

HIDDEN STORMS FOR THOSE IN SAFE HARBORS: THE SEC'S PROFESSIONAL CONDUCT RULES AND THE FEDERAL PREEMPTION DOCTRINE

As chief legal officer, you have decreed that every lawyer in your department and all of your outside counsel—whether or not they are covered by § 205 of the regulations promulgated by the U.S. Securities and Exchange Commission (“SEC”) governing the conduct of counsel appearing and practicing before the SEC—will abide by the substantive standards of § 205. This requirement goes beyond what is required by law and will look great to the world. “Pardon me,” says your law intern, “but how can you implement such a requirement if § 205 differs from the state ethics rules?” “No problem,” you reply, “the SEC has adopted a ‘safe harbor’ rule that protects lawyers who comply with the SEC standards.” “Pardon me again,” she says, “but that safe harbor applies only to those who comply in good faith with § 205. Many of the attorneys are not complying with § 205 because it simply does not apply to them. They are complying with your directive to keep their jobs.” Hmmm. Does she have a point here?

By John K. Villa

Author of *Corporate Counsel Guidelines*, published by ACC and West



John K. Villa is a partner with Williams & Connolly LLP in Washington, DC. He specializes in corporate litigation (civil and criminal) involving financial services, directors', officers', and lawyers' liabilities, securities, and related issues. He is an adjunct professor at Georgetown Law School and a regular lecturer for ACC. He is also the author of *Corporate Counsel Guidelines*, published by ACC and West. He is available at JVilla@wc.com.

Yes, she does. Considerable confusion exists over the reach of the SEC's § 205, its new Standards of Professional Conduct for Attorneys appearing before the Commission. Although many inside lawyers are clearly “appearing and practicing before the Commission” in the representation of an issuer, some fall in the gray zone where the regulation's applicability is debatable or are clearly not covered. Some companies have “solved” these interpretive questions by proclaiming that all of

their in-house lawyers will follow the procedures of § 205 whether or not those lawyers are actually “appearing and practicing before the Commission.” Some companies have also informed all outside counsel that all lawyers in the law firms are expected to comply with the standards in § 205 whether or not those standards are in fact applicable. Is this requirement wise? Is it even ethical?

To highlight the issue more pointedly, could a company with its offices in, say,

New York, properly instruct all of its in-house and outside lawyers that they must conform to the ethics standards of Ohio or Germany because corporate management believed it to be good corporate policy? What if the ethics rules of Ohio or Germany permitted conduct that was prohibited by New York or vice versa? The company's lawyers would obviously face serious problems because, of course, lawyers cannot arbitrarily choose the ethics rules that govern their conduct. Model Rule 8.5 governs the choice of law provisions for the ethical rules.

This analogy becomes important in considering whether a company can decide to impose upon its lawyers—both in-house and outside—the substantive standard of the SEC's § 205 even if the lawyers are not “appearing and practicing before the Commission.” If by doing so the company authorizes the lawyer to engage in conduct that would be prohibited under the otherwise applicable state ethics rules, such as disclosing confidential information, would the lawyer's compliance with federal law protect the lawyer from state disciplinary action? For the lawyer “covered” by § 205, most practitioners would point to § 205.6(c), which provides the lawyer a “safe harbor” and federal preemption. But does that “safe harbor” apply to the lawyer who voluntarily chooses to follow the standards in § 205? This problem presents two issues: the scope of the preemption doctrine and the protection provided by the SEC's “safe harbor” for those who voluntarily comply with § 205 but are not required to do so.

PREEMPTION

The SEC's rules differ from the ethical standards of the Model Rules. Although commentators have stated that the SEC's rules control under the

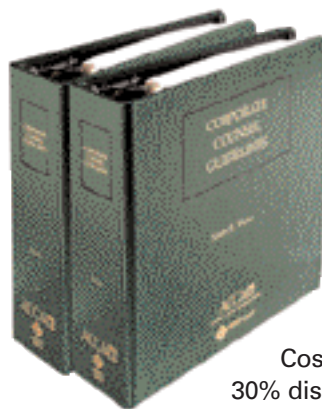
federal preemption doctrine,¹ several state bar associations have opined that the SEC's regulations do not supersede a lawyer's obligations under applicable state rules.² Noting the absence of case law addressing this precise issue, the Washington State Bar Association, for example, has even advised its lawyers in a recent ethics opinion³ to abide by state ethical rules prohibiting certain disclosures of confidential client information, even though such a disclosure may be authorized by the SEC.⁴ Failure to do so, the opinion cautions, will subject the lawyer to state disciplinary action, notwithstanding the “good faith” protection afforded by the SEC regulations.⁵

How will this debate be resolved? Does the law support federal preemption of what traditionally has been a matter entrusted to state regulation?

