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Nationalizing Ethical Standards for Securities Lawyers

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In his article, *The Corporate/Securities Attorney as a "Moving Target" – Client Fraud Dilemmas*, Marc Steinberg does an outstanding job of identifying the complex and significant ethical issues currently confronting securities lawyers. In particular, Professor Steinberg explains that although some state ethical rules permit attorneys to reveal client confidences to prevent or mitigate a client's fraud, the federal securities laws historically have never imposed upon lawyers an independent duty to "blow-the-whistle" on their clients.[1]

Professor Steinberg, however, demonstrates that the new Securities and Exchange Commission (SEC) standards have changed the landscape regarding attorney conduct. Promulgated pursuant to congressional authority granted by Section 307 of the Sarbanes-Oxley Act (SOX), the SEC's new standards require attorneys to report evidence of a material violation of the federal securities laws "up-the-ladder" to the chief legal counsel or the chief executive officer of the issuer-client. In the absence of an appropriate response, the attorney must then report such evidence to the audit committee, another committee of independent directors, or the full board of directors.[2] Alternatively, the issuer

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1. *See* Marc I. Steinberg, *The Corporate/Securities Attorney as a "Moving Target" – Client Fraud Dilemmas*, 46 WASHBURN L.J. 1, 1, 4-5 (2006).

2. *See* Steinberg, *supra* note 1, at 13 n.61; Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 47276, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823 (Jan. 29, 2003) (codified at 17 C.F.R. §205). The SEC Standards define evidence of a material violation as, "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." 17 C.F.R. § 205.2(e) (2006). According to SEC Standards, "appropriate response" means:

> A response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:
>
> (1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;
>
> (2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or
>
> (3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported

may establish a "Qualified Legal Compliance Committee" (QLCC) to which counsel may report evidence of a material securities law violation.[3]

More significantly, the SEC Rule allows an attorney "without the consent" of an issuer-client to reveal confidential information to the SEC related to his or her representation

> to the extent the attorney reasonably believes necessary:
>
> (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interests or property of the issuer or investors;
>
> (ii) To prevent the issuer [from committing an illegal act]; or

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> evidence of a material violation and either:
>
> (i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or
>
> (ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation

17 C.F.R. § 205.2(b).

3. *See* Steinberg, *supra* note 1, at 13-14 (citing 17 C.F.R. § 205.2(k)). A QLCC is a committee that:

> (1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));
>
> (2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under § 205.3;
>
> (3) Has been duly established by the issuer's board of directors, with the authority and responsibility:
>
> (i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in § 205.3(b)(4));
>
> (ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:
>
> (A) Notify the audit committee or the full board of directors;
>
> (B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and
>
> (C) Retain such additional expert personnel as the committee deems necessary; and
>
> (iii) At the conclusion of any such investigation, to:
>
> (A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and
>
> (B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and
>
> (4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

17 C.F.R. § 205.2(k). Professor Steinberg indicates that the QLCC "may not be widely adopted." Steinberg, *supra* note 1, at 13-14 n.62; *see* Rachel McTague & Michael Brady, *QLCC Option in New Conduct Rule Could be Disadvantage to Corporate G.C.*, 35 Sec. Reg. & L. Rep. (BNA) 354 (Mar. 3, 2003).

> (iii) To rectify the consequences of a material violation . . . [in] which the attorney's services [have been] used.[4]

The SEC further provides that its Rule will preempt any state laws or ethical standards that are inconsistent with its minimal requirements.[5] Finally, the SEC affirmatively declares that its Rule does not "create a private cause of action" and that "[a]uthority to enforce compliance with [the rules] is vested exclusively in the Commission."[6]

Professor Steinberg also astutely recognizes that an attorney's decision to act in response to a client's fraud may be particularly difficult where there is a lack of clarity about whether fraud in fact exists. Professor Steinberg recommends that where the client fails to respond to the lawyer's advice to take corrective action, the client should obtain a "second opinion" from an independent lawyer or firm.[7]

In this article, I attempt to explore the important legal and political implications of Professor Steinberg's salient points. First, the article places the absence of an independent obligation of an attorney to "blow-the-whistle" on a client in the context of evolving federal securities law precedent. Although the Seventh Circuit was unwilling to create a federal common law obligation to "blow the whistle," other circuits have come close to doing so, creating a patchwork of judicial authority on ethical questions. Second, the article argues that SOX, and the SEC Rules promulgated pursuant to its authority, may indeed impose upon attorneys a federal duty to disclose client confidences in certain situations. Third, the article observes that the creation of such a federal duty is consistent with a broader trend in securities law jurisprudence toward the creation of national standards. This nationalization trend is manifest in the most recent Supreme Court decisions expanding both the preemptive force of the federal securities laws, and the jurisdictional force of federal courts over securities fraud class actions. Finally, the article also suggests that an attorney's breach of the newly-created federal duty to "blow-the-whistle" on the client could itself give rise to a viable private right of action for securities fraud.

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4. 17 C.F.R. § 205.3(d)(2)(i)-(iii).

5. *See* Steinberg, *supra* note 1, at 16 n.64; 17 C.F.R. § 205.1 ("Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern."); *see also* 17 CFR § 205.6(c) ("An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state . . . ."). Professor Steinberg also shows that the states of California and Washington in fact have ethical standards that may be incompatible with the SEC Rule. *See* Steinberg, *supra* note 1, at 16 n. 64-65.

