Clients&FriendsMemo

SEC Commissioner Signals Need to Fulfill Mandate of Sarbanes-Oxley Act and Develop "Minimum Standards" for Lawyers Practicing Before the Commission

June 2, 2022

In remarks on March 5, 2022 on PLI's Corporate Governance webcast, Commissioner Allison Herren Lee of the Securities and Exchange Commission stated that, 20 years after its enactment, it is time to revisit the "unfulfilled mandate" of Section 307 of the Sarbanes-Oxley Act of 2002 and establish minimum standards for lawyers practicing before the Commission.[1] Commissioner Lee, who announced that she will not seek a second term when her current one ends this month, took issue with what she called the "goal-directed reasoning" of some securities lawyers—that is, focusing primarily on the outcome sought by executives, rather than the impact on investors and the market as a whole. Such lawyering, Commissioner Lee observed, has a host of negative consequences, including encouraging non-disclosure of material information, harming investors and market integrity, and stymying deterrence. The solution, Commissioner Lee opined, is to fulfill the mandate of Section 307, which empowered 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 in any way in the representation of issuers."[2]

Over the last 20 years, the Commission has declined to adopt enhanced rules of professional conduct for lawyers appearing before the Commission. There are good reasons for the Commission's inaction, including the attorney-client privilege, the goal of zealous advocacy, the fact-specific nature of materiality determinations, and the traditionally state-law basis for the regulation of attorney conduct. Commissioner Lee, moreover, did not propose specific new rules, and recognized that the task was difficult and should be informed by the views of the securities bar and other stakeholders. Nor did she say that action by the Commission was imminent; it is unclear whether the Commission has authority to promulgate new rules under Section 307 given a 180-day

[1] Commissioner Allison Herren Lee, *Send Lawyers, Guns and Money: (Over-) Zealous Representation by Corporate Lawyers Remarks at PLI's Corporate Governance – A Master Class 2022* (Mar. 4, 2022), available at https://www.sec.gov/news/speech/lee-remarks-pli-corporate-governance-030422 [hereinafter "Commissioner Lee Remarks"].

[2] *See* Sarbanes-Oxley Act, § 307, 15 U.S.C. § 7245 (2002).

sunset under the statute that occurred in 2003. Indeed, neither Commissioner Lee nor any of the other SEC commissioners have issued statements on this topic since the PLI webcast. SEC Enforcement Director Gurbir Grewal has, however, indicated an increased emphasis on gatekeeper accountability in order to restore public trust in the market.[3] Nonetheless, given the Commission's existing authority to impose discipline under its Rules of Practice, practitioners should be mindful of the potential for increased scrutiny moving forward.

Background

In the wake of corporate accounting scandals involving Enron, Worldcom, and other companies, Congress enacted the Sarbanes-Oxley Act in 2002 "[t]o safeguard investors in public companies and restore trust in the financial markets."[4] The Act was aimed at "combating fraud, improving the reliability of financial reporting, and restoring investor confidence,"[5] including by empowering the SEC with increased regulatory authority and enforcement power.[6] To that end, the Act includes provisions to fortify auditor independence, promote corporate responsibility, enhance financial disclosures, and enhance corporate fraud accountability.[7]

The Sarbanes-Oxley Act was passed just six months after the collapse of Enron in December 2001, and neither the House nor Senate bills originally contained professional responsibility language.[8] Hours before the Senate passed its version of the Act, however, the Senate amended the bill to include language that would eventually become Section 307.[9] Around the same time, 40 law professors sent a letter to the SEC requesting inclusion of a professional conduct rule governing corporate lawyers practicing before the Commission.[10] The letter picked up on a 1996 article by Professor Richard Painter, then of the University of Illinois College of Law, which recommended corporate fraud disclosure obligations for attorneys similar to those imposed on accountants by the Private Securities Litigation Reform Act of 1995.[11] Senator John Edwards, one of the sponsors of

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[3] Gurbir Grewal, Director, Division of Enforcement, *Remarks at SEC Speaks 2021* (Oct. 13, 2021), available at https://www.sec.gov/news/speech/grewal-sec-speaks-101321.

[4] *Lawson v. FMR LLC*, 571 U.S. 429, 432 (2014).

[5] Stephen Wagner and Lee Dittmar, *The Unexpected Benefits of Sarbanes-Oxley*, HARVARD BUS. REV. (Apr. 2006), https://hbr.org/2006/04/the-unexpected-benefits-of-sarbanes-oxley.

[6] *See* Sarbanes–Oxley Act, § 3, 15 U.S.C. § 7202 (2002).

