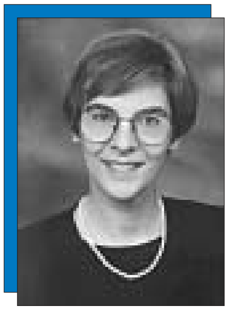

What Impact Will the New SEC Rules Have on the Attorney-Client Privilege?

By Leslie Wharton
Arnold & Porter, Washington, D.C.

The attorney-client privilege is based on public policy. As the Supreme Court explained in *Upjohn*, the privilege exists "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."[1] The privilege exists because it is assumed that clients will not be completely candid with counsel or seek legal advice when needed unless they know that their communications with counsel will be secure from disclosure. Counsel's duty to protect attorney-client communications from disclosure and the correlative attorney-client privilege are therefore essential tools in ensuring that corporate clients get the advice they need in order to comply with the law. But clients will not have the assurance of confidentiality they require for "full and frank communication" with counsel if the privilege can easily be abrogated. As the Supreme Court noted, "[A]n uncertain privilege, or one which purports to be certain but results in widely varying applications . . . is little better than no privilege at all."[2]

Section 307 of the Sarbanes-Oxley Act of 2002 authorizes the Securities and Exchange Commission (SEC) to issue rules "setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission." In February 2003, the SEC published rules implementing the Sarbanes-Oxley-mandated up-the-ladder reporting requirements for Attorneys.[3] Those rules set up internal reporting requirements designed to ensure that evidence of any material violation of the securities or other laws reaches the chief legal officer (CLO), senior executives, or the board of directors, and that an internal investigation of the suspected wrongdoing is conducted and appropriate corrective action taken if wrongdoing is discovered. The SEC also proposed a "noisy withdrawal" rule requiring counsel to withdraw from representing the client and disaffirm any statement made to or filing made with the SEC that is materially false or misleading.

Although members of the bar have been critical of many aspects of the proposed rules, they have expressed almost overwhelming opposition to the noisy withdrawal provision. This opposition is based on the belief that the noisy withdrawal rule, by requiring counsel to disclose attorney-client communications, may undermine the trust and confidentiality on which the attorney-client relationship depends. As a result of the negative comments received on the proposed noisy withdrawal provisions, the SEC has extended the comment period on that proposal and offered an alternate disclosure rule for comment.[4]

Lawyers who represent a publicly traded company (issuer),

More on Sarbanes-Oxley, Attorney-Client Privilege, and Reporting Requirements with Leslie Wharton

By Michael Kline

In your article, you warn against the erosion of the protections of the attorney-client privilege vis à-vis new SEC regulations. Why do you think the "powers that be" have chosen this moment to narrow the scope of the privilege?

I think that the SEC has wished that it could look to attorneys as gatekeepers for a long time, because it views the function of the attorney as not only advising and representing clients, but also as acting as a policeman and essentially preventing clients from going too far outside the straight and narrow. I think what we've seen with Enron, WorldCom, and other corporate scandals over the past few years is tremendous anxiety by the SEC, because it believes that, but for lawyers, these scandals could not have occurred and that the ultimate failure was the failure of the lawyers in these individual cases to function as policemen for that sort of behavior.

I'm not saying that the SEC hasn't thought of this before, or that this is a brand-new idea, but I think that scandals such as Enron and WorldCom not only led to the congressional enactment of the Sarbanes-Oxley Act, but also are very much the motivating force for these new rules. Remember that the SEC up-the-ladder reporting rules are mandated in Sarbanes-Oxley. Those rules are congressionally mandated. The SEC went beyond the internal reporting requirements in Sarbanes-Oxley and gave lawyers permission to

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or a subsidiary or affiliate of an issuer, need to give careful thought to how the attorney-client privilege, and therefore their practice as attorneys, will be affected by the new rules governing attorney conduct being issued by the SEC. These rules apply not only to securities lawyers, but to any lawyer who represents an issuer before the SEC, makes representations to the SEC, or provides advice on any documents that are filed with or submitted to the SEC.[5] The rules preempt all conflicting laws or rules,[6] and give the SEC exclusive jurisdiction to bring disciplinary proceedings or civil actions against an attorney for failing to comply with the rules.[7] Because these rules change the operating assumptions that govern the attorney-client relationship, they have the potential to affect profoundly the ability of counsel to provide fully informed legal advice to their issuer clients.