6. 17 C.F.R. § 205.7.

7. *See* Steinberg, *supra* note 1, at 20.

I. THE EVOLVING NATURE OF THE FEDERAL COMMON LAW DUTY TO BLOW-THE-WHISTLE

As Professor Steinberg indicates, liability for securities fraud under Section 10(b) of the Securities and Exchange Act[8] and Rule 10b-5[9] requires a showing that the defendant with scienter made either a material misrepresentation or a material omission in connection with the purchase or sale of securities.[10] Where an attorney acting with the requisite state of mind affirmatively makes a material misrepresentation, the attorney is liable for securities fraud, even in the absence of any independent duty to disclose.[11] On the other hand, if the attorney is silent in the face of the client's securities fraud, the attorney cannot be liable for fraud in the absence of an independent duty to disclose the fraud.[12]

The Seventh Circuit's classic opinion in *Barker v. Henderson, Franklin, Starnes & Holt*,[13] to which Professor Steinberg assigns proper prominence, announces that the federal securities laws do not by themselves create any such independent duty to blow the whistle.[14] Yet, the *Barker* opinion did not foreclose viable securities fraud claims against attorneys for their failure to disclose a client's fraud. The opinion itself addressed the issue of an attorney's liability for aiding and abetting a client's securities fraud, not the issue of an attorney's primary liability for securities fraud.[15] In *Barker*, the Seventh Circuit held that a defendant must have committed a manipulative or deceptive act in order to be liable under Section 10(b).[16] As the Supreme Court recognized in *Central Bank of Denver v. First Interstate Bank of Denver*,[17] this requirement "in effect forecloses liability on those who do no more than aid or abet a 10b-5 violation."[18] In the context of aiding and abetting claims, attorneys could be liable only for providing knowing and substantial assistance to their client's primary violation.[19] The issue confronting the Seventh Circuit in *Barker* was whether the attorney's knowing failure to disclose a client's fraud could provide the "substantial assistance" necessary to an aiding and abetting claim.[20] The *Barker* court responded that silence alone could not provide the level of sub-

8. Securities Exchange Act of 1934, 15 U.S.C. § 78a (1994).
9. 17 C.F.R. § 240.10b-5 (2005).
10. *See* Steinberg, *supra* note 1, at 4-5; *see also* Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1507 (2006); Chiarella v. United States, 445 U.S. 222, 228 (1980).
11. *See, e.g.*, *Chiarella*, 445 U.S. at 228; *see also* Ackerman v. Schwartz, 947 F.2d 841, 848 (7th Cir. 1991) ("Under Rule 10b-5 . . . the lack of an independent duty does not excuse a material lie.").
12. *See Chiarella*, 445 U.S. at 233-35; *see also* Steinberg, *supra* note 1, at 4-5 & nn. 18-21.
13. 797 F.2d 490 (7th Cir. 1986).
14. *See* Steinberg, *supra* note 1, at 4-5 (citing *Barker*, 797 F.2d at 496-97).
15. *Barker*, 797 F.2d at 495.
16. *Id.*
17. 511 U.S. 164 (1994).
18. *Id.* at 170.
19. *Id.*
20. *Barker*, 797 F.2d at 495.

stantial assistance requisite to aiding and abetting liability.[21] In part, the court argued that attorneys—like other professionals—would have little incentive to assist their client's fraud. As such, an inference of an attorney's intent to participate in their client's scheme should not be drawn from an attorney's silence alone. The court's holding, thus, was limited to the aiding and abetting issues in that case.[22] Moreover, the court's actual result was rendered obsolete when the Supreme Court in *Central Bank of Denver* rejected the very existence of a private right of action for aiding and abetting a federal securities law violation.[23]

Although the Seventh Circuit's aiding and abetting holding in *Barker* has been rendered obsolete, its reasoning that the federal securities laws do not create a generic duty to disclose material facts still seems unassailable. Indeed, the Supreme Court held in *Chiarella v. United States*[24] that Section 10(b) does not create any express statutory duties to disclose material facts.[25] A failure to disclose material facts is actionable as fraud under Section 10(b) only if "one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'"[26] In concluding that the failure to disclose violates Section 10(b) only if a relationship of trust and confidence giving rise to such a duty exists, the Supreme Court expressly rejected the argument that Section 10(b) itself imposed a duty to disclose material nonpublic information.[27] Rather, the Supreme Court in *Chiarella* relied on the common law rule embodied in Restatement (Second) of Torts Section 551(2)(a) to determine whether the requisite relationship and duty was present.[28]

Interpreting *Chiarella*'s duty to disclose analysis, the Fourth Circuit has held that "the duty to disclose material facts arises only where there is some basis outside the securities laws, such as state law, for finding a fiduciary or other confidential relationship."[29] The Eighth Circuit similarly has adopted the position that a fiduciary relationship and concomitant duty to disclose may be established by state or federal law, or upon a finding by the court that the nature of the parties' relationship and other enumerated factors warrant the imposition of such a duty.[30] To