Back to Con Law 101 to review the preemption doctrine. The doctrine of

federal preemption, derived from the Supremacy Clause of the U.S. Constitution,⁶ provides that federal statutes supersede state statutes that interfere with or are contrary to the federal law.⁷ In determining whether a federal statute preempts a state statute, the courts look to the intent of Congress,⁸ which may be either express or implied from the purpose of the statute, and to the extent to which the federal government regulates or has an interest in the subject of the statute.⁹ In the case of a field traditionally occupied by the states, such intent must be clear and manifest in order to defeat the assumption that the historic police powers of the states are not to be superseded by federal law.¹⁰ In cases in which the federal government and the states share concurrent authority within a particular field, a federal statute displaces state law in the event of a conflict between the laws, which occurs, as

Do Not Miss John K. Villa's
Corporate Counsel Guidelines
published by ACC and West



In this post-Enron environment, you need the best ethics guidance that you can get. Here it is. *Corporate Counsel Guidelines* is a two-volume treatise written expressly for in-house counsel. This treatise tackles the most common issues facing corporate counsel, even those issues that have no guiding precedent or ethics opinions.

Cost: \$220, and ACC members receive a 30% discount. To order, contact West at 800.344.5009 or at www.westgroup.com.

construed by the courts, when compliance with both statutes is impossible¹¹ or when state law “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”¹²

Federal regulations have the same preemptive effect as federal statutes.¹³ When authorized by statute,¹⁴ the regulations of a federal agency “will preempt any state or local law that conflicts with such regulations or frustrates the purposes thereof.”¹⁵ Surprisingly, express congressional authorization to preempt state law is not required; rather, in determining the question of a regulation’s preemptive effect, the inquiry is twofold: (1) whether the agency intended to preempt state law and (2) whether its action falls within the scope of its delegated authority.¹⁶

The SEC’s new § 205 rules do not fit comfortably into this analysis. True, federal agency regulations governing the qualifications and conduct of attorneys who practice before the agency are not new.¹⁷ Also, their preemptive effect on inconsistent state laws has generally been upheld by the courts when promulgated pursuant to the authority granted by statute.¹⁸

But the SEC’s standards of professional conduct are clearly distinguishable from agency regulations prescribing the qualifications of those who may practice before the agency and the rules of practice within such agency.¹⁹ These rules seek not to maintain the qualifications of lawyers but to reposition the lawyer in the corporate governance structure of the American corporation. Yet under the principles discussed above for determining the preemptive effect of federal regulations, the SEC rules could be found to preempt inconsistent state rules of professional conduct.²⁰ First, the intent to preempt conflicting state standards is set forth in the regulation itself.²¹ Second, the authority to prom-

ulgate minimum standards of conduct is expressly provided by § 307 of the Sarbanes-Oxley Act.²²

Another factor that may support a finding of preemption is the federal government’s pervasive regulation of and interest in the securities industry.²³ See, for example, *Mayo v. Dean Witter Reynolds, Inc.*²⁴

Perhaps the larger question, however, is whether preemption is a significant issue.²⁵ Is there really a great divergence between the SEC’s standards and the rules of professional conduct as adopted by the states? There are pronounced differences in the “up-the-ladder” reporting requirement of the SEC rules and the corresponding requirement in Model Rule 1.13.²⁶ The SEC rule authorizing, but not compelling, disclosures outside of the organization in order to prevent or rectify the consequences of a material violation that is likely to cause substantial financial injury²⁷ is similar to the recently amended Model Rule 1.6, as well as the ethical rules in most jurisdictions that also authorize disclosures of confidential client information under similar circumstances.²⁸ Yet other jurisdictions have more “conservative” rules. In short, the answer is “yes,” there are material differences between § 205 and the ethics rules of many states.

SAFE HARBOR

Although many jurisdictions have adopted or will adopt ethical rules governing the disclosure of confidential information that are similar to the § 205 rules, there are still several jurisdictions with significantly different rules governing this issue. Recognizing that compliance with § 205 in those jurisdictions with different rules may subject counsel to disciplinary action under state law, the SEC has included a

safe harbor provision in its rules that purportedly protects against such adverse state action. Section 6(c) of the SEC rules provides, among other things:

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.”²⁹

Can this provision effectively insulate counsel from liability under state law? At least one state bar has answered this question with a definitive “no.”