[7] *See* Sarbanes–Oxley Act, § 1, 15 U.S.C. § 7201 (2002).

[8] Jennifer Wheeler, *Securities Law: Section 307 of the Sarbanes-Oxley Act: Irreconcilable Conflict with the ABA's Model Rules and the Oklahoma Rules of Professional Conduct?*, 56 OKLA. L. REV. 461, 464 (2003).

[9] *Id.*

[10] *Id.* at 468-69.

[11] *See generally* Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225 (1996).

the Senate floor amendment of the bill, emphasized the importance of including professional conduct rules for attorneys in such a significant piece of legislation, stating that "[o]ne of the problems we have seen occurring with this sort of crisis in corporate misconduct is that some lawyers have forgotten their responsibility" is to the companies and shareholders they represent, not corporate executives.[12]

In its final form, Section 307 imposed a professional responsibility requirement for attorneys that represent issuers appearing before the Commission. Specifically, Section 307 directed the Commission, within 180 days of enactment of the law, 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 in any way in the representation of issuers,"[13] and, at minimum, promulgate "a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer or any agent thereof to appropriate officers within the issuer and, thereafter, to the highest authority within the issuer, if the initial report does not result in an appropriate response."[14]

Since enactment of Section 307, however, the Commission has promulgated only one rule pursuant to its authority, commonly known as the "up-the-ladder" rule.[15] The up-the-ladder rule imposes a duty on attorneys representing an issuer before the Commission to report evidence of material violations of the securities laws. When an attorney learns of evidence of a material violation, the attorney has a duty to report it to the issuer's chief legal officer ("CLO") and/or the CEO.[16] If the attorney believes the CLO or CEO did not take appropriate action within a reasonable time to address the violation, the attorney has a duty to report the evidence to the audit committee, another committee of independent directors, or the full board of directors, until the attorney receives "an appropriate response."[17] Alternatively, attorneys can satisfy their duty by reporting the violation to a qualified legal compliance committee.[18] To date, the SEC has never brought a case alleging a violation of the up-the-ladder rule.

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[12] Wheeler, *supra* note 8, at 465 (quoting 148 CONG. REC. S6551 (daily ed. July 10, 2002) (statement of Sen. Edwards)).

[13] *See* Sarbanes-Oxley Act, § 307, 15 U.S.C. § 7245 (2002).

[14] Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Securities Act Rel. No. 8185 (Sept. 26, 2003), https://www.sec.gov/rules/final/33-8185.htm.

[15] 17 C.F.R. §§ 205.1-205.7.

[16] 17 C.F.R. § 205.3(b)(1).

[17] 17 C.F.R. §§ 205.3(b)(3), (b)(4).

[18] 17 C.F.R. § 205.3(c).

Commissioner Lee's Remarks

In her remarks, Commissioner Lee stated that it is time to revisit the "unfulfilled mandate" of Section 307 and consider whether the Commission should adopt and enforce minimum standards for lawyers who practice before the Commission. Commissioner Lee criticized "goal-directed reasoning" employed by sophisticated counsel in securities matters, and cited as an example *Bandera Master Fund v. Boardwalk Pipeline*,[19] a recent decision in which the Delaware Court of Chancery rebuked the attorneys involved for their efforts to satisfy the aims of a general partner instead of their duty to the partnership-client as a whole. The Court, specifically, stated that counsel "knowingly made unrealistic and counterfactual assumptions, knowingly relied on an artificial factual predicate, and consistently engaged in goal-directed reasoning to get to the result that [the general partner] wanted."[20] *Bandera* and cases like it, according to Commissioner Lee, are emblematic of a "race to the bottom" caused by pressure on securities lawyers to compete with each other for clients, while failing to give due consideration to the potential impact on investors, market integrity, and the public interest.

In Commissioner Lee's view, "goal-directed" lawyering not only falls short of ethical standards, but causes harm to the market and reduces deterrence. Commissioner Lee expressed concern that, in an effort to give management the answer it wants, lawyers may downplay or obscure material information.[21] Although recognizing that materiality determinations are fact-intensive, Commissioner Lee said that should not provide blanket cover for legal advice aimed at concealing material information from the public. Non-disclosure has a host of negative consequences, including distorting market-moving information, interfering with price discovery, misallocating capital, impairing investor decision-making, and eroding confidence in the financial markets and regulatory system. Further, such lawyering diminishes deterrence by creating legal cover for inadequate disclosure, making it more difficult for regulators to hold responsible individuals accountable. This

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[19] *Bandera Master Fund LP v. Boardwalk Pipeline Partners, LP*, No. CV 2018-0372-JTL, 2021 WL 5267734, at *1 (Del. Ch. Nov. 12, 2021). In *Bandera*, plaintiffs brought suit against a general partner for breach of a partnership agreement stemming from the general partner's exercise of a call right without satisfying two requisite preconditions. The court held for the plaintiffs and found the general partner had engaged in willful misconduct. *Id.* at *51. Contributing to the misconduct were the general partner's outside counsel, who drafted an opinion letter justifying the general partner's exercise of the call right. *Id.* Throughout the drafting process, the court found, the outside counsel manipulated the facts in order to achieve the general partner's desired conclusion. *Id.* at *18-*47.

