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Washington State Bar Takes On the SEC

BY ROY SIMON

A New York legal ethics newsletter may seem like an unlikely place to write about federal preemption doctrine. For more than 100 years, the rules that govern the conduct of lawyers have ordinarily been promulgated by the courts of each state, not by Congress or by federal agencies. But on August 5, 2003, the SEC's new Standards of Professional Conduct for Attorneys took effect, bringing about the most sweeping federal effort to regulate attorneys in our nation's history, an effort that expressly intends to preempt contrary state rules of professional conduct. The Washington State Bar, however, has thrown down the gauntlet to the SEC by taking the position that attorneys who practice in Washington State must abide by the Washington Rules of Professional Conduct, not the new SEC rules, whenever those rules clash. The SEC, in turn, has sharply refuted the Washington State Bar's position, arguing that the SEC's rules preempt any state legal ethics rules that conflict with the SEC rules.

This article looks at the Washington State opinion, the SEC's position on preemption, and the cases and other authorities that may settle the issue. Because the relevant sections of the Washington State Rules of Professional Conduct ("RPCs") governing confidentiality are essentially identical to the equivalent provisions of the New York Code of Professional Responsibility, the outcome of the battle between Washington State and the SEC has far-reaching implications for lawyers who practice in New York.

Background

This is not the first time the states have fought the federal government regarding preemption. Many readers will remember the famous "Thornburgh Memorandum," originally issued in 1989 by U.S. Attorney General Richard Thornburgh, stating that the Constitution's Supremacy Clause prohibited state legal ethics rules (principally the "no- contact rule" in DR 7-104) from disciplining federal employees and their agents for communicating with represented parties. After a multi-chaptered see-saw battle in the courts, Congress resolved the tension by enacting the so-called "McDade Amendment," 28 U.S.C. § 530B, which provides that federal government attorneys are subject to the same ethical standards as all other attorneys practicing in a given state.

A similar battle raged in Oregon a few years ago, when the federal government filed suit to enjoin Oregon from disciplining federal attorneys for supervising undercover operations, which Oregon said violated the prohibition in DR 1-102(A)(4) against conduct involving dishonesty, fraud, deceit, or misrepresentation. (New York has the same rule.) Last year, Oregon resolved this stand-off by adopting a new DR 1-102(D) permitting lawyers to supervise lawful "covert activity" in certain circumstances. But because the federal government has seldom adopted regulations to govern the professional conduct of lawyers, preemption battles over state legal ethics rules have been relatively rare.

The new SEC rules, however, mark a new high water mark for federal intrusion into regulating lawyer conduct. On January 29, 2003, in keeping with the mandate of § 307 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7245, the SEC promulgated Standards of Professional Conduct for Attorneys who appear and practice before the SEC in any way in the representation of issuers. These new regulations were published in the Federal Register about a week later, with an effective date 180 days after publication, which worked out to August 5, 2003.

I address in this article only the SEC regulations relating to the doctrine of preemption and relating to so called "reporting out," which in limited circumstances authorize attorneys to report certain corporate misconduct to the SEC. The "reporting out" regulations, which are found at §205.3(d), provide as follows:

> (2) An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:
>
> > (i) To prevent the issuer from committing a material violation [of the federal 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, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate 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 investors in the furtherance of which the attorney's services were used.

Thus, §205.3(d) permits, but does not require, an attorney to disclose a client's confidential information to the SEC in the three delineated circumstances.

SEC Provisions On Preemption

The new SEC Standards also contain two provisions addressing preemption. The first one, §205.1, anticipates that the SEC's rules may clash with the rules of professional conduct governing lawyers in some states. It provides:

> §205.1 Purpose and scope. This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern. [Emphasis added.]

Another section, §205.6(c), seeks to insulate attorneys from professional discipline in states where the SEC rules permit conduct that would be prohibited by equivalent state rules of professional conduct. Specifically, §205.6(c) provides:

> (c) An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

In sum, §205.3(d) of the new SEC rules authorizes an attorney to disclose a corporate client's confidential information in three situations – (1) to prevent the client from violating the securities laws in a way that is "likely to cause substantial injury" to the company or its investors; (ii) to prevent the client from committing perjury, suborning perjury, or committing fraud during an SEC investigation or administrative proceeding; or (iii) to rectify the consequences of a material violation by the client that has caused – or may in the future cause – "substantial injury" to the company or its investors and in the furtherance of which the attorney's services were used. Section 205.1 makes clear that these new rules preempt any inconsistent state regulations of attorney conduct. And, for good measure, §205.6(c) ensures that an attorney who discloses confidential information "in good faith" pursuant to the authority granted by the SEC in §205.3(d) is immune from professional discipline or civil liability if the disclosures violate state rules of professional conduct or other state laws.