The Up-the-Ladder Reporting Rules

The up-the-ladder reporting rules go into effect on August 5, 2003. These new rules require an attorney who learns of evidence of a material violation to report that evidence to the CLO, Chief Executive Officer (CEO), or equivalent, who must then initiate an investigation and, if a material violation is discovered, take steps to ensure that it is dealt with appropriately and inform the reporting attorney of the results of the investigation.[8] The up-the-ladder reporting requirement does not require counsel to disclose attorney-client communications to anyone outside of the corporation. For this reason, many commentators believe that it will have little effect on the attorney-client relationship. Overlooked, perhaps, are two provisions that may well result in the disclosure of client confidences.

First, the new rule expressly invites counsel to disclose client confidences. Section 203.5(d)(2) permits an attorney to “reveal to the Commission without the issuer’s consent, confidential information related to the representation to the extent the attorney reasonably believes necessary” to prevent the issuer from a material violation likely to cause significant financial injury to the issuer or investors, to prevent the issuer from committing perjury or a fraud on the Commission, or to “rectify the consequences of a material violation.”[9] Although this rule is strictly permissive, in conjunction with other provisions that purport to preempt any conflicting rule or duty,[10] it eliminates any impediment to the disclosure of privileged information. Many states have adopted rules of professional conduct that permit or require an attorney to disclose client confidences if the attorney believes disclosure is necessary to prevent or rectify substantial financial injury. However, the impact of these rules on the attorney-client relationship has not yet been determined, because they do not appear to have been tested in practice. Furthermore, the new SEC rule permits attorneys to disclose client confidences “without the issuer’s consent.” Under this rule, issuer-clients can have no assurance that they will be given notice and an opportunity to convince misguided attorneys that their assumptions are in error and that no disclosure is warranted.

Second, Section 205.6 of the new rule gives the SEC the power to sanction attorneys who do not comply with its up-the-ladder reporting requirements. As a practical matter, this gives the SEC the power to require an attorney who participated in up-the-ladder reporting, or who the SEC believes should have engaged in such reporting, to disclose attorney-client communications in order to defend the attorney’s own actions.[11] Of course, the SEC will have little reason to question attorney compliance unless it believes that the client-issuer has violated the law. Thus, the new rule gives the SEC the power to force attorneys to disclose privileged information in their own self-defense at the very time the SEC is proceeding against the client-issuer for substantive violations of the law. To be sure, the SEC historically has been hesitant to bring disciplinary proceedings against counsel. In the post-Enron environment, however, the SEC may be more inclined to proceed against counsel, whose failure as “gatekeepers” the SEC views as a major contributor to issuer non-compliance.

The SEC’s Proposed Disclosure Rules

If the rules already adopted by the SEC open the door to the disclosure of attorney-client confidences, the proposed noisy withdrawal and issuer disclosure rules threaten to do so even more.

The proposed noisy withdrawal rule requires an attorney retained by the issuer who prepares a submission to or filing with the Commission and who “reasonably believes” that a “material violation is ongoing or is about to occur” and that the material violation is “likely to result in substantial injury to the financial interest or property of the issuer or of investors” to do three things:

- withdraw from representing the issuer;
- provide written notice to the Commission indicating that counsel’s withdrawal is based on “professional considerations;” and
- “promptly disaffirm to the Commission” the content of the submission or filing that the attorney prepared or assisted in preparing and that the “attorney reasonably believes is or may be materially false or misleading.”[12]

An attorney employed by the issuer is not required to withdraw from the representation but must notify the Commission in writing of her intent to disaffirm and then “promptly disaffirm” in writing.[13] An attorney may not simply disaffirm a submission or filing in general, but must “disaffirm . . . any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document.”[14] The SEC takes the position that this rule “does not breach the attorney-client privilege.”[15]

Some have taken the position that the proposed noisy withdrawal rule is consistent with the ABA Model Rules. For instance, ABA Model Rule 4.1, Comment 3, prohibits an attorney from counseling or assisting a client in conduct that “the lawyer knows is criminal or fraudulent,” and acknowledges that “it may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm an opinion, document, affirmation, or the like." ABA Model Rule 1.16(a)(1) requires an attorney to withdraw if the lawyer's services will be used by the client in materially furthering a course of criminal or fraudulent conduct, and permits the lawyer to withdraw or disaffirm any opinion, document, affirmation or the like.[16] However, the conditions that permit an attorney to disaffirm under the Model Rules are sufficiently general that counsel may be able to withdraw and disaffirm without actually disclosing attorney-client confidences.