As construed by the Washington State Bar Association, the good faith defense set forth in the safe harbor provision applies only to disclosures that are mandatory under the SEC rules—not to those that are discretionary in nature, such as those set forth in § 205.3(d)(2).³⁰ The opinion therefore cautions that an attorney who voluntarily makes a disclosure of confidential information in contravention of the Washington Rules of Professional Conduct (“RPC”) “cannot as a defense against an RPC violation fairly claim to be complying in good faith with the SEC Regulations.”³¹ The SEC, of course, disputes this characterization of what constitutes good faith under the safe harbor provision, stating that federal law will determine whether there has been good faith compliance with the SEC rules.³²

If the Washington State rule prevails, then there is little doubt that a lawyer who voluntarily adopts the entire § 205 framework would have difficulty fitting within a safe harbor.

And that’s the rule. Your legal intern was right.

What is the right call? There is no clear answer.

What we can say thus far is as follows:

- You must decide whether it is really necessary to decree that all lawyers working for the corporation subscribe to § 205. In many instances, it is not.
- If you choose to decree that all lawyers abide by § 205, then you should also advise them that, if they have an occasion to apply § 205 and it is not absolutely clear that they are covered by § 205 (by appearing and practicing before the SEC), then they should at least review the state ethics rules. If there is any hint of a conflict between the two rules, the company should provide them access to ethics resources, such as a law professor or an ethics lawyer, to help them sort this question out. ■

NOTES

1. See Jeffrey W. Stempel, *The Sarbanes-Oxley Act: Lawyer Professional Responsibility, and a Heightened Role for Business Lawyers*, 11 NEV. LAW. 8 (Mar. 2005); Symposium, *The Evolving Legal and Ethical Role of the Corporate Attorney after the Sarbanes-Oxley Act of 2002*, 52 AM. U. L. REV. 655, 689 (Feb. 2003).
2. Wash. State Bar Ass'n, Interim Formal Ethics Op. (July 26, 2003). A section of the State Bar of California has also questioned whether the SEC has the authority to adopt these rules, particularly those relating to permissive disclosures to the SEC, and whether these rules preempt state laws and rules. See Letter of the Corporations Committee of the Business Law Section of the State Bar of California to the General Counsel of the SEC, dated Aug. 13, 2003.
3. Wash. State Bar Ass'n, Interim Formal Ethics Op., *supra* note 2.
4. *Id.* at 1, 5.
5. *Id.* at 1, 6–7. See, *infra*, for a discussion of the safe harbor provision of § 205.6(c) of the SEC's professional conduct rules.
6. U.S. Const. art. 6, cl. 2.
7. See *Gibbons v. Ogden*, 9 Wheat 1, 211, 22 U.S. 1 (1824). In cases in which federal power is exclusive, of course, the issue of preemption does not arise. Exclusive federal power exists in cases in which (1) the power is lodged exclusively in the Constitution, (2) it is given to the United States and prohibited to the states, and (3) it must necessarily be exercised by the federal government based on the nature and subject of the power. *Gilman v. City of Philadelphia*, 70 U.S. 713, 730 (1865).
8. *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 152 (1982); *New York Tel. Co. v. New York State Dep't of Labor*, 440 U.S. 519, 540 (1979).
9. *de la Cuesta*, 458 U.S. at 153. "[C]ongress' intent to supersede state law altogether may be inferred because '[t]he 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,' because 'the Act of Congress may touch a field 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,' or because 'the object sought to be obtained by federal law and the character of obligations imposed by it may reveal the same purpose.'" *Id.* (quoting, in part, *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)).
10. *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947); *Napier v. Atlantic Coast Line R. Co.*, 272 U.S. 605, 611 (1926).
11. *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142–143 (1963).
12. *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).
13. *de la Cuesta*, 458 U.S. at 153; see *Hillsborough County, Fla. v. Automated Medical Labs., Inc.*, 471 U.S. 707, 713 (1985) (noting that the Court has "held repeatedly that state laws can be preempted by federal regulations as well as by federal statutes").
14. "An agency's promulgation of rules without valid statutory authority implicates core notions of the separation of powers, and [the courts] are required by Congress to set these regulations aside." *United States ex rel. O'Keefe v. McDonnell Douglas Corp.*, 132 F.3d 1252, 1257 (8th Cir. 1998).
15. *City of New York v. F.C.C.*, 486 U.S. 57, 64 (1988).
16. *de la Cuesta*, 458 U.S. at 154.
17. See, e.g., 12 C.F.R. §§ 513.1 *et seq.* (Office of Thrift Supervision); 31 C.F.R. §§ 10.0 *et seq.* (Internal Revenue Service); see generally Thomas Lee Hazen, *Administrative Law Controls on Attorney Practice: A Look at the Securities and Exchange Commission's Lawyer Conduct Rules*, 55 ADMIN. L. REV. 323, 338 (Spring 2003) (discussing the various federal agency regulations governing the practice of law before the agency).
18. See *Sperry v. Florida*, 373 U.S. 379 (1963) (involving regulations governing the right to practice before the U.S. Patent and Trademark Office); *Silverman v. State Bar of Texas*, 405 F.2d 410 (5th Cir. 1968) (same). In *Sperry v. Florida*, for example, the U.S. Supreme Court held that the State of Florida could not enjoin a nonlawyer from preparing and prosecuting patent applications before the Patent Office, even though such conduct constituted the unauthorized practice of law under Florida law. Although noting that "the State maintains control over the practice of law within its borders," the Court recognized that the state's authority in this area must give way to federal authority "to the limited extent necessary for the accomplishment of the federal objectives." Because Congress had the power to regulate patent rights and the regulation at issue was adopted pursuant to a federal statute expressly permitting the promulgation of rules of practice before the federal tribunal, the Court held that Florida could not interfere with the petitioner's right to practice before the Patent Office.
19. See Hazen, *supra* note 17, at 338 (noting that the SEC's professional conduct rules represent a change in focus—that is, "a shift from the integrity of the administrative process to investor protection[.]"); cf. E. Norman Veasey, *Issues of Federalism in Light of the SEC Final Rules under Section 307 of the Sarbanes-Oxley Act*, 14 PROF. LAW. 26 (Fall 2002) (suggesting that the SEC rules "may not be ethics rules in the traditional sense" but "may more clearly be seen as organic law, external to lawyer ethics rules. These SEC rules constitute the applicable law regulating lawyers' conduct in a limited area of practice regulation before a federal agency, much like the practice rules of the

