duty by the company or its agents to the chief legal counsel or officer ("CLO") or chief executive officer ("CEO"). If this failed to produce an appropriate response, then the attorney would be required to "go up-the-ladder" within the company by reporting the problem to an audit committee, an independent set of directors or, if necessary, the full board of directors.

The Association of the Bar for the City of New York ("CityBar") fully supports Section 307 of the Act. The legislation is consistent with ethical prescriptions contained within New York's Code of Professional Responsibility ("New York Code") and the American Bar

Association's Model Rules of Professional Conduct ("Model Rules").[1] In defining the obligations of an attorney representing an organization, including an "issuer" of securities, both the New York Code and the Model Rules begin with recognition that the lawyer's client is the organization, not its constituents - officers, employees, directors or individual shareholders. (22 NYCRR §1200.28; Model Rules 1.13). As well, we endorse the proposition that "[t]he lawyer is part of a judicial system charged with upholding the law. One of the lawyer's functions is to advise clients so that they avoid any violation of the law in the proper exercise of their rights." (Comment, Model Rules 1.6). Accordingly, in order for the attorney to act "in the best interest of the organization," both the Code and the Model Rules require the attorney to report violations of law by officers, employees or agents of the company up-the-ladder when the violations "might be imputed to the company" or otherwise are "likely to result in substantial injury to the company." *Id.* For that reason, we welcome the Act and support proposed rules consistent with the Act.

Unfortunately, the Commission, in its first draft, has proposed rules that we believe go beyond, if not counter to, the Act's language and intent. The rules impose obligations requiring or, in some circumstances, allowing an attorney to act against the client's interest and over its objection, including: (1) withdrawal from representation; (2) public notification to the Commission of withdrawal; (3) affirmative disavowal of documents filed on the client's behalf with the Commission; (4) creation and maintenance of non-privileged documentation by the attorney of wrongdoing within the organization which may then be used against the organization; (5) disclosure of confidential client information; and (6) disclosure of privileged information. The net practical effect of the proposed rules would be to require an attorney, concerned about

[1] There are some differences in approach between the New York Code, the Model Rules and the Act regarding "up-the-ladder" reporting - some of which are discussed within this report - but in practice there is more

personal liability, to investigate and report actions and statements of employees either working for an issuer or associated with an issuer and then, if not satisfied with the response, to report misconduct to the SEC. The rules as drafted, if aggressively enforced, could eviscerate the attorney's traditional role as advocate, confidant and advisor. This would drive a wedge between attorney and client. Corporate officers and employees would not be forthcoming and this, in and of itself, would in the long run hurt the corporation and its investors. As explained in the report that follows, the rules ask an attorney to give a higher priority to documentation and reports to the SEC than to the interests of the corporation. As well, an attorney fearing disciplinary sanction, civil liability or potential criminal exposure for a failure to report misconduct by others is asked to document and expose client confidences over the client's (the corporation's) objection when disclosure might well not be in the client's interest. If the rules are created to protect the client-corporation from malfeasance by wayward employees or agents, the client-corporation, through, for example, a board of directors exercising proper business judgment, should have a voice in deciding whether attorney-client secrets or confidences will be disclosed.

It is not possible to explore in adequate depth the many issues and problems raised by the proposed rules in the brief time, thirty days, that we have been allotted to prepare comments upon the proposal. (The Act was signed into law in July but only specified "up-the-ladder" reporting. Rules requiring withdrawal, documentation, disclosure and disaffirmance were added by the Commission in its November release.) However, we have endeavored to highlight a few issues of significance in this report. As well, since we continue to support the stated objectives of the Act, we offer suggestions for implementing regulations that we believe are consistent with our recognized obligation to contribute to confidence in the securities market by requiring a high standard of professional conduct from attorneys who practice before the Commission.

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coincidence than conflict.

At the outset, it should be noted that we share many points of agreement with the proposed rules and find support for them in the New York Code, Model Rules and existing decisional law. Our greatest concern is with the disruption to the attorney-client relationship and with those provisions that hold an attorney accountable for frauds or omissions performed by others, without the lawyer's assistance or participation, and where the attorney may not have actual knowledge of the wrongdoing.

Points of Agreement

A legitimate, and we believe persuasive, argument can be made that the Act granted only a limited rule-making authority to the Commission. Up-the-ladder reporting is mandated, but the proposed rules requiring withdrawal, record-keeping, disaffirmance, and disclosure go beyond statutory authority. As well, we argue later, that those issues, as a matter of policy, history and law, are best left with Congress, the States and Bar Associations. However, before highlighting our differences with the Rules, it's necessary to place those differences in context by explaining essential points of confluence with the Commission's proposal. The Model Rules and the New York Code, along with opinions further explaining them by the pertinent Bar Committees, have provisions which address these same issues. They provide a framework which can and should provide the Commission with an abundance of authority to demand honesty, competence and professional behavior from lawyers who practice before it.

- The Commission has the right to, and should, censure or bar an attorney from practicing or appearing before it when the attorney has engaged in misconduct in the representation of an issuer. The New York Code defines prohibited misconduct to include "dishonesty, fraud, deceit, or misrepresentation." DR 1-102 (A)(4). That provision should be incorporated within the Commission's rules.

- The Commission has the right to demand, consistent with Model Rules 4.1("Truthfulness in Statements to Others"), that an attorney not knowingly make a false statement of material fact or law to the Commission, or fail to disclose a non-confidential material fact when necessary to avoid assisting a criminal or fraudulent act by the client.
- Further, we agree that the Commission should expect compliance with the New York Code that a lawyer shall not counsel or assist the client in conduct that the lawyer knows to be illegal or fraudulent; knowingly make a false statement of law or fact; or knowingly fail to disclose that which the lawyer is required by law to reveal. (See, generally, DR 7-102, "Representing a Client Within the Bounds of the Law").
- We support a rule that a lawyer may reveal, over the objection of the client, the intention of a client to commit a crime and confidential or secret information necessary to prevent the crime. (DR 4-101[C][3]).
- As well, we support the rule that confidences or secrets may be revealed, over the client's objection, to the extent implicit in disaffirming a written or oral opinion or representation previously given by the lawyer and believed by the lawyer still to be relied upon by a third person where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud. (DR 4-101[C][5].
- With regard to withdrawal from representation, a lawyer must withdraw when the lawyer knows or it is obvious that continued representation will result in a violation of a disciplinary rule, including all of the above. (DR 2-110). Thus, withdrawal is mandatory, whether the lawyer is "inside counsel" employed by the issuer or "outside counsel" retained by the issuer, when the representation would involve knowingly making a false statement, failing to disclose that which is required by law to be disclosed, or assisting the client in conduct that the lawyer knows to be illegal or fraudulent.
- We recognize that one of the most difficult areas in which to fashion a fair rule involves the situation where the attorney has not committed a fraud, has not assisted in the commission of the fraud and has not participated in the preparation of material to be used in the fraud, but still learns that the client or a third person such as an employee, director, officer or investor has perpetrated a fraud upon a third person, including the Commission

itself. In that case, we subscribe to DR 7-102. If the lawyer receives information clearly establishing client fraud and the client refuses or is unable to rectify the fraud, the lawyer must reveal the fraud to the affected person, unless the information is protected as a confidence or secret. Beyond that, when a person other than the client has perpetrated the fraud upon a tribunal, which includes all adjudicatory bodies, the lawyer must reveal the fraud. (DR 7-102 [B][2]). (The issue is discussed in much greater depth in Formal Opinion No. 1990-2 by the Committee on Professional and Judicial Ethics of the Association [Feb.27, 1990]. We support the resolution of the dilemma propounded by that Formal Opinion.)

The above list is not intended to be complete or even comprehensive. It is presented merely to point out that despite some differences over the proposed rules - important to our membership - there remains a fertile and extensive landscape upon which can be built a strong set of regulations. We share a common understanding about the need for attorneys representing issuers to act not only as advocates but as members of the bar sworn to uphold the law.

Concerns

The report that follows this preliminary statement explains some of our concerns and differences with the proposed rules in greater detail. Unfortunately, given the size and diversity of our membership and the enormous number of complex issues raised by the proposed rules, we have not been able to address all that could have been covered in an appropriate comment. For example, applying the rules of practice to foreign attorneys carries with it such an extensive array of potential problems that we have deferred, for another day, comment on that issue. In that regard, while understanding that the Act required promulgation of rules within 180 days, we do not read the Act as specifically requiring any other particular rule beyond up-the-ladder reporting. Any rules which go beyond the one rule mandated by Congress could and should, consistent with the Act, be adopted with caution and reserve after a full hearing, more than a 30 day comment period, from the many groups who will be affected by the proposal. Rules

regarding withdrawal, disaffirmance, documentation and disclosure do not have to be adopted in the first 180 days.

Criminal and Civil Liability

Section 307 of the Act calls for rules setting forth minimum standards for professional conduct for attorneys appearing and practicing before the Commission. Such rules, including the Model Rues, the New York Code and even the Commission's own previous rules under 17 CFR 102, traditionally are not enforced as criminal matters. However, 15 U.S.C. § 7202, as added by the Act provides that a violation of any rule or regulation issued by the Commission pursuant to the Act shall be treated as a violation of the Securities Exchange Act of 1934, which carries criminal penalties. (15 U.S.C. § 78ff). The Commission's release accompanying the proposed rules said that "[t]he Commission does not believe…that violations of the proposed rule would, without more, meet the standard prescribed…for the imposition of criminal penalties." The phrase "without more" apparently refers to the fact that Sec. 78ff authorizes up to twenty years imprisonment for "willful" violations of any regulation of the Commission. In sum, a willful violation of one of the new rules is a serious criminal matter, notwithstanding the Commission's assurances. This is not consistent with the Senate sponsors' assurances on the Senate floor where Sen. Sarbanes asked, "Furthermore, I understand that under this amendment it can only be enforced by the SEC through an administrative proceeding. Is that correct?" To which Sen. Edwards responded,

"The answer is yes. The only way to enforce this legal requirement is through an administrative process." Congressional Record, Senate S6557.

The Commission should specifically include, within the regulations, language which guarantees that the administrative process will be the exclusive means of enforcement.

As well, although it was made clear during floor debate that the sponsors had no intention of creating civil liability for violation of the promulgated professional standards,[2] there is no clear statement in the Act or rules establishing that protection. In light of the ensuing discussion regarding *mens rea* and the definitions of "appropriate response" and "material breach of fiduciary duty," it becomes critical that the sponsor's intent, i.e., no criminal or civil liability should attach by virtue of a professional standard violation, be clearly enunciated.

***Mens Rea* - Evidence of a violation - the duty to act**

There is, and should be, a critical distinction between the responsibility of an attorney for his or her own conduct – conduct in which the attorney personally engaged such as giving advice, counseling and assisting in the preparation and filing of documents with the Commission - and conduct of others of which the attorney has only been informed. Attorneys can and should be held to a high standard with regard to their own professional activities. For example, Model Rule 1.1 requires a lawyer to act with "the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." That rule can apply to the services provided by the lawyer in a professional capacity. There are circumstances where the attorney's own participation in committing a fraud or violating the law may be assessed – just as with any other person so accused - by constructive knowledge or measured by an obligation to meet an objective standard.

