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COMMENTARY: SARBANES-OXLEY AND SEC STANDARDS OF PROFESSIONAL CONDUCT

Robert N. Rapp[†]

I appreciate the opportunity to comment on the valuable insights that Richard Humes¹ and GERALYN PRESTI² have shared with you. It would be a severe understatement to say that Section 307 of Sarbanes-Oxley (SOX)³ and the Securities and Exchange Commission (SEC) Rule 205⁴ adopted under it amount to anything less than a sea change for lawyers who have the privilege, either as inside or outside counsel, to represent public companies. While most of us here today would answer to the professional call as securities lawyers, SEC Rule 205 adopted under Sarbanes-Oxley has established a discrete securities bar, the members of which, by reason of the broad definition of appearing and practicing before the SEC, are subject to a specialized code of professional responsibility.

Under SEC Rule 205 lawyers for issuers of securities are subject to minimum standards of professional conduct that now require “reporting up” within an organization client when there is credible evidence of a material violation of securities laws or other legal obligations by a constituent within that organization. The reporting up mechanism under SEC Rule 205 is mandatory, but the rule also specifically permits reporting out, that is, blowing the whistle to the SEC, in circumstances when a lawyer reasonably believes that the response to report-

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¹ Richard Humes, *Remarks of an SEC Associate General Counsel*, 57 CASE W. RES. L. REV. 341 (2007).

² GERALYN PRESTI, *Current Ethical Issues for Securities Lawyers—A Comment on Humes*, 57 CASE W. RES. L. REV. 357 (2007).

³ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (2006)).

⁴ 17 C.R.F. § 205 (2006).

ing up is insufficient. For those of you who practice in Ohio, SEC Rule 205 takes on particular significance in light of the new Ohio Rules of Professional Conduct that became effective on February 1, 2007. The new Ohio Code, which draws heavily on the ABA Model Code of Professional Responsibility, contains its own reporting up provision in regard to representing an organization as client.

My colleagues also addressed some of what is happening with Sarbanes-Oxley compliance in general, and the challenge it presents, for example, for in-house counsel. Before I share some particular comments with you about the challenges that both inside and outside counsel now deal with under SEC Rule 205, allow me to address just a few brief comments to these broader Sarbanes-Oxley compliance issues that Ms. Presti has highlighted.⁵ Then after commenting on the particular challenges securities lawyers now face as a result of an important definition that is the product of section 307 of the Sarbanes-Oxley Act, I will finish with some comments in reaction to Richard Humes' thoughtful discussion of the use of confidentiality agreements in dealing with waivers of attorney-client privilege in today's SEC enforcement environment.⁶

SARBANES-OXLEY COMPLIANCE COSTS

Ms. Presti discussed the extraordinary cost of compliance with section 404 of the Sarbanes-Oxley Act (SOX),⁷ and shared her personal insight and experience. Compliance is incredibly expensive, and one piece of fallout is that many small public companies are being driven seriously to consider going private. In this context you increasingly hear the term "going dark" to describe the process by which companies can avoid section 404 compliance by reducing the number of shareholders below the threshold for Securities Exchange Act reporting requirements, which also is the trigger for SOX section 404 compliance. I do not know if this is good or bad, but it is happening. Maybe some of those companies never should have been public in the first place, but nevertheless it appears that going dark is at least a serious consideration for many small companies. It is not clear yet whether the desire to avoid section 404 will lead to a significant number of smaller companies going dark, or for that matter going private. Sarbanes-Oxley compliance does present an incredibly difficult challenge for small public companies to meet that expense but, as Ms. Presti noted, the accountants certainly do love it.

⁵ Presti, *supra* note 2.

⁶ Humes, *supra* note 1.

⁷ Presti, *supra* note 2.

Let me now turn to some particular ethics responsibilities and challenges SEC Rule 205 creates for lawyers representing organizations that are issuers of securities. One of those challenges has to do with the fact that securities lawyers representing public companies now find themselves subject to both state and federal rules of professional conduct that are not entirely consistent.