In contrast, the detailed preconditions for a noisy withdrawal leave no room for doubt about the reason for counsel's withdrawal. In withdrawing for "professional considerations," and disaffirming a statement in a filing or submission, an attorney is affirmatively stating that he or she "reasonably believes" that a "material violation" has occurred, is ongoing, or is about to occur and that the material violation is "likely to result in a substantial injury to the financial interest or property of the issuer or of investors." The attorney is also affirmatively stating that the client has been so informed and has failed to respond "appropriately." Since the rule only permits counsel to disaffirm if counsel has advised the client of the material violation and the client has failed to make an "appropriate response" or respond in a reasonable time, a noisy withdrawal is also an affirmative statement about the issuer's knowledge and intent. Finally, counsel is stating that the disaffirmed statement is directly related to and in furtherance of that material violation. Because the noisy withdrawal rule, by its terms, forces counsel to disclose the substance of communications with the client-issuer and to affirmatively testify about the issuer's knowledge and intent, the noisy withdrawal rule goes far beyond that currently permitted under the ABA Model Rules.

Given the heated opposition to the noisy withdrawal provisions, the SEC has offered for comment an additional proposal in which the issuer, rather than the attorney, would be required to notify the SEC of an attorney's withdrawal "and the circumstances related thereto on Form 8-K, 20-F, or 40-F."[17] The SEC has offered this alternative as a way of permitting counsel to fulfill their duty of confidentiality and preserve the attorney-client privilege.

The alternative proposed rule does not obviate any of the problems associated with the noisy withdrawal provision; it compounds them. An attorney's unauthorized disclosure of privileged information does not prevent the client from continuing to claim privilege for the same information. Only the client can waive the privilege. If the client voluntarily discloses privileged information in complying with this proposed disclosure rule, that disclosure will be treated as a waiver. Furthermore, the alternate proposed disclosure provision would come into play only when the issuer disagrees with withdrawing counsel's opinion and believes the withdrawal is unnecessary. In explaining the "circumstances" of counsel's withdrawal, the issuer will almost certainly be forced to disclose withdrawing counsel's opinions, the information on which those opinions were based, and—unless the issuer's "innocence" is self-evident—the advice of other counsel, and the results of their investigation, to establish that the withdrawing attorney is in error and the issuer is not in material violation of the law. Because any such disclosure would be voluntary, it would not only effect a waiver for the privileged information disclosed, but almost certainly for all other privileged information on the same subject matter.[18]

Conclusion

Both the rules already adopted by the SEC and the proposed rules will have a significant impact on the attorney-client privilege and therefore the relationship between issuers and their counsel. The full extent of the impact will depend very much on how the SEC applies and interprets these rules in practice. If the rules increase issuers' uncertainty about protecting attorney-client confidences, it is possible, perhaps even likely, that issuers will find it more difficult to seek and obtain fully informed legal advice. This chilling effect may ultimately affect their ability to comply with the securities laws. ■

Leslie Wharton is a litigation partner in the Washington, D.C. office of Arnold & Porter. Ms. Wharton has spent the past six years litigating privilege claims in courts throughout the country and advising clients on best practices for protecting attorney-client communications.

Endnotes

1. *Upjohn Company v. United States*, 449 U.S. 383, 389 (1981).
2. *Id*. at 393.
3. 68 Fed. Reg. No. 25 (Feb. 5, 2003): 6296-6323 (covering 17 CFR Parts 205, 240, and 249).
4. Implementation of Standards of Professional Conduct for Attorneys: Rel. No. 33-8186 (hereinafter Proposed Rule), located at www.sec.gov/rules/proposed/33-8186.htm. The electronically filed comment letters are available at this Web site address.
5. 17 CFR § 205.2(a).
6. See, 17 CFR §§ 205.1, 205.6(c), and 205.7(a).
7. 17 CFR § 205.6.
8. 17 CFR § 205.3(b).
9. 17 CFR 205.3(d)(2).
10. See, 17 CFR 205.1 (which preempts conflicting state or federal law), 17 CFR 205.6(c) (which exempts an attorney from liability or disciplinary sanctions for good faith compliance), and 17 CFR 205.7(a) (which states that the rule is not intended to create a private right of action against an attorney).
11. 17 CFR 205.3(d)(1) provides that an attorney may disclose privileged information to defend against accusations of non-compliance.
12. Proposed Rule 205.3(d)(1)(i).
13. Proposed Rule 205.3(d)(1)(ii).
14. Proposed Rule 205.205.3(d)(1)(i)(c) and (ii)(B) and, for past violations that are no longer ongoing, 205.3(d)(2)(i)(c) and (ii)(B).
15. Proposed Rule 205.3(d)(3).
16. ABA Model Rule 1.16 at Comment 6.
17. Proposed Rule 205.3(e).
18. See, e.g., *Brownell v. Roadway Package Sys.*, 185 F.R.D. 19, 25 (N.D.N.Y. 1999).