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The SEC, the States and Attorney Conduct Rules: An Analysis of Preemption Issues

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NOTE

THE SEC, THE STATES AND ATTORNEY CONDUCT RULES: AN ANALYSIS OF PREEMPTION ISSUES

I. INTRODUCTION

Following the implosion of Enron, WorldCom, and other corporate behemoths due to corporate malfeasance, policy-makers,[1] academics,[2]

1. *See* Demetri Sevastopulo, *Enron Task Force Slowly Closes in on Higher Level Targets: Investigation Has Its Critics but Gradual Progress is Being Made*, FIN. TIMES, Dec. 4, 2002, at 2.

2. *See, e.g.*, Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J.L. & PUB. POL'Y 195 (2003); Andrew F. Kirkendall, *Filling in the GAAP: Will the Sarbanes-Oxley Act Protect Investors from Corporate Malfeasance and Restore Confidence in the Securities Market?*, 56 SMU L. REV. 2303 (2003); Andre Douglas Pond Cumming, *The Integration Conundrum: Debilitating Failures of the Securities and Exchange Commission Must Be Addressed as U.S. Corporate Malfeasance is "Getting Serious, So Serious,"* 48 WAYNE L. REV. 1305 (2003); Larry E. Ribstein,

and regulatory bodies[3] sought to reassess securities industry practices and regulations. First, it was the accountants. As a result of Arthur Andersen's role in the malfeasance, the big five accounting firms dwindled down to the final four.[4] Given that the frauds perpetuated by these entities centered on shoddy accounting practices and rosy balance sheets, Congress boldly substituted the self-regulatory scheme that traditionally governed accountants with the Public Company Accounting Oversight Board.[5]

Congress did not stop with accountants. Attorneys also played a role in the malfeasance, so they too were targeted.[6] Congress, via congressional mandate in Section 307 of the Sarbanes-Oxley Act of 2002,[7] instructed the Securities and Exchange Commission ("SEC") to "issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys

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Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 IOWA J. CORP. L. 1 (2002).

3. For recent discussion on the initiatives of regulatory bodies see generally, Karen Contoudis, Note, *Analyst Conflicts Of Interests: Are The NASD and NYSE Rules Enough?*, 8 FORDHAM J. CORP. & FIN. L. 123 (2003); Karessa Cain, *New Efforts To Strengthen Corporate Governance: Why Use SRO Listing Standards?*, 2003 COLUM. BUS. L. REV. 619; Jillian M. Lutzy, *Analysis of the Proposed NYSE Corporate Governance and Audit Committee Listing Requirements*, 2 DEPAUL BUS. & COMM. L.J. 99 (2003).

4. *See* Stephen C. Gara and Craig J. Langstraat, *The Sarbanes-Oxley Act of 2002: A New Ballgame for Accountants*, 34 U. MEM. L. REV. 73, 112 (2003). For a discussion on the jury conviction of Arthur Andersen on obstruction of justice charges, see generally, Stephan Landsman, *The Jury In Practice: Death Of An Accountant: The Jury Convicts Arthur Andersen Of Obstruction Of Justice*, 78 CHI.-KENT. L. REV. 1203 (2003) (arguing that the Andersen verdict may be a watershed in American legal thinking about the misconduct of large corporations and their advisors).

5. *See* Judith Burns, *Attorneys Face a Paradox in the SEC's Conduct Rules*, WALL ST. J., Aug. 19, 2003, at C1.

6. Specifically, the Houston based law firm of Vinson & Elkins, who represented Enron in certain off-shore transactions, was targeted. *See* Carrie Johnson, *House Panel To Question Enron's Attorneys*, WASH. POST, Mar. 14, 2002, at E1. Corporate attorneys have been suspected of furthering the fraud of their clients since the Securities and Exchange Commission's inception. As Former SEC commissioner and Supreme Court Justice William O. Douglas artfully noted:

> [J]ust as a fine, natural football player needs coaching in the fundamentals and schooling in the wiles of the sport, so, too, it takes a corporation lawyer with a heart for the game to organize a great stock swindle or income tax dodge and drill the financiers in all the precise details of their play. Otherwise, in their natural enthusiasm to rush in and grab everything that happens not to be nailed down and guarded with shotguns they would soon be caught offside and penalized, and some of the noted financiers who are now immortalized as all-time and all-American larcenists never would have risen beyond the level of the petty thief or short-change man.

William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1329 (1934) (quoting Westbrook Pegler, N.Y. WORLD TELEGRAM, Jan. 24, 1923, at 19).

7. Pub. L. No. 107-204, § 307, 116 Stat. 745 (2002) [hereinafter "Sarbanes-Oxley"].

appearing and practicing before the Commission in any way in the representation of issuers."[8]

This Note will explore the SEC's attempt to regulate the conduct of attorneys practicing before it, which until now has been a right that the states, for the most part, have assumed.[9] Recently enacted SEC rules require attorneys to report "evidence" of wrongdoing up the corporate chain of command to corporate directors and officers.[10] One part of the SEC's proposed rule-making that is still pending adoption even requires attorneys to report misconduct to the SEC itself,[11] the so-called "noisy withdrawal" or "reporting out" requirement.[12] The American Bar Association ("ABA") and other critics of the proposed new law, however, believe that the SEC has invaded their authority by exploiting the recent congressional delegation of power.[13] This debate is still open and several legal issues remain unresolved.[14]

The scope of this debate is wide-ranging and could potentially affect the way in which attorney conduct is governed in the future. When the SEC initially proposed its professional conduct rules under Section 307, many law firms, academics, and regulators expressed important concerns regarding the scope and consequences of such a rule. Over 167 comments were received and published on the SEC's website, many of which were concerned with the SEC's regulation of attorney conduct and preemption of state ethics rules.[15]

For instance, in a comment to the SEC, the New York State Bar Association wrote with respect to the preemption issue: "[d]espite the indisputable importance of this question, the SEC scarcely addresses the question. In the 73-page adopting release, the SEC never confronts the question head-on . . . [t]he SEC simply 'reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state.'"[16] Another commentator suggested that "the Commission must address the issue of

8. *See id.*

9. *See infra* notes 28-31 and accompanying text.

10. Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296-01 (to be codified at 17 C.F.R. pt. 205) [hereinafter "Final Rule"].

11. *See id.*

12. *See* Gary Young, *Corporate-Fraud Statute: A New Source of Lawyer Regulation*, NAT'L L.J., Aug. 5, 2002, at A19. This Note will use these terms interchangeably.

13. *See id.*

14. *See* Susan P. Koniak, *When The Hurlyburly's Done: The Bar's Struggle With The SEC*, 103 COLUM. L. REV. 1236, 1237 (2003) ("This saga is not yet over; that much is true.").

15. *See* Final Rule, *supra* note 10.

16. Comment of The Association of the Bar of the City of New York, April 7, 2003, *at* http://www.sec.gov/rules/proposed/s74502.shtml (last visited Nov. 20, 2003).

whether the Proposed Rules could or should preempt state ethics rules."[17]

The purpose of this Note is to discuss the powers and authority of both governmental entities, and analyze both the states' and the SEC's position with respect to the preemption issue. Central to this debate is the organized bar associations' opposition to reporting requirements in the newly enacted corporate-fraud statute, which will be discussed below in greater detail.[18] Several bar associations have been critical of the SEC's proposals.[19] This is due in large part to the potential conflicts with state legal ethics rules that may arise as a result of the SEC's reporting requirements.[20] In response to state bar criticisms, the SEC has taken a firm position regarding their authority to preempt contrary state ethics rules.[21] While the debate remains unresolved, it may have broader ramifications in future administrative agency rule-making efforts.

Part II generally discusses the SEC's authority to regulate the securities markets,[22] and then focuses on the relevant congressional delegation of authority and the SEC's rulemaking authority.[23] Additionally, the SEC's attempts to regulate professionals that practice before it, such as attorneys and public accountants, are explored. The SEC's prior attempts, beginning in the 1970s and continuing as a result of recent corporate malfeasance, are discussed.[24] It becomes clear that the SEC's desire to regulate attorney conduct has been long-standing and persistently on the Commission's agenda. This provides the proper context to discuss the SEC's recent efforts.

Part III discusses the attorney confidentiality rules that are the subject of the SEC's action.[25] The Sarbanes-Oxley congressional

17. Comment of Nancy B. Rappaport, Dean and Professor of Law, University of Houston Law Center, December 18, 2002, *at* http://www.sec.gov/rules/proposed/s74502/nbrapoport1.htm (last visited Nov. 20, 2003).

18. *See infra* notes 169-193 and accompanying text.

19. *See, e.g.*, Sue Reisinger, *Two State Bars Protest SEC Rule; Calif., Wash. Dislike 'Reporting Out'*, NAT'L L.J., Sept. 15, 2003, at 1.

20. *See id. See* also Sue Reisinger, *California and Washington State Bars Protest SEC Rule*, RECORDER, Sept. 23, 2003, at 9.

21. *See infra* notes 187-229 and accompanying text.

22. *See infra* notes 28-31 and accompanying text.

23. *See, e.g.*, Sarbanes-Oxley, *supra* note 7.

24. For a discussion on these early SEC attempts see Dennis J. Block & Jonathan M. Hoff, *SEC Adopts Professional Conduct Standards for Attorneys*, N.Y. L.J., Apr. 24, 2003 (citing Edward F. Greene, Lawyer Disciplinary Proceedings before the Securities and Exchange Commission, Remarks to the New York County Lawyers' Association (Jan. 18, 1982), Fed. Sec. L. Rep. (CCH) ¶ 83,089).

25. *See infra* notes 88-92 and accompanying text.

delegation of power and the rules the SEC subsequently adopted pursuant to the delegation are explored.[26] Further, the details of the legislative mandate and the procedures attorneys are now required to pursue when confronted with corporate malfeasance are illustrated.

Part IV analyzes the federal preemption doctrine.[27] This includes a discussion of the Constitution's Supremacy Clause,[28] and the differences between explicit and implicit preemption. The Supreme Court cases discussing preemption will be analyzed to formulate a step-by-step preemption analysis. This Part then discusses the legal opinions issued by the Washington Bar Association ("Washington Opinion")[29] and the Corporations Committee of the California State Bar ("Corporations Committee").[30] These two powerful expressions of state authority are important to understanding the states' position in the debate.