[20] *Id.* at *51.

[21] Commissioner Lee specifically cited, among other matters, environmental, social, and governance ("ESG") disclosures. The Commission is currently considering additional climate change-related disclosures to Regulation S-K and Regulation S-X. *See* Jason Halper et al., *SEC Proposes Climate-Related Changes to Regulation S-K and Regulation S-X*, CADWALADER, WICKERSHAM & TAFT LLP (Mar. 23, 2022), https://www.cadwalader.com/resources/clients-friends-memos/sec-proposes-climate-related-changes-to-regulation-s-k-and-regulation-s-x; *see also* Paul Kiernan, *SEC Proposes More Disclosure Requirements for ESG Funds*, THE WALL STREET JOURNAL (May 25, 2022, 6:26 pm ET), https://www.wsj.com/articles/sec-to-propose-more-disclosure-requirements-for-esg-funds-11653498000?mod=hp_lead_pos6.

type of legal counsel, in Commissioner Lee's view, "is merely rent-seeking masquerading as legal advice, while providing a shield against liability."

Commissioner Lee stated that the existing framework governing professional conduct is not adequate to hold lawyers accountable for such "reckless" advice. According to Commissioner Lee, state bars—the principal source for lawyer discipline nationwide—are not up to the task because they lack resources, expertise in securities matters and the ability to impose adequate monetary sanctions. Additionally, Commissioner Lee noted that state law standards focused mostly on the behavior of individual lawyers, assigning few responsibilities to the firm for quality assurance. Indeed, state law standards are mostly drafted in a "one-size-fits-all fashion" according to Commissioner Lee and do not take into account the different issues faced at large firms who represent public companies, which are quite different from a solo practitioner handling personal injury or estate law matters. Likewise, although the SEC has the power under Rule 102(e) of its Rules of Practice to suspend or bar attorneys whose conduct falls below "generally recognized norms of professional conduct," there has been little effort to define or enforce that standard.[22] Nor has the SEC rigorously enforced standards of attorney conduct under the one rule it has issued under Section 307, the "up-the-ladder" rule.

Commissioner Lee stated that it was time for the Commission to fulfill its mandate under Section 307. Although not proposing any specific rules, Commissioner Lee offered the following concepts as a starting point:

- Greater detail on lawyers' obligations to a corporate client, including how advice must reflect "the interests of the corporation and its shareholders rather than the executives who hire them";

- Requirements of "competence and expertise" (as an example, disclosure lawyers should not opine on materiality "without sufficient focus or understanding of the views of 'reasonable' investors");

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[22] Rule 102(e) states, in relevant part:

> (1) *Generally.* The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter:
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> (i) not to possess the requisite qualifications to represent others; or
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> (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or
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> (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

17 C.F.R. § 201.102(e)(1).

- Continuing education for securities lawyers advising public companies (similar to requirements set by the Public Company Accounting Oversight Board for minimum hours of qualifying continuing professional education for audit firm personnel);

- Oversight at the firm level (similar to quality-control measures implemented at audit firms);

- Emphasis on the need for independence in rendering advice (similar to substantive and disclosure requirements implemented in Rule 2-01 of Regulation S-X for auditors);

- Obligations to investigate red flags and ensure accurate predicates for legal opinions (similar to the obligations that an auditor must perform to certify to the accuracy of their client's financial statements); and

- Retention of contemporaneous records to support the reasonableness of legal advice.

Commissioner Lee noted that the content of any specific rules or standards will require "careful thought," as well as assistance from the securities bar, experts on professional responsibility, and other interested parties and market participants. She invited input from the legal community and other stakeholders, and noted that she appreciated the complexity of the task and concerns of the American Bar Association and others regarding protection of the attorney-client privilege. Indeed, outside auditors are generally regarded as "public watchdogs" and such communications between the corporation and an auditor are not entitled to the affirmative attorney-client privilege afforded to legal counsel. Accordingly, regulating the legal profession using a similar framework to that applied to the accounting profession has sparked more controversy. Nonetheless, in Commissioner Lee's view, those concerns should be weighed against "the costs of there being few, if any, consequences for contrived or tortured advice."