21. *Id.* at 493-95.
22. *Id.* at 495.
23. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 176 (1994).
24. 445 U.S. 222 (1980).
25. *See id.* at 233-35.
26. *Id.* at 228 (alteration in original) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).
27. *See id.* at 233-35.
28. *See id.* at 228-29 & n.9.
29. Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469, 472 (4th Cir. 1992) (citing Windon Third Oil & Gas Drilling P'ship v. FDIC, 805 F.2d 342, 347 (10th Cir. 1986); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 (7th Cir. 1986)).
30. *See* Camp v. Dema, 948 F.2d 455, 460 (8th Cir. 1991).

the extent that a duty to disclose under Section 10(b) may exist if either a federal statute (other than Section 10(b) itself) or state statutory, ethical, or common law recognizes such a disclosure duty, attorneys may face Section 10(b) liability for their failure to disclose client confidences in breach of any such duty. Indeed, according to *Chiarella*'s progeny, an attorney could acquire a duty to disclose a client's fraud from: (1) state ethical standards; (2) state securities laws; and (3) federal common law interpretations of Section 10(b). As Professor Steinberg notes, the ethical standards in a majority of the states have in fact imposed upon lawyers a duty to disclose a client's fraud in a variety of contexts.[31] He concludes that, "under the vast majority—but not all—state ethical rules, counsel may reveal information outside the organization to the extent that such information is necessary to prevent or mitigate the client's fraud or crime."[32] Professor Steinberg also demonstrates that "[a] few states require disclosure of client fraud in this context."[33] In addition, as Professor Steinberg also shows in a separate article, attorneys also may acquire duties to disclose material facts under a host of state securities laws.[34]

Finally, even under recent federal court interpretations of Section 10(b) itself, an attorney acquires a federal duty to disclose material facts when that attorney begins to speak, or when the attorney participates in the creation of the client's misrepresentations. *Rubin v. Schottenstein, Zox & Dunn*[35] presents an excellent example of when attorneys who speak on behalf of their clients to third-party strangers may acquire a duty to disclose all material facts.[36] In that case, the Sixth Circuit held an issuer's attorney liable under Section 10(b) for failing to disclose material facts to a potential third-party purchaser: "while an attorney representing the seller in a securities transaction may not always be under an independent duty to volunteer information about the financial condition of his client, he assumes a duty to provide complete and non-misleading information with respect to subjects on which he undertakes to speak."[37] In *Klein v. Boyd*,[38] as well, the Third Circuit developed a

31. *See* Steinberg, *supra* note 1, at 1-2 nn.3-5.
32. *Id.* at 3.
33. *Id.* at 3-4 n.12.
34. *Id.*; Marc Steinberg, *Attorney Liability Under State Securities Laws: Landscapes and Minefields*, 3 BERK. BUS. L.J. 1, 5 (2005).
35. 143 F.3d 263 (6th Cir. 1998).
36. *Id.* at 266-68.
37. *Id.* at 268; *see also* Trust Co. of La. v. N.N.P. Inc., 104 F.3d 1478, 1490-91 (5th Cir. 1997) (holding primary liability under section 10(b) appropriate when attorney assured third-party investor that his firm was custodian of certificates securing investment); Kline v. First W. Gov't Sec., Inc., 24 F.3d 480, 491 (3rd Cir. 1994) ("[W]hen [an attorney] 'undertakes the affirmative act of communicating or disseminating information,' there is a general obligation or 'duty' to speak truthfully . . . .") (quoting Rose v. Ark. Valley Envtl. & Util. Auth., 562 F. Supp. 1180, 1207 (W.D. Mo. 1983)); Ackerman v. Schwartz, 947 F.2d 841, 848 (7th Cir. 1991) (holding that although the attorney had no duty to the investors to blow the whistle on his client and he had no duty to correct a letter he had not au-

multi-factor test to determine whether an attorney's participation in the client's misstatements rendered the attorney primarily liable for "making" those statements: (1) the lawyer knows (or is reckless in not knowing) that the statement will be relied upon by investors; (2) the lawyer is aware (or is reckless in not being aware) of the material misstatement or omission; (3) the lawyer played such a substantial role in the creation of the statement that the lawyer can fairly be said to be the "author" or "co-author" of the statement; and (4) the other requirements of primary liability are satisfied.[39] By this view, attorneys acquire obligations to speak truthfully when they play a substantial role in the creation of a client's statement.

In reaching its decision, the Third Circuit relied on its prior decision in *Kline v. First Western Government Securities, Inc.*[40] In *Kline*, the court reasoned that a lawyer who undertakes the affirmative act of communicating information has a general obligation or "duty" to speak truthfully.[41] The court concluded that if an attorney knows that the documents he or she prepares contain material misstatements or omissions that will be distributed to investors, that attorney has a duty to correct the material nondisclosures in those documents. The Third Circuit, however, granted a motion to reconsider *Klein*, vacated the judgment, and voted to hear the case en banc.[42] The parties then settled the action.