INTERSECTION OF STATE RULES OF PROFESSIONAL RESPONSIBILITY AND SARBANES-OXLEY

Reporting Up and Out

There is tension between state ethics codes and what may or may not be required under SEC Rule 205. In some cases there is outright conflict that has, in the State of Washington for example, led to litigation in which the state bar has challenged SEC authority to override state bar rules.

Ohio has a new code of professional responsibility effective February 1, 2007. The new Ohio Code is taken substantially, although not entirely, from the ABA Model Code of Professional Responsibility. Thus, as provided in the ABA Model Code, the new Ohio Code provides for up-the-ladder reporting by a lawyer representing an organization client who finds evidence of certain wrongdoing by a constituent or other person connected with the organization.⁸ The Ohio rule contains both discretionary and mandatory elements. A lawyer who discovers evidence of wrongdoing is required to act in a manner that he or she reasonably believes to be necessary in the best interests of the organization. The Ohio Code mandates reporting up only when it is necessary to enable an organization to address the matter in a timely and appropriate manner.

Some of you may be aware that the current version of the ABA Model Code includes a provision for "reporting out," that is, blowing-the-whistle. The new Ohio Code does not include this provision, nor is it a part of SEC Rule 205. The SEC Rule under SOX expressly empowers a lawyer to report out, but it is not required. State codes, such as Ohio's, provide for circumstances in which a lawyer may reveal client information in the context of their client confidentiality rules. SEC Rule 205, on the other hand, states that reporting either up or out by a lawyer will not violate client confidentiality.

This has caused the problem noted above. SEC Rule 205 under SOX expressly states that it preempts any inconsistent state rules of professional conduct. This is the stuff of controversy and confronta-

⁸ OHIO RULES OF PROF'L CONDUCT R. 1.13 (2007).

tion, and as I mentioned, the Washington State Bar has thrown down the gauntlet given that state's strict prohibition against revealing client confidences. Richard Humes' remarks earlier about the potential for SEC enforcement actions in this arena put the entire matter in sharp focus.⁹

In Ohio and numerous other states that have not adopted the reporting out provision of the ABA Model Code, there are some provisions allowing a lawyer to report out, and thus disregard client confidentiality in circumstances that are relevant to what we talk about in regard to Sarbanes-Oxley and the post-Enron world. Under the new Ohio Code, for example, a lawyer may reveal client information when necessary to mitigate substantial injury to the financial interests of another that has resulted from the client's commission of an illegal or fraudulent act in furtherance of which the client has used the lawyer's services. There is also a provision in the Ohio Code stating that other laws may require a lawyer to disclose information about a client.¹⁰ It does not go on to say what that really means. But the reference to other laws could conceivably dovetail into the requirements for attorneys appearing and practicing under Rule 205. Also, on the point about SEC Rule 205 preemption of state rules, the new Ohio Code provides that whether another law supersedes the rule is a question beyond the scope of the Code.¹¹

Much of what you have heard so far today is a function of the Rule 205 definition of "appearing and practicing" before the SEC. This has now become a very important concept, particularly in light of Richard Humes' discussion of SEC enforcement initiatives.¹² Let me address the concept of "appearing and practicing" and its consequences further.

Sarbanes-Oxley Section 307: Challenges of "Appearing and Practicing"

Section 307 of the Sarbanes-Oxley Act requires the SEC to establish minimum standards of professional conduct for lawyers "appearing and practicing" before the Commission. The SEC response, Rule 205, imposes specific responsibilities on securities lawyers. This is an important departure from the historic reliance on SEC Rule 102(e) (formerly Rule 2(e)), to deny the privilege of appearing and practicing before the SEC to any person found to be

⁹ Humes, *supra* note 1, at 313–16.

¹⁰ OHIO RULES OF PROF'L CONDUCT R. 1.6(b)(6) (2007).