Part V analyzes the conflict between SEC and state rules in light of Supreme Court precedent. This Part reduces the Supreme Court's preemption jurisprudence to several principles and applies these principles to the conflict at hand. In applying these principles, and assessing the legislative history of Sarbanes-Oxley relating to the congressional delegation to the SEC in Section 307, it becomes apparent that a court will likely hold that the SEC's permissive reporting out rule preempts contrary state ethics rules. Part VI ultimately concludes that the positions articulated by the Washington and California Bar Associations are contrary to undisputed principles traditionally and consistently applied by the Supreme Court in its long-standing preemption jurisprudence.

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26. *See* Sarbanes-Oxley, *supra* note 7.

27. *See infra* notes 130-132 and accompanying text.

28. U.S. CONST. art. VI, cl. 2. The Supremacy Clause states, "[t]his Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

29. *See* Interim Formal Ethics Opinion Re: The Effect of the SEC's Sarbanes-Oxley Regulations On Washington Attorneys' Obligations Under the RPCs (As approved and adopted by WSBA Board of Governors on July 26, 2003), *at* http://www.wsba.org/lawyers/groups/ethics2003/formalopinion.doc (last visited Feb. 12, 2004) [hereinafter Washington Bar Opinion].

30. *See* Letter from the Corporations Committee of the Business Law section of the State Bar of California to Giovanni P. Prezioso, U.S. Securities and Exchange Commission (Aug. 13, 2003), *at* http://dwalliance.com/sbar/SEC.PDF (last visited Feb. 12, 2004) (regarding the effect of the SEC's Attorney Conduct Rules) [hereinafter "California Letter"].

II. BACKGROUND ON SEC AUTHORITY

Pursuant to the Securities Exchange Act of 1934 ("Exchange Act"),[31] Congress created the SEC to oversee and regulate the securities markets.[32] Congress also empowered the SEC to enforce the provisions of the Exchange Act. Most importantly, and of relevance to this Note, Congress granted the SEC rule-making authority.[33] Section 23(b) of the Exchange Act grants broad authority to the SEC to adopt rules and regulations "as may be necessary or appropriate," to implement the Exchange Act.[34] Congress conferred this broad authority to adopt rules that further the public interest.

A. *The SEC's Rule-Making Authority*

Section 23(a) of the Exchange Act grants broad rule-making authority to the SEC and provides the Agency with the

> power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title for which they are responsible or for the execution of the functions vested in them . . . and may for such purposes classify persons, securities, transactions, statements, applications, reports and other matters within their respective jurisdictions and prescribe greater, lesser, or different requirements for different classes thereof.[35]

This rule-making authority has been questioned, challenged, affirmed and struck down.[36] Nevertheless, this delegation of rule-making power has served as the SEC's source of authority.[37]

Case law has impeded the SEC's ability to promulgate rules concerning securities fraud and the regulation of accountants.[38] The courts have generally recognized that it is appropriate for the SEC to

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31. 15 U.S.C. § 78w(a) (2004).

32. *See* SEC, *The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity* (modified July 21, 2003), *available at* http://www.sec.gov/about/whatwedo.shtml.

33. *See* 15 U.S.C. § 78w(a).

34. *See id.*

35. *Id.*

36. For more on this controversial area see *supra* notes 33-35 and accompanying text, and *infra* notes 37-48 and accompanying text.

37. For a discussion on the SEC's rule-making authority, see generally Ely R. Levy, *The Law and Economics of IPO Favoritism and Regulatory Spin*, 33 SW. U.L. REV. 185, 209-10 (2004).

38. *See, e.g.*, U. S. v. Chestman, 947 F.2d 551, 557 (2d Cir. 1991) (restricting the SEC's rulemaking authority with respect to insider trading rules). *See also* Davey v. SEC, 792 F.2d 1418, 1422 (9th Cir. 1986) (granting agencies the power to police the conduct of those who practice before them or participate in their programs).

protect the integrity of its processes, and to encourage professionals to maintain minimum standards of competence.[39] There have been instances, however, where the SEC's authority in this respect has been questioned and challenged.

For instance, in *Davy v. SEC*[40] the SEC found that a certified public accountant had engaged in improper professional conduct and had willfully violated the federal securities laws by certifying inaccurate financial statements.[41] Davy, the accountant, argued that Rule 2(e)[42] under which his actions were banned, was beyond the SEC's statutory authority.[43] The Ninth Circuit Court of Appeals held that the SEC did in fact have authority to police the conduct of those who practice before it or participate in their programs.[44] The court found that the SEC's rule-making is a necessary adjunct to the Commission's power to protect the integrity of its administrative procedures and the public in general.[45]

A similar challenge occurred in *United States v. Chestman*.[46] In Chestman, the defendant bought shares of a company after he received information from a client that the company was about to be sold.[47] The defendant claimed that Rule 14e-3(a), a rule prohibiting trading based on insider knowledge of a tender offer, was invalid because the SEC had exceeded its statutory authority by promulgating a rule that dispensed with one of the common law elements of fraud.[48] The district court rejected the argument, however, and the defendant was convicted of insider trading in violation of several SEC anti-fraud rules including Rule 14e-3(a),[49] Rule 10b-5,[50] and 18 U.S.C. § 1341.[51] On appeal, the Second Circuit held that the SEC had been given broad authority to

39. *See* Touche Ross & Co. v. SEC, 609 F.2d 570 (2d Cir. 1979) (holding that Rule 2(e) was validly promulgated pursuant to the Commission's "broad authority" to adopt rules and regulations necessary to carry out the Commission's designated functions).

40. 792 F.2d 1418 (9th Cir. 1986).

41. *See id.* at 1419.

42. 17 C.F.R. § 201.2 (2004).

43. *See* Davey, 792 F.2d at 1419.

44. *See id.* at 1422.

45. *Id.* at 1421-22.

46. 947 F.2d 551 (2d. Cir. 1991).

47. *See id.*

48. *See id.* at 556.

49. 17 C.F.R. § 240.14e-3(a) (2004).

50. 17 C.F.R. § 240.10b-5 (2004).

51. *See Chestman*, 947 F.2d at 554.

promulgate rules that would prohibit tender offer insider trading, and had not exceeded its authority in promulgating Rule 14e-3(a).[52]

These challenges notwithstanding, the general rule-making authority pursuant to Section 23 has been relatively unfettered. The SEC has used this delegation as its primary mechanism in promulgating rules and policies.[53] The SEC's rulemaking in the specific context of professional conduct has been, and still is, more controversial.

B. Regulating Professional Conduct: Past and Present

The SEC has its own rule governing the conduct of professionals that practice before it: Rule 102(e), formerly Rule 2(e), of the Commission's Rules of Practice.[54] The authority of the SEC to promulgate and enforce this rule has been consistently upheld pursuant to its "broad authority" to adopt rules and regulations necessary to carry out the Commission's functions.[55] This rule functions as a "means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence."[56] Rule 102(e) does not establish professional standards, yet it enables the SEC to discipline professionals engaging in improper conduct by failing to satisfy rules, regulations, or standards to which they are already subject.[57] This rule

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52. *See id.* at 570. The defendant, however, could not be convicted for Rule 10b-5 or 18 U.S.C. § 1341 violations since he owed no fiduciary duty to the company nor did his client. As a result, the court affirmed defendant's conviction under Rule 14e-3(a), but reversed his convictions for Rule 10b-5 and 18 U.S.C. § 1341 violations.

53. *See* Touche Ross & Co. v. SEC, 609 F.2d 570 (2d Cir. 1979).

54. 17 C.F.R. § 201.102(e) (2004). Rule 2(e), the predecessor to Rule 102(e), was promulgated in 1935. Rule 2(e) was redesignated Rule 102(e) in 1995. This rule will be referred to throughout this Note as Rule 102(e).

55. *See Touche Ross & Co.*, 609 F.2d at 570; *Davy*, 792 F.2d at 1418 (holding that the SEC had statutory authority to adopt Rule 102(e)); Checkosky v. SEC, 23 F.3d 452, 456 (D.C. Cir. 1994) (stating that "[t]here can be little doubt that the Commission, like any other institution in which lawyers or other professionals participate, has authority to police the behavior of practitioners before it") (Silberman, J., quoting Polydoroff v. ICC, 773 F.2d 372, 374 (D.C. Cir. 1985)).

56. *Touche Ross & Co.*, 609 F.2d at 582.

57. 17 CFR 201.102(e)(2) and (f)(2). The statute reads, in relevant part, as follows:

> (e) Suspension and disbarment. (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:
>
> (i) Not to possess the requisite qualifications to represent others; or
>
> (ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or
>
> (iii) To have willfully violated, or willfully aided and abetted the violation of any

has traditionally allowed the SEC to initiate disciplinary proceedings against attorneys who violate federal securities law. The rule also allows the SEC to use appropriate sanctions including censure, temporary suspension, and permanent bar.[58]

In the late 1970s, the SEC was confronted with issues relating to the responsibilities of attorneys to report misconduct of their public company clients. In In re *Keating, Muething & Klekamp*,[59] the Commission instituted and settled a Rule 102(e) proceeding against a law firm which had prepared SEC filings for a financial client.[60] The SEC concluded that virtually every practicing member of the law firm was privy to the fact that disclosures contained in the client's disclosure filings were fraudulent and misleading.[61] Furthermore, the attorneys knew or had reason to know that the internal procedures at the firm were inadequate to ensure that this information was properly evaluated in connection with the firm's preparation of SEC filings.[62] The Commission specifically noted that law firms have a duty "to make sure that disclosure documents filed with the Commission include all material facts about a client of which it has knowledge as a result of its legal representation of that client."[63] This case planted the seed for the SEC's first genuine attempt to regulate attorney conduct.

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provision of the Federal securities laws or the rules and regulations thereunder.

(iv) With respect to persons licensed to practice as accountants, "improper professional conduct" under § 201.102(e)(1)(ii) means:

(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or (B) Either of the following two types of negligent conduct:

(1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.

(2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission. . . .