The Washington State Bar reacts to the SEC rules

On July 26, 2003, ten days before the effective date of the new SEC rules, the Washington State Bar Association Board of Governors adopted an Interim Formal Ethics Opinion on "The Effect of the SEC's Sarbanes-Oxley Regulations on Washington Attorneys' Obligations Under the RPCs." (A footnote explains: "Because of the lack of case law about the extent to which the SEC Regulations addressed in this opinion pre-empt state ethics rules and because a WSBA committee is considering changes to RPC 1.6, this opinion is an interim opinion only.") The opinion asks whether the new SEC rules – especially the provisions of § 205.3(d) authorizing disclosure of a client's confidential information – have altered the obligations of Washington State attorneys under the Washington State Rules of Professional Conduct.

The opinion then reviews the Washington State rules governing disclosure of confidential information. Washington State has in many respects adopted the ABA Model Rules of Professional Conduct (at least as the ABA Rules stood before the extensive 2002 and 2003 amendments to those rules), but Washington State has not adopted the main ABA confidentiality rule, Rule 1.6. Instead, Washington State's confidentiality rule is in most respects identical in substance to New York's DR 4-101. Washington State's version of Rule 1.6(a)(a) provides that a lawyer "shall not reveal confidences or secrets" unless the client consents after consultation or the revelation is "impliedly authorized" or permitted by an express exception. (New York's DR 4-101 does not permit "impliedly authorized" disclosures, but that is irrelevant to the issue at hand because any disclosures pursuant to the SEC rules would be expressly authorized, not impliedly authorized.) The pertinent express exceptions in Washington State's confidentiality rules provide:

> (b) A lawyer may reveal such confidences or secrets to the extent the lawyer reasonably believes necessary:

(1) To prevent the client from committing a crime; or
(2) . . . pursuant to court order. . . .

The Washington State Bar then measured these exceptions against the three situations in which the SEC's §205.3(d) would authorize disclosure of client confidences.

The Bar said that disclosures under § 205.3(d)(ii), permitting an attorney to disclose confidential information to prevent a client from committing perjury, suborning perjury, or committing any act proscribed by 18 U.S.C. § 1001 likely to perpetrate a fraud on the SEC during an SEC investigation or administrative proceeding do not pose any problem for Washington State attorneys.. Rather, the SEC regulation was consistent with the Washington State Rules of Professional Conduct because Washington State Rule 1.6(b)(1) – like New York's DR 4-101(C) – permits a lawyer to disclose confidential information necessary to prevent a client from committing a "crime."

On the other hand, disclosures under §205.3(d)(2)(i) are problematic, because the SEC regulation goes further than the Washington State Rules of Professional Conduct. Specifically, the SEC rule permits an attorney to disclose confidential information to prevent the client from committing a civil violation of the securities laws that does not rise to the level of a crime.

Disclosures under §205.3(d) (2)(iii) are also problematic for Washington State lawyers, because a material violation by the client which could damage financial interests or property of the client or investors "could include non-criminal conduct which would also be barred from being revealed by RPC 1.6(b)(1)." A much stronger argument, which the Washington State Bar did not make, is that §205.3(d) (iii) applies only when disclosures are necessary to "rectify" the consequences of a client's past material violation of the securities laws, but the Washington State Rules of Professional Conduct never permit a lawyer to disclose a client's past wrongdoing -- even criminal wrongdoing - absent the client's consent.

In light of these differences between the SEC regulations and the Washington State Rules of Professional Conduct, the Washington State Bar concluded:

> It is the opinion of the Board that, to the extent that this SEC regulation authorizes but does not require revelation of client's confidences and secrets, the Washington lawyer cannot reveal such confidences and secrets unless authorized to do so under the Washington RPCs.