However, the proposed rules go well beyond regulating the personal conduct of the attorney. They assign a "watchdog" function to attorneys. Under the rules as proposed, attorneys are required to report the misconduct of others even where the attorney played no role in any of the actions that led to the violation. In other cases the attorney may have only learned of the

[2] Sen. Edwards, in explaining the bill, said, "One final point. Nothing in this bill gives anybody a right to file a private lawsuit against anybody. The only people who can enforce this amendment are the people at the SEC."

misconduct through confidential, secret or privileged communications. In still other cases, the attorney may have a conscious awareness of the violation, being committed or having been committed by others, while not having personally engaged in any of the wrongful conduct. In some cases the attorney may only have circumstantial grounds to form a suspicion or belief that others, including officers, employees, agents, directors or shareholders, have engaged in misconduct – but cannot be certain.

Under the proposal, the attorney is required to act based upon two determinations: Is there "evidence of a material violation?" And, was there an "appropriate response?" These "triggers" for action are measured upon an objective assessment of the information available to the attorney about misconduct by others and the conclusions that should have been drawn by the attorney.

Although we oppose mandatory disclosure, as discussed *infra,* if the proposed rules will continue, notwithstanding our objections, to allow the attorney no discretion, then it becomes essential that a rigorous *mens rea* standard be employed. An attorney should not be forced to disclose confidences and secrets, or act against the interests of the client, unless the attorney has actual awareness of essential facts and, under all the known facts and circumstances, it is clear that a material violation is continuing or is about to occur. It simply is not fair to expect an attorney to report misconduct, withdraw or disaffirm or otherwise act in the attorney's best judgment against the interests of the client when the attorney merely has "constructive" knowledge of essential facts necessary to draw a conclusion of misconduct by others in which the attorney has not personally engaged. Unlike the situation where an attorney is accused of personal wrongdoing and it may be fair, in proving that wrongdoing, to ask what the attorney

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Cong. Record, Senate 7/10/02, S6552.

knew or should have known, here, the concept is stretched to new limits by holding an attorney accountable for conclusions he "should" have made about other actors' wrongdoing.

The definition of "evidence" invites "Monday morning quarterbacking." When the definitions contained in Part 205.2 (e), (k), and (l) are read in combination, as they must be, "evidence of a material violation" means "information that would lead a reasonably prudent and competent attorney, acting reasonably, to reasonably believe that a material violation has occurred, is occurring, or is about to occur." If the definition makes any sense at all, it is dangerous. First, what constitutes "information?" Is it gossip, hearsay, innuendo, a combination of circumstances from which the attorney, in retrospect, should have drawn an inference? The proposal asks, in hindsight, "Would it have been unreasonable for a prudent, competent attorney to have concluded that there was misconduct?" The proposal shifts the burden to an attorney, facing an after-the-fact inquiry, to defend by proving the negative, i.e., to prove that the information would not have led a reasonably prudent attorney to believe that another person had engaged in wrongdoing. This is simply unfair. Reasonable people, even prudent attorneys, can differ in drawing the conclusion that an officer or employee has breached a duty or broken a law. That difference of opinion cannot be turned into a basis for disciplinary sanction.

The issues and problems that arise in representing issuers require informed advice, zealous advocacy and creative solutions. Clients need to trust their lawyers, and lawyers need to feel free to give independent advice. The definitions employed by the rules to trigger investigatory action will create a world of caution, suspicion and distrust, thereby casting a pall over the attorney client relationship.

Compounding the problem, the misconduct that must be reported ("material violation") includes any breach of fiduciary duty, which can include omissions or failures to act. Therefore,

an attorney will be obliged to act by reporting up-the-ladder or beyond under the rules when, in retrospect, a "prudent, competent" attorney would have had enough "information" to "reasonably believe" that another actor, be it employee or agent, failed or omitted to do something which ought to have been done.

When the New York Code mandates corrective action, it is because the lawyer "knows or it is obvious" that the attorney will be drawn into participating in misconduct. On the other hand, actual knowledge is not required when the attorney's response is discretionary. *Compare* "Mandatory Withdrawal" and "Permissive Withdrawal" provisions of DR 2-110. This combination of standards mandates action to which the attorney can be held readily accountable, but merely authorizes action, upon an expectation of good faith, when the circumstances or conclusions to be drawn from the circumstances are not so clear. Our concern is that the proposed rules consistently mandate action, leaving no discretion to the attorney, even where the attorney is acting in good faith and may not have actual knowledge of the information which may lead someone later, second-guessing the decision after the unforeseen has occurred, to conclude that the attorney failed to perform a required act.

Willful blindness should not be condoned. A conscious disregard of material violations is inconsistent with acting in good faith. An attorney should not be able to consciously avoid information in order to defend inaction later by claiming ignorance. However, in the absence of such a demonstration, an attorney should not face sanctions for failing to see what becomes clear only in hindsight.

***Mens rea* - Appropriate Response**

Under the proposed formulation, an attorney is required to pursue a matter up-the-ladder and to the Commission (either directly or indirectly through a QLCC) when there is not an "appropriate response." Once again, we believe that the definition - a response that provides a basis for an attorney reasonably to believe that no material violation has occurred or that appropriate measures have been taken - invites second-guessing which is perilous to the attorney. The inevitable result will be over-caution by attorneys who, motivated by self-protection, will document and pursue matters when, in fact an appropriate response was given, but they are not in possession of enough information to make a reasoned judgment or are too frightened to accept a reasonable response. The resulting atmosphere of mistrust and doubt among attorneys and clients is counterproductive - to the point of dysfunction.

Once an attorney has reported and documented a possible violation, the attorney should be assured that good faith reliance upon the response protects the attorney against further sanction. Otherwise, the rules and an instinct for self-preservation would require an attorney to ignore or bypass higher-ranking officers, attorneys and directors even though the attorney in good faith believes that further corrective action is not required. Once again, recklessness or willful blindness is not acceptable. But in the absence of recklessness, a reporting attorney should be able to desist from further action once the attorney, in good faith, under all the known facts and circumstances, believes that appropriate corrective measures have been taken.

Confidentiality and Attorney-Client Privilege

An attorney should not be required to disclose confidential (privileged) information or client secrets without the client's consent. Privilege and client confidentiality are impinged upon by four different sets of provisions in the proposed rules: mandatory withdrawal with

notification; disaffirmance, documentation and disclosure. The CityBar opposes any rules which require an attorney, over the client's objection, to withdraw, report, notify or disaffirm beyond the requirements now embodied in the New York Code. The withdrawal, notification and disaffirming requirements, discussed below, to the extent that they mandate actions against the client's interest or disclosure of confidences or secrets are unnecessary, and unwarranted, and constitute an unjustified disruption of necessary attorney-client communication.

Mandatory withdrawal

The Model Rules and the New York Code follow the same formulation with regard to withdrawal: if it is obvious that the lawyer's continued representation will result in a violation of a disciplinary rule, the lawyer must withdraw. If it is "likely" that continued representation will result in a violation of a disciplinary rule or the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent, the lawyer may withdraw. In either event, the lawyer must take steps to avoid foreseeable prejudice to the client.

The proposed rules require a retained attorney to withdraw when the attorney has not received an "appropriate response" to a reported material violation and the violation is ongoing, or about to occur, and is likely to result in substantial injury to the financial interest of the issuer or investors. The proposed rules permit withdrawal when the attorney reported a past violation which went uncorrected, and which was likely to have resulted in substantial injury to the financial interest of issuers or investors in the past but is not ongoing. The proposed rules say nothing about taking steps to mitigate harm to the issuer. To the contrary, we believe the proposed rules would exacerbate the harm to the issuer by requiring notice that the withdrawal "is based upon professional considerations."

As can be seen, the proposed rules are more demanding in some respects and less demanding in others. The New York Code and Model Rules only address the situation in which the lawyer's conduct or the use of the lawyer's services are at issue. The bar rules do not speak of withdrawal where the client has engaged in misconduct or persists in misconduct, but the attorney merely has notice of the misconduct and is not implicated directly or indirectly through misuse of the lawyer's services. On the other hand, the Commission's proposed rules would require attorneys who were aware of a continuing violation to withdraw, even where the misconduct was unrelated to the attorney or the attorney's services.

There are three problems with the proposed scenario:

- An attorney should not be required to abandon the client when the misconduct is unrelated to the attorney's performance. If, for example, a client wrongfully fails to disclose material information in a filing, the attorney may, in good faith, decide to stay with the client, while continuously urging compliance with the law. As long as the attorney's services are not being misused - the attorney played no role in preparing the filing - and the attorney is, personally, acting ethically, why should the attorney be forced to abandon the corporation as a client?

- An announcement to the Commission and others that the withdrawal is "for professional considerations" is a red flag - an invitation to enforcement action and adverse litigation. Obviously, withdrawal can be accomplished quietly, without notice to anyone but the client - consistent with the obligation to protect the interests of the client.

- There may be situations where it could be argued the lawyer may or should choose to act: where the lawyer's services were used to assist in an ongoing crime or fraud; where the lawyer needs to disaffirm the lawyer's own work-product upon which third persons continue to rely to their potential detriment (See, ABA Comm. on Ethics and Professional Responsibility, Formal Op. 92-366); or where the lawyer seeks to prevent a crime which the client intends to commit. (EC 4-7). On the other hand, where the misconduct and the harm are things of the past and where the lawyer's services have not been utilized to

accomplish or conceal the violation, there is no justifiable reason for the attorney to notify the Commission other than to provide the SEC with information with which to commence an enforcement action, and that is insufficient reason to override client privilege.

- The proposed rules provide (Part 205.3[d][3]), "the notification to the Commission prescribed.... [upon withdrawal] does not breach the attorney-client privilege." We think this is an unauthorized usurpation of the power to define the scope of the attorney-client privilege. As well, it confuses the privilege with disciplinary rules which also may protect client confidences. The attorney-client privilege is not a creature of professional conduct rules. It stands independently as a hybrid product of State and Federal Constitutional, legislative and common law. It is neither created, nor can it be diminished, by rules designed to regulate the profession. Congressional authorization to promulgate standards of conduct for professional practice before the Commission cannot support a claim that the proposed rules now override Fed. Rules of Evidence 501, or the Constitution or State authority. Consistent with the Act, one could argue that the Commission can create disciplinary rules governing practice before the Commission which forgive, in the course of that practice, or provide safe harbor to, an attorney who has violated rules of confidentiality established within Part 205. We do not believe Section 307 "impliedly" gives an enforcement agency the right to define privileges.

Disaffirmance

The New York Code permits disaffirmance, without more, of a written or oral representation or opinion by the attorney, which the lawyer has come to learn was based on materially inaccurate information. If the representation or opinion is still being relied upon or is being used to further a crime or fraud, the disaffirmance can be done over the client's objection. Confidences or secrets may be revealed to the extent implicit in withdrawing the document. As well, the attorney may reveal the intention of the client to commit a crime and information necessary to prevent the crime. If the inaccurate representation by the lawyer is not currently

being used to commit a crime and is no longer relied upon by others, then the lawyer can rectify the error, but cannot reveal confidences or secrets.

The proposed rules would permit disaffirmance to rectify past harm even where confidences and secrets would be revealed. The proposed rules would also mandate disaffirmance where the violation is ongoing or about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors. We think this goes too far. There are occasions when a lawyer and the client prepared a document for filing, which was believed to be true at the time of the filing. If later events render the document false, the lawyer should not be permitted, over the client's objection and to the client's detriment, in the name of rectifying the past wrong, to disaffirm the document while revealing client confidences.