(3) Temporary suspensions. An order of temporary suspension shall become effective upon service on the respondent. No order of temporary suspension shall be entered by the Commission pursuant to paragraph (e)(3)(i) of this section more than 90 days after the date on which the final judgment or order entered in a judicial or administrative proceeding described in paragraph (e)(3)(i)(A) or (e)(3)(i)(B) of this section has become effective, whether upon completion of review or appeal procedures or because further review or appeal procedures are no longer available.

58. 17 C.F.R. 201.102(e)(2) and (f)(2).
59. 47 S.E.C. 95 (July 2, 1979).
60. *See id.*
61. *See id.*
62. *See id.*
63. *Id.*

Following the line of argumentation in *Keating*, the SEC again pursued attorney misconduct. In *SEC v. National Student Marketing Corp.*,[64] National Student Marketing Corporation consummated a merger with Interstate National Corporation, an insurance company.[65] Shortly after the merger was completed the value of the publicly traded stock dramatically decreased.[66] The attorneys, who negotiated and issued opinions in approval of the merger, were targeted.[67] The SEC brought an enforcement action arguing that

> the attorneys should have refused to issue the opinions in view of the adjustments revealed by the unsigned comfort letter, and after receipt of the signed version, they should have withdrawn their opinion with regard to the merger and demanded resolicitation of the Interstate shareholders.[68]

Essentially, the SEC's enforcement effort centered on the fact that the attorneys failed to take action against the fraud and issued an opinion that was not withdrawn after fraud was apparent.[69] The court, however, rejected the SEC's arguments and found that the activities of the lawyers did not facilitate the merger.[70] The court ultimately refused to impose liability on the attorneys.[71]

In In re *Carter & Johnson*,[72] two attorneys failed to correct company press releases and earnings reports that were later determined to be misleading. An SEC administrative law judge found the attorneys liable for aiding and abetting their clients under the federal securities laws. On appeal, the SEC reversed the judge's decision because the appeals court held that Rule 102(e) did not clearly proscribe the conduct of the attorneys.[73] Consequently, the attorneys were let off without sanction.

Going forward, however, the SEC warned that it would expand the scope of Rule 102(e) to cover such situations. Specifically, in future instances, the rule would be interpreted as follows:

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64. 457 F. Supp. 682 (D.D.C. 1978).
65. *See id.* at 687.
66. *See id.* at 700.
67. *See id.* at 699.
68. *Id.* at 700-01.
69. *See id.* at 712.
70. *See id.* at 713.
71. *See id.*
72. 47 S.E.C. 471 (Feb. 1981).
73. *See id.* at *29-*31.

> When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance.[74]

With respect to attorney regulation, the administrative law judge indicated that the attorney can "counsel accurate disclosure" by the client. If the attorney learns of a discrepancy, the attorney is then required to take "more affirmative steps," including possibly a "direct approach to the board of directors or one or more individual directors or officers" or an attempt "to enlist the aid of other members of the firm's management" to correct the deficiency.[75]

Central to the *Carter & Johnson* decision was the Commission's solicitation of comments from the public regarding whether the scope of Rule 102 should modified.[76] Specifically, the SEC sought to expand the definition of "unethical or improper professional conduct" in Rule 102(e) and impose the aforementioned responsibilities on attorneys.[77] The very prospect of tinkering with standards regulating attorney conduct attracted harsh criticism and strong opposition from bar associations. The SEC's initiative to broaden the scope of Rule 102(e) as a means to regulate attorney conduct later failed. This was only the beginning of the festering debate.

Following this episode, the SEC's then general counsel, Edward Greene, criticized the effort to regulate attorneys.[78] In a speech by Greene to the New York County Lawyers' Association, he stated that the SEC lacks the time and expertise to promulgate a code for professionals, specifically attorneys who practice before it.[79] Furthermore, Greene suggested that the SEC focus its attention on bringing Rule 102(e)

74. *See id.* at *30.

75. *Id.* at *31.

76. *Id.* at *28.

77. *See* Request for Comments on Standard of Conduct Constituting Unethical or Improper Professional Practice Before the Commission, Exchange Act Release No. 18100, 1981 SEC LEXIS 730 at *2 (Sept. 21, 1981).

78. *See* Block & Hoff, *supra* note 24 (citing Edward F. Greene, Lawyer Disciplinary Proceedings before the Securities and Exchange Commission, Remarks to the New York County Lawyers' Association, (Jan. 18, 1982), Fed. Sec. L. Rep. (CCH) 83,089).

79. *See SEC Official's Speech Urging Narrow 2 (e) Approach*, LEGAL TIMES, Jan. 25, 1982 at 25.

proceedings against attorneys when the misconduct represents "a violation of established state law ethical or professional misconduct rules and has a direct impact on the Commission's internal processes."[80]

Along these lines, Greene stated:

> When the attorney's alleged misconduct is predicated on theories of aiding and abetting liability, as it almost always is when the conduct involves the preparation and filing of documents, and the Commission is also proceeding against the principals in a simultaneous injunctive action, I believe that the wisest course for the Commission to follow is to add the attorney to the injunctive action as a co-defendant. If that is not possible for unusual reasons, then an administrative proceeding under Rule [102(e)] could be commenced. And in those administrative proceedings based upon violations of standards of ethical or professional conduct, I believe that the Commission should use existing state law standards.[81]

This strict adherence to the state law ethics paradigm was the general position embraced by state bar associations, commentators, and practitioners. From the private bar's perspective, the SEC should never regulate or discipline attorney conduct absent a clear judicial determination that the lawyer has violated federal securities laws.

The SEC nevertheless refused to give up. In 1988, the SEC issued a release announcing adoption of an amendment to Rule 102(e) to provide for public proceedings initiated under the rule.[82] The SEC's main focus in this release was to conduct its Rule 102 proceedings in public.[83] The release contained a lengthy discussion supporting the SEC's conclusion that the benefit of conducting such proceedings in public outweighed the competing privacy concerns.[84] The SEC noted that it "has generally utilized Rule proceedings against attorneys only where the attorney's conduct has already provided the basis for a judicial or administrative order finding a securities law violation in a non-rule [102(e)] proceeding" thus adhering to Greene's advice and the bar associations' position articulated earlier.[85] This model of regulation was later altered

80. *See id.*

81. *See id.*

82. *See* Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, Exchange Act Release Nos. 33-6783; 34-25893; 35-24676; 39-2175, File No. S7-26-86 (July 7, 1988), *available at* 1988 S.E.C. LEXIS 1365.

83. *See id.*

84. *See generally id.*

85. *See supra* text accompanying footnotes 79-81.

when the SEC attempted to regulate attorney conduct outside the Rule 102 context.

For instance, in In re *Kern*,[86] an SEC administrative law judge concluded that a lawyer serving as outside counsel of a corporation failed to amend his client's prior filing with the SEC to reflect more recent developments during the course of a tender offer, thereby causing his client to violate the disclosure provisions of the Exchange Act. The SEC, citing to a lack of authority, discontinued the proceedings against the attorney.

In another decision, In re *Gutfreund, Strauss & Meriwether*,[87] an SEC judge concluded that a chief officer at a broker-dealer who was informed of a corporate officer's criminal wrongdoing had an obligation "to take affirmative steps to ensure that appropriate action is taken to address the misconduct," including "disclosure of the matter to the entity's board of directors, resignation from the firm, or disclosure to regulatory authorities."[88]

Similarly, in 1997, the SEC issued another report of investigation in a matter involving officers and directors of W.R. Grace Co.[89] The SEC concluded that these individuals failed to take action to ensure complete and prompt disclosure of substantial retirement benefits and compensation the corporation had agreed to pay to its former Chief Executive Officer in the company's annual report, a 10-K filing, and a proxy statement.[90] The SEC issued the report "to emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the federal securities laws."[91]

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86. 50 S.E.C. 596 (June 21, 1991).

87. 51 S.E.C. 93 (Dec. 3, 1992).

88. *Id.* at 113-14.

89. *See* Report of Investigation Pursuant to section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., 1997 S.E.C. LEXIS 2038 (Sep. 30, 1997). It is important to note that these officers were not attorneys though this SEC report does shed light on its efforts to regulate professional conduct.

90. *See id.*

91. *See id.* at *3. While none of those targeted in the report were lawyers, the report insinuated the SEC's continual yearning to regulate professional conduct and impose affirmative obligations on professionals to ensure the accuracy of SEC filings. Specifically, the report emphasized the affirmative duty of an issuer's management to correct misconduct and make full disclosure of relevant matters to investors; the very methodology the SEC sought to impose on attorneys in the late 1970s and early 1980s.

The history of the SEC's attempts to regulate the professional conduct of securities attorneys has planted the foundations for the current debate. Several clear themes are derived from this history: the SEC has long desired to regulate attorney conduct on its own without heeding to a judicial determination of misconduct; the state bar associations and practitioners have long resisted the SEC's regulation and disciplining of attorneys outside the Rule 102 framework; and the SEC has continually failed to firmly establish comprehensive standards of attorney conduct. With the passage of the Sarbanes-Oxley Act and its congressional delegation of power to the SEC, the agency seized the opportunity to pursue its regulatory goals on the professional conduct front with renewed vigor.

III. THE CONGRESSIONAL DELEGATION OF SECTION 307

On January 29, 2003, the SEC adopted final rules under Section 307 of the Sarbanes-Oxley Act, establishing standards of conduct for attorneys "appearing and practicing before the Commission" on behalf of an issuer.[92] The new rules potentially redefine the relationship between public companies and their attorneys.[93] Specifically, Section 307 of the Sarbanes-Oxley Act requires that the SEC

> 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—
>
> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
>
> (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised

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92. *See* Final Rule, *supra* note 10.

93. *See id.* SEC Rule 205, 17 C.F.R. Part 205, the lawyer conduct rule for attorneys appearing and practicing before the Commission, became effective August 5, 2003.

> solely of directors not employed directly or indirectly by the issuer, or to the board of directors.[94]

The SEC accordingly circulated rules for public comment on this important initiative.