Then the Washington State Bar went even further. Taking aim directly at the "good faith" element of § 205.6, which pro- vides that an attorney who "complies in good faith" with the SEC regulations cannot be disciplined or held civilly liable under inconsistent state standards, the Washington State Bar stated:

> As a general matter and with the current lack of case law on the pre-emption issue, a Washington attorney could not fairly claim to be complying in "good faith" with the SEC Regulations, as that term is used in Section 205.6(c) of the Regulations, if (s)he took an action that was contrary to this Formal Opinion.

The Bar based this conclusion on two related factors. First, § 205(d)(2) does not require a lawyer to reveal anything to the SEC even in the circumstances expressly articulated there. Rather, § 205.3(d)(2) provides only that a lawyer "may reveal" confidential information, thus giving a lawyer discretion to determine

whether to make a disclosure or not. Second, the Board took the position that the use of the term "complies" in § 205.6(c) "means that the good faith defense applies only to those provisions which are mandatory in nature and not to discretionary disclosures." In other words, a Washington State attorney "complies" with § 205.3(d)(2) even if the attorney exercises discretion not to disclose. Therefore, if an attorney were to disclose confidential information that the attorney has discretion not to disclose under the SEC rules and is prohibited from disclosing under Washington State's rules, the attorney would not be acting in "good faith" and would not be immune from professional discipline or liability for breach of fiduciary duty, legal malpractice, or other civil wrongs under Washington State law.

However, in an apparent effort not to force the preemption issue too aggressively, the Washington State Bar said that "none of the requirements of the Washington Rules of Professional Conduct conflict with any of the regulations in Section 205 …." In other words, nothing required by the Washington State Rules of Professional Conduct is prohibited under the SEC rules, and nothing prohibited under the SEC rules is required by the Washington State Rules of Professional Conduct. Consequently, the

Washington State Bar opinion reached the following cryptic conclusion:

> Since it is the opinion of the Board of Governors that none of the requirements of the Washington Rules of Professional Conduct conflict with any of the regulations in Section 205, the Board does not at this time reach the question of whether, if there were such a conflict, the SEC laws or regulations would be deemed to have pre-empted the field, such that Section 205 would govern over a Washington RPC to the contrary. Though the Board recognizes the possibility that Section 205 may ultimately be interpreted as preempting Washington law, a cautious attorney should refrain from making any disclosures in violation of the Washington RPCs until this issue is resolved by the courts.

The SEC stakes its claim to preemption

Before the Washington State Bar issued its interim opinion on the SEC rules, it provided an advance copy of the proposed opinion to the SEC and asked for the SEC's reactions. In a July 23, 2003 letter to the President and President-elect of the Washington State Bar, the SEC's General Counsel, Giovanni P. Prezioso, refuted the Washington State Bar's position point by point. For starters, he called it "inconsistent with prevailing Supreme Court precedent" regarding preemption. As examples, Mr. Prezioso cited Sperry v. State of Florida, 373 U.S. 379 (1963), and *Fidelity Federal Savings & Loan Association v. de la Cuesta*, 458 U.S. 141, 155 (1982).

The SEC also argued that federal law would determine whether an attorney had complied in "good faith" with the SEC's rules within the meaning of § 205.6(c). Because the issue whether an attorney has acted in "good faith" under § 205.6(c) requires an interpretation of an SEC rule, "states must defer to the Commission's construction." For this proposition, Mr. Prezioso cited *Barnhart v. Walton,* 535 U.S. 212 (2002), which held that a federal agency's interpretation of regulation must be sustained if based on a permissible construction. Finally, the SEC noted that the purposes of the SEC's "good faith" provision would be frustrated by a state- based definition of "good faith" that is inconsistent with the SEC's interpretation. Thus, a conflicting state definition of "good faith" would be preempted. Here, Mr. Prezioso cited *United States v. Locke,* 529 U.S. 108, 110 (2000), and City of New York v. FCC, 486 U.S. 57, 64 (1989).

I have read the cases cited by the SEC and they support the SEC's position. In particular, they directly contradict the Washington State Bar's position that a permissive federal regulation – one that merely authorizes rather than requires certain conduct – must yield to a state law or regulation that prohibits the same conduct. The cases cited by the SEC also undermine the Washington State Bar's effort to define the phrase "good faith" in § 205.6.