In an attempt to clarify the appropriate standard of primary liability for this type of misconduct, however, the SEC submitted an illuminating amicus curiae brief in *Klein*. The Commission proposed the following standard:

> [A] person who has the requisite *scienter* can be liable as a primary violator of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder when he or she, acting alone or with others, creates a misrepresentation, whether or not the person is identified with the misrepre-

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thorized to be circulated in the first place, the attorney cannot evade primary section 10(b) liability to the extent he permitted the promoters to release his opinion letter to the investors when he knew such letter contained material misrepresentations); Walco Invs., Inc. v. Thenen, 881 F. Supp. 1576, 1585-86 (S.D. Fla. 1995) (holding that attorneys who drafted solicitation materials knowing that investors would rely on such materials in their purchases of securities may owe a duty to such investors to ascertain and disclose deficiencies contained in the private placement memorandum); Employers Ins. of Wausau v. Musick, Peeler & Garrett, 871 F. Supp. 381, 388-89 (S.D. Cal. 1994) (concluding no "need to show a duty to disclose when [attorneys were] alleged to have participated in drafting offering documents containing material omissions" even though such attorneys were not named in any document).

38. 24 F.3d 480 (3d Cir. 1994).

39. *See id.*

40. *Id.* (finding where law firm was put on notice that investors were relying on firm's tax opinion letters, law firm could be held primarily liable under section 10(b) for misstatements and omissions contained in those letters even though firm stated in the letters that the opinions were based on facts represented by the client).

41. *Id.*

42. *See id.*

sentation by name.[43]

Attorneys, therefore, who act together with their clients to create a disclosure document that fails to disclose material facts would engage in an act of deception in violation of Section 10(b).

Similarly, in *In re Enron Corporation Securities, Derivative & ERISA Litigation*, the law firm of Vinson & Elkins was found to have an obligation to disclose all material facts necessary to make its previous statements not misleading.[44] In that matter, the federal court declared:

> This Court concludes that professionals, including lawyers and accountants, when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, do have a duty to third parties not in privity not to knowingly or with severe recklessness issue materially misleading statements on which they intend or have reason to expect that those third parties will rely. . . . In this suit, Lead Plaintiff has alleged as a crucial part of the Ponzi scheme that at least some fraudulent misrepresentations were made by Vinson & Elkins . . . and were aimed at investors to attract funds into Enron, as well as at credit rating agencies to keep Enron's credit rating high and bank loans flowing. Therefore the "limited group" that the attorneys . . . allegedly intended, or might reasonably have expected, to rely on their material misrepresentations, and who allegedly did rely and suffered pecuniary loss, included Plaintiffs in this suit.[45]

As such, attorneys who participate in the drafting of a client's disclosure documents with the SEC may be held to have made statements in those documents which give rise to a broader duty to disclose all material facts that are necessary to make the documents not misleading.[46]

II. THE NEW INDEPENDENT FEDERAL STATUTORY DUTY TO DISCLOSE CLIENT CONFIDENCES

In Section 307 of SOX, Congress authorized the SEC to promulgate a Rule that requires securities lawyers to engage in "up-the-ladder" reporting of a client's material violation of fiduciary duty or securities law.[47] The SEC's Rule in fact adopted some standards based on the model of "up-the-ladder" reporting.[48] As Professor Steinberg points out, however, the promulgated Rule also permits an "attorney, without the consent of an issuer client, to reveal [to the SEC] confidential information related to his or her representation to the extent the attorney

43. *Id.* at 20.
44. *See In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).
45. *Id.* at 610-11.
46. *See, e.g.*, MARC I. STEINBERG, ATTORNEY LIABILITY AFTER SARBANES-OXLEY § 2.05[2], at 2-27 (2005).
47. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (codified at 15 U.S.C. § 7245 (Supp. II 2002).
48. *See* Steinberg, *supra* note 1, at 12-13 & n.59.

reasonably believes necessary" to either prevent "a material violation likely to cause substantial financial injury" to investors or to "rectify the consequences of [such] a material violation."[49] The SEC's standard thus does not *require* disclosure of client confidences, but it does *allow* disclosure of those confidences.

The issue raised by the SEC's permissive disclosure standard is whether that standard creates an independent duty to disclose in certain circumstances. Certainly, a federal statutory *requirement* that attorneys disclose a client's material violation of the securities laws would create an independent disclosure duty. In keeping with *Chiarella* and its progeny, that statutory requirement would give rise to an independent duty to disclose that would render an attorney's failure to disclose fraudulent.[50] Yet, a statutory standard that merely permits disclosure of client confidences would seem not to create such an affirmative *duty* to disclose.

Nonetheless, in the specific context of an attorney's decision to disclose a client's violation of the federal securities laws, the SEC's federal standard permitting disclosure is tantamount to an affirmative duty to disclose. First, attorneys have a duty to disclose a material violation of the federal securities laws, unless their professional ethical obligation to protect client confidences provides a viable defense to such a nondisclosure. The rationale in cases such as *Barker* for insulating attorneys from liability for failure to disclose client confidences was that the attorney may be *precluded* from doing so by state ethical rules. An overriding ethical standard that no longer precludes attorneys from disclosing a client's material securities law violation also no longer insulates them from liability for failing to disclose that violation.