Generally, the new rules impose an "up-the-ladder" reporting obligation on attorneys if they come in contact with evidence of a material violation of either federal or state law or a breach of a fiduciary duty by an issuer or any of its directors, officers, employees or agents. In addition, a proposed rule that has not been made final and is still being assessed by the SEC requires attorneys to make a "noisy withdrawal" from representing the issuer.[95] This noisy withdrawal obligation would be triggered when, after reporting evidence of a material violation up the ladder, the attorney reasonably believes that the issuer's directors did not appropriately respond within a reasonable time.

The new rules adopted by the Commission apply to all attorneys "appearing and practicing before the Commission."[96] The phrase "appearing and practicing before the Commission" is broadly defined to include:

> (i) Transacting any business with the Commission, including communications in any form;
>
> (ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;
>
> (iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document;
>
> (iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the securities laws or the Commission's rules or regulations thereunder to be filed with or

94. *See* Sarbanes-Oxley, *supra* note 7.
95. *See* Final Rule, *supra* note 10.
96. 17 C.F.R. § 205.2(a) (2004).

submitted to, or incorporated into any document that will be filed with or submitted to, the Commission.[97]

The definition covers almost all attorneys who perform legal services for public companies. The specific obligations and procedures the rules impose on these attorneys will now be discussed in greater detail.

A. SEC Rule 205

The rules require attorneys to report to company officials any "evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the issuer or any agent thereof."[98] The attorney must act when he or she becomes aware of information that would lead a reasonable attorney to believe a material violation has occurred, is occurring, or is about to occur.[99] This limits the instances in which the reporting duty arises to situations where it is appropriate to protect investors.[100]

As defined in the rules, "evidence of a material violation" means "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."[101] A "material violation" is a violation of an applicable federal or state securities law, a breach of fiduciary duty,[102] or a similar violation of any federal or state law which is material.[103] Furthermore, the Commission noted in the final rule[104] that the term

97. *See id.*

98. *See* Final Rule, *supra* note 10.

99. *See id* at 6.

100. *See id.* at 35.

101. *See id.* at 9.

102. Generally, two fiduciary duties exist under most state business corporation statues, the duty of care and the duty of loyalty. Directors and officers of the corporation owe these duties to the corporation and its shareholders. The duty of care requires that corporate managers "discharge their duties in the honest belief that the action taken was in the 'best interests of the company.' Best interests will be met if the board can show 'any rational business purpose' for the action." J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 RICH. L. REV. 317, 340 (2004) (footnote omitted). The duty of loyalty protects against self-dealing by officers and directors by ensuring fairness in conflicts of interest transactions undertaken by corporate management. *See id.* at 342.

103. Sarbanes-Oxley, *supra* note 7.

104. *See* Final Rule, *supra* note 10.

"material" has a well-settled meaning under the federal securities laws.[105]

Whether there is "evidence of a material violation," which triggers an attorney's reporting obligations under the rules, is based on an objective standard rather than the subjective belief of the attorney.[106] The "circumstances" upon which the conduct of an attorney will be based are the circumstances existing at the time the attorney makes a decision as to whether or not there is evidence of a material violation that must be reported.[107] Among other things, these circumstances may include the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client and the availability of other attorneys with whom the attorney may consult.[108]

B. *Reporting "Up the Ladder"*

Rule 205 sets forth several alternatives for reporting the material violations up the ladder.[109] The attorney is initially directed to make a report to the issuer's chief legal officer ("CLO"), or to the issuer's chief executive officer ("CEO").[110] Absent exigent circumstances, the attorney is also obligated to take reasonable steps to document his or her reports, as well as any response received from the CLO or CEO and retain the documentation for a reasonable time.[111]

After receiving an attorney's report, the CLO is required to investigate the material violation and to determine if a material violation has occurred, is ongoing, or is about to occur.[112] If the CLO concludes that no material violation has occurred, is ongoing, or is about to occur,

105. *See id. See* Basic, Inc. v. Levinson, 485 U.S. 224, 231-36 (1988) (holding that the common test of materiality under federal securities laws is whether there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the "total mix" of information made available).

106. *See* U.S. Sec. and Exch. Comm'n, *SEC Adopts Attorney Conduct Rules under Sarbanes-Oxley Act* (Jan. 23, 2003), *available at* http://www.sec.gov/news/press/2003-13.htm.

107. *See id.*

108. *See id.*

109. *See* 17 C.F.R. § 205.3(c) (2004).

110. *See* Disclosure Required by sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110 (Jan. 31, 2003) (to be codified at 17 C.F.R. pts. 228, 229, and 249). *See also* Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57276 (Sept. 9, 2002) (to be codified at 17 C.F.R. pts. 228, 229, 232, 240, 249, 270, and 274) (adopting new rule as directed by 302(a) of the Sarbanes-Oxley Act).

111. *See* 17 C.F.R. § 205.3(b)(1).

112. *See* 17 C.F.R. § 205.3(2).

the CLO must communicate this information to the attorney who reported the violation and indicate his or her basis for the determination that no material violation is evident.[113] If the CLO concludes that a material violation has occurred, is ongoing, or is about to occur, the CLO must take reasonable steps to devise an "appropriate response" to the violation and communicate this resolution to outside counsel.[114]

A response is "appropriate" when the reporting attorney reasonably believes that the issuer's response shows that there is no material violation, that the issuer has undertaken appropriate remedial measures, or that the issuer has retained or directed an attorney to review the matter and has implemented corrective measures.[115] Alternatively, if the reporting attorney has advised the issuer that it has a valid colorable defense to the violation, then the issuer is not required to make any response.[116] If the attorney who reported the violation is satisfied with both the CLO's response and the timing of the response, the obligation to report the evidence further up the ladder is no longer required.[117]

If the reporting attorney reasonably concludes that the CLO's response to the evidence of a material violation is insufficient or the reporting attorney determines that reporting the violation to the CLO would be futile, he or she is further obligated to report the violation further up the ladder to the issuer's board of directors, to the audit committee, or another board committee.[118] The reporting attorney must present evidence of the material violation to one of the following entities: the audit committee of the issuer's board of directors; another committee of the issuer's board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer; or the issuer's board of directors (if the issuer's board of directors has no committee consisting solely of directors who are not employed by the issuer).[119]

The entity to which the report is made is then obligated to investigate the evidence and provide an "appropriate response" to the evidence of a material violation.[120] This response must be communicated

113. *See id.*

114. *See id.*

115. *See* 17 C.F.R. § 205.2(b).

116. *See id.*

117. *See id.*

118. *See* 17 C.F.R. § 205.2(3)(A).

119. *See* 17 C.F.R. § 205.2(k).

120. *See id.*

to the reporting attorney.[121] If the reporting attorney reasonably believes that the entity to whom the violation was reported has fashioned an appropriate response, the reporting attorney is under no further reporting obligation with respect to that material violation.[122]

C. Optional Reporting Out

Section 205.3(d) permits, but does not expressly require, an attorney to divulge a client's confidences to the SEC.[123] This provision would permit attorneys to do so upon the happening of three occurrences.[124] Under this provision, an attorney "may reveal... confidential information" to the SEC "to the extent the attorney reasonably believes is necessary":

> (i) To prevent the issuer from committing a material violation [of the securities laws] that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
>
> (ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury... or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetuate a fraud upon the Commission; or
>
> (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or the investors in the furtherance of which the attorney's services were used.[125]

The state bar associations find these permitted disclosures to be problematic and inconsistent with state ethics rules.[126]

Specifically, the SEC's permitted disclosure scenarios can potentially allow an attorney to disclose confidences to the SEC to prevent a civil securities law violation not arising to the level of a crime. Some state ethics rules do not permit such disclosures in non-criminal circumstances. For instance, New York Disciplinary Rule 1200.19, like Washington State's rule on the subject, permits attorneys to disclose client confidences necessary to prevent the client from committing a

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121. *See id.*
122. *See* 17 C.F.R. § 205.3(b)(8).
123. *See* 17 C.F.R. § 205.3(d).
124. *See id.*
125. *See id.*
126. *See infra* notes 176-186 and 230-243 and accompanying text.

crime.[127] Moreover, committing a violation of the securities laws resulting in damage to financial interests or property of investors would also be barred under some state laws that do not permit disclosure in non-criminal circumstances. Consequently, the optional disclosure framework set forth in Section 205 is important to the preemption issue as the permissive disclosures may subject attorneys to differing legal rules at the state and federal level.

D. The Still-Pending "Noisy Withdrawal" Requirement

The most controversial part of the SEC's proposed rule that is still pending is the so-called "noisy withdrawal" or reporting out obligation. After reporting evidence of a material violation up the ladder, if an attorney reasonably believes that the issuer's directors did not make an appropriate response[128] within a reasonable time to address the evidence of the material violation, and if the attorney believes that the material violation is "likely to result in substantial injury to the financial interest or property of the issuer or of investors,"[129] he or she would be required to make a "noisy withdrawal" from representing the issuer.[130]

Along these lines, there are two alternatives an unsatisfied reporting attorney can pursue. First, under one of the alternatives of the proposed rule, a reporting attorney who has not received an "appropriate response" from the issuer and who believes that the material violation is "likely to result in substantial injury to the financial interest or property of the issuer or of investors" would be required to withdraw from representing the issuer and notify the SEC in writing.[131] Within one day, the reporting attorney would have to notify the SEC in writing that he or she has withdrawn from representing the issuer and that the reporting attorney intends to disaffirm some representation in a document to be filed with the SEC or incorporated into a document to be filed with the Commission.[132] In addition, the reporting attorney would have to actually disaffirm in writing the information causing the material violation.[133]

127. *See* 22 N.Y.C.R.R. § 1200.19 (2004).
128. *See* 17 C.F.R. § 205.2.
129. *See* C.F.R. § 205.3.
130. *See id.*
131. *See* C.F.R. § 205.3(d); Final Rule, *supra* note 10.
132. *See* Final Rule, *supra* note 10.
133. *See id.*

Under the second alternative of the proposed rule, a reporting attorney who did not receive an "appropriate response" from the issuer and who believes that the material violation will result in an injury to investors would be required to withdraw from representation of the issuer.[134] Following the receipt of the written notice of withdrawal from the reporting attorney, the issuer would be required to report the withdrawal and the circumstances surrounding it to the SEC on Form 8-K.[135] The Form 8-K would have to be filed with the Commission within two business days of receipt of the notice of withdrawal.[136] If the issuer fails to file the required notice on Form 8-K, the reporting attorney may report the issuer's failure to file the Form 8-K and disclose the withdrawal to the SEC.[137]

The controversy in the noisy withdrawal section, as relevant to this Note, lies in the SEC's authority to enact such broad regulations and its potential preemption on existing state ethics rules.[138] The American Bar Association Model Rules and the ethics rules adopted by many state supreme courts permit some form of noisy withdrawal.[139] Opponents of the current pending noisy withdrawal argue that the SEC's version transcends those state ethics rules and would problematically impose this

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134. *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Exchange Act Release Nos. 33-8106, 34-46084 at *18 (June 17, 2002) (to be codified at 17 C.F.R. pts. 228, 229, 240, and 249).