Documentation

We are concerned that the documentation requirements are impractical and will threaten the free flow of ideas and candid conversation between attorney and client as well as between attorneys. Since there is a risk that documents will find their way into court proceedings, be they criminal or civil, the requirement that they be made contemporaneously and preserved will stultify ordinary communications, which are a necessary part of any successful venture. As a practical matter, both sides to a conversation will protect their position by excessive documentation. In turn, CEOs or CLOs may soon find themselves mandating review and collection of all documentation created pursuant to the rules. It is unlikely that this will produce the desired result - honest compliance with the law.

Safe Harbor for Chief Legal Officers

A CLO who has been advised of a past, present or future material violation may conduct an inquiry or ask the QLCC to conduct the inquiry. However, if the CLO believes that the issuer has failed to take remedial measures directed by the QLCC to stop any material violation that is occurring, to prevent any material violation that is about to occur and/or has failed to rectify a past material violation, then the CLO must go outside the company to disaffirm, in writing, any documents that have been submitted or filed with the SEC that the CLO reasonably believes are false or materially misleading.

The proposed rules do not appear to give a CLO the same safe harbor provision afforded other attorneys. Part 205.3(c)(1) declares that an attorney who has reported a violation to a QLCC has satisfied the attorney's reporting obligations. However, the same section creates an exception: the provisions of 205.3(b)(3) requiring a CLO to report the failure of the issuer to take remedial measures demanded by the QLCC still apply. As well, 205.2(j)(5) make it clear that the CLO, the highest ranking attorney within the organization, must personally notify the Commission and disaffirm filings when the issuer has failed to comply with the QLCC's directives. In contrast, the rules should provide safe harbor to a CLO who submits information to the QLCC.

The obligation to go outside of the organization instead of up-the-ladder is significantly different than the duty imposed upon other attorneys. First, the CLO is required to disaffirm any writing or document submitted or filed by the issuer with the Commission which the CLO reasonably believes to be false or materially misleading. Other attorneys are only obligated to disaffirm documents that they prepared or assisted in preparing. The CLO, however, must disaffirm all false documents, from whatever source, including documents and filings the CLO never prepared. How will the CLO know which documents are false? Since the initial report

and request for inquiry works its way up to the CLO or the QLCC and CLO, the result is that the CLO hears all or most claims calling into question any documents which are filed with the Commission during the internal up-the-ladder process. Thereafter, if the CLO is required to disavow documents the CLO "reasonably believes" to be false, the CLO will in effect be called upon to disclose a large number of documents that the CLO reviewed during an inquiry.

Secondly, other attorneys are mandated to disaffirm documents they prepared when the violation is ongoing or about to occur. There is no obligation to report past false filings where there is no ongoing violation. On the other hand, the CLO is required to report to the Commission past violations as well as ongoing and future violations.

Finally, the CLO is required to report a failure to rectify past violations, or the existence of present or future violations, without regard to any consideration of whether the violation is likely to result in substantial injury to the financial interest or property of the issuer or investors.

In sum, upon an issuer's failure to comply with a QLCC directive, the CLO is mandated to notify the Commission of past, present and future violations of which the CLO learned and which have not been rectified or prevented by the issuer regardless of whether there is a risk of ongoing or future injury to the issuer or investors. The CLO must then disaffirm, to the Commission, all false or materially misleading documents submitted by the client, whether prepared by the CLO or submitted by others – even in circumstances where the disaffirmance may harm the issuer or its investors. We believe this goes too far.

The CLO is the attorney closest to the Board and the CEO. The CLO is in a position to know the most important and private confidences and secrets of the client. The CLO's obligation or authority to reveal confidences and secrets should be limited to those situations authorized by

the New York Code. The issuer and the CLO should be permitted to prevent disclosure of past misconduct of which the CLO became aware in confidence.

"Breach of Fiduciary Duty"

The definition of "breach of fiduciary duty" (Part 205.1[d]) is confusing and a trap for the unwary. It is unreasonable to expect an attorney to become familiar with the various common law and statutory definitions of fiduciary duty in 51 jurisdictions. We propose that the breach should be measured by the governing body of law in the jurisdiction of incorporation. It should also be made clear that duty is that owed by the officers and directors to the issuer and the shareholders only.

"Representation of an Issuer"

The definition, Part 205.1(f), should not include attorneys acting "for the benefit of an issuer," as this would include attorneys having no attorney-client relationship with the issuer. It is sufficient to refer to attorneys who are engaged or retained to act in their capacities as an attorney for the issuer, or to provide legal services to the issuer. Otherwise, attorneys who work for underwriters, banks, financial advisors, etc., all of whom owe separate duties to actors other than the issuer, will inadvertently find themselves governed by a whole new set of practice regulations.

"Appearing and Practicing"

There is no sound reason, and it is unfair, to include attorneys who are adverse parties in enforcement or administrative proceedings within the reporting and withdrawal requirements of the proposed rules. The attorneys in that situation are performing traditional adversarial

advocacy roles. It is untenable to place them in the position of enforcing the law against clients they are defending in an enforcement action.

Attorneys who merely give advice against the need to file are not appearing or practicing before the Commission and should not be included. If an attorney never comes into contact with the Commission, the Commission should not claim authority to regulate the attorney's conduct. It is impractical for the commission to attempt to extend control over professional conduct beyond contact with the agency. The agency can properly review the client's decision to file or fail to file, but private consultations in remote places that may have factored into that decision cannot be deemed to constitute "practicing" before the agency.

Who's the client?

The Model Rules and the New York Code make it clear that the client is the organization and not any of its constituents. It is inconsistent and inviting conflict to ask the attorney to represent both the issuer and the investors, when their interests, which may overlap, do not always coincide.

Best Interests

Part 205.3 mistakenly states that an attorney "shall act in the best interest of the issuer and its shareholders." (emphasis added) The addition of this phrase subverts the basic principle recognized both in the New York Code and the Model Rules that the attorney represents the issuer and not any of its constituents. We believe that this single provision of the proposed rules will spawn a set of conflicting and competing governing principles that will lead to unintended liability and lawsuits for breach. Corporate officers and directors have a fiduciary duty to shareholders to act in their best interest. Under the business judgment rule, as long as they have performed that task with independence, disinterest, good faith and diligence, they are protected

from personal liability. Directors look to maximize investment security, stability and profit. On the other hand, attorneys have an entirely different set of governing principles. They are bound to perform with diligence, competence and loyalty; they owe a duty of confidentiality. They give legal advice, but attorneys do not run the company and do not make the client's decisions. They are not in a position of governing responsibility, they do not have an officer or director's immunity and they should not be exposed to liability for lapses in governance.

Subordinate Attorneys

The proposed rules impose an artificial hierarchy of supervisory and subordinate attorneys and unnecessarily impose separate duties upon them. Law firm structures come with wide variety. It is an incorrect assumption that firms are structured as viewed in the regulations. For those firms that do have subordinates and supervisors working on behalf of a client, the rules would interfere with the collaborative nature of the professional relationship. Subordinates would pass problems up to supervisors without attempting to solve them. Supervisors would be artificially forced to make decisions which more naturally should be delegated or shared by a team effort. There is no legitimate justification for rules creating separate categories of attorneys within a firm. It is sufficient to hold attorneys who have ultimate responsibility for a decision accountable for their own decision making.

Conclusion

The Citybar appreciates the effort and good intentions that underlie the proposed rules. We recognize that the Commission staff had time constraints as it undertook a project of enormous complexity. Our Association is committed to working with the Commission on this project. We represent nearly 22,000 members, many of whom can lend experience and knowledge to the highly technical and difficult task before the Commission. To the extent that

the report that follows might appear critical of the Commission's effort, we reiterate that we share the Commission's goal – demanding honest and faithful service from attorneys who represent issuers. We believe the Commission can write rules to achieve that objective and we appreciate the opportunity to work with you to accomplish it.

REPORT OF THE TASK FORCE[3]

The Association of the Bar of the City of New York Supports the Promulgation of Regulations Implementing Section 307 that are Consistent with the Model rules and the New York Code of Professional Responsibility

The fiduciary relationship between clients and their attorneys provides sufficient comfort to clients to make them feel free to share any information that the attorney may need in order to advise the client on compliance with the securities laws. This may include notifying the client that past conduct may have constituted a violation of the securities laws and may require disclosure and/or other remedial action, or notifying the client that some contemporaneous action or planned conduct by an officer, employee or agent of the issuer may lead to a violation of the securities laws and should be stopped before such violation occurs.

Both the Model Rules and the New York Code have recognized that attorneys may be in a unique position to learn of misconduct and to advise their clients appropriately. Therefore, both the Model Rules and the New York Code have prescribed the action that lawyers should take when they learn that an officer, employee or other person associated with the organization has acted, intends to act (or refuses to act) in a manner that constitutes a breach of an obligation to the organization or a violation of law that may be imputed to the organization, and that the conduct is likely to result in substantial injury to the organization. Each prescribes that the lawyer in these circumstances should consider:

> asking for reconsideration of the matter,
>
> advising that the organization obtain a separate legal opinion for presentation to the appropriate authority in the organization, or

[3] Representatives of five committees of the Association of the Bar for the City of New York worked to assemble this response for presentation to the Executive Committee. The committees so represented were: the Professional Responsibility Committee; the Professional Discipline Committee, the Securities Regulation Committee, the Professional & Judicial Ethics Committee and the Corporation Law Committee.

referring the matter to the highest authority within the organization. Each also prescribes that if, despite these efforts, the highest authority in the organization insists on acting (or refuses to act) in a way that "is clearly a violation of law and is likely to result in substantial injury to the organization," the lawyer may withdraw in accordance with the Model Rule 1.16 or DR 2-110, respectively.[4]

Moreover, we believe that the response of issuer's counsel to evidence of misconduct that may be attributed to the issuer under either the Model Rules or the New York Code is consistent with the course of conduct prescribed under Section 307. Attorneys who represent issuers have an obligation to act in the best interests of the issuer. When such attorneys become aware of misconduct by officers, employees or other agents of the issuer, or material misstatements made by these persons, the attorneys have an obligation to act to correct the situation within the organization, which includes disclosing the conduct "up the ladder" within the organization to the chief legal officer, chief executive officer, and/or to board members. Further, though not specifically authorized under Section 307, we believe that the Commission has the right to regulate the conduct of attorneys who appear before it to ensure that these attorneys adhere to professional rules of conduct, do not engage in or assist in unlawful or fraudulent conduct, do not knowingly submit or allow others to present false information to the Commission, and withdraw from employment where failure to withdraw will cause the attorney to violate the law or state disciplinary rules.

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[4] Model Rules of Professional Conduct 1.13; Code, DR 5-109. Indeed, we believe that Section 307 merely reinforces existing obligations governing the conduct of New York attorneys under DR 5-109 and other disciplinary rules in the Code. See, e.g., DR 4-101(C)(5) (permitting lawyers to reveal confidences or secrets to the extent implicit in withdrawing a written or oral representation previously given by the lawyer where the lawyer discovers that it was based on materially inaccurate information or is being used to further a crime or fraud); DR 7-102(B)(requiring a lawyer who receives information clearly establishing that the client has perpetrated a fraud upon a person or tribunal to call upon the client to rectify same, and if the client refuses, to reveal the fraud to the person or tribunal except where the information is protected as a confidence or secret).