Second, in the absence of any duty to the client to conceal a client's securities fraud, attorneys do have an obligation to disclose that fraud by virtue of their position as an insider in the organization of the client. *Chiarella* is often relied upon for the proposition that attorneys cannot be liable for failing to disclose material facts to investors because they have no disclosure duty running to those investors. But *Chiarella* involved a printer, not a securities lawyer. Attorneys, unlike printers, can become insiders of the entity they represent for purposes of disclosure obligations. In a portion of *Chiarella* often overlooked, the Supreme Court recognized that the party charged with failing to disclose market information must be under a duty to disclose it, but then made clear that such a duty is incumbent on both an "insider" and a "fiduciary." Moreover, the Supreme Court, in its subsequent *Dirks v. SEC*[51] opinion,

49. Steinberg, *supra* note 1, at 15.
50. *See, e.g.*, STEINBERG, *supra* note 46, § 2.05[2], at 2-27.
51. 463 U.S. 646 (1983).

makes clear that attorneys should be treated as both insiders and fiduciaries where they have been given access to their client-organization's confidences. Attorneys are insiders because they are the entity's agents.[52] If they are otherwise "outsiders," attorneys may nonetheless become fiduciaries:

> Under certain circumstances, such as where corporate information is revealed legitimately to a[] . . . lawyer, . . . these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.[53]

Both *Dirks* and *Chiarella* were decided in the context of insider trading and the breach of the duty to disclose material nonpublic information or abstain from trading. Still, the precise language, holding, and reasoning of these seminal cases does not relieve the attorney of the duty to disclose material nonpublic information in order to protect the client or its shareholders from financial harm.

III. THE NATIONALIZATION OF SECURITIES REGULATION

In its standard of professional conduct for attorneys, the SEC declares that those standards shall preempt less rigorous obligations imposed on attorneys by state laws or ethical rules.[54] In particular, the SEC asserts that if "the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with [this standard], [this standard] shall govern."[55] This assertion of the preemptive force of an SEC Rule raises three questions. First, are there state standards that are in "conflict" with the SEC's regime? Second, if there are state standards that are in conflict with the SEC's regime, is the SEC's assertion of the preemptive force of its own Rule legitimate? Third, will the Supreme Court's recent trend favoring national securities regulation lead it to favor the SEC's preemptive force in this case?

A. State Attorney Confidentiality Standards in Conflict with the SEC's Regime

As Professor Steinberg suggests, the attorney confidentiality standards in at least California and Washington are in tension with the SEC's reporting requirements.[56] California's attorney professional conduct rules do not permit attorneys to disclose client confidences merely

52. *Id.* at 655 n.14.
53. *Id.*
54. 17 C.F.R. § 205.1 (2006).
55. *Id.*
56. *See* Steinberg, *supra* note 1, at 16 & n.66.

to prevent or rectify financial harm.[57] Similarly, Washington's Rules of Professional Conduct permit an attorney to disclose client confidences only "to the extent the lawyer reasonably believes necessary . . . to prevent the client from committing a crime."[58] In its Proposed Interim Formal Ethics Opinion, a Washington State Bar Association Committee concluded that attorneys admitted to practice in Washington should not follow the SEC Rule where doing so would allow the lawyer to reveal client confidences in violation of the Washington Rules.[59]

Professional conduct rules such as those in Washington and California, however, are not necessarily in conflict with the SEC Standards. Those state standards preclude attorneys from disclosing client confidences merely to prevent or rectify financial harm. The SEC Standards do not *require* lawyers to disclose such confidences. The SEC Standards merely permit attorneys to disclose client confidences to prevent or rectify financial harm. The attorney who does not disclose confidences in that situation thus would seem to comply with both state and SEC Rules. Only the lawyer who decides to disclose these confidences under SEC authorization would appear to run afoul of the contrary local rules. The lawyer who decides to disclose client confidences to prevent or rectify financial harm to his or her client or to investors, therefore, would likely defend the decision to disclose by pointing to the preemptive force of the SEC regime. It is in that precise context that the issue of whether SEC Rules preempt irreconcilable state laws likely will be raised.

B. The Legitimacy of the Preemptive Force of the SEC's Professional Standards

In addressing the preemptive force of the SEC's standards, the first issue is whether the regulations passed by a federal agency like the SEC have the same preemptive power as federal statutes passed by Congress. The Supreme Court has clearly answered that question in the affirmative: "Federal regulations have no less preemptive effect than federal statutes."[60] Accordingly, in *Sperry v. Florida*,[61] the Court concluded that the Commissioner of Patents had the authority to promulgate a federal rule establishing qualifications for persons representing patent applicants before the Patent Office, which preempted the contrary Florida law requiring attorneys to be properly licensed by the State.[62] So

57. *See* CAL. BUS. & PROF. CODE § 6068(e) (West 2003); CAL. RULES OF PROF'L CONDUCT R. 3-600(c) (2006).
58. WASH. RULES OF PROF'L CONDUCT § 1.6(b)(2) (2006).
59. *See* State Bar of Washington, Interim Formal Ethics Opinion (2003).
60. Fid. Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 153 (1982).
61. 373 U.S. 379 (1963).
62. *Id.* at 381-83.

too in *Fidelity Federal Savings & Loan Association v. de la Cuesta*,[63] the Supreme Court held that the Federal Home Loan Bank had the authority to promulgate national regulations for real estate loans that preempted any contrary state laws.[64] The SEC's regulations thus may be given preemptive effect.