135. *See id.* at *11. A Form 8-K is filed when a company experiences a material event that shareholders would attach importance to. For more on Form 8-K see generally, Edmund W. Kitch, *The Theory And Practice Of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995).

136. *See id.*

137. *See id.* at *96.

138. It should be noted, that the noisy withdrawal section is controversial in many other respects. For instance, commentators have argued that the provision "would undermine the attorney-client privilege and turn lawyers into government informants." Jonathan Weil & Cassell Bryan-Low, *Report Bolsters SEC's Proposal for Attorneys*, WALL ST. J., Sept. 15, 2003, at C1. Those in favor of the noisy withdrawal section cite to a case where the existence of such a provision would have prevented investor harm. *See id.* Following retailer Spiegel, Inc.'s implosion, a bankruptcy court-appointed examiner explained that Spiegel's advisors could have prevented investor losses. After learning of accounting irregularities and other substantive problems with SEC periodic filings, the company's auditors, KPMG, "stood by . . . did not make a report to Spiegel's board, did not resign and did not report the matter to the SEC." *Id.* Additionally, Spiegel's attorney, who repeatedly advised the company that withholding public disclosures of their debt was illegal, did not withdraw "noisily or otherwise." *Id.* Of this behavior the court-appointed examiner suggested that "the absence of a 'noisy withdrawal' requirement allowed Spiegel to keep investors and the SEC in the dark." *Id.*

139. *See* MODEL RULES OF PROF'L CONDUCT R. 1.6 (2002). For a discussion on the differing state rules in this area, *See, e.g.* Thomas D. Morgan & Ronald D. Rotunda, 2003 SELECTED STANDARDS ON PROFESSIONAL RESPONSIBILITY (2003).

broad rule by federal regulation.[140] Essentially, they contest and question the SEC's position that this rule, if enacted (and the optional reporting out rule already enacted), would preempt state ethics rules.

IV. THE BAR ASSOCIATIONS, PREEMPTION AND RULE 205

The federal preemption doctrine has been dubbed an enigma.[141] One commentator recounts that his grandfather made him promise three things on his deathbed, one of which was to "never read a Supreme Court decision dealing with federal preemption."[142] Another commentator cites to the "fundamental confusion in the thinking of judges and scholars alike about the underlying nature of preemption."[143] Furthermore, what contributes to the muddled nature of preemption is that the study of preemption itself has been marginalized by constitutional law scholars.[144]

Scholars and courts alike generally express the belief that the federal preemption doctrine derives from the Supremacy Clause of the United States Constitution.[145] The Supremacy Clause in Article Four, Clause Two of the Constitution, states that

> the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.[146]

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140. This will be discussed in greater detail in text accompanying *infra* notes 178-186 and 230-243.

141. *See, e.g.*, David E. Seidelson, *Express Federal Preemption Provisions, State Law Actions for Damages, Congress, and the Supreme Court: A Penitent Seeks Redemption*, 58 LA. L. REV. 145, 145 (1997); Stephen D. Kinnard, *Judicial Refusal to Apply ERISA Preemption to Tort Actions Against Health Care Providers*, 26 THE BRIEF 24, 29 (1997).

142. Seidelson, *supra* note 141, at 145.

143. Stephen A. Gardbaum, *The Nature of Preemption*, 79 CORNELL L. REV. 767, 768 (1994).

144. There have been many articles that discuss preemption as applied to specific state and federal conflicts but few that discuss preemption generally. *See, e.g.*, Gardbaum, *supra* note 143; S. Candice Hoke, *Preemptive Pathologies and Civic Republican Values*, 71 B.U. L. REV. 685 (1991).

145. *See, e.g.*, Netland v. Hess & Clark, 140 F. Supp. 2d 1011, 1015 (D. Minn. 2001) (beginning preemption analysis with citation to the Supremacy Clause in the Constitution). *Contra* Gardbaum, *supra* note 143, at 770 (arguing that "[i]n reality, the Supremacy Clause adds nothing to what should be a question of interpreting what Congress has in fact done" and further suggesting that the connection between the Supremacy Clause and preemption analysis is a result of "muddled thinking about preemption and supremacy").

146. U.S. CONST. art. VI, cl. 2.

It is a well-established principle that the Supremacy Clause invalidates state laws that "interfere with, or are contrary to" federal law.[147] The preemption question therefore necessarily focuses on interpretation of statutes and legislative history; interpretation that is guided by a series of principles originating from the vast amount of Supreme Court jurisprudence addressing potential and actual federal and state law conflicts.

A. Supreme Court Jurisprudence on Preemption

The United States Supreme Court has held that a finding of preemption is only proper when Congress's intent to supersede state law is "clear and manifest."[148] Such intent may be explicit in the language of the statute, or implicit in the statute's structure and purpose.[149] When a state law is expressly preempted, "the only question for courts [is] whether the challenged state law is one that the federal law is intended to preempt."[150] Alternatively, when Congress invokes implied preemption, courts are forced to search beyond the actual language of the federal statute in their evaluation of whether federal purposes are frustrated by state law.[151]

Congressional intent to preempt is assessed by examining a statute's language and legislative history.[152] Absent express or implied congressional intent that a federal statute occupies the field of authority in a particular area, state regulation still may be preempted if it conflicts with the federal statute.[153] As the Supreme Court stated in *Rice v. Santa Fe Elevator Corp.*[154]

> [The congressional] purpose may be evidenced in several ways. The scheme of federal regulation may be so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it. Or the Act of Congress may touch a field in which the federal interest is so dominant that the federal system will be assumed

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147. Gibbons v. Ogden, 22 U.S. (9 Wheat) 1, 211 (1824).

148. Cipollone v. Liggett Group, Inc., 505 U.S. 504, 516 (1992).

149. *See id.*

150. The Supremacy Clause and Federal Preemption. The issue: How should courts determine whether a federal law preempts state law?, at http://www.law.umkc.edu/faculty/projects/ftrials/conlaw/preemption.htm.

151. *See id.*

152. *See* Arizona Pub. Serv. Co. v. Snead, 441 U.S. 141, 146-51 (1979); *see also Northern States Power*, 447 F.2d at 1146.

153. Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947).

154. 331 U.S. 218, 230 (1947).

> to preclude enforcement of state laws on the same subject. Likewise, the object sought to be obtained by the federal law and the character of the obligations imposed by it may reveal the same purposes.[155]

Congress's intent to preempt all state law in a particular area may be inferred where the scheme of federal regulation is sufficiently comprehensive to make reasonable the inference that Congress "left no room" for supplementary state regulation.[156] Preemption of a whole field will be inferred where the field is one in which "the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject."[157] Thus, the Court may find "occupation preemption" where an extensive federal regulatory scheme exists, where a significant federal interest exists, or where federal law regulates for the same purpose as a state law.[158]

Direct conflict preemption occurs if a court finds that "compliance with both federal and state regulations is a physical impossibility."[159] The Supreme Court has acknowledged that such a situation may assume one of many names including, "conflicting," "contrary to," "repugnance," "difference," "irreconcilability," "inconsistency," "violation," "curtailment," or "interference."[160] A state law conflicting with federal law is also preempted when the state law frustrates Congress' accomplishment of the full purposes and objectives of the federal law.[161]

The "conflict" test is used to assess whether the state regulation "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[162] As stated in *Florida Avocado Growers v. Paul*,[163] "[a] holding of federal exclusion of state law is inescapable and requires no inquiry into congressional design where compliance with both federal and state regulations is a physical impossibility."[164] It is "often a perplexing question whether Congress

155. *Id.* (citations omitted).

156. *Id.*

157. *Id.*

158. *N.E. Hub*, 239 F.3d 333, 346 (2001).

159. *See Pac. Gas & Elec. Co.*, 461 U.S. 190, 204 (1983).

160. Geier v. Am. Honda Motor Co., 529 U.S. 861, 873 (2000) (internal quotations omitted).

161. *See Pac. Gas & Elec. Co.*, 461 U.S. at 204 (citing Hines v. Davidowitz, 312 U.S. 52, 67 (1941)).

162. Hines v. Davidowitz, 312 U.S. 52, 67 (1941) (quoting Jones v. Rath Packing Co., 430 U.S. 519, 526 (1977)).

163. 373 U.S. 132, 142-43 (1963).

164. *Id.*

has precluded state action or by the choice of selective regulatory measures has left the police power of the States undisturbed except as the state and federal regulations collide."[165]

A state law that may come into conflict with federal law is not necessarily preempted; however, it might be preempted if the state measure seeks to achieve a different purpose or objective.[166] Even similarity of purpose between state and federal laws does not necessarily compel a finding of preemption.[167] Accordingly, in *City of Philadelphia v. New Jersey*,[168] the Supreme Court found that a state measure "is not preempted because of a square conflict with particular provisions of federal law or because of general incompatibility with basic federal objectives."[169] This is particularly true when the state measure "can be enforced consistently with the program goals and the respective federal-state roles intended by Congress."[170]

When applying preemption analysis, the Supreme Court generally presumes that the "historic police powers of the States [are] not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress."[171] The Court uses this rule to ensure that it "will not be presumed that a federal statute was intended to supersede the exercise of the power of the state unless there is clear manifestation of intention to do so. The exercise of federal supremacy is not lightly to be presumed."[172] Additionally, the Court has indicated that federal-state conflicts must be genuine and significant in order to merit resolution by preemption.[173]

The Court prefers to reconcile and uphold federal and state provisions that potentially conflict, rather than invalidate the entire state law. The Court has stressed the importance of the "body of law relating to the sensitive interrelationship between statutes adopted by the separate yet coordinate, federal and state sovereignties" and has stated that "the proper approach is to reconcile the operation of both statutory

165. *Santa Fe Elevator Corp.*, 331 U.S. at 230-31.