Proposed Part 205, however, far exceeds the above-stated premise and the authority granted to the Commission by Congress in the Act. The Act is the first federal statute that Congress has enacted and the President has signed that affirmatively mandates regulation of attorney conduct by a federal agency on a national basis. The pertinent language in Section 307 authorizes the Commission to set forth "minimum standards of professional conduct for attorneys appearing and practicing before the commission in any way in the representation of issuers." Rather than setting forth "minimum standards," proposed Part 205 sets forth standards far beyond those set forth under the Model Rules and the ethical codes in each state, and in some instances is inconsistent with federal and state case law.

We understand that the Commission has prepared this rule, which has far-reaching consequences, while working under extreme time pressure. Given the complexity of the subject matter, the nascent state of the public debate of the statute, the brevity of the period available for analysis, and the limits of our predictive capacities, we recommend that the Commission meet its statutory obligation by enacting a simplified rule, such as the one contained in the appendix, on January 26, 2003, and leave the balance of the proposed rules for more considered comment and discussion over a longer period of time. Accordingly, this letter is limited to:

i. discussing how the proposed rule modifies the attorney-client privilege and may be contrary to state and federal law;

ii. discussing the negative impact of the proposed regulation on the attorney-client relationship;

iii. discussing the proposed extension of the Act's reach beyond those attorneys prescribed and anticipated under Section 307;

iv. commenting on the role of the QLCC;

v. discussing adding a "safe harbor" for the chief legal officer;

vi. discussing the proposed sanctions against attorneys;

vii. discussing questions raised by terminology used in the proposed Act;

viii. discussing our support for the promulgation of rules consistent with Section 307, the Model Rules and the New York Code of Professional Responsibility, and presenting a proposed rule that may be enacted on January 26, 2003.

DISCUSSION

I. THE PROPOSED RULES MODIFY THE ATTORNEY-CLIENT PRIVILEGE

An area of primary concern for the CityBar is with the "noisy withdrawal" provisions of proposed Section 205.3. Section 205.3(d) prescribes instances in which a reporting attorney who has not received an "appropriate response" from the issuer within a reasonable time is either required or permitted to report otherwise privileged information relating to a suspected material violation to the Commission. Section 205.3(d)(1) mandates that an attorney retained by the issuer who (1) has reported evidence of a material violation up-the-ladder and has not received an appropriate response in a reasonable time, and (2) believes that a material violation is ongoing or about to occur and likely to result in substantial injury to the financial interest or property of the issuer or investors, to withdraw from the representation of the issuer, provide notice of withdrawal "based on professional considerations" to the Commission, and disaffirm any document submitted to the Commission that the attorney assisted in preparing that the attorney reasonably believes may be materially false or misleading (the same section provides that the reporting attorney who is in-house counsel need not withdraw from the representation).[5] Section 205.3(d)(2) permits a reporting attorney who reasonably believes that a material violation has occurred and likely has resulted in substantial financial injury to the issuer, but does not believe the violation is ongoing, to disaffirm any tainted submission to the Commission, withdrawing

from representing the issuer and providing notice to the Commission of his or her withdrawal "based on professional considerations." In the Commission release describing proposed Part 205, the Commission acknowledges that "[p]roviding notification to the Commission . . . goes beyond what the Act expressly directed the Commission to do." SEC Release 33-8150.

The external reporting rules proposed by the Commission conflict with the principle recently reaffirmed by the United States Supreme Court that the integrity of the attorney-client privilege takes precedence over unauthorized disclosure except in very limited circumstances. In Swidler & Berlin v. United States, 524 U.S. 399, 118 S.Ct. 2081 (1998), the Court, rejected the government's effort to create a new exception to the privilege which would allow disclosure by an attorney of privileged client communications after the death of the client to a grand jury conducting an investigation into alleged criminal wrongdoing. The Court stated that the purpose of the privilege is "to encourage full and frank communications between attorneys and their clients and thereby promote broader public interest in the observance of law and the administration of justice." 524 U.S. at 403, 118 S.Ct. at 2084 (internal quotations omitted). Thus, the Court held that a client's confidence that his or her discussions with counsel would remain privileged was of paramount importance in the administration of justice. That importance "justified" "the loss of evidence admittedly caused by the privilege …" even in grand jury investigations. 524 U.S. at 408, 118 S.Ct. at 2086. We believe that the "noisy withdrawal" provisions of proposed 17 C.F.R. 205.3 would erode the duty of loyalty in a far more serious manner than the breach of the privilege that the Supreme Court rejected in Swidler & Berlin.

The modification of the attorney-client privilege is governed by Rule 501 of the Federal Rules of Evidence, which states, in relevant part, that:

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[5] Under the Model Rules and the New York Code, a lawyer in the same situation would be permitted to withdraw, and may disclose the intent of the client to commit a crime and that information necessary to prevent the

> Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience.

Thus, the Federal attorney-client privilege can be modified only by a judicial constitutional ruling, by an Act of Congress or through the Supreme Court's rule-making authority. The external reporting rules proposed by the Commission are being promulgated solely upon the Commission's rule-making authority and Section 307 of the Act, which, while directing the Commission to "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," does not provide authority to the Commission to change the attorney client privilege Rule. Thus, we believe that the proposed rules are not propounded in a manner authorized by Rule 501. As such, the external reporting rules are beyond the Commission's rule-making authority, and will be a nullity if formally promulgated.

Further, it is entirely unclear that the Commission can supercede state ethical rules governing the attorney-client privilege and the attorney-client relationship in the manner suggested by proposed Part 205 and the Commission release. The release states that

> a commission rule permitting disclosure would appear to preempt a state's rule forbidding disclosure. Accordingly an attorney appearing and practicing before the Commission who is admitted in a jurisdiction that forbids disclosure of confidential information under circumstances where the proposed rule would permit disclosure, may disclose the information to the Commission, notwithstanding the contrary state rule.

SEC Release No. 33-8150. There is nothing in Section 307 to suggest that Congress authorized the Commission to preempt state law and rules governing attorney conduct. On the contrary the

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crime. See Model Rule 1.13; NY Code, DR 5-109, DR 4-101(C).

states are the primary regulators of attorney conduct, and the relationship between attorneys and clients. The proposed external reporting rules are in conflict with the Model Rules (which have been adopted by most states) and the New York Code. Assuming that the Commission could validly promulgate these rules, there would be serious questions regarding whether the Commission rules could "trump" conflicting state ethics rules (see In the Matter of John Doe, Esquire 801 F. Supp. 478 (D. NM 1992)) and whether the new disclosure/non-waiver rules would protect any disclosure to the Commission of privileged information from third parties who would argue that the privilege no longer attaches (see In re Subpoenas Duces Tecum, 738 F.2d 1367 (D.C.Cir.1984)).

In addition, the external reporting provisions are inconsistent with the legislative history of the Act. The legislation which mandates the creation of Rule 205 is contained in §307 of the Act. Section 307 was proposed as an amendment to the Act by, among others, Senators Edwards and Enzi. In discussing the proposed amendment, Senator Sarbanes, the sponsor of the legislation, questioned Senator Edwards concerning whether the amendment would impose any duty on attorneys to notify the SEC of a violation. The following colloquy appears in the congressional record (148 Congressional Record S6524, p. 95):

> "Mr. SARBANES: It is my understanding that this amendment, which places responsibility upon the lawyer for the corporation to report up the ladder, only involves going up within the corporation structure. He doesn't go outside of the corporate structure. So the lawyer would first go to the chief legal officer, or the chief executive officer, and if he didn't get an appropriate response, he would go to the board of directors. Is that correct?
>
> Mr. EDWARDS: Mr. President, my response to the question is the only obligation that this amendment creates is the obligation to report to the client, which begins with the chief legal officer, and, if that is unsuccessful, then to the board of the corporation. There is no obligation to report anything outside the client the corporation." [Emphasis supplied]

Senator Enzi was also at pains to point out during the debate that the legislation would impose no duty on attorneys to report to the SEC. Senator Enzi noted (148 Congressional Record S6524 at p. 90):

> "In the wake of Enron, over forty professors with expertise in Federal securities and ethics law, have written to SEC Chairman Harvey Pitt asking for some form of regulation over the practice and conduct of attorneys involved in Federal securities law.
>
> In their letter, they state that if senior managers will not rectify a violation, lawyers who are responsible for the corporations' securities compliance work, should be required to report to the board of directors.
>
> As they point out, such a disclosure obligation is still less onerous than that imposed on accountants under section 10A of the 1934 Securities Exchange Act, which requires an auditor to report, both the client's directors and simultaneously to the SEC, and illegal act if management fails to take remedial action.
>
> The amendment I am supporting would not require the attorneys to report violation to the SEC, only to corporate legal counsel or the CEO, and ultimately, to the board of directors.
>
> Some argue that the amendment will cause a breach of client/attorney privilege, which is ludicrous. The attorney owes a duty to its client which is the corporation and the shareholders. By reporting a legal violation to management and then the board of directors, no breach of the privilege occurs, because it is all internal within the corporation and not to an outside party, such as the SEC." [Emphasis supplied]

Since the founding of the Republic, the states have fiercely asserted and preserved for themselves the primary and principle role in the regulation of lawyers. That continues to hold true. We note, for example, that Judge Judith S. Kaye, President of the Conference of Chief Justices, commenting upon the proposed rules on behalf of the Conference, recently wrote, "In our view, the expansive approach now proposed by the Commission for the regulation of the ethics of lawyers, as set forth in these proposed rules, is radically inconsistent not only with principles of federalism but also with historic Commission policy." Letter to Jonathan G. Katz,

Secretary, SEC by Hon. Judith S. Kaye, Dec. 13, 2002. In the past, Federal court encroachment has been limited to asserting rights to determine admission to practice and to disciplining lawyers who appear before them, and federal agencies have established regulatory authority over lawyers conducting business before them. In each instance, the regulation has been narrowly tailored to encompass only lawyers having direct dealings with the court or agency. Indeed, before Sarbanes-Oxley, the only prior intervention by Congress in the arena of regulation of lawyers was the so-called "McDade Amendment" passed in 1999, in which Congress enforced the states' right to apply their respective versions of the no-contact rule (Model Rule 4.2) to federal government lawyers over the strident objections of the Department of Justice, which sought to exclude the enforcement of the no-contact rule against federal prosecutors. In keeping with federal, state, and Congressional legislative precedent, we believe that the Commission should not promulgate rules that affect an issue so fundamental to state legislation as the attorney-client privilege and attorneys' duties to preserve client confidences.

