

**LAWYER CONDUCT RULES UNDER
SARBANES-OXLEY & STATE BARS:
CONFLICTS TO NAVIGATE?**

by

G. Thomas Stromberg, Jr.

Anna R. Popov

Winston & Strawn LLP

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ABOUT THE AUTHOR

G. Thomas Stromberg, Jr. is a corporate partner in Winston & Strawn's Los Angeles and San Francisco offices and concentrates his practice in mergers and acquisitions, private equity, joint ventures, corporate finance transactions, and Sarbanes-Oxley compliance. Mr. Stromberg's mergers and acquisitions and joint venture experience includes transactions in a broad range of industries, including life sciences, information technology, telecommunications, chemical, manufacturing, business services, agribusiness, retail and alternative fuels.

Anna R. Popov is a corporate associate in Winston & Strawn's Los Angeles office and concentrates in mergers and acquisitions, corporate finance and general corporate matters.

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INTRODUCTION

The attorney-client privilege and the duty of client confidentiality are long-standing principles of the legal profession. But following the corporate scandals of Enron and WorldCom, Congress set out to change the traditional attorney-client relationship in an attempt to reassure investors and restore the public's faith in the capital markets.

This WORKING PAPER will discuss the conflict between the new Securities and Exchange Commission (SEC) rules enacted pursuant to the Sarbanes-Oxley Act and certain state bar authority requirements which prohibit attorneys from reporting violations outside the company. The paper will begin by discussing SEC Rule 205, including "up-the-ladder" reporting requirements and the noisy withdrawal proposals. Section II will address the amended Model Rules 1.6 and 1.13 and compare them with the Rule 205 requirements. The next two sections will compare California's ethical obligations with Rule 205 and address the SEC's assertion of federal

preemption and the good faith defense. Finally, the paper will conclude by offering suggestions on how counsel can navigate between the new federal regulations and the states' long-standing ethical obligations.

I. RULE 205 REQUIREMENTS

In the summer of 2002, Congress adopted Section 307 of the Sarbanes-Oxley Act (15 U.S.C. § 7245) mandating that the SEC issue rules governing the conduct of lawyers representing public companies. The SEC responded with Rule 205 (17 C.F.R. Part 205) which established “up-the-ladder” reporting requirements for attorneys representing public companies.

SEC Rule 205 requires covered attorneys (both in-house and outside counsel) who become aware of “credible evidence of an issuer’s material violation” of securities law, a breach of a fiduciary duty, or any “similar violation” to report such evidence “up-the-ladder” within the issuer until an “appropriate response” is made.¹

Shortly after issuing Rule 205, the SEC proposed a “noisy withdrawal” provision² requiring attorneys who do not receive an appropriate response

¹See 17 C.F.R. § 205.3(b), available at <http://www.sec.gov/rules/final/33-8185.htm>.

²Text of the original and alternative noisy withdrawal proposals can be found at Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8186, 34-47282, Part III.B.–C., available at http://www.sec.gov/rules/proposed/33-8186.htm#P25_3653.

to withdraw from representation and notify the SEC of their withdrawal or disavow any tainted documents filed with the SEC. In particular, outside attorneys who reasonably believe that a violation is ongoing or about to occur would be required to withdraw from representation, notify the SEC of their withdrawal, and promptly disaffirm any filings made to the SEC that the attorney reasonably believes may be materially false or misleading.³ Although in-house counsel would not need to resign, they would still be required to disaffirm any filed documents.⁴ Noisy withdrawal would be permitted, but not mandated, if a violation has already occurred and has no ongoing impact.

The original proposal spawned such controversy and commentary from the legal community that it has yet to be adopted. Commentators, including state bar associations and several law firms, argued that Sarbanes-Oxley only required up-the-ladder reporting and did not authorize the enactment of a noisy withdrawal provision. Furthermore, practicing attorneys were shocked that the proposal would require attorneys to notify the Commission of otherwise privileged information in violation of traditional rules governing client confidentiality.⁵ As a result, the SEC

³See Felman, David S., *Final (Almost) Attorneys' Reporting Requirements Under Section 307 of the Sarbanes-Oxley Act of 2002*, 16 (SEC Hot Topics Institute Fall 2003) (Oct. 21, 2003) available at <http://www.legalwks.com/conferences/handouts/secatlanta/felman.doc>.