That preemptive effect, however, depends on whether Congress authorized the SEC's regulations. In both *Fidelity Federal Savings* and *Sperry*, the Supreme Court specifically found that Congress had clearly authorized the administrative agency to promulgate the preemptive regulations. In *Sperry*, the Court suggested that the congressional "authorization" to an administrative agency must be "unqualified" before the agency's regulations may receive preemptive power.[65] In *Fidelity Federal Savings*, the Court first assured itself that "Congress has directed an administrator to exercise his discretion" before giving preemptive effect to the regulations adopted by that administrator.[66]

Accordingly, the issue becomes whether Congress has given to the SEC "unqualified" authorization to promulgate its attorney conduct standards. A careful analysis of the language and legislative history of Section 307 of SOX reveals that Congress did not provide the SEC with unqualified authorization to promulgate an attorney conduct rule which permits attorneys to disclose client confidences. In Section 307, Congress explicitly authorized the SEC 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, including a rule [that requires] attorney[s] to report . . . a material violation of securities law ["up-the-ladder" within the organizational client.][67]

The statute's authorization contains examples of attorney conduct rules. Neither example allows attorneys to report a material securities law violation *out* of the organizational client. Indeed, the chief sponsors of Section 307 made clear during Senate debates that they underlined Section 307 to authorize only internal "up-the-ladder" reporting and not external reporting. For instance, Senator Enzi states:

> The amendment I am supporting would not require the attorneys to report violations 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

63. 458 U.S. 141 (1982).
64. *Id.* at 170.
65. *Sperry*, 373 U.S. at 385.
66. *Fid. Fed. Sav. & Loan Ass'n*, 458 U.S. at 141.
67. 15 U.S.C. § 7245 (Supp. II 2002).

> 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.[68]

Moreover, Senator Sarbanes even asked Senator Edwards whether Section 307's language would require lawyers to report to the SEC:

> [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 corporate 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 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 successful, then to the board of the corporation. There is no obligation to report anything outside the client—the corporation.[69]

Nevertheless, the statute's reporting out rules are only examples of rules that provide minimum standards for lawyers. Congress's use of the word "including" before the examples makes clear that the SEC could devise methods of serving the public interest and protecting investors through alternative minimum standards of professional conduct for attorneys. The language of Section 307, despite the apparent contrary understanding from its sponsors, does authorize the SEC to promulgate minimum standards for attorneys "including," but not limited to, reporting "up-the-ladder." Yet, the general congressional authorization to the SEC to promulgate Rules setting forth minimum standards for attorneys in the public interest and for the protection of investors is hardly an "unqualified" authorization to permit attorneys to report out.

The Supreme Court's precedents on the issue of administrative regulation preemption, therefore, do not fully resolve the question of the legitimacy of the SEC's attempt to preempt state laws that are contrary to its Rule allowing attorneys to reveal client confidences to prevent or rectify financial harm. In predicting the Supreme Court's resolution of this question, it is important to weigh the apparent inconsistent Supreme Court trends. On the one hand, the Court takes seriously the sovereignty of the state over local matters such as the conduct of attorneys licensed to practice under the privilege of state law.[70] That respect for state sovereignty has led the Court to require clear congressional language or intent preempting state law.[71]

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68. *See* 148 CONG. REC. S6555 (daily ed. July 25, 2002) (statement of Sen. Enzi).

69. *See id.* at S6557 (statements of Sen. Sarbanes and Sen. Edwards).

70. *See, e.g.*, Bates v. Dow Agrosciences LLC., 544 U.S. 431, 449 (2005) (recognizing the presumption against federal preemption of state law claims).

71. *See, e.g.*, *id.*

C. The Trend Toward National Securities Law Standards

On the other hand, a more recent contrary nationalization trend has emerged in the Supreme Court's key securities law cases. In *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*,[72] the Supreme Court unanimously concluded that the Securities Litigation Uniform Standards Act[73] (SLUSA) preempted state law class action claims by investors who allegedly were fraudulently induced to *hold* rather than to purchase or sell securities. The SLUSA governs fraud claims "in connection with the purchase or sale of a covered security."[74] The Supreme Court had long held that a claim based on allegations that the plaintiffs merely were induced to hold their securities rather than to purchase or sell their securities is not a claim based on fraud "in connection with the purchase or sale of securities."[75] The Second Circuit therefore held that the SLUSA did not govern and thus did not preempt such state law claims alleging only that the plaintiffs were induced to *hold* their securities. Nonetheless, the Supreme Court extended the preemptive effect of the SLUSA to state law fraud claims and remedies not even recognized by the federal securities laws.