We recognize that, in certain rare circumstances, adherence to the privilege might prevent the Commission from learning of a violation which an issuer has determined not to self-report, notwithstanding an attorney's advice. We believe, however, that current rules which permit an attorney to gain a client's trust, to learn of potential wrongdoings or client failures and to encourage compliance are, as a practical matter, more effective in the long run than a rule that discourages confidential communication. The salutary effect of preserving the attorney-client privilege – encouraging disclosure by an issuer to its attorney of any possible violations – more than outweighs any hypothetical detrimental impact.[6]

[6] This is not to say that attorneys are free, under state ethics rules, to assist an issuer client in perpetuating an ongoing fraud. Ethical rules already mandate that where an attorney learns that a client has committed a fraud, that the fraud is of an ongoing nature, and the client has refused to correct the fraud, the lawyer should resign. Further, where a document has been circulated publicly which contains an express or implied representation by an attorney

A. Limited Waiver and Proposed 17 C.F.R. 205.3(e)(3).

Section 205.3(e)(3) of the rules proposes the potentially beneficial principle that an issuer's disclosure of privileged information to the Commission under a confidentiality agreement results in only a limited waiver, and thereby preserves the attorney-client and work product privileges in, for example, subsequent litigation brought by private plaintiffs in federal court. Plainly, the proposed section benefits both the Commission, in granting the Staff access to information that may allow the Staff to conduct investigations much more expeditiously, and issuers, who may have wished to share privileged information with the Staff, but have been prevented from doing so by concerns over a possible general waiver. But in enacting Sarbanes-Oxley, Congress did not confer authority upon the Commission to promulgate a limited waiver rule. Thus, the rule's validity rises or falls solely upon the strength of the Commission's rule-making authority. Unfortunately, it is unclear that, standing alone, the Commission's rule-making authority suffices for this purpose.[7]

For any rule affecting privilege to bind litigants in subsequent federal court proceedings, the rule must pass muster under Rule 501 of the Federal Rules of Evidence. Because the proposed limited waiver rule lacks any Congressional imprimatur, to be effective, the proposed rule must then accord with the "principles of common law" as interpreted by the federal courts. But, as the proposing release acknowledges (fn. 75), the federal case law on limited waiver is "in a state of hopeless confusion."[8] Indeed, a review of the relevant authorities suggests that only

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which the attorney subsequently learns is materially false or misleading, the lawyer should disclaim such representation.

[7] This concern also applies to proposed Sections 205.3(d)(1)(i) and 205.3(d)(3).

[8] Citing In re Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289, 294-95 (6th Cir. 2002).

a minority view upholds the doctrine of limited waiver, even in the presence of a confidentiality agreement.[9]

The concern over whether the proposed limited waiver rule rests on an adequate foundation is highlighted by the clash between the Commission's present position that its rule-making authority suffices, and the Commission's position in 1984 that the Commission requires specific Congressional authority to promulgate a limited waiver rule. Although nowhere mentioned in the 93-page proposing release, in 1984 the Commission requested that Congress adopt a new Section 24(d) of the Securities Exchange Act authorizing the rule.[10] Indeed, in the Commission's statement in support of proposed Section 24(d), the Commission pointed to a similar piece of specific Congressional legislation, the Antitrust Civil Process Act, 15 U.S.C. §§ 1311, et seq., providing that, under certain circumstances, producing privileged information to the Antitrust Division does not waive privilege. Moreover, Congress apparently rejected proposed Section 24(d).[11]

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[9] Compare In re Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289 (6th Cir. 2002), (rejecting limited waiver of both attorney-client and work product privileges, even with a confidentiality agreement); Bowne of New York City, Inc. v. AmBase Corp., 150 F.R.D. 465, 480 (S.D.N.Y. 1993) (holding that "even if the disclosing party requires, as a condition of disclosure, that the recipient maintain the materials in confidence, this agreement does not prevent the disclosure from constituting a waiver of the privilege; it merely obligates the recipient to comply with the terms of any confidentiality agreement"); Westinghouse Elec. Corp. v. Republic of Philippines, 951 F.2d 1414, 1427 (3d Cir. 1991) (stating that "under traditional waiver doctrine a voluntary disclosure to a third party waives the attorney-client privilege even if the third party agrees not to disclose the communications to anyone else"); with In re Leslie Fay Co., Inc. Sec. Litig., 161 F.R.D. 274, 284 (S.D.N.Y. 1995) (rejecting claim of waiver where "disclosures [to USAO] were made pursuant to confidentiality agreements intended to preserve any privilege applicable to the disclosed documents);In re Steinhardt Partners L.P., 9 F.3d 230, 236 (2d Cir. 1996) (stating that disclosure of privileged information to the government may not constitute a waiver if the government agreements to maintain the confidentiality of the disclosed materials); Permian Corp. v. U.S., 665 F.2d 1214 (D.C. Cir. 1981) (limited waiver upheld with respect to work product) Diversified Industries Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1978) (en banc) (no waiver of either privilege), but see In re Grand Jury Proceedings Subpoena, 841 F.2d 230 (8th Cir. 1988) (holding selective disclosure inconsistent with privilege claim and questioning Diversified).

[10] 16 *Sec. Reg. & L. Rep.* (BNA) 460 (March 2, 1984).

[11] See Westinghouse, 951 F.2d at 1425 ("Congress rejected an amendment to the Securities and Exchange Act of 1934, proposed by the Commission, that would have established a selective waiver rule regarding documents disclosed to the agency").

In addition, the scope of the confidentiality agreement that the Staff would enter into under Section 205.3(e)(3) is not defined. This is important not only because issuers need to know in advance the protection that the privileged information will receive, but also because the more the confidentiality agreement allows exceptions, the more likely that a general, rather than a limited, waiver may ultimately be found.

As a threshold matter, it does not appear that the confidentiality agreement would be "so ordered," so the agreement would remain a private agreement between the Commission and the issuer. This calls into question its effectiveness against later compelled disclosure. As well, what restraints would the confidentiality agreement impose on Staff? For example, if the Staff concludes that the privileged information contains evidence of securities law violations, no guidance is offered as to whether the Commission, over issuer objection and notwithstanding the confidentiality agreement, may file a complaint and publicly disclose the privileged information. Guidance is similarly lacking about the restrictions, if any, the confidentiality agreement would place on the Staff's ability to share the privileged information with other federal and state agencies, Congress, the self-regulatory organizations, civil litigants (pursuant to subpoena) and others listed in the Commission's disclosure form as routine recipients of information provided to the Commission.[12]

If the confidentiality agreements are not binding upon the Commission and are not enforceable against third parties, then they have little utility and pose great potential peril for the parties to the agreement.

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[12] See SEC Form 1662.

III THE PROPOSED REGULATION WILL HAVE A NEGATIVE IMPACT ON THE ATTORNEY-CLIENT RELATIONSHIP

The proposed rules represent a substantial encroachment on the attorney-client relationship because, as discussed above, they may significantly erode the attorney-client privilege.

> A client must feel free to discuss anything with his or her lawyer and a lawyer must be equally free to obtain information beyond that volunteered by the client. . . . The observance of the ethical obligation of a lawyer to hold inviolate the confidences and secrets of a client not only facilitates the full development of facts essential to proper representation of the client but also encourages non-lawyers to seek early legal assistance.[13]

The privilege exists "to protect not only the giving of professional advice . .. but also the giving of information to the lawyer to enable him to give sound and informed advice."

The proposed rules will have the contrary effect on attorney-client communications. For example, Section 205.3(b) states that, "[a]bsent exigent circumstances, the attorney [reporting a violation] is obligated to take reasonable steps to document his or her reports, as well as any response received . . . ." Such documents "will protect the attorney in the event his or her compliance with the proposed rule is put in issue. . . . " Those documents, prepared in the press of circumstances, upon less than complete information, and motivated by an instinct for self-protection may protect the lawyer only at the client's expense by serving as productive litigation fodder against the client. In fact, the rules make clear to issuers that their attorneys may be obligated to report any suspected misconduct to the Commission when the attorney disagrees with the company's response. Thus, any communications with the company's attorney relating to the potential violation, and possibly other privileged communications, may ultimately be disclosed to the Commission and may eventually form the basis of private lawsuits filed against the issuer.

Attorneys act as advocates and advisors to their clients. Unlike accountants, their role is not to "attest" to information, "certify" information or vouch to the public. Nor are they employed to enforce the law or regulations governing their issuer clients. Unlike an auditor whose very role is to be skeptical and utterly independent, an attorney acting as an advocate must be able to make full use of the attorney-client privilege (consistent with the crime-fraud exception) to make effective and zealous advocacy possible. Despite this basic understanding of the attorney's role, the proposed rules attempt to transform attorneys into investigators of their clients, and put attorneys in the impossible position of simultaneously acting as advocates and unilateral judges of even past misconduct by the issuer and whistleblowers, rendering practically impossible the mandate that attorneys must zealously represent their clients.

A likely consequence of this erosion of privilege is that corporate officers or employees may not turn to lawyers for advice in situations where legal advice may, if obtained, have benefited the corporation and its shareholders. Another likely consequence is that, when a corporation turns to a lawyer for advice, it may, in light of the lawyer's new obligation to report the client's transgressions, limit the information it provides to its counsel upon which to formulate such advice. This chilling of communications between attorneys and clients, causing issuers to act without legal advice or to act upon legal advice rendered upon more limited information, will likely undermine the attorney's ability to gather the relevant facts and advise the issuer as to appropriate conduct with respect to disclosures that should be made to the public or actions that should be taken to remedy material misconduct by an agent of an issuer. As the Supreme Court reminds us, a limitation upon the attorney-client privilege in the corporate context

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[13] NY Code, EC 4-1.

> not only makes it difficult for corporate attorneys to formulate their advice when their client is faced with a specific legal problem but also threatens to limit the valuable efforts of corporate counsel to ensure their client's compliance with the law. In light of the vast and complicated array of regulatory legislation confronting the modern corporation, corporations, unlike most individuals, constantly go to lawyers to find out how to obey the law . . . .[14]

Thus, the proposed rules, part of an effort to further compliance with law by public companies, may, as a consequence, have precisely the opposite effect.

IV THE REGULATION SHOULD PROVIDE A NARROW DEFINITION OF "ATTORNEY" WHOSE CONDUCT IS GOVERNED BY PART 205

The Commission acknowledges that the proposed rule "is broad enough to include attorneys who do not serve in the legal department of an issuer or do not act in their capacities as attorneys, but who either transact business with the Commission or assist in the preparation of documents filed with or submitted to the Commission." Thus, for example, an investment banker or executive for an issuer who fortuitously also happens (perhaps as of many years ago) to have been "admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign" [Section 205.2(c)] -- but who in no fashion engages in the "professional conduct" of an "attorney" -- would be within the scope of the proposed rule if s/he were "participating in the process of preparing any statement, opinion, or writing which the attorney has reason to believe will be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the Commissioners, the Commission, or its staff." Section 205.2(a)(4).