166. *See* Ray v. Atlantic Richfield Co., 435 U.S. 151, 164 (1978) (state enforcement of laws for other purposes is permissible).

167. *See* Exxon Corp. v. Governor of Maryland, 437 U.S. 117, 132 (1978).

168. 437 U.S. 617, 621 n.4. (1978).

169. *Id.*

170. *Id.* (citations omitted).

171. *Santa Fe Elevator Corp.*, 331 U.S. at 230.

172. New York State Dep't of Soc. Serv. v. Dublino, 413 U.S. 405, 413 (1973) (quoting Schwartz v. Texas, 344 U.S. 199, 202-03 (1952)).

173. *Exxon Corp.*, 437 U.S. at 130; *New York State Dep't of Soc. Serv.*, 413 U.S. at 423 n.29.

schemes with one another rather than holding one completely ousted."[174] Moreover, the Court has expressed its strong preference for resolving federal-state preemption conflicts "only to the extent necessary to protect the achievement of the aims of the federal law."[175]

Another related element to the preemption analysis is the interplay between preemption and the Tenth Amendment. The Supremacy Clause is arguably limited by the Tenth Amendment to the Constitution, which provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[176] The Tenth Amendment "expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system."[177] The reading of the Tenth Amendment in this manner has been the subject of much constitutional debate.[178]

B. *The Washington State Bar Association Opinion*

On June 26, 2003, the Board of Governors for the Washington State Bar Association unanimously approved and adopted an interim formal ethics opinion addressing obligations of Washington State lawyers under the SEC's professional conduct rules regarding, reporting, disclosure and or withdrawal under certain circumstances.[179] The Washington State Bar Association was troubled by the SEC's proposed noisy withdrawal requirement as well as the SEC's statement that a lawyer who complies in good faith "shall not be subject to discipline or otherwise liable under

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174. Merrill Lynch, Pierce, Fenner & Smith v. Ware, 414 U.S. 117, 127 (1973) (quoting Silver v. New York Stock Exchange, 373 U.S. 341, 357 (1963)).

175. DeCanas v. Bica, 424 U.S. 351, 358 n.5 (1976) (quoting in part *Merrill Lynch, Pierce, Fenner & Smith*, 414 U.S. at 127).

176. U.S. CONST. amend. X.

177. Nat'l League of Cities v. Usery, 426 U.S. 833, 843 (1976) (quoting Fry v. United States, 421 U.S. 542, 547 n.7 (1975)).

178. The detail of this constitutional debate is beyond the scope of this Note. For a discussion on this debate see generally, Barry Latzer, *Whose Federalism? or, Why "Conservative" States Should Develop Their State Constitutional Law*, 61 ALB. L. REV. 1399 (1998); Peter A. Lauricella, *The Real "Contract With America": The Original Intent of the Tenth Amendment and the Commerce Clause*, 60 ALB. L. REV. 1377 (1997); David M. Sprick, *Ex Abundanti Cautela (Out of an Abundance of Caution): A Historical Analysis of the Tenth Amendment and the Continuing Dilemma Over "Federal" Power*, 27 CAP. U. L. REV. 529 (1999).

179. *See* Washington Bar Opinion, *supra* note 29. The opinion was labeled "interim" because of the "lack of case law about the extent to which the SEC Regulations . . . pre-empt state ethics rules and because a Washington State Bar Association committee is considering changes to RPC 1.6." *Id.*

inconsistent standards imposed by any state or other United States jurisdiction."[180]

The SEC rule allowing lawyers to disclose civil violations that do not rise to the level of crimes is in conflict with Rule 1.6 of the State of Washington's Rules of Professional Conduct, which permits attorneys to disclose a client's confidences and secrets,[181] only "to the extent the lawyer reasonably believes necessary . . . to prevent the client from committing a crime."[182] The conflict therefore lies in the SEC's rule permitting an attorney to disclose confidences and secrets in situations not authorized or allowed by Washington's Section 1.6.

The interim opinion warns Washington State lawyers not to disclose client information allowed by the SEC regulations unless such disclosures are also permitted by the state's own professional conduct rules.[183] The Washington Bar also warned Washington state lawyers not to rely on the "good faith" provision found in the SEC Rule.[184] This provision protects attorneys from potential disciplinary action due to inconsistent state standards if the attorney "complies in good faith" with the SEC's regulations.[185] According to the Board of Governors, a Washington state lawyer who "takes action contrary to this formal opinion cannot as a defense against [a state ethics] violation fairly claim to be complying in good faith with the SEC Regulations."[186]

This is based on "the fact that Section 205(d)(2) states that a lawyer 'may reveal' confidential information but does not mandate a revelation [thereby] giv[ing] the lawyer discretion to determine whether to make a disclosure" that would not be permitted under Washington's ethical rules. Furthermore, the Board was of the opinion that "the use of the term 'complies' in Section 205.6(c) means that the good faith defense applies only to those provisions which are mandatory in nature and not to discretionary disclosures."[187]

180. *Id.*

181. *See id.*

182. *Id.*

183. *See* Mark Hansen, *State Fights the SEC: State Bar Warns Lawyers Against Permissive Disclosure under SEC's New Rules*, A.B.A. J. E-REPORT, Aug. 29, 2003.

184. *See* Washington Bar Opinion, *supra* note 29.

185. *Id.*

186. *Id.*

187. *Id.*

C. *The SEC's Position on Preemption*

At the outset of the SEC's proposal to regulate attorney conduct, the SEC stated that

> the prospect of simultaneous Commission and state disciplinary proceedings for the same misconduct raises the question of the impact of the rule upon state ethical rules and regulations. Due to the breadth and specificity of the Congressional mandate to the Commission to implement an 'up the ladder' reporting system applicable to attorneys representing issuers, the Commission is considering whether Congress intended for the agency's rule to 'occupy the field' on this issue, and whether Part 205 would preempt any state rules governing the reporting of evidence of a material violation by attorneys representing issuers before the Commission.[188]

Prior to the adoption of the interim opinion, the SEC general counsel sent a published letter to Washington State Bar Officials urging them not to adopt the opinion.[189] The SEC general counsel, Giovanni P. Prezioso, argued that the interim opinion squarely conflicts with several Supreme Court precedents that have upheld the authority of federal administrative agencies to promulgate rules that differ from state laws.[190] Specifically, the general counsel suggested that where state law prescribes an attorney from exercising the discretion allowed by a federal regulation, the federal regulation trumps the state measure.[191] Accordingly, because "the issue of whether an attorney has acted in good faith . . . requires an interpretation of a Commission rule [the good faith provision], states must defer to the Commission's construction."[192]

Despite the SEC general counsel's letter, the Board of Governors adopted the interim opinion. As a result of the seemingly irreconcilable positions of the SEC and the Washington State Bar Association, one commentator has stated that Washington lawyers "will naturally be concerned that such disclosure will result in state disciplinary sanctions,

188. 67. Fed. Reg. 71697-98 (footnotes omitted).

189. *See* General Counsel, Giovanni P. Prezioso, U.S. Securities and Exchange Commission, Public Statement by SEC Official: Letter Regarding Washington State Bar Association's Bar Opinion on the Effect of the SEC's Attorney Conduct Rules, July 23, 2003, *at* http://www.sec.gov/news/speech/spch072303gpp.htm (last visited Feb. 12, 2004) [hereinafter, SEC Letter].

190. These cases will be discussed *infra* at notes 199-230 and accompanying text.

191. *See* SEC Letter, *supra* note 189.

192. SEC Letter, *supra* note 189 (citing Barnhart v. Walton, 535 U.S. 212 (2002) (sustaining agency's interpretation of a regulation as long as it is based on a permissible construction)).

at least in the absence of a definitive ruling that the SEC rule pre-empts the state ethics standards."[193] "The practical reality is that Washington lawyers are likely for now to limit their disclosures to what the Washington state ethical standards permit, and not take full advantage of the scope of permissive disclosure under the SEC rule."[194] Thus, the conflict persists and preemption remains an important concern.

Most states permit an attorney to reveal confidences and secrets "in order to prevent the client from committing a criminal or fraudulent act."[195] Additionally, these states "either permit or require disclosure to prevent a client from perpetuating a fraud that constitutes a crime, and eighteen states permit or require disclosure to rectify substantial loss resulting from client crime or fraud in which the client used the lawyer's services."[196] This leaves a handful of states that require such disclosure and thirty-seven that permit it. As a result, the SEC rules and state ethics rules are discordant in some capacity and the preemption debate transcends Washington State; its outcome will have far-reaching implications.

At the outset, the SEC general counsel's letter explained that the SEC's rules rarely conflict with state ethics rules.[197] This is due in part to the narrow scope and applicability of the Commission's rules that only apply to "attorneys . . . appearing and practicing before the Commission."[198] Thus, lawyers not appearing before the SEC will not encounter the conflict between the SEC rules and Washington State's ethics rules. Furthermore, the letter illustrates that barring Washington attorneys from complying with the Commission's rules is inconsistent with Supreme Court precedent, namely *Sperry v. State of Florida*,[199] and *Fidelity Federal Savings & Loan Association v. de la Cuesta*.[200]

In *Sperry*, the petitioner was registered to practice before the United States Patent Office, but not admitted to practice law before the Florida or any other bar.[201] Petitioner appealed a lower court order enjoining him

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193. Hansen, *supra* note 183.

194. *Id.*

195. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, § 67 cmt. F (2000).

196. ABA Task Force, Preliminary Report of the ABA Task Force on Corporate Responsibility at 32 (July 16, 2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

197. *See* SEC Letter, *supra* note 189.

198. *Id.*

199. 373 U.S. 379 (1963).

200. 458 U.S. 141 (1982).