Implications

The Commission has declined to adopt enhanced rules of professional conduct for lawyers appearing before it in the 20 years since enactment of the Sarbanes-Oxley Act. Commissioner Lee's call for minimum standards, however, potentially signals increased scrutiny by the SEC with respect to lawyers who "practice before the Commission." As Commissioner Lee noted, that means "counsel involved in the formulation and review of issuers' public disclosure, including those who address the many legal questions that often arise in that context."[23] Nonetheless, Commissioner Lee cautioned that she did "not intend with these comments to address the conduct of attorneys serving as litigators or otherwise representing their client(s) in an advocacy role in an adversarial proceeding or other similar context, such as in an enforcement investigation."[24]

[23] Commissioner Lee Remarks, *supra* note 1.

[24] *Id.*

Although framing her call for standards in terms of Section 307 of the Sarbanes-Oxley Act, it is not clear that the Commission will—or even can—promulgate any further rules under that authority. Commissioner Lee did not state that she was speaking on behalf of the Commission or indicate that the Commission would be taking concrete, imminent steps to adopt such standards. The Commission has not put its imprimatur on the remarks by incorporating them into a formal release or statement of policy. Moreover, the text of Section 307 appears to foreclose the possibility of further rulemaking, as it provides that the Commission shall issue any such rules "[n]ot later than 180 days after the date of enactment of this act," *i.e.*, January 27, 2003. Consistent with that constraint, the SEC proposed the up-the-ladder requirements on November 21, 2002, in Release No. 33-8150, and the rule became final on January 29, 2003.[25] But the SEC has not issued any other rule under Section 307 to date.

Even if official action under Section 307 may not be forthcoming, Commissioner Lee's call for action should not be discounted. Setting aside the up-the-ladder requirements, the SEC has authority under Rule 102(e) of the SEC's Rules of Practice to censure or bar a lawyer from appearing or practicing before the Commission if found, among other things, "[t]o be lacking in character or integrity or to have engaged and unethical or improper professional conduct."[26] Commissioner Lee cited prior SEC guidance to indicate that Rule 102(e) may apply to attorney conduct that falls below "generally recognized norms of professional conduct,"[27] a standard that has been left undefined to date.[28] In practice, the SEC "will hold attorneys who practice before it to the standards to which they are already subject, including state bar rules."[29] At minimum, then, Commissioner Lee's objective of greater accountability may be achieved through more aggressive

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[25] Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, Securities Act Rel. No. 8150 (Nov. 21, 2002), https://www.sec.gov/rules/proposed/33-8150.htm; Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Securities Act Rel. No. 8185 (Sept. 26, 2003), https://www.sec.gov/rules/final/33-8185.htm; *see also* 2 Legal Malpractice § 14:114 (2022 ed.).

[26] 17 C.F.R. § 201.102(e). The Rules of Practice generally "govern proceedings before the Commission under the statutes that it administers." 17 C.F.R. § 201.100. The SEC has the authority to administer and enforce such rules pursuant to the Administrative Procedures Act, 5 U.S.C. § 551 *et. seq. See* Comment to Rule 100, SEC Rules of Practice (July 2003), https://www.sec.gov/about/rulesprac072003.htm#:~:text=The%20Administrative%20Procedure%20Act%20(%22APA%22)%2C%205%20U.S.C.%20%C2%A7%20551%20et.%20seq.%2C%20is%20the%20source%20of%20various%20provisions%20of%20the%20Rules.

[27] *In the Matter of William R. Carter Charles J. Johnson*, 47 S.E.C. 471 (Feb. 28, 1981) ("elemental notions of fairness dictate that the Commission should not establish new rules of conduct and impose them retroactively upon professionals who acted at the time without reason to believe that their conduct was unethical or improper. At the same time, however, we perceive no unfairness whatsoever in holding those professionals who practice before us to generally recognized norms of professional conduct, whether or not such norms had previously been explicitly adopted or endorsed by the Commission. To do so upsets no justifiable expectations, since the professional is already subject to those norms.").

[28] In the past, the Commission has sought to discipline lawyers for violating securities laws with scienter, rendering misleading opinions used in disclosures and engaged in otherwise liable conduct, but not for giving negligent legal advice to issuers. *See In the Matter of Scott G. Monson*, Release No. 28323 (June 30, 2008) (collecting cases).