Surely, this goes beyond what Congress was trying reasonably to achieve. First, Section 307 aims to have the Commission regulate the "professional conduct" of "attorneys" in their "representation" of issuers, not the non-professional conduct of those whom the Staff themselves

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[14] Id. at 593 (citations and internal quotations omitted).

acknowledge "do not act in their capacities as attorneys." Second, the very broad "participating in the process of preparing" standard [§ 205.2(a)(4)] is already fraught with problems for attorneys actually involved in the representation of issuers, as the Staff members themselves acknowledge (stating that "Comment is also particularly invited on the breadth of 'participating in the process of preparing' in paragraph (a)(4) and whether the 'has reason to believe' standard in that paragraph is too high or too low").[15] Third, the proposed rule's broad sweep, to include non-lawyers (which the Staff characterize as those who "do not act in their capacities as attorneys"), is internally inconsistent with the very next phrase in the definition of "attorney," which extends to one "who holds him or herself out as admitted, licensed, or otherwise qualified to practice law." Section 205.2(c) (emphasis added)

It is beyond the scope of this comment (given the very limited time available) to discuss, but nonetheless should be noted, that the proposed rule's extension to foreign attorneys is also fraught with problems and appears to go well beyond what Congress was seeking. Determining what would constitute an "attorney" and the practice of law in foreign jurisdictions will often be difficult. Moreover, practical concerns for both international regulatory comity and material differences in various foreign jurisdictions' respective corporate governance and reporting structures auger against the effort to extend the proposed rule to foreign "attorneys." The desirable statutory objective of enhancing the responsibility of attorneys to their issuer clients will inevitably lead multinational law firms and companies to establish more efficient, internal

[15] For example, attorneys regularly are called upon to respond to so-called "audit inquiry letters" which can call for highly technical responses. The inability to assess the potential outcome of threatened (or even pending) litigation frequently leads to a response that may -- or may not -- eventually make its way into a filing/submission to the Commission. The Staff's proposed rule makes it most difficult for *attorneys* in their *representation* of issuers to not only formulate meaningful responses, but also to have "reason to believe" that such a communication will ultimately be communicated on to the Commission. *A fortiori*, imposing such legal analyses on executives who "do not act in their capacities as attorneys" would only create a trap for the unwary and not materially better inform shareholders or the investing public.

communications structures. But that is quite different than the sort of unilateral extension to foreign "attorneys" that the Commission's proposed rule would have.

A **Proposed Part 205 Should Be Modified To Clarify Which Attorneys Will Be Deemed To Represent An Issuer In Practice Before the Commission.**

In addition to the above examples of attorneys who are not engaged in a professional capacity as lawyers and foreign lawyers to whom the rule should not be applied, there are several other category of lawyers who, while employed in a professional capacity, should nonetheless be exempt from the application of the rule, including a lawyer who is "acting in any way on behalf, at the behest, or for the benefit of an issuer, whether or not employed or retained by the issuer."

The broad sweep of this definition would include lawyers who are retained by another party, separate from the issuer, in a transaction, such as an underwriting, which is for the benefit of the issuer. This excessively broad application of the rule does fundamental damage to the attorney-client relationship, may require the disclosure of confidences of clients who are not themselves the issuer and, at a minimum, inappropriately divides the loyalty of a lawyer between his actual client and the issuer on the other side of the transaction.

Of equal concern, is the inevitable harm that the rule will cause in the relationship between attorneys within a firm - those who are responsible for the securities practice in representing an issuer and those who provide specialized, non-securities expertise who are often called upon by their colleagues in the representation of issuers. These non-securities professionals will generally not be in a position to evaluate or even know the facts with sufficient completeness to render a judgment as to whether the aspect of the matter entrusted to them is "material" to the issuer. To subject these non-securities practitioners to the harsh obligations and penalties of the proposed rule is both unfair and counterproductive.

Similarly, the proposed rule creates categories of attorneys denominated as supervisory or subordinate which will substantially compromise the collaborative nature of a law firm or law department practice. We note that this provision seems to assume that lawyers working together are nevertheless definable as supervisors and subordinates, not always the reality of a particular situation. But no matter what the assumption, if ever there was a provision designed to inhibit the free and open discussion among colleagues, this is certainly one. For example, does the Commission seriously expect that every time a young associate raises an issue with a partner which after discussion and consideration the partner rejects as a concern, the partner will have to document his reasoning and will reject the concern at his peril? Or is it more likely that as a result of this rule, subordinates are going to be increasingly cautious in raising issues with supervisors, thereby depriving the client of fresh and imaginative thinking about a matter? Either way, the losers are the client and the law firm or law department, as well as the public's concern with assuring the compliance with law by clients will not be enhanced but rather degraded. The attorney in charge the law firm's practice with regard to a client is the attorney who is practicing and appearing before the Commission. It is impractical for the Commission to attempt to regulate internal practices within a law firm or to ask subordinate attorneys to act independently of the principal attorney in the representation of an issuer.

We therefore suggest that the definition of "representing an issuer" be limited to attorneys employed by or retained by an issuer to act on its behalf as an attorney. We further suggest that the definition of "attorney" be limited to people who are, or hold themselves out to be, admitted, licensed or otherwise qualified to practice law in any domestic jurisdiction. The definition should not include someone who otherwise would fall within the definition but who works on a

matter that is before the Commission under the supervision, direction or supervisory authority of another attorney employed by the issuer or the law firm retained by the issuer.

V THE PROPOSAL TO CREATE A QUALIFIED LEGAL COMPLIANCE COMMITTEE ("QLCC") SHOULD BE MODIFIED TO REMOVE THE NOISY WITHDRAWAL PROVISION

Paragraph 205.3(c) permits reporting attorneys to follow an alternative reporting procedure and avoid a "noisy withdrawal" if the issuer chooses to establish a committee of at least three non-employee directors (including an audit committee member) with the responsibilities of a "qualified legal compliance committee" described in paragraph 205(2)(j). If the issuer has a QLCC, a reporting attorney has the option of reporting a material violation to the QLCC rather than the chief legal officer. If this alternative procedure is followed, the reporting attorney need not determine whether the response is appropriate and need not follow the "noisy withdrawal" procedure.

As proposed, a QLCC would have the responsibility of investigating reports, notifying the audit committee or full board of directors, directing the adoption of remedial measures and sanctions to stop the violations and rectify any that have occurred, and informing the chief legal officer and chief executive officer. If the issuer fails to take the remedial measures directed by the QLCC, each member of the QLCC, as well as the chief legal officer and chief executive officer, must also notify the Commission of the material violation and identify any Commission-filed documents that as a result are materially false or misleading.

We believe that the idea behind the QLCC proposal — that a committee of independent directors can be an appropriate and effective mechanism for assessing and dealing with possible material violations — is a sound one. We also believe that the "noisy withdrawal" mechanism reflected in clause (5) of the definition of QLCC substantially reduces the likelihood that issuers will use QLCCs, and, as well, reduces the effectiveness of the QLCC mechanism, because it

substantially reduces the likelihood that a QLCC will be able to put difficult issues to rest. To be an attractive option, the QLCC must hold out substantial hope of finality. In particular, the requirement that each member of the QLCC have an independent responsibility to notify the Commission, if the issuer fails "in any material respect" to take directed remedial steps, significantly increases the likelihood of such reporting, even where the committee as a whole is satisfied that problems have been addressed, and further undercuts the QLCC's usefulness. The "noisy withdrawal" requirement also introduces the same "chilling" effect on attorney-client communications as the other "noisy withdrawal" provisions of the proposed rule discussed elsewhere in this letter. We would therefore eliminate this aspect of the proposed definition.

We believe that many directors will be concerned about the potential heightened risk of liability that may flow from QLCC membership. While this may limit the number of issuers using QLCC's, it is not, in our view, a reason not to permit use of the QLCC mechanism. However, imposing a "noisy withdrawal" obligation on individual QLCC members can only aggravate this liability concern. For this reason as well, we would eliminate the "noisy withdrawal" requirement.

We also believe the provisions of clause (1) of the definition should be simplified. In particular, we suggest that a QLCC be comprised of any number of non-employee directors designated by the board, which need not include a member of the audit committee, but which alternatively could consist of the audit committee. As long as the committee members are all non-employees, we do not see any reason to restrict further the board's flexibility in selecting a suitable membership for the committee. Smaller issuers, in particular, will more likely be able to use the QLCC mechanism if granted this added flexibility.

VI THE PROPOSAL TO CREATE A QUALIFIED LEGAL COMPLIANCE COMMITTEE ("QLCC") SHOULD BE MODIFIED TO PROVIDE A SAFE

HARBOR FOR THE CHIEF LEGAL OFFICER WHO REPORTS UP TO THE QLCC OR AN APPROPRIATE AUDIT COMMITTEE

As noted above, the Commission's proposed rule regarding the QLCC provides an attorney representing an issuer before the Commission with an effective way to avoid the nettlesome ethical issues that would be presented by a "noisy withdrawal." This is true whether the attorney is "inside counsel" or "outside counsel." No such safe harbor, however, is provided to the issuer's Chief Legal Officer. The Commission's proposed rule provides that even where a CLO avails himself or herself of the alternative method of reporting a violation provided by 205.3(c), he or she is still responsible for reporting that violation to the Commission should the issuer not take appropriate remedial action after the QLCC finishes its investigation and makes its recommendation. We believe that the very same ethical concerns presented by the "noisy withdrawal" provisions to outside counsel for the issuer as well as inside counsel apply equally to the CLO as the issuer's chief attorney. Accordingly, we believe it would be appropriate to afford the CLO the same "safe harbor" that the Commission has provided to the rest of the issuer's attorneys. The Commission should revise its proposed rule to make it clear that where a CLO reports a material violation to a QLCC, he or she "is not required to assess the issuer's response to the reported evidence of a material violation, and is not required to take any action under paragraph (d) of this section regarding the evidence of a material violation."

VII THE SANCTION FOR VIOLATION OF THE PROPOSED RULE SHOULD BE LIMITED TO DISCIPLINARY PROCEEDINGS UNDER RULE 102(E)

Another area of great concern to the CityBar, is the Commission's attempt to assume the power to bring an enforcement action against attorneys for violating the proposed rule. As discussed below, we believe that the sanction for violating the rules of conduct promulgated by the Commission pursuant to Section 307 of the Act should be limited to disciplinary proceedings under Rule 102(e).

The very first paragraph of the proposed rule states:

> A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), and any such attorney shall be subject to the same penalties and remedies, and to the same extent, as of a violation of that Act

The Commission relies upon Section 3 (b) of the Act to justify this extreme position. Section 3(b) of the Act provides:

> A violation by any person of this Act, any rule or regulation of the Commission issued under this Act, or any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations. (emphasis added.)

As noted below, however, it is far from clear whether Congress intended to subject attorneys to an enforcement action brought by the Commission for failure to comply with the rules of conduct promulgated pursuant to Sec. 307.

Section 307 of the Act directs the Commission to "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." (emphasis added). Section 4C of the Exchange Act (15 U.S.C. 78d-3) governs professionals who "appear and practice" before the Commission. That section provides simply that the Commission may censure any person who, after notice and opportunity to be heard, is found to be lacking in competence or integrity or who is found to have willfully aided and abetted a violation of the securities laws. That section does not provide that a violation of the Commission's rules of conduct constitute a substantive violation of the Exchange Act, nor does that section give the Commission the ability to bring an enforcement action for a violation of its rules of conduct. If Congress had intended to empower

the Commission to bring such enforcement actions, we believe it is self evident that Congress would expressly have amended this section to so provide.

Equally troubling is the Commission's attempt to incorporate in its proposed rules the definition of "improper professional conduct" contained in Section 602 of the Act. The definition of "improper professional conduct" set forth in the Act by its express terms does not apply to attorneys.

Proposed Section 205.6(b), which seeks to define "improper professional conduct," provides:

> With respect to attorneys appearing and practicing before the Commission on behalf of an issuer, "improper professional conduct" under section 4C(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78d-3(a)) includes:
>
> (1) Intentional or knowing conduct, including reckless conduct, that results in a violation of any provision of this part; and
>
> (2) Negligent conduct in the form of:
>
> > (i) A single instance of highly unreasonable conduct that results in a violation of any provision of this part; or
> >
> > (ii) Repeated instances of unreasonable conduct, each resulting in a violation of a provision of this part.