In *Sperry*, the petitioner, Alexander Sperry, was a non-lawyer registered to practice before the United States Patent Office. He maintained an office in Tampa, represented Florida clients before the United States Patent Office, rendered opinions as to patentability, and had prepared patent applications and other legal instruments for filing in the United States Patent Office in Washington, D.C. Florida prosecuted him for the unauthorized practice of law, and the Florida Supreme Court concluded that petitioner's conduct constituted the unauthorized practice of law that the State, acting under its police power, could properly prohibit. Moreover, the Florida Supreme Court held that neither federal statute nor the Constitution of the United States could empower any federal body to authorize such conduct.

The United States Supreme Court unanimously held that Florida could not enjoin a nonlawyer registered to practice before the United States Patent Office from preparing and prosecuting patent applications in Florida, even though that activity violated Florida's unauthorized practice laws, because a federal statute and Patent Office regulations authorized nonlawyers to practice before the Patent Office. The federal statute in question provided that the U.S. Patent Commissioner (subject to the approval of the Secretary of Commerce) "may prescribe regulations governing the recognition and conduct of agents, attorneys, or other persons representing applicants or other parties before the Patent Office …" The statute thus expressly permitted the Commissioner to permit (though, of course, not require) non- lawyers to practice before the Patent Office. The Supreme Court understood that Florida prohibited nonlawyers from engaging in these activities, but – hearkening back to Chief Justice Marshall's landmark opinion in *Gibbons v. Ogden,* 9 Wheat. 1 (1824) – the Court said "'the law of the State, though enacted in the exercise of powers not controverted, must yield' when incompatible with federal legislation." Florida, citing the Tenth Amendment, argued that the Supreme Court must read into any federal authorization "the condition that such practice not be inconsistent with state law," but the Court found this argument "singularly without merit." Moreover, in a phrase particularly relevant to an analysis of state Rules of Professional Conduct adopted by a state's highest courts rather than by the state legislature, the Supreme Court added: "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." The Sperry case thus makes clear that state rules regulating the practice of law may be preempted like other state laws and rules.

In *Fidelity Federal,* the second case cited by Mr. Prezioso, the federal regulation at issue had been promulgated pursuant to § 5(a) of the Home Owners' Loan Act of 1933 ("HOLA"), which empowered the Federal Home Loan Bank Board to prescribe regulations governing federal savings and loan associations. Pursuant to this authorization, the Board issued a regulation providing that a federal savings and loan association had power to include in its loan instruments — "at its option" — a "due-on-sale" clause, i.e., a provision that permitted the association to declare the entire balance of the loan immediately due and payable if the property securing the loan was sold or transferred without the association's prior written consent. A preamble to the regulation stated – similar to the preamble in § 205.1 of the new SEC Standards of Conduct for Attorneys – that the due-on-sale practices of federal savings and loan

associations shall be governed "exclusively by Federal law" and that the association "shall not be bound by or subject to any conflicting State law which imposes different… due-on-sale requirements."

California challenged the federal due-on-sale regulation, arguing that it violated California law limiting a lender 's right to exercise a due-on-sale clause to cases where the lender demonstrated that the borrower's transfer of the property has impaired its security. But the United States Supreme Court, invoking general principles governing preemption of state law, held that in conflicts with federal law, state law did not triumph over federal law simply because real property was a matter of special concern to the States. Moreover, the Court said, federal regulations "have no less pre-emptive effect than federal statutes." Where Congress has directed an administrator to exercise discretion, the administrator's judgments are subject to judicial review only to determine whether the regulator "has exceeded his statutory authority or acted arbitrarily." Finally, and most pertinent to the clash between the SEC and the Washington State Bar, the Supreme Court held that the conflict between state and federal regulation did not evaporate because the federal regulation "simply permits, but does not compel," the conduct at issue. By limiting the availability of an option the Board considered essential to the economic soundness of the thrift industry, the State had created "an obstacle to the accomplishment and execution of the full purposes and objectives" of the federal regulation. Accordingly, the Court concluded that conclude that the federal regulation "was meant to pre-empt conflicting state limitations …." First Federal thus shows that a mandatory state rule cannot trump an optional federal regulation if the state rule would hinder the federal regulation from achieving its objectives.