¹¹ *Id.* R. 1.6 cmt. 12.

¹² Humes, *supra* note 1, at 313–16.

lacking in character or integrity, or who has engaged in unethical or improper professional conduct or aided and abetted a violation of the federal securities laws.¹³ The key element of Rule 205 is the definition of “appearing and practicing before the Commission.”¹⁴ In the historical context of Rule 2(e), that was a relatively simple term. Today, however, the definition of “appearing and practicing before the Commission” has taken on an entirely different character.

Rule 205 states that “appearing and practicing before the Commission” for purposes of these rules includes advising or consulting about securities law compliance, in regard to or assisting in the preparation of, any document that will be a part of the submission to the Commission, or in regard to any matter that the lawyer knows is subject to SEC disclosure requirements.¹⁵ This definition has nothing to do with standing before the Commission and arguing a case or making submissions to the Commission on behalf of a client in the context of an administrative proceeding. This is a very broad definition of basically practicing law in the securities area when you are counseling or advising an issuer.

This definition becomes the premise for requiring, under the rule, an attorney to act in the face of credible evidence of a material violation. Reporting up is the first and only mandatory responsibility. The ethical dilemma that corporate and securities lawyers face in this process is that Rule 205 expressly states that a lawyer is authorized to disclose to the SEC client communications—confidential information that would otherwise be privileged—if the lawyer believes that disclosure would prevent a fraud on investors, a fraud on the SEC, or would stem the threat of serious financial harm to investors. Additionally, you can also use the information to defend your own compliance if that becomes an issue. And as Richard Humes touched on, compliance by the lawyer is expressly addressed. The lawyer’s responsibility under Rule 205 is now a subject for enforcement and administrative action if the attorney involved in the process does not do it right.¹⁶

For the lawyer appearing and practicing before the SEC, reporting up is mandatory if the lawyer becomes aware of credible evidence of a material violation. Keep in mind that “material violation” under Rule 205 means not only a material violation of an applicable federal or state securities law, but also a material breach of a fiduciary duty

¹³ SEC Rule 102(e), 17 C.F.R. § 201.102(e).

¹⁴ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745 (codified at 15 U.S.C. § 7245 (2006)).

¹⁵ 17 CFR § 205.2(a).

¹⁶ Humes, *supra* note 1, at 314.

arising under federal or state law.¹⁷ When you are engaged in this process, particularly as an outside lawyer, ask yourself how you would come to a determination whether there is credible evidence of a material violation. Others are going to disagree on that. How do I come to a conclusion in my own professional judgment that there has been something that I consider to be a material violation that would trigger my responsibility to report up, and ultimately make an “appropriate response”? It is a very difficult thing to do. It is compulsory to report up only when the lawyer makes the critical determination. But, if you call it wrong, you are in trouble.

Let me go back for a moment to the preemption point: Richard Humes discussed the position that section 307 of the Sarbanes-Oxley Act and Rule 205 preempt inconsistent state ethics rules.¹⁸ As I mentioned earlier in my comments, this is problematic. Up-the-ladder reporting provisions all relate to disclosing client information within a client organization—that is fine as far as that goes, but there is nothing that mandates revealing client information or disclosing it outside the organization. The lawyer that is representing the organization deals with the responsibility within the organization, but going beyond that is something else. SEC Rule 205 implies that there will be situations in which a lawyer determines that reporting out is necessary. Herein lies the difficulty that you face with complying with much more narrowly stated ethics requirements. Simply knowing that counsel may have to confront this problem prompts one to ask whether this will have a chilling effect on clients’ willingness to seek effective outside counsel, or effective counsel period. Additionally, you have to ask whether this is something that would cause otherwise effective counsel not to want to be engaged in this process because it could lead to disclosure when a state code of professional responsibility is at odds, if not contrary. Again, in Ohio we have some help on the way with these questions, but that is not the case everywhere. And it was not the case prior to the adoption of the new Ohio Code.