In the release seeking comments on the proposed rule, the Commission states that Congress, in enacting Section 602 of the Act, "amend[ed] the Exchange Act to add Section 4C(a), which incorporates that portion of the text of Rule 102(e) providing the Commission with the authority to discipline professionals for improper professional conduct." The Commission then concludes that this provision applies to attorneys and states: "Accordingly, an attorney who violates any provision of Part 205 engages in improper professional conduct." However, the Commission's conclusion is contradicted the express language of the Act.

The definition of "improper professional conduct" in Section 602 of the Act is expressly limited to "registered public accounting firms." The term "registered public accounting firms" is

defined in the Act as referring to public accounting firms that are registered with the Commission. By its express terms, the definition of "improper professional conduct" in Section 602 does not apply to attorneys.

Nor does any language in the rest of the Act to suggest that Congress intended to subject attorneys to enforcement actions for violations of the "minimum standards of professional conduct" called for by Section 307 of the Act.

A The Commission Should Include Language In The Regulation That Makes Clear That A Violation Of The Regulation Does Not Expose The Attorney To Criminal Liability.

In its Release, when discussing proposed rule 205.6, the Commission states that "The Commission does not believe, however, that violations of the proposed rule would, without more, meet the standard prescribed in Section 32(a) of the Exchange Act (15 U.S.C. 78ff), which provides for the imposition of criminal penalties." As discussed above, we believe that proposed rule 205.6 should be revised to limit the sanctions for violating the regulations to disciplinary proceedings pursuant to Rule 102(e). We do not believe that Congress intended, nor do we believe that the language of the Act provides, that a violation of the rules of conduct promulgated by the Commission pursuant to Section 307 should rise to the level of a violation of the Exchange Act. Therefore, we believe that the Commission when revising proposed rule 205.6 should make it clear that a violation of the rules promulgated pursuant to Section 307 cannot and shall not subject an attorney to criminal penalties.

B The Commission Should Clarify That Attorneys Subject To The Proposed Rule Owe A Duty Solely To Their Client, The Corporate Entity, And Not To Investors, And Should Modify The Language In The Proposed Rules To Clarify That There Is No Private Right Of Action For Violation Of The Proposed Rule.

Section 205.3(a) of the proposed rule states that:

> An attorney appearing and practicing before the Commission in the representation of an issuer represents the issuer as an organization and shall act in the best interest of the issuer and its shareholder . . . "

This statement mischaracterizes the relationship between legal counsel to an issuer and the issuer, and incorrectly states that that issuer's counsel has a duty to the shareholders.

The Model Rules and New York Code identify many duties running from attorneys to their clients, including duties of loyalty, confidentiality and competence.[16] The only instance in which a lawyer is charged with acting in the "best interest" of an organization occurs when the lawyer knows that (1) an individual associated with the organization is violating a legal duty; and (2) the behavior is likely to result in substantial injury to the organization. Only in this narrow circumstance is a lawyer charged with proceeding "as is reasonably necessary in the best interest of the organization," which may include up-the-ladder reporting.[17] On the contrary, officers and directors are charged with determining the company's best interests, and are protected from undue exposure to liability by the business judgment rule.[18] Thus, while issuer's counsel is obligated to provide competent legal advice, it is up to management to select the course of action that is in the best interest of the corporation in light of all relevant considerations, including legal advice obtained from counsel. The Commission's proposed imposition on attorneys of a duty to act in the best interest of their corporate clients unreasonably increases counsel's exposure to

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[16] See Model Rules of Professional Conduct, Rules 1.7 (duty of loyalty requires absolute fidelity by the attorney to the client); Rule1.6 (duty of confidentiality requires attorney to maintain inviolate the client's confidential information); and Rule 1.1 duty of competence requires attorneys to act with requisite knowledge, skill, thoroughness and preparation); see also NY Code, DR, 4-101 ((lawyer shall not knowingly reveal a client confidence or secret); DR; NY Code DR 6-101 (lawyer shall not handle a legal matter which the lawyer knows or should know he or she is not competent to handle or is without adequate preparation, and shall not neglect a legal matter entrusted to the lawyer).

[17] Model Rules, Rule 1.13; NY Code, DR 5-109.

[18] Restatement (Third) of the Law Governing Lawyers § 96 cmt. F (2000). Under the "business judgment rule," officers and directors are not liable for errors or mistakes in judgment so long as they were disinterested and independent, acted in good faith, and were reasonably diligent in keeping informed of the relevant facts.

lawsuits by private litigants, who will use this language to charge that attorneys failed to intervene in the company's "best interest."

In addition, under both the Model Rules and the New York Code, a lawyer who is employed or retained to represent an organization as a client represents only the organization, and not the constituents of the organization – a group that would include officers, directors, employees, members and shareholders.[19] The principle that the company counsel's duty of loyalty and competence runs solely to the organization has been confirmed repeatedly in federal and state courts.[20] Indeed, where the organization's interests become adverse to those of a constituent, the lawyer must advise the constituent that he or she cannot represent such constituent.[21] Accordingly, the proposed rule's statement that lawyer's must act in the best interest of shareholders is plainly contradicted by the Model Rules, the New York Code, and case law, and therefore the rule should be revised. We suggest that Section 205.3(a) be revised to state that "[a]n attorney appearing and practicing before the Commission in the representation of an issuer represents the issuer and owes his or her professional and ethical duties to the issuer."

Moreover, the suggestion in the language of the proposed rule that the attorney for the issuer also owes a duty to the shareholders contradicts the view expressed by the Commission in the release that "nothing in Section 307 creates a private right of action against an attorney." The statement that the attorney must act in the best interest of the issuer's shareholders suggests that a failure to do so could form the basis for a private action against the attorney by any of these shareholders.

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[19] Model Rule 1.13(a); NY Code, DR. 5-109(a).

[20] See, e.g., Pellettier v. Zweifel, 921 F.2d 1465 (11th Cir.), cert. denied, 502 U.S. 855 (1991) (shareholder may not sue entity's lawyer for violation of duties to shareholder because lawyer's fiduciary duty is to the entity); Egan v. McNamara, 467 A.2d 733 (D.C. 1983) (lawyer who drafted agreement owed duty to corporation and not to shareholder adversely affected by its terms); Skarbrevik v. Cohen, England and Whitfield, 231 Cal. App. 3d 692, 282 Cal. Rptr. 627 (1991) (lawyer for close corporation had not duty of care to minority shareholders).

[21] Model Rule 1.13, Cmt. 7; NY Code, DR 5-109(a).

During the debate in the Senate on amendment to Sarbanes-Oxley, which ultimately became §307, Senator Edwards, one of the sponsors of the amendment, noted:

> Nothing in this bill gives anybody a right to file a private lawsuit against anybody. The only people who can enforce this amendment are the people at the SEC. They will enforce this amendment not on behalf of any private party, but in the name of the American people....

Similarly, Senator Enzi, a co-sponsor of the amendment, noted in his statement in support: "... this amendment creates a duty of professional conduct and does not create a right of action by third parties." (Emphasis added)

Like the legislation itself, the Commission's proposed rules are silent with respect to creating a private right of action. The question arises, however, whether absent an express disclaimer, there is a risk that courts might imply a private right of action from the creation of a new Commission Rule which imposes new obligations on attorneys.

The principal vehicle by which private actions are brought pursuant to the securities laws is, of course, 10(b)(5) promulgated pursuant to 15 U.S.C. §78(j) (§10[b] of the Securities Exchange Act of 1934). The courts have long implied a private right of action for violations of 10(b)(5). However, the courts have also limited the class of potential defendants to persons who have directly engaged in conduct violative of the rule, i.e. persons who have engaged in a device, scheme or artifice to defraud, or who have deliberately made untrue statements of a material fact or material admissions, or have engaged in acts or practices operating as a fraud. The Supreme Court has held that individuals who have merely aided and abetted violations of 10(b)(5) are not subject to a private lawsuit. Central Bank of Denver, N.A. the First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994). Similarly, auditors for issuers have been held not to be liable to private parties (other than the issuer) for negligence in the preparation of audited financial statements. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

Even prior to Central Bank, which abolished aiding and abetting liability in private actions, plaintiff's have found it difficult to survive motions to dismiss 10(b)(5) actions against law firms representing issuers. See generally Towers Financial Corporation Securities Litigation, 1995 U.S. Dist. Lexis 21147, at p. 44, fn. 13 (SDNY 1995 (report of Andrew J. Peck, United States Magistrate))(report adopted at 1996 U.S. Dist. Lexis 11008 (SDNY 1996)), which contains a compendium of Second Circuit and Southern District of New York cases in which claims against lawyers have been dismissed.

Most cases seeking to impose liability on attorneys founder for failure adequately to allege privity or one or more of the requisites for proof in a private securities fraud litigation, including reliance, causation, absence of a purchase or sale, or scienter. Several cases note that there is no direct duty between a corporation's attorneys and its shareholders, or investors.

Notwithstanding the substantial body of case law in which claims against issuers' attorneys have been dismissed, the reference to a duty owed by issuer's counsel to the issuer's shareholders in Section 205.3(a), while probably not intended to create a new duty for issuer's counsel directly to shareholders, still creates the risk that the language may be interpreted by some to satisfy the requirement of privity.

Additionally, §205.6(a) provides that

> A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78(a) et sec.) and any such attorney shall be subject to the same penalties and remedies, and to the same extent, as for a violation of that Act." (Emphasis supplied)

While it is doubtful that, in the context of the rule, the Commission meant to imply that an attorney is subject to a private right of action as if he had violated §10(b)(5) or one of the other sections of the act giving rise to private rights of action, the language of §205.6(a) creates

the potential for confusion. Reading these two sections of the Rule together, a private litigant might claim that private right of action exists on behalf of shareholders who purchase or sell an issuer's securities where, for example, an attorney is later found by the Commission to have uncovered "evidence" of a violation of the rules, but failed to comply with disclosure requirements.. Indeed, some might read this section (which imposes sanctions on attorneys for negligent conduct, §205.6[b][2]) as creating a new duty on the part of attorneys to shareholders (as distinct from the issuer) and a new ground for imposing civil liability.

Accordingly, we believe the Commission should modify proposed Part 205 to remove any reference to a duty to act on behalf of shareholders, and amend the regulation to include a "safe harbor" provision to clarify that no private right of action against the attorney is created by the rules of conduct being promulgated by the Commission pursuant to Section 307 of the Act.

C The Commission Should Add A Safe Harbor Provision Regarding Shareholder Suits.

There is no "safe harbor provision" in the Act protecting attorneys from private actions brought by shareholders. Congress enacted Section 10A(3)(c) of the Exchange Act to provide a "safe harbor" provision protecting auditors from private causes of action for failure to comply with the "up the ladder" reporting requirements. Section 10A(3)(c) of the Exchange Act provides:

> (c) Auditor liability limitation. No registered public accounting firm shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b), including any rule promulgated pursuant thereto.

Yet, no such provision protecting attorneys is explicitly included within the Act. Thus, one could argue that since Congress demonstrated its ability to protect auditors from private suits for failure to comply with the "up the ladder" reporting requirements, its decision not to provide similar protection to attorneys must have been deliberate.