The Court's rationale for the extension of the preemptive force of SLUSA is tantamount to an argument for the nationalization of federal securities regulation and litigation. The Court argues that the market for securities transactions is national and international. According to the Court, Congress from 1933 to the present has recognized the national importance of the securities markets and has decided to impose national standards for buying and selling securities. In his opinion, Justice Stevens begins his analysis of the preemptive force of SLUSA by declaring that "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated."[76] In fact, the Court recognizes that the federal securities laws "have anchored federal regulation of vital elements of our economy."[77]

The Court's view of the propriety of national regulation of the securities markets then leads it to two additional conclusions. First, in keeping with the heightened federal role in securities regulation, the Supreme Court extends its recent expansion of the scope of Section 10(b)'s anti-fraud remedies to include deceptive conduct in connection with the purchase or sale of securities, even if that conduct merely "co-

72. 126 S. Ct. 1503 (2006).
73. 15 U.S.C. § 78bb(f)(1)(A)(2000).
74. *Id.*
75. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738 (1975).
76. *Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 126 S. Ct. at 1509.
77. *Id.*

incides" with a securities transaction by someone other than the plaintiff.[78] According to the Court, Congress endorsed this broad construction of the reach of Section 10(b) when it enacted SLUSA. The Court therefore concludes that Section 10(b) broadly prohibits all "fraudulent manipulation of stock prices."[79] Second, the Court relies on the strong federal interest in regulating securities markets when it expands the reach of exclusive federal court jurisdiction over many securities fraud class actions. The possibility that state courts might be available to adjudicate securities fraud claims on behalf of non-purchasers or non-sellers "squarely conflicts" with "the congressional preference for 'national standards for securities class action lawsuits involving nationally traded securities.'"[80] Indeed, the Court supports its position by referring to SLUSA's House Report asserting that the "solution" to circumvention of the Private Securities Litigation Reform Act of 1995 (PSLRA) is "to make Federal court the exclusive venue for securities fraud class action litigation."[81] The Court leaves little room for local state regulation of securities.

In light of the Court's recognition of the importance of national standards for securities trading, its recent decision in *Dura Pharmaceuticals, Inc. v. Broudo*[82] can also be seen as an effort to limit the reach of state law in the area.[83] In *Broudo*, the Supreme Court unanimously held that the requirement of alleging "loss causation" in securities fraud actions under the PSLRA cannot be satisfied by mere allegations that investors purchased securities at an artificially inflated price. Although the issue in *Broudo* did not involve preemption, the Court stressed the national interest in regulating securities litigation. In particular, the Court disregarded state common law principles of causation and even modified federal pleading rules based on its allegiance to the principle of the efficiency of the national capital market.[84] The Court's definition of "investor loss" is dependent upon the Court's acceptance of the efficient movement of securities prices in the national capital market in response to the disclosure of fraud.[85] Moreover, the Court's extension of the PSLRA is based in part on its effort to curtail securities fraud litigation perceived to interfere with the efficient functioning of the national

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78. *Id.* at 1513 n.10 (quoting SEC v. Zandford, 535 U.S. 813, 819 (2002) ("[A] broker who accepts payment for securities that he never intends to deliver, or who sells customers securities with intent to misappropriate the proceeds, violates § 10(b) . . . ."); *see also* United States v. O'Hagan, 521 U.S. 642, 651-52 (1997) (analyzing attorney's liability for securities fraud even if no breach of duty to the victim).

79. *Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 126 S. Ct. at 1515.

80. *Id.* at 1514 (quoting Securities Litigation Uniform Standards Act § 2(5)).

81. *Id.* at 1514 n.12 (quoting H.R. REP. NO. 105-640, at 10 (1998)).

82. 544 U.S. 336 (2005).

83. *Id.* at 345.

84. *Id.* at 345-48.

85. *Id.*

capital markets.[86]

The Court's renewed respect for the interstate nature of the securities markets thus has led it to minimize any role played by state regulation and litigation in the field. That recent respect likely will lead the Court as well to accept the authority of the SEC to establish minimal standards for securities lawyers that include permitting such lawyers to reveal a client's confidences to prevent or rectify financial harm.

IV. PRIVATE RIGHTS OF ACTION AGAINST ATTORNEYS FOR FAILING TO BLOW-THE-WHISTLE

The Supreme Court's acceptance of the preemptive force of SEC Rules allowing securities lawyers to reveal client confidences to prevent or rectify financial harm, however, may leave the federal courts with little choice but to recognize a private right of action for an attorney's failure to reveal those confidences. The SEC, in its Rule, attempts to preclude any private action for damages based on an attorney's failure to "blow-the-whistle" by asserting:

> (a) Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based on compliance or noncompliance with its provisions.
>
> (b) Authority to enforce compliance with this part is vested exclusively in the Commission.[87]

This SEC Rule, however, does not, and cannot, abrogate private rights of action for securities fraud against attorneys. The Rule itself does not by its own terms *create* a private right of action. Nor does the Rule give to the SEC exclusive authority to remedy noncompliance with its provisions. The Rule merely gives the SEC power to "enforce compliance."[88] As such, this Rule is very similar to Congress's proclamation in the PSLRA that the statute does itself create a private right of action for securities fraud.[89] Neither the PSLRA nor the SEC's attorney conduct standards *abrogate* any private remedies for securities fraud that might otherwise exist.