Another ethical challenge that arises, without regard to disclosure of client confidences, is understanding what an attorney is expected to know. A lawyer’s first line of defense in these cases, as Professor George Dent mentioned earlier, has simply been, “I didn’t know.”¹⁹ When you look at the definitions that are now in Rule 205, they include terms such as “credible evidence of a material violation” for example, and the duty to report that comes from that, but there is no

¹⁷ Rule 202.2(i), 17 C.F.R. § 205.2(i).

¹⁸ Humes, *supra* note 1, at 314–16.

¹⁹ George W. Dent, Jr., *Introduction*, 57 CASE W. RES. L. REV. 337 (2007).

guidance about what that means.²⁰ “Credible evidence” means that the prospect of a material violation is more than a mere possibility, but not necessarily more likely than not. Is it evidence somewhere between a five or ten percent chance but less than a fifty-one percent chance? These are determinations that the lawyer is now charged with making.

One other thing to keep in mind is that there is nothing about credible evidence under SEC Rule 205 that has to be related to a lawyer’s specific representation of a client—it is evidence of a material violation, period. For a lawyer engaged for a particular project, or engaged for a particular scope or subject, who in the course of that particular engagement comes across what he or she determines is a material violation completely unrelated to the engagement, there is a problem knowing what to do because the rules do not say that your responsibility is limited only in the narrow area of your engagement. State rules, such as those in Ohio, clearly imply that a reporting out that responsibility is determined by circumstances in which a lawyer’s services have been used directly in the commission of wrongdoing. SEC Rule 205 does not support such a limiting implication. One thing is certain in all of this: determining if there is evidence of a material violation can, obviously, be extraordinarily difficult because these are not necessarily “I know it when I see it” situations.

Law firms have taken some new approaches when serving as outside counsel. These approaches are based on the simple admonition, the wisdom of which I think you can now appreciate—that is, you do not go solo when dealing with SEC Rule 205 and Sarbanes-Oxley compliance. Individual partners who are in charge of or working on a particular situation with a public client take a team approach to making these determinations and judgments. You will see, for example, that within a law firm there may be a designated Sarbanes-Oxley partner. Or, you may see a committee created for Sarbanes-Oxley compliance within the law firm. The key is structurally establishing a resource within a firm for the assessment of issues that may arise and coming up with a collective judgment rather than trying to fly solo on making those judgments.

Another thing to keep in mind about Rule 205 is the attention given to the supervisory-attorney subordinate-attorney relationship. Rule 205 makes the supervisory attorney responsible for compliance by a junior or subordinate attorney who is directly involved in the

²⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745 (codified at 15 U.S.C. § 7245 (2006)).

representation.²¹ Here again, you cannot look away even if you are not directly involved in the representation in the engagement. Under Rule 205 you are responsible for the conduct of all those under your supervision, which is a serious challenge.

CONFIDENTIALITY AGREEMENTS

In an SEC investigation there are incentives to waive attorney-client privilege. The SEC uses a carrot and stick approach. I know that I have personally been involved in it. In the corporate investigations area, in some published material the Commission has, in effect, stated that their enforcement decisions can be influenced or determined by the extent and quickness that a corporation acts to commence an investigation to deal internally with issues, and then making all the work product available to the Commission, agreeing to waive attorney-client privilege in the process. But is there any effective way to limit the waiver of privilege? Confidentiality agreements under which information and the fruits of internal investigations are selectively provided are the most obvious possibility. But in practice they can be highly problematic.

Richard Humes mentioned the Sixth Circuit case *Columbia/HCA*.²² Frankly, that case makes it pretty tough to deal with confidentiality agreements. The Sixth Circuit simply rejected any approach that would allow selective disclosure. In this circuit, confidentiality agreements do not matter. Stipulations regarding selective disclosure do not matter. A waiver is a waiver. Consequently, it is very difficult to counsel a client in this circuit to consider a confidentiality agreement and to comfortably expect any protection. *Columbia/HCA* is there, and it very straightforwardly rejects such protection.