[29] *In the Matter of Steven Altman, Esq.*, Release No. 63306 (Nov. 10, 2010).

application of Rule 102(e), which, as she noted, has generally only been applied as a follow-on penalty for primary violations of the securities laws by lawyers.

Commissioner Lee's term expires on June 5, and she has announced that she intends to step down from the Commission once a successor has been confirmed.[30] Should the Commission nonetheless take up her call to action in the future, it will be no easy task to adopt clear standards that can be implemented in a predictable manner. In particular, Commissioner Lee's focus on the role of lawyers in advising issuers on determinations of materiality and disclosure does not lend itself well to oversight or enforcement. The well-established standard for materiality—whether "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote"—is far from clear-cut.[31] The Supreme Court, moreover, long has recognized that materiality "depends on the facts and thus is to be determined on a case-by-case basis."[32] As such, and as evidenced by the sundry cases concerning disclosure issues reversed on appeal, disagreement between litigants—as well as jurists—on matters of materiality and disclosure are par for the course. If that is so, how can a lawyer's advice on such matters (which will inevitably turn on the facts and the lawyer's judgment and experience) be subject to oversight in any objective sense?

Even if lawyers' materiality advice could be evaluated under objective standards, there are other difficulties. First and foremost is that oversight of legal advice implicates the attorney-client privilege and the underlying benefit of candid advice from securities disclosure and corporate counsel. As the Supreme Court has observed, the attorney-client privilege "is founded upon the necessity, in the interest and administration of justice, of the aid of persons having knowledge of the law and skilled in its practice, which assistance can only be safely and readily availed of when free from the consequences or the apprehension of disclosure."[33] Aside from situations in which the client has voluntarily waived privilege (as sometimes occurs in SEC investigations) or where another exception to the privilege applies, it is unclear how the SEC could evaluate legal advice without invading privilege. Such attempts could have led to an increase in corporate wrongdoing as corporate executives could be more reluctant to seek expert legal advice. In addition, it is unclear how regulators assessing materiality advice would—or could—balance an assessment of whether a lawyer has given the "correct" advice with a lawyer's ethical obligations of zealous representation of the client.[34] The divide between overreaching "goal-directed" reasoning and

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[30] Statement of Planned Departure from the Commission, https://www.sec.gov/news/statement/lee-20220315 (Mar. 15, 2022).

[31] *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[32] *Basic Inc. v. Levinson*, 485 U.S. 224, 250 (1988).

[33] *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981) (quoting *Hunt v. Blackburn*, 128 U.S. 464, 470 (1888)).

[34] Rule 1.3: Diligence, American Bar Association, https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_3_diligence/ (last visited Mar. 18, 2022) ("A lawyer shall act with reasonable diligence and promptness in representing a client."); Rule 1.3 Diligence – Comment 1, American Bar Association,

permissible zealous advocacy for the client is often murky, and reasonable minds can differ depending on the circumstances. Moreover, it is already well-accepted that a corporate lawyer's obligation is to the corporation as its client, not to any individual officer or director.[35] That obligation carries with it ethical duties to "proceed as is reasonably necessary in the best interest" of the corporation, including when the lawyer is aware of violations of the law or other misconduct by senior management.[36] In that sense, Commissioner Lee's proposal could be viewed as a call for the SEC to take on enforcement of existing ethical rules, rather than for the development of novel "minimum standards."

Ultimately, there are good reasons for the Commission's reluctance to date to formally adopt minimum standards of professional conduct for lawyers appearing before it, including the attorney-client privilege, the goal of zealous advocacy, and the fact-specific nature of materiality inquiries. The manipulation of facts and bad reasoning targeted by Commissioner Lee are not only the exception, and difficult if not impossible to eliminate completely, but largely covered by existing rules and practices. Nonetheless, Commissioner Lee's call for lawyers to strive for higher legal and ethical standards in their counsel should be welcomed. Sound legal advice is not only important for issuer clients, but also for the financial well-being of investors, the integrity of the markets, and public confidence in the regulatory system and capital markets. Enhancements in ethical standards for the legal profession could also lead to reputational benefits and greater integrity in the profession. It remains to be seen whether Commissioner Lee's remarks will serve as an aspirational goal for securities lawyers, or translate into concrete action by the Commission.

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https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_3_diligence/comment_on_rule_1_3/ (last visited Mar. 18, 2022) ("A lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf.").

[35] *See, e.g.*, *Upjohn*, 449 U.S. at 389.

[36] Rule 1.13: Organization As Client, American Bar Association, cmt. 2 https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_13_organization_as_client/comment_on_rule_1_13/ (last visited April 19, 2022).

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