201. 373 U.S. 379 (1963).

from practicing before the Patent Office, and the issue on appeal was whether he was permitted to represent clients before the United States Patent Office.[202] The Supreme Court held that under the Supremacy Clause, federal law, which permitted non-lawyers to represent applicants before the Patent Office under 35 U.S.C. § 31, preempted Florida law.[203] The order enjoining petitioner was therefore vacated because it prohibited him from performing tasks which were incident to the preparation and prosecution of patent applications before the United States Patent Office. [204]

The basis for the Supreme Court's decision was the federal patent statute's authorizing the Commissioner of Patents to "prescribe regulations governing the recognition and conduct of agents, attorneys, or other persons representing applicants or other parties before the Patent Office" providing the Commissioner of Patents with adequate authority to promulgate a rule preempting a Florida law requiring attorneys to be licensed by the state.[205] The Court expressly stated that "by virtue of the Supremacy Clause, Florida may not deny to those failing to meet its own qualifications the right to perform the functions within the scope of the federal authority."[206] Ultimately, relevant to the professional responsibility context, the Court opined that the "authority of Congress is no less when the state power which it displaces would otherwise have been exercised by the state judiciary rather than by the state legislature."[207]

The other case cited by the general counsel to support the SEC's preemption position was *Fidelity Federal Savings & Loan Association v. de la Cuesta*.[208] In *Fidelity*, at issue was a federal statute, the Federal Owners' Loan Act of 1933, which authorized the Federal Home Loan Bank Board to promulgate rules governing savings and loan associations. One of the promulgated regulations permitted federal savings and loan associations to include a "due on sale" clause in its loan documentation.[209] A savings and loan bank challenged a decision of the

202. *See id.*
203. *See id.*
204. *See id.*
205. *Id.* at 385 (emphasis added).
206. *Id.*
207. *Id.*
208. 458 U.S. 141 (1982).
209. *Id.* A due on sale clause is a clause "that accelerates the loan whenever the debtor sells the collateral to a third party." David Gray Carlson, *Rake's Progress: Cure and Reinstatement of Secured Claims in Bankruptcy Reorganization*, 13 BANK. DEV. J. 273, 287 (1997).

Court of Appeals of California, denying the bank's motion for summary judgment in an action for a judicial declaration that a due on sale clause was not enforceable unless the bank first showed the transfer of real property had harmed its security interest.[210] California challenged the federal regulation, contending that the regulation violated a California statute that only permitted a lender to exercise a due on sale clause where the lender first demonstrates that the borrower's transfer of the property harms the lender's security interest.[211] Appellee, home purchasers, requested an injunction, compensatory damages and punitive damages.[212]

Reversing the court of appeals, the Supreme Court held that there was ample federal statutory authority allowing the Federal Home Loan Bank Board, a federal administrative agency, to displace contrary restrictions imposed by the state.[213] The state law framework created the sort of conflicting state limitation that the federal regulations were aimed at preventing.[214] The Court granted appellant's motion for summary judgment ultimately holding that federal law controlled.

The SEC general counsel letter also concluded that states must defer to the Commission's construction of what constitutes "good faith" compliance with the SEC rules.[215] In support of this proposition, the letter cites to a recently decided Supreme Court case, *Barnard v. Walton*.[216] In *Barnard*, at issue was a social security regulation coupled with an agency interpretation. The Social Security Act authorizes payment of Title II disability insurance benefits and Title XVI Supplemental Security Income to individuals who have an "inability to engage in any substantial gainful activity by reason of any medically determinable . . . impairment . . . which has lasted or can be expected to last for a continuous period of not less than 12 months."[217] The Social Security Administration, a federal agency, denied benefits to respondent Walton, finding that his "inability" to engage in substantial gainful activity lasted only eleven months.[218]

210. 458 U.S. 141 (1982).
211. *See id.*
212. *See id.*
213. *See id.*
214. *See id.*
215. SEC Letter, *supra* note 189.
216. 535 U.S. 212 (2002).
217. *Id.* at 214.
218. *Id.* at 215.

The district court affirmed the denial of benefits.[219] On appeal to the Fourth Circuit, the court reversed the district court's holding that the twelve month duration requirement modifies "impairment" not "inability," that the statute leaves no doubt that no similar duration requirement relates to an "inability." Therefore, the Fourth Circuit held that Walton was entitled to benefits despite the federal agency's regulations restricting them to those unable to work for twelve months.[220] On appeal, the Supreme Court held that the Agency's reading of the term "inability" was reasonable.[221]

The Supreme Court explained that the statute requires both an "inability" to engage in any substantial gainful activity and an "impairment" providing "reason" for the "inability," adding that the "impairment" must last or be expected to last not less than twelve months.[222] Along these lines, the Agency determined in its formal regulations and its interpretation that "inability" must last the same amount of time.[223] Citing to several cases, the Court likened the dispute at issue to other instances where the courts have granted considerable leeway to the interpretation by an agency of its own regulations.[224] Thus, if an Agency's interpretation of a federal statute is "based on a permissible construction," a court will uphold the agency interpretation.

In addition to *Barnhart*, the SEC letter cites to *United States v. Locke*,[225] and *City of New York v. FCC*.[226] In *United States v. Locke*, the Supreme Court invalidated state regulations governing oil spill remedies that were more stringent than federal remedies.[227] The Court held that state regulations conflicting with federal agency regulations pursuant to a congressional mandate were preempted.[228] Similarly, in *New York v. FCC*,[229] the Court held that the Federal Communications Commission

219. *See id.* at 216.

220. *Id.*

221. *See id.* at 222, 224.

222. *See id.* at 218-19.

223. *See id.* at 219.

224. Along these lines, the Court stated that

> [i]f the statute speaks clearly to the precise question at issue, [courts] must give effect to the unambiguously expressed intent of Congress. If, however, the statute is silent or ambiguous with respect to the specific issue, [courts] must sustain an Agency's interpretation if it is based on a permissible construction of the Act.

Id. at 217-18.

225. 529 U.S. 108, 110 (2000).

226. 486 U.S. 57 (1989).

227. 529 U.S. 108, 110 (2000).

228. *See id.*

229. 486 U.S. 57 (1989).

did not exceed its authority to promulgate rules that were contrary to state cable rules.[230] The Court held the contrary state rules that frustrated the purpose of the federal agency rules were preempted. Under the case law cited in the SEC letter, if the SEC's attorney conduct regulations are authorized under Section 307 of the Sarbanes Oxley Act, any state rules frustrating the purpose underlying the SEC rules should presumably be preempted.

D. *Opinion of the California Bar's Corporations Committee*

Similar to the Washington Bar Association's opinion, the Corporations Committee of the Business Law section of the State Bar of California sent a letter to the SEC general counsel.[231] The letter responded to the SEC's position that SEC regulations trump state rules of conduct prohibiting disclosure of confidences and secrets.[232] Additionally, the Corporations Committee, like the Washington Bar, took issue with the notion that SEC regulations protect a lawyer from discipline when the attorney complies in good faith with the SEC's rules.[233] Specifically, the letter stated that "[a]n attorney faced with choosing between potentially irreparable harm to a client's interests arising from disclosure of a confidence or the cost of a good faith, well founded objection to the SEC's rules is virtually duty-bound to select the latter."[234]

Notwithstanding the SEC's seemingly plausible position, the Committee explained that the "significant potential basis of the challenge [is] that there is no evidence of Congressional intent to preempt state ethics rules."[235] Additionally, the Committee noted past instances where the "courts have struck down SEC rulemaking for lack of authority."[236]

The Corporations Committee specifically warned that it is "the duty of an attorney . . . to maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."[237] Indeed, under the California Business and Professions Code section

230. *See id.*
231. *See* California Letter, *supra* note 30.
232. *See id.*
233. *See id.*
234. *Id.*
235. *Id.* (footnote omitted).
236. *Id.* (footnote omitted).
237. *Id.*

6068(e), an attorney who reports out is subject to discipline by the California State Bar Association.[238] Interestingly, California's State Constitution specifically requires California State agencies to enforce state statutes notwithstanding any federal law purporting to preempt it, until a court finds that federal law preempts the California State law.[239]

Ultimately, regarding the SEC's good faith provision, the Corporations Committee sternly warned that "clients and lawyers could be severely harmed if lawyers rely on the SEC's assurances . . . that good faith disclosures of client confidences will be immunized, but courts ultimately rule that the positions taken [by the SEC] are incorrect."[240] After articulating reasons why the SEC exceeded its authority, including public policy problems created by allowing disclosure of client confidences, the letter respectfully requested that the SEC reconsider its positions.[241]

The Corporations Committee stressed the difficulty the SEC would have in asserting preemption of California law.[242] The letter sent to the SEC indicated that the "Committee believes that the authority of the SEC to adopt either Rule 205.3(d) or Rule 205.6(c) is likely to be challenged."[243] The challenge will likely occur when a California lawyer (or a Washington lawyer for that matter) is confronted with an issue that will require compliance with the SEC rule, while concomitantly disregarding the conflicting state rule.

The Committee letter also distinguishes *Sperry v. State of Florida*,[244] one of the cases cited to in the SEC letter in support of the

238. BUS. AND PROF. CODE SEC. 6068(e) provides that "[i]t is the duty of an attorney . . . [t]o maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."

239. CAL. CONST. art. III, § 3.5 reads as follows:

> An administrative agency, including an administrative agency created by the Constitution or an initiative statute, has no power:
>
> . . .
>
> (c) To declare a statute unenforceable, or to refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

For examples of the courts applying this provision see, e.g., Regents of University of California v. Superior Court, 225 Cal. App. 3d 972, 976 (Ct. App. Cal. 1990) and see generally Barlow v. Davis, 72 Cal. App. 4th 1258 (Ct. App. Cal. 1990).

240. California Letter, *supra* note 30.

241. *See id.*

242. *See id.*

243. *Id.*

244. 373 U.S. 379 (1963). For a plenary discussion of this case, see *supra* notes 200-206 and accompanying text.