In Barnhart v. Walton, decided by the Supreme Court only last year, the Supreme Court held that if a federal statute is "silent or ambiguous" with respect to a specific issue covered by a federal agency's regulation, the Court must sustain the Agency's regulatory interpretation of the statute if it is "based on a permissible construction" of the Act. The Court rejected the Fourth Circuit's "linguistic reason" for holding that the federal agency's interpretation was impermissible. In my view, the SEC's new rules are a permissible construction of § 307 of the Sarbanes-Oxley Act of 2002, which expressly commanded the SEC to issue rules "in the public interest and for the protection of investors …." Barnhart is not a preemption case, but it explains the burden that Washington State would have to meet to show that the SEC's new rules are invalid, and I do not think the State can meet that burden.

In *United States v. Locke,* the Supreme Court struck down Washington State regulations governing remedies required in the event of an oil spill that were more stringent than federal regulations on the same subject. Stating that federal agency acting within the scope of its congressionally delegated authority "may pre-empt state regulation" and thus render inconsistent state or local laws unenforceable, the Supreme Court held that Washington State's more stringent regulations were pre-empted. Thus, the fact that Washington State's legal ethics rules protect client confidences and secrets more stringently than the SEC's new rules does not inoculate them against preemption.

Finally, and of particular interest to New Yorkers, in *City of New York v. F.C.C.,* cable television franchisors challenged F.C.C. regulations establishing technical standards to govern the quality of cable television signals. The United States Supreme Court held that the FCC had not exceeded its statutory authority by preempting state and local technical standards governing the quality of cable television signals. "The statutorily authorized regulations of an agency," the Court said, "will pre-empt any state or local law that conflicts with such regulations or frustrates the purposes thereof." If the regulations in § 205.3(d)(2) are authorized by the Sarbanes-Oxley Act, then they preempt any state ethics rules that

contradict or frustrate them, as Rule 1.6(b) of the Washington State Rules of Professional Conduct surely does.

Conclusion: New York lawyers may follow the SEC rules

I am a legal ethics scholar, not a constitutional law scholar. Perhaps the SEC misrepresented or misconstrued the law of preemption. But the Washington State Bar's interim ethics opinion did not take issue with the SEC's interpretation of preemption law. In fact, the Washington State Bar's opinion did not cite a single preemption case, or make any attempt to analyze preemption doctrine. Nor did the Washington State Bar's opinion attempt to show that the new SEC regulations are beyond the statutory authority of the SEC, or are unreasonable interpretations of the Sarbanes-Oxley Act. Perhaps that is just as well, since the Washington State Bar, like the New York State Bar Association, has no authority to issue ethics opinions that decide questions of law. But the opinion has thrown a monkey wrench into the SEC's efforts to restore public trust in the securities markets and to prevent or rectify fraud by companies that issue securities. The opinion essentially threatens any Washington State lawyer with discipline if the lawyer exercises the authority conferred by the new SEC regulations and those regulations are later found not to preempt the Washington State Rules of Professional Conduct regarding confidentiality. That puts lawyers and investors in an unfair position, because the preemption question may take many months (or years) to decide. If the Washington State Bar believes the new SEC regulations are invalid and therefore do not preempt Washington State's ethics rules, the Bar should bring a declaratory judgment action. If the Bar has no basis for believing that the regulations are invalid, it had no business issuing an "ethics opinion" designed to scare Washington State lawyers into ignoring the SEC regulations whenever they grant more discretion than Washington State Rule 1.6(b).

As for New York lawyers, I will go out on a limb. No New York-based ethics committee has issued an opinion like the one issued by the Washington State Bar. Unless the SEC has seriously distorted the law of preemption, the opinion of the Washington State Bar is far off base and essentially meritless. New York lawyers may choose for their own professional reasons not to report client wrongdoing to the SEC in circumstances authorized by §205.3(d) (2) of the new SEC regulations, but fear of professional discipline should not figure into that calculation. Unless and until a federal court declares the SEC regulations invalid or holds that they do not preempt DR 4-101 of the New York Code of Professional Responsibility for other reasons – and I doubt that will happen – New York lawyers should completely discount the Washington State Bar's opinion and feel free to exercise the discretion afforded by §205.3(d) (2) in appropriate circumstances.

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