In *Columbia/HCA* there is an excellent dissenting opinion by Judge Boggs. Frankly, it is this dissenting opinion that is mentioned more often than not when you see *Columbia/HCA* cited today. Judge Boggs' dissenting opinion notes the public interest and the necessity, in terms of the public interest, to permit recognition of selective disclosure.²³ But that is not what the court said. We live with that in the Sixth Circuit, and it is not entirely different in a number of other circuits.

²¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (2006)).

²² *In re Columbia/HCA HealthCare Corp. Billing Practices Litig.*, 293 F.3d 289 (6th Cir. 2002).

²³ *Id.* at 307-14.

If we are going to have selective waiver it is going to come through something like proposed Federal Rule of Evidence 502.²⁴ But that raises an issue, too, and it will be interesting to see the comments on it. I am not certain how a federal rule of evidence can control what happens in state courts and trump state rules of evidence, but that appears to be the goal. It is an interesting challenge that will have to be debated because the federal rule as proposed would extend to state courts as well. If the federal rule was adopted but not also made available in every state court, you would have a horrible dilemma and would, really, have accomplished nothing.

Did you have a comment on that, Mr. Humes?

MR. HUMES: Yes, I was going to say that the original version of Rule 502 had a provision that would have preempted state law on the issue of whether the selective waiver doctrine should apply. The newest version that came out on August 10, 2006 leaves that issue to the states to determine.

MR. RAPP: Well, it seems that really adds to the dilemma here. The state bars are very parochial about some of these things. So that the issue is still very much up in the air then.

MR. HUMES: I think the advantage of even a provision that does not address what happens before the state courts takes us a long ways, because most of the shareholder actions, where these internal reports are being sought, are in the federal courts. So maybe you are eighty percent there. You have still got some exposure, but that is still better than having no rule at all.

MR. RAPP: That is true, but we went through that cycle with the Private Securities Litigation Reform Act and the migration of cases to state court, which then led to Securities Litigation Uniform Standards Act. Now we are still going back and forth on all of that, as to what is preempted and the like. So, there are cases that are still being brought in state courts under state and common law theories. They are viable. But somehow in this picture there is going to have to be a rule. Right now it is an all or nothing proposition. You either waive it or you do not, and there is a lot of encouragement to

²⁴ Report of the Advisory Committee on Evidence Rules, Proposed Rule 502 (May 15, 2006), available at http://www.uscourts.gov/rules/EV_Hearing_April_2006.pdf (last visited on March 3, 2007).

waive. Perhaps as a practical matter you are right and these issues will largely be confined to federal courts where some significant comfort will be available if proposed Rule 502 is adopted.²⁵

I should say, too, that the entire matter of attorney-client privilege waivers is a major issue in the context of white collar criminal investigations. That, however, is a topic unto itself these days, and is beyond the scope of my comments.

This concludes my comments on two very insightful presentations by my colleagues that highlighted elements of the sea change ushered in for securities lawyers by Sarbanes-Oxley and some of the challenges we face in the post-Enron world. The bottom line in all of this is that securities lawyers today must be comfortable and confident in the exercise of independent judgment. There are new and better defined responsibilities, and some real challenges. But I think that real securities lawyers have always been in tune with the notion that they have a special responsibility. The things my colleagues talked about pose challenges more than they raise issues or create problems. I believe that securities lawyers will meet those challenges just fine, and do a much better job for their clients and the public as a result.

²⁵ Richard M. Humes, Esq. & Robert N. Rapp, Remarks at the Case Western Reserve University Law Review Symposium: Lawyers in the Crosshairs: The New Legal and Ethical Duties of Corporate Attorneys (Jan. 26, 2007) (transcript on file with the Case Western Reserve Law Review).