SEC's position. In this regard, the Committee illustrated the following points:

First, the power of Congress to establish a patent office is expressly set forth in the United States Constitution. Second, Congress expressly granted the Commissioner of Patents the authority to prescribe regulations, among other things, recognizing agents or other persons before the Patent Office. Third, the practice by lay patent agents was long-standing at the time that Congress considered the statute.[245]

Essentially, the Committee's contention was that the source of authority for the rule promulgation in *Sperry* was stronger than that of the SEC in the present context. The next Section assesses whether California, Washington or any other conflicting state rule will be preempted by the SEC's rules.

V. APPLYING THE PREEMPTION ANALYSIS

When acting within constitutional limits, Congress is empowered to preempt state law by stating so in express terms.[246] For example, in the Sarbanes-Oxley Act, Congress could have said, "the regulations promulgated pursuant to this congressional mandate hereby supercede and preempt any existing and future state laws that conflict with or impede their operation."[247] Congress, however, did not do so. We must therefore search for implicit preemption.

When searching for implicit preemption we look to any congressional intent with respect to whether congress intended for the SEC to occupy the field. The federal regulations in question are not sufficiently comprehensive to infer that, given the current SEC rules, congress left no room for supplementary state regulation. It is also difficult to argue that the federal government's interest in this area is dominant and overwhelming so as to preclude state regulation.

245. *See* California Letter, *supra* note 30.

246. *See* Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977).

247. Congress has done this in several other important statutes. For example, in the Employment Retirement Income Security Act of 1974, better known as ERISA, Congress expressly stated that ERISA laws "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan . . . ." 29 U.S.C. § 1144(a) (2004). Similarly, in the recently enacted Health Insurance Portability and Accountability Act ("HIPAA"), congress established that any federal regulation resulting from implementation of the Act preempts any contrary state law. *See* 42 U.S.C. § 1320 d-7(a)(1) (2004). An example of a less broad preemption provision is in the Federal Railroad Safety Act of 1970 ("FRSA") where congress provided that a state may regulate railroad safety until the secretary of transportation prescribes a regulation covering the subject matter of the state requirement. *See* 49 U.S.C. § 20106 (2004).

Perhaps, the more difficult part of the preemption analysis relates to whether "compliance with both federal and state regulations is a physical impossibility."[248] If the state regulations that differ from the SEC rules "stand[] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress" a finding of preemption is a possibility.[249] In the present conflict between the SEC and the states complying with both the SEC rules and the Washington and California rules relating to confidentiality may indeed be impossible. An in-house attorney confronted with corporate fraud may be obligated by Section 205.3 to report the corporate malfeasance to the SEC. But by reporting to the SEC, the same attorney may be violating state confidentiality rules that subject him to discipline by these state bar associations. Thus, compliance with both may very well be an impossibility.

In the present case, both Washington State and California (and other states who have released public comments on the SEC proposals) assert compelling state interests in support of their rules governing confidentiality between attorneys and clients.[250] For these states, it is a breach of the highest order when attorneys "blow the whistle" on their clients and reveal their confidences and secrets, particularly to a governmental agency with enforcement ability. By restricting the ability of attorney disclosure, these states implicitly assert that the preservation of client confidentiality is a pure and near-absolute value that should not be forsaken, even when confronted with securities fraud and other criminal acts.

Both Washington and California cite to the important policy objectives being frustrated by the SEC's rule-making attempts.[251] The California Committee's letter states that "the disclosure of confidential information, including information protected by the attorney-client privilege, could have devastating effects. The risk of waiving the attorney-client privilege through the attorney's selective disclosure to the SEC is high and may result in the information becoming available in civil or criminal proceedings."[252] These compelling public policy concerns, however, are not taken into account when a court undertakes preemption review. Put another way, the presence of legitimate state

248. *Pac. Gas & Elec. Co.*, 461 U.S. 190, 204 (1983).

249. Hines v. Davidowitz, 312 U.S. 52, 67 (1941) (quoting Jones v. Rath Packing Co., 430 U.S. 519, 526 (1977)).

250. *See* Washington Opinion, *supra* note 29; California Letter, *supra* note 30.

251. *See, e.g.*, Washington Opinion, *supra* note 29; *see also*, California Letter, *supra* note 30.

252. California Letter, *supra* note 30 (footnote omitted).

interests in enacting statutes "does not inoculate them against preemption."[253] Indeed, the Supreme Court has held that a state law does not triumph over federal law because the subject matter is of special concern to the states.[254]

One of the main bases of the Washington and California bars' contention is that there is "no evidence of Congressional intent to preempt state ethics rules."[255] As the argument goes, absent a manifestation of intent to preempt state rules, federal supremacy "is not lightly to be presumed."[256] It is important to note, that the preemption of state ethics rules is not a stake in this dispute. The SEC has not attempted to displace entire state ethics regimes. The SEC rule conflicts with a single state ethics rule (albeit an important one). Furthermore, the conflict only surfaces where the client confidentiality is disclosed by a California or Washington State attorney "appearing and practicing before the Commission."[257]

The Supreme Court's preemption jurisprudence can be reduced to several propositions that will undoubtedly be applied by any court reviewing the dispute. These general propositions have been consistently applied by the Supreme Court and lower federal courts undertaking preemption review. While the factual contexts in different cases can be distinguished, the following principles derived from these cases are not as amenable to differing interpretations:

(1) "[T]he law of the State, though enacted in the exercise of powers not contraverted, must yield when incompatible with federal legislation."[258]
(2) Federal regulations "have no less pre-emptive effect than federal statutes."[259]
(3) Congressional authority is "no less when the state power which it displaces would otherwise have been exercised by the state judiciary rather than by the state legislature."[260]

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253. Roy Simon, *Washington State Bar Takes on the SEC*, N.Y. PROF'L RESP. REPORT, Oct. 2003, at 5.

254. *See* Fidelity Fed Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141 (1982).

255. California Letter, *supra* note 30.

256. New York State Dep't of Soc. Serv. v. Dublino, 413 U.S. 405, 413 (1973) (quoting Schwartz v. Texas, 344 U.S. 199, 202-03 (1952)). This argument will be addressed in this Part.

257. *See* Final Rule, *supra* note 10.

258. Sperry v. Florida, 373 U.S. 379 (1962) (citing Gibbons v. Ogden, 22 U.S. (9 Wheat) 1 (1824)).

259. Fidelity Fed Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141 (1982).

260. *Sperry*, 373 U.S. at 385.

(4) State laws that function as an "obstacle to the accomplishment and execution of the full purposes and objectives" of a federal regulation will not be upheld;[261] and

(5) (a) Where a federal statute is silent regarding an activity covered by a federal agency regulation, the courts will sustain the agency action if the "agency's interpretation [of the statute] is based on a permissible construction of the Act;"[262] and

(b) A federal agency acting within the scope of a delegation of authority from congress can preempt state law.

In applying these preemption principles, the SEC can preempt any state rule that conflicts with its Rule or any state rule that frustrates the purpose of its rule. The SEC's authority to do so is not in question and is not lessened or susceptible to attack because the source of the power it is displacing is state courts that enact and enforce state ethics rules. Furthermore, as discussed, the content of the state law, the state's interest in enacting the law and its underlying policy or objective, is not factored in to the preemption equation.[263]

The only issue, as far as preemption analysis goes, is the SEC's construction of Congress' delegation in Section 307 of Sarbanes Oxley and whether the SEC rule is a permissible construction of that delegation (proposition 5(a) and (b) above). In related vein, the Washington and California positions both focus on the Supreme Court's unwillingness to find federal preemption "unless that was the clear and manifest purpose of Congress."[264]

Section 307 of the Sarbanes-Oxley Act mandates that the SEC

> shall 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—
>
> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

261. *Fidelity*, 458 U.S. at 147.
262. Barnhart v. Walton, 535 U.S. 212, 218 (2002).
263. *See supra* notes 249-252 and accompanying text.
264. Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947).

> (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.[265]

The delegation is silent regarding the SEC's authority to promulgate a rule permitting disclosure to the SEC in certain circumstances. Consequently, the legislative history relating to Section 307 must be examined.

Given the haste of the Sarbanes Oxley Act's passage, the legislative history is scant. Nevertheless, there are expressions of legislative history relevant to the SEC's permissive reporting out rule. Senator Enzi stated that Section 307 "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."[266] Senator Edwards stated that "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 unsuccessful, then to the board of the corporation.[267] There is no obligation to report anything outside the client—the corporation."[268]

The SEC's permissive reporting out rule does not contravene the legislative history. In light of the legislative pronouncements, it is clear that the senators were concerned with a "requirement" or "obligation" to report outside the corporate structure to the SEC. Since Section 205.3(d) states that an issuer "may reveal" and does not require or obligate disclosure to the SEC, it will be difficult to argue that the SEC's rule exceeds the scope of the congressional delegation.[269] Moreover, the burden is on a state challenging federal preemption to demonstrate that the SEC's rule is not "based on a permissible construction."[270] Since the plain language of Rule 205.3(d) conforms to the congressional delegation's purpose, namely the enactment of rules regulating attorneys "[for] the public interest and for the protection of investors,"[271] a finding that the rule is an impermissible construction is highly unlikely. Given

265. Sarbanes-Oxley, *supra* note 7, at 745.
266. 148 CONG. REC. S6524, (daily ed. July 10, 2002) (statement of Sen. Enzi).
267. *Id.* (statement of Sen. Edwards) (emphasis added).
268. *Id.* (emphasis added).
269. 17 C.F.R. § 205.
270. *Barnhart*, 535 U.S. at 218.
271. Sarbanes-Oxley, *supra* note 7.

the application of the preemption principles, a court will likely hold that SEC's permissive reporting out rule preempts contrary state ethics rules.

VI. CONCLUSION

This Note has addressed issues relating to the conflict between the SEC attorney conduct rules and state ethics rules. This Note takes the position that the SEC's stance on preemption as adopted and incorporated by the SEC general counsel's letter, will likely preempt contrary state ethics rules. After applying the preemption principles articulated by Supreme Court precedent, it becomes apparent that federal preemption of contrary state ethics rules is likely to occur. While the Washington and California bar associations have aggressively articulated their cases against preemption, their positions are contrary to undisputed principles traditionally and consistently applied by the Supreme Court in its preemption jurisprudence.

*Sara Levy**

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