We do not believe that Congress did not include attorneys within the statutory safe-harbor provision because it intended to expose attorneys to shareholder actions. The floor debate, as described earlier, makes it clear Congress did not wish to create that kind of liability. We believe Congress never anticipated that the Commission would promulgate regulations that were so broad that they would carry the potential of creating attorney civil liability. Therefore, a statutory safe-harbor was not needed.

The Commission should, at a minimum, include a provision in its rule protecting attorneys from potential unintended consequences of the rules' breadth . If it is not the Commission's intent to expose attorneys to private liability for failure to adhere to the new rules, it should say so.

D <u>The Definition of Appearing And Practicing Before The Commission Should Not Include Advice That A Party Is Not Obligated To Submit Or File A Registration Statement.</u>

Section 307 of the Act directs the Commission to issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission. Section 2.05.2(a)(5) (ii) of the Proposed Rule provides that appearing and practicing before the commission includes "Advising a party that "(ii) The party is not obligated to submit or file a registration statement, notification, application, report, communication or other document with the Commission or its staff."

The language quoted above is a significant expansion of what would commonly be understood to constitute appearing and practicing before the Commission. Over the past decades, the Commission has adopted a series of Rules designed to simplify the process of raising money in a variety of "private placement" transaction in order to avoid delays and costs entailed in registering securities with the Commission. By and large, these rules have been effective in accomplishing their objectives without giving rise to systemic problems involving

fraud or evasion of the securities laws. A number of years after adoption of Regulation D, for example, the Commission conducted a nation-wide review of numerous transactions claiming the exemption under Regulation D for the purpose of determining whether that safe harbor was being used to perpetuate fraud. Such review did not identify serious issues warranting restricting the use of safe harbor.

The recent events giving rise to the adoption of the Act did not involve non-reporting companies and nothing suggests that the Commission intended to impose the Act's regimen on non-reporting companies. The financial resources of many of these companies are limited and to subject such companies to the scope of the new Commission rules is unwarranted by any perceived deficiencies in the existing regulatory scheme and uncalled for by the Act.
In light of the above, to create a new and expansive definition of practicing before the Commission, which would then bootstrap a dramatic range of new procedures applicable to reporting companies and apply these procedures to non-reporting companies, seems to be an unwarranted expansion of the Commission's activities well beyond the intention of the Act.

Taken to its extreme, and in light of the proposed rule's ambiguities, attorneys rendering advice to non-reporting companies regarding private placements would now be required to report to the Commission any violation of securities laws or breaches of fiduciary duty by non-public companies. The Act does not attempt to apply the wide-range of enacted corporate governance provisions to these private companies, and it is hard to imagine that it was the intent of Congress in passing the Act to broaden the Commission's activities in the non-public company context.

Attorneys play a major role in aiding non-reporting companies in conducting private placements in a manner which undoubtedly raises the compliance levels of these financial activities to a significant extent. To turn outside counsel of these companies into an enforcement

arm of the Commission as a condition to obtain legal advice regarding compliance with private placement rules would likely reduce the role of attorneys in these areas and therefore adversely affect overall compliance with securities laws.

E <u>The Definition of "Fiduciary Duty"</u>

Section 307 of the Act requires the Commission to issue rules regarding standards for practice before the Committee, including a rule requiring an attorney to provide evidence of breach of fiduciary duty[22] (or similar material violations by the company).[23] Proposed Rule 205.2(d) defines "breach of fiduciary duty" as follows: "(d) Breach of fiduciary duty refers to any breach of fiduciary duty recognized at common law, including, but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions." The explanatory material indicates that definition is intended to identify typical common law breaches of fiduciary duty.

Issues involving fiduciary duty are governed by state law and vary from state to state. There is no federal law of fiduciary duty. Issues involving alleged breaches of fiduciary duty have generally been resolved through civil litigation and not by means of intervention of the Commission. While certain aspects of fiduciary duty are related to securities laws, such as breaches of fiduciary duty which involve fraud and possibly those involving self-dealing, a whole array of potential fiduciary violations and have nothing to do with securities laws and should not be subject to expanded activities by the Commission. Expanding the reach of the Commission's authority and the application of the federal securities laws to all aspects of

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[22] The language of Section 307 of the Act is ambiguous as to whether the "material" qualifier modifies breach of fiduciary duties or only violations of securities laws. We agree with the Commission's clarification – applying the modifier to all violations and breaches. Congress did not intend to extend the new rule to minor violations.

[23] The issue of what is meant by a "similar material violation" is beyond the scope of this comment. Additional time should be permitted by the Commission to allow for comment on this and numerous other issues that could not be addressed herein.

fiduciary duties is a dramatic change in the legal system's approach to the issue of fiduciary duty. Such a dramatic change is unwarranted by any of the events leading up to the Act.

Finally, we believe it is unrealistic to require an attorney for an issuer to be fully conversant in the common law of all 50 states (plus Puerto Rico) in the area of fiduciary duty. Accordingly, we recommend that the definition of breach of fiduciary duty as defined in Proposed Part 205 be limited to breach of fiduciary duty as defined in the common law of the issuer's state of incorporation.

Participating Members of the Task Force

Richard M. Asche	Professional Discipline Committee
Robert E. Buckholz, Jr.	Securities Regulation Committee
Anthony E. Davis	Professional & Judicial Ethics Committee
Paul Dutka	Professional Responsibility Committee
Andrew D. Kaizer	Securities Regulation Committee
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Mark S. Wojciechowski	Corporation Law Committee

APPENDIX A

Proposed Section 307 Rule

Part 205-Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer

[Index to Rule]

(3) Purpose and scope

Consistent with Section 307 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7245, the Commission is adopting rules setting forth the minimum standards of professional conduct for attorneys appearing and practicing before it in the representation of an issuer.

The rules may be used, pursuant to Part 102, to censure, suspend or bar an attorney from appearing or practicing before the Commission. A violation of the rules, regardless of the mental culpability of the actor, is not a criminal act as defined by 15 U.S.C. ∋78ff. The Rules are not intended to create a private right of action for any person against the actor.

(4) Definitions

For purposes of this part, the following definitions apply:

a. Appearing and practicing before the Commission shall have the meaning in Rule 102(f) and includes, but is not limited to:

i. Transacting any business with the Commission, including with Commissioners, the Commission, or its staff;

ii. Representing any party to, or the subject of, or a witness in a Commission administrative proceeding;

iii. Representing any person in connection with any Commission investigation, inquiry, information request, or subpoena; and

iv. Preparing or participating in the preparation of any registration statement, periodic report or other writing with to be filed with, or is to be incorporated by reference into any document that is filed with, the Commission or its staff (but excluding preparing or participating in the preparation of a writing that is not intended to be filed with or submitted to the Commission or its staff or is not intended to be incorporated by reference into any document that will be filed with the Commission but is used in connection with any such filing or submission).

b. Appropriate response means a response to evidence of a material violation reported to appropriate officers or directors of an issuer as provided by these rules that

provides a basis for an attorney who has reported such evidence to believe, in good faith:

i. That no material violation is occurring or is about to occur; or

ii. That the issuer has adopted measures that can be expected to stop any material violation that is occurring, and/or prevent any material violation that has yet to occur.

c. Attorney means any person who is, or holds himself or herself out as, admitted, licensed, or otherwise qualified to practice law in any domestic jurisdiction but shall not include an attorney who works under the supervision, direction or supervisory authority of another attorney employed by the issuer or the firm retained by the issuer with regard to the matter in question.

d. Breach of fiduciary duty means the breach of any fiduciary duty recognized at common law of the jurisdiction of incorporation.

e. Evidence of a material violation means information that an attorney knows which clearly establishes that a material violation has occurred, is occurring or is about to occur.[24]

[24] DR 7102 (B)

f. In the representation of an issuer means being employed or retained by the issuer to act on its behalf as an attorney.

g. Issuer means an issuer (as defined in Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under Section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under Section 15(d) of that Act (15 U.S.C. 780(d)), or that files a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

h. Material violation means a violation of the securities laws, breach of fiduciary duty, or similar violation which in each case is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization and is likely to result in substantial injury to the organization.[25]

i. Report means to make known to directly, either in person, by telephone, by email, electronically, or in writing.

(5) Issuer as client

[25] DR 5-109(A)

a. An attorney appearing and practicing before the Commission in the representation of an issuer represents the issuer as an organization. That 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, or its shareholders, the attorney's clients. When it appears that the organization=s interest may differ from those of the constituents with whom the lawyer is dealing, the lawyer shall explain that the lawyer is the lawyer for the organization and not for any of its constituents.[26]

(6) In the representation of an issuer a lawyer shall not:

a. engage in conduct involving dishonesty, fraud, deceit, or misrepresentation;[27]

b. conceal or knowingly fail to disclose that which the lawyer is required by law to reveal;[28]

c. knowingly make a false statement of law or fact;[29]

d. counsel or assist the client in conduct that the lawyer knows to be illegal or fraudulent;[30] or

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[26] DR 5-109(A)

[27] DR 1-102(A)(4)

[28] DR 7-102(A)(3)

[29] DR 7-102 (A)(5)

e. knowingly engage in other illegal conduct or conduct contrary to a rule contained within this Part 205.[31]

(7) Duty to Report Evidence of Material Violation

a. Duty to report evidence of a material violation.

ii. Subject to the provisions of subparagraph (iv), if, in appearing and practicing before the Commission in the representation of an issuer, an attorney knows of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer acting in such capacity, the attorney shall report such evidence to the issuer's chief legal office (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or to the equivalent thereof) forthwith.

ii. Subject to the provisions of subparagraph (iv), the chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation as he or she believes is necessary to determine whether the material violation as described in the report is occurring, or is about to occur. If the chief legal officer believes that no

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[30] DR 7-102 (A)(7)

[31] DR 7-102(A)(8)

material violation is occurring, or is about to occur, he or she shall so advise the reporting attorney. If the chief legal officer believes that a material violation is occurring, or is about to occur, he or she shall proceed to seek to ensure that the issuer adopts appropriate measures to stop any material violation that is occurring, or to prevent any material violation that is about to occur. The chief legal officer shall promptly report the measures adopted to the chief executive officer, to the audit committee of the issuer's board of directors, or to the issuer's board of directors, and to the reporting attorney.

iii. If an attorney who has made a report under paragraph (b) does not receive an appropriate response to his or her report, the attorney shall 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 issuer, or to the board of directors.

iv. A lawyer acting pursuant to this paragraph shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer=s representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Provided:

(a) A lawyer may reveal confidences or secrets to the extent implicit in withdrawing a written or oral opinion or representation previously given by the lawyer and believed by the lawyer still to be relied upon by a third person where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud[32]; and

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[32] DR 4-101 (C)(5)

(b) A lawyer may reveal the intention of a client to commit a crime and the information necessary to prevent the crime.[33]

(8) Withdrawal from Representation

a. Where an attorney who has reported evidence of a material violation under Section 205.4 hereof does not receive an appropriate response, or has not received a response in a reasonable time, to his or her report, and the attorney believes that a material violation is ongoing or is about to occur:

i. An attorney employed by a law firm retained by the issuer shall withdraw forthwith from representing the issuer, and report to the audit committee and the board of directors that the withdrawal is based on professional considerations; and

ii. An attorney employed by the issuer shall disassociate himself or herself from such material violation, and report to the audit committee and the board of directors of his or her disassociation and that his or her disassociation is based on professional considerations.

[33] DR 4-101 (C)(3)