⁴See *id.*

proposed an alternative “noisy withdrawal” provision.

The alternative proposal was drafted to avoid (albeit unsuccessfully⁶) the state law conflicts raised in the initial proposal by placing the burden of notification on the client corporation.⁷ Instead of requiring the attorney to notify the SEC of the withdrawal, the alternative proposal only required an attorney to report within the organizational client. More specifically, an attorney who “reasonably concludes” that there still exists a material violation of the securities laws after having reported up-the-ladder would be required to cease participation in the matter and immediately notify the issuer in writing that he has not received an “appropriate response.” Within two days of the attorney’s notification, the *issuer* would be required to disclose to the SEC in a Form 8-K, Form 20-F, or Form 40-F that it received notice of a failure to receive an appropriate response. Although the attorney would also be permitted to disclose the information to the SEC, in the alternative proposal, the attorney would *not be required* to disclose the violation to the SEC.⁸ The SEC has yet to adopt either noisy withdrawal

⁵*See id.*

⁶The alternative noisy withdrawal proposal merely shifts the duty of disclosure from the attorney to the client (ie. the issuer). This does nothing to solve the client confidentiality problem because client confidentiality rules and the attorney-client privilege is breached regardless whether the confidential information is procured from the attorney or the client.

⁷JOHN T. BOSTELMAN, *THE SARBANES-OXLEY DESKBOOK* § 18:13.2 (1st ed. 2003).

⁸*See id.*

proposal.

II. THE MODEL RULES

When the SEC adopted the up-the-ladder reporting rules, it postponed adopting any noisy withdrawal requirements primarily because it wanted the American Bar Association (ABA) to amend Model Rules 1.6 and 1.13 to permit attorneys to report violations publicly. In April 2003, a special ABA commission issued the Cheek Report in which it proposed to amend Model Rule 1.6 (Client Confidentiality) and Rule 1.13 (Entity Clients).⁹ The amendments were approved by the ABA House of Delegates in August 2003.

A. Model Rule 1.6

As modified by the ABA, Model Rule 1.6 now permits attorneys to report evidence of a client corporation's ongoing or future financial fraud if the fraud is "reasonably certain" to result in "substantial injury" to the financial interest of another, and if the lawyer's services have been used by the client in the commission of such a fraud.¹⁰ On the other hand, SEC Rule

⁹See Report of the American Bar Association Task Force on Corporate Responsibility (Mar. 31, 2003) at <http://www.acca.com/public/policy/corpresp/aba.pdf>.

¹⁰See MODEL RULES OF PROF'L CONDUCT R. 1.6 and cmt. 7. The relevant parts of Model Rule 1.6 as amended now read (2003 amendments italicized):

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm

205.3(d) authorizes an attorney to reveal to the SEC — without the client’s consent — confidential information related to the representation to the extent the attorney reasonably believes necessary:

- (i) To prevent the [client] from committing a material violation that is *likely* to cause substantial injury to the financial interest or property of the [client] or investors;
- (ii) To prevent the [client], in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. § 1622; 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 [client] that caused, or may cause substantial injury to the financial interest or property of the [client] or investors in the furtherance of which the attorney’s services were used.¹¹

Compared with Rule 205.3(d), the SEC rule is much broader and requires disclosure more often than Model Rule 1.6. Under Model Rule 1.6, a lawyer is permitted to disclose the fraud only if the fraud is “reasonably certain” to result in substantial injury to the financial interests of another. SEC Rule 205, on the other hand, permits an attorney to disclose the fraud even when the attorney only believes it is “likely” to cause substantial

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another in furtherance of which the client has used or is using the lawyer’s services

(3) to prevent, mitigate, or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client’s commission of a crime or fraud in furtherance of which the client has used the lawyer’s services

¹¹⁷ C.F.R. § 205.3(d) (emphasis added), available at <http://www.sec.gov/rules/final/33-8185.htm>.

financial injury.

Although these differing standards appear trivial in print, they may in fact cause an ethical problem for some attorneys. SEC Rule 205 uses a “reasonably likely” standard in Rule 205.2(e) for the credible evidence trigger required to