-
- Internal Revenue Service or the Patent and Trademark Office.”).
20. See Stempel, *supra* note 1, at 8 (noting that “[w]ithin its sphere of authority, Sarbanes-Oxley probably controls by benefit of federal preemption doctrine”).
21. See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6320, codified at 17 C.F.R. § 205.1 (“Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflicts with this part, this part shall govern.”).
22. Pub. L. No. 107-204, Title III, 116 Stat. 745, 784 (2002).
23. See Veasey, *supra* note 19, at 26 (noting that the rules could be regarded as organic law pertaining to securities enforcement, which “properly belongs in SEC”); see generally Roger C. Crampton, *Enron and the Corporate Lawyer: A Primer in Legal and Ethical Issues*, 58 BUS. LAW. 143, 181 (Nov. 2002) (noting the federal government’s “strong interest in assuring the integrity of the securities’ market and the role of accountants and attorneys”).
24. 258 F. Supp. 2d 1097 (N.D. Cal. 2003).
25. See Stempel, *supra* note 1, at 8 (questioning whether the Sarbanes-Oxley rules constitute merely a “tempest in a teapot,” rather than “the road to preemption”); see also Veasey, *supra* note 19, at 26 (noting that, with the adoption of the final rules, which are less sweeping than the proposed rules, he is less concerned that the SEC intends to undertake a “wide-ranging ethics regime”).
26. See *Final Report of the ABA Task Force on Corporate Responsibility* at 43–45 (Mar. 2003) (noting that the SEC rules are more rigid with respect to the reporting up requirement and the exercise of the lawyer’s professional judgment as to the need to do so).
27. *Implementation of Standards of Professional Conduct for Attorneys*, 68 Fed. Reg. at 6323, codified at 17 C.F.R. § 205.3(d)(2).
28. See *Final Report of the ABA Task Force on Corporate Responsibility*, *supra* note 26, at 49–50, n. 89.
29. 68 Fed. Reg. 6295, 6323 (Feb. 6, 2003), codified at 17 C.F.R. § 205.6(c). This provision was not included in the proposed rule, but was added in response to suggestions submitted by several of the commentators. See *id.* at 6314.
30. Wash. State Bar Ass’n, Interim Formal Ethics Op., *supra* note 2, at 7 (explaining that this interpretation is based on the use of the term “complies” in the safe harbor provision).
31. *Id.*
32. See Public Statement by Giovanni P. Prezioso, General Counsel, SEC: Letter Regarding Washington State Bar Association’s Proposed Opinion on the Effect of the SEC’s Attorney Conduct Rules (July 23, 2003).
-