In the wake of the SEC's new attorney conduct standards, a private remedy for securities fraud based on an attorney's failure to reveal client confidences indeed may otherwise exist. A private action for securities fraud under Section 10(b) and the PSLRA can be established against an attorney who with scienter makes a material misrepresentation or a material nondisclosure in breach of a duty to disclose that

86. *Id.*
87. 17 C.F.R. § 205.7 (2006).
88. *Id.*
89. *See* 15 U.S.C. § 78t-1(a) (1994).

causes economic loss to investors.[90] Attorneys, by virtue of their attorney-client relationship with the organizational client, invariably acquire knowledge, or at least have access to knowledge, of their client's material violation of the securities laws. As such, specific facts which give rise to a strong inference that an attorney acted with the requisite state of mind for securities fraud are not difficult to allege.[91] We have seen that courts have found attorneys liable for securities fraud where they have "made" material misstatements or have traded on material nonpublic information in breach of their duty to the source of that information. Traditionally, however, attorneys who had knowledge of their client's securities fraud and even had intent to deceive investors could not be liable for securities fraud by virtue of their mere failure to disclose that fraud. The SEC's new Rule authorizing attorneys to disclose their client's securities fraud in order to prevent or rectify financial harm to investors will alter that result. By failing to disclose a client's material securities law violation where doing so would prevent or rectify investor harm, attorneys will disregard the SEC's Rule authorizing them to do so. If that Rule is given national, preemptive force, attorneys will be unable to defend their failure to disclose their client's fraud by relying on their local, state law professional obligation of confidentiality. The preemptive effect of the SEC's Rule not only removes an attorney's defense of reliance on a state rule precluding disclosure, it also removes the rationale in cases like *Barker* for not holding lawyers to federal disclosure standards.

Moreover, an attorney who disregards the SEC Rule permitting disclosure of a client's fraud necessarily does so despite the fact that the nondisclosure will cause financial injury to investors. Hence, an attorney's failure to follow the SEC Rule is tantamount to an attorney's failure to disclose facts, the disclosure of which will prevent financial harm to investors. Put another way, the attorney's nondisclosure of the client's fraud in disregard of the SEC's Rule will necessarily cause financial injury to investors. Financial injury to investors in turn is indistinguishable from economic loss. As the Supreme Court suggested in *Broudo*, economic loss occurs when investors purchase securities at an artificially inflated price and then suffer a decline in value of their securities as the price declines when the fraud is disclosed. Investors who purchase securities at a market price that is uninformed by an ongoing fraud will commonly purchase at an artificially inflated price. When the truth is eventually disclosed and the market price drops as a result, investors may readily plead and prove "loss causation." Accordingly, the

90. *See Broudo*, 544 U.S. at 345-46.
91. The PSLRA requires such allegations. *See* 15 U.S.C. § 78t-1 (1994).

attorney's failure to disclose that "truth" in disregard of the SEC's disclosure Rule will in that circumstance cause the economic loss suffered by those investors.

The SEC Rule thereby either supplies the basis for an independent duty on lawyers to disclose the client's fraud, or—at a minimum—abrogates any defense that a lawyer might raise to the lawyer's failure to disclose facts that the lawyer knows will cause investor losses. The SEC Rule does not and need not create a private right of action. Yet that Rule does provide a duty, the breach of which by an attorney gives rise to a viable securities fraud claim against a lawyer for a failure to "blow-the-whistle."

An attorney's failure to disclose a client's securities fraud can give rise to a viable private action for damages under the federal securities laws, even if the attorney owes no duty directly to investors. As the Supreme Court made clear in *Dabit*, a lawyer can be liable for securities fraud by breaching a duty to disclose to persons other than investors.[92] In broadening the scope of Section 10(b) liability to include any act of deception that coincides with any securities transaction, the Court makes clear that attorneys may be liable even if their act of deception is not perpetrated on the actual purchaser or seller of securities. Indeed, in *United States v. O'Hagan*, the Court found a Section 10(b) securities fraud violation by an attorney who breached a duty to disclose running only to the client—the source of the information received.[93] The failure to disclose material facts to the source of the information supplied the element of deception requisite to a fraud claim even though that act of deception only later resulted in a purchase or sale of securities by third-party investors. As well, an attorney's failure to disclose a client's fraud in breach of a duty to disclose running to the SEC may supply the act of deception requisite to a viable securities fraud claim even though the attorney may owe no direct disclosure duty to the investors themselves.

If, therefore, the courts determine that the SEC's new attorney disclosure Rule has preemptive force, that determination may lead to the logical result that the SEC's national standard of attorney disclosure will give rise to a private cause of action for damages against attorneys for failing to disclose their client's fraud.

V. CONCLUSION

Prior to the SEC's new attorney disclosure Rule, the federal courts were loath to interpret the federal securities laws as a source of national standards for securities lawyers. Attorney disclosure obligations were

92. Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503 (2006).
93. United States v. O'Hagan, 521 U.S. 642, 651-52 (1997).

left to state laws and ethical rules. The state laws and ethical rules created a patchwork of disclosure obligations. In SOX, Congress authorized the SEC to create a national standard for attorney disclosure. The disclosure standard adopted by the SEC is in tension with state regimes precluding attorneys from "blowing-the-whistle" on clients. Yet, the Supreme Court recently suggested that national preemptive standards are appropriate in the context of the regulation of securities markets and litigation. If that trend continues, the SEC's disclosure standard as well will be given national, preemptive force. By giving the SEC's attorney disclosure standard preemptive effect, the courts may begin a chain of logic that ends in the recognition of a private right of action against lawyers for losses caused to investors by their failure to disclose their clients' fraud. The courts may well convert lawyers from fiduciaries of their clients to fiduciaries of the national securities markets. To nationalize securities regulation is to come close to nationalizing securities lawyers.