The Public Company Accounting Reform and Investor Protection Act of 2002 includes a provision that (i) requires the Securities and Exchange Commission ("SEC" or "Commission") to establish rules setting forth minimum standards of conduct for attorneys practicing before the Commission, and (ii) requires attorneys to report misconduct to senior management or, in certain circumstances, their client's board of directors.

The full text of the provision is as follows:

> Not later than 180 days after the date of enactment of this section, the Commission shall establish rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of public companies, including a rule requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof) and, if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the company, or the board of directors.

The provision Alters Existing Law by Requiring the SEC to Prescribe Regulations Governing the Conduct of Lawyers Practicing Before the Commission.

A. Except in Limited Circumstances, Existing Law Does Not Permit the Commission to Regulate the Conduct of Lawyers.

Currently, there is no "federal securities bar," *i.e.*, a recognized and definable branch of the legal profession that practices "securities law" before the SEC and thereby is subject to the Commission's special oversight. Attorneys are licensed by the designated authorities of the several States to practice law. That license entitles a lawyer to counsel clients with respect to their rights and obligations in every substantive and

procedural area of law, state and federal, and to appear as an advocate before courts of the State. While the various federal courts independently admit lawyers to appear as attorneys at their bars, nothing more than licensing by State is required to act as a counselor as to any area of federal law. *See leis v. Flynt*, 439 U.S. 438, 442 (1979) ("Since the founding of the Republic, the licensing and regulation of lawyers has been left exclusively to the States . . . .").

Existing federal law concerning practice by attorneys before federal administrative agencies recognize as much. Section 500 of the Administrative Procedure Act 5 U.S.C. § 500, expressly states, in subsection (b):

> An individual who is a member in good standing of the bar of the highest court of a State may represent a person before an agency on filing with the agency a written declaration that he is currently qualified as provided by this subsection and is authorized to represent the particular person in whose behalf he acts.

The purpose of this provision was to deny agencies the power to prescribe admission qualifications for lawyers acting as attorneys (*i.e.*, advocates and representatives) before them and to thereby create such entities as a "federal securities bar" or a "federal antitrust bar." *See* H.R. Rep. No. 1141, 89th Cong., 1sr Sess. 3 (1965). The sole exception made was for "practice before the United States Patent and Trademark Office." 5 U.S.C. § 500(e).

Until now, Congress' express denial of authority to federal agencies to prescribe standards of admission for lawyers acting as attorneys, a power possessed by the federal courts and formerly granted to or asserted by some agencies,[1] has precluded the

[1] *See*, e.g., 23 Stat. 258 (1884) (IRS); *Schwebel v. Orrick*, 153 F. Supp. 701 (D.D.C. 1957), *aff'd per curiam on other grounds*, 251 F2d. 919 (D.C. Cir), *cert. denied*, 356 U.S. 927 (1958) (SEC).

assumption of authority by an agency to determine who, among those licensed by the States to practice law, may act as advisers in particular areas of substantive law.

This conclusion is reinforced by subsection (d)(2) of Section 500, which states:

> This section does not—
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> . . . .
>
> (2) authorize or limit the discipline, including disbarment, of individuals who appear in a representative capacity before an agency.

Thus, Congress has chosen not to confirm or deny the power of an agency that conducts proceedings to control contumacious behavior in its presence or that of its officers by appropriate means, such as physical exclusion of the offending attorney. But whatever authority was preserved by § 500(d)(2) was carefully limited to control of those who "appear" before the agency in a "representative capacity" and in the course of such appearance act in a manner that would justify a court's exercise of the power of summary contempt. H.R. Rep. No. 1141, 89th Cong., 1st Sess., 2 U.S. Code, Cong. & Ad. News 4170, 4178 (1965) (letter from Deputy Attorney General Katzenbach; the preserved authority allows discipline for misconduct "observed" by an agency); *compare In re Oliver*, 333 U.S. 257, 274 (1948).

B. The Provision Requires the Commission to Establish Standards of Conduct for Lawyers Representing Public Companies Before the Commission.

The provision alters existing law by requiring the SEC to establish "rules . . . setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of public companies . . . ." S. 2673, sec. 602(d). If enacted into law, the provision will effectively establish a federal securities bar, with minimum standards of conduct that must be followed by lawyers "appearing

and practicing before the Commission in any way in the representation of public companies." *Id.* While the Provision does not define the scope of "appearing and practicing before the Commission," similar language in the SEC Rules of Practice indicates that it applies to a lawyer's representation of a client in any agency process initiated by an order instituting proceedings. SEC Rules of Practice 102.

The provision does not appear to limit the scope of the SEC's authority to exercising control over attorneys appearing in SEC proceedings. The provision might authorize the SEC to establish rules analogous to those under State law that regulate all aspects of attorney conduct. Indeed, included in the minimum standards of conduct promulgated by the SEC will be a requirement that an attorney report evidence of a material violation of the securities laws, a breach of fiduciary duty, or "other similar violation" to senior management and, if senior management does not respond "appropriately," to the board of directors or a committee thereof. S.2673, sec. 602(d). This specific mandate expands the SEC's [power beyond existing federal law, and it places an obligation on attorneys that goes beyond many State rules of professional conduct. The reporting requirement in the provision derives from Rule 1.13(b) of the American Bar Association's Model Rules of Professional Conduct.[2] Rule 1.13(b) requires only that a lawyer who knows of a violation of law proceed "as is reasonably necessary in the best interests of the organization;" one of the measures that the lawyer "may" take is "referring the matter to higher authority." The provision *requires* lawyers to report violations of securities law or breaches of fiduciary duty.

Opponents of the measure have argued:

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[2] Most States have adopted all or a significant portion of the Model Rules of Professional Conduct. *See* American Bar Association, *ABA Compendium of Professional Rules and Standards* 525 (1999).

- Most of the reporting by attorneys that the Provision mandates is already mandated by the requirement under State law that the lawyer act as is reasonably necessary in the best interest of the company. The Provision will make reporting a requirement in all circumstances; this requirement will discourage corporate employees from discussions with lawyers so as to avoid having their conduct "reported up the chain." The Provision will also destroy the ability of lawyers to gain the confidence of employees and seek to persuade them to follow "best practices" in their business.
- Failure to abide by the mandatory reporting requirement—as well as all other regulations of attorney conduct imposed by the SEC—will be met with harsh sanctions, including the possibility of criminal sanctions.[3] The possibility of fines, suspension and disbarment under existing State law is more that sufficient to require the appropriate level of attorney conduct. And the possibility of criminal penalties for violation of SEC rules of conduct means that a lawyer would have the lawyer's own interest, not the client's, uppermost in mind when looking at any set of facts. Since facts are seldom clear in the real world, the lawyer is always in peril of having his or her conduct second-guessed by the SEC, a judge or a jury. Lawyers reacting to such peril will put their clients in a terrible quandary in all but the clearest cases: a CEO or Board confronted with a report by an attorney will have to engage in costly and most often useless processes to avoid putting themselves in peril.
- Under the provision, lawyers must report "evidence of a material violation of securities law or breach of fiduciary duty or similar violation" to senior management or the board of directors. It, however, provides no guidance on when and under what circumstances the lawyer must report. For example, it is unclear whether the phrase "evidence of a violation" means that the lawyer must report conduct that falls short of a violation (but is nonetheless "evidence" of a violation) or that the lawyer must report evidence that the lawyer believes actually constitutes a violation. And it is unclear under the provision what a "material" violation is and who will decide what is material and what is not. Further, the phrase "breach of fiduciary duty" is unclear because t does not specify to whom the fiduciary duty is owed. Moreover, the phrase "similar violation" does not provide fair notice because it is unclear

[3] It is unclear what the sanction will be for violation of the standards of conduct, but the possibility exists for both civil and criminal sanctions for violation of standards of conduct for attorneys. This possibility emanates from section 3(b)(1) of S.2673, which states that

> any violation by any person of . . . any rule or regulation of the Commission issued under this Act . . . 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 and regulations.

Violations of the '34 Act or regulations promulgated thereunder carry civil penalties, *see* 15 U.S.C.§ 78-u(d)(3)(A), and, if the conduct is willful, criminal penalties, *see* 15 U.S.C. § 78ff.

> what must be violated and what the violation must be “similar” to. The requirement that the lawyer report to the board of directors if senior management does not “appropriately respond” and adopt “appropriate remedial measures” is also unclear because it gives no guidance on what is “appropriate.”

For a different perspective on the general issue of a lawyer’s disclosure obligations see a letter to SEC Chairman Harvey Pitt in which the signatories raise the question of "whether lawyers should inform a client corporation's directors about violations of the securities laws." To read, go to
http://www.fed-soc.org/Publications/practicegroupnewsletters/PG%20Links/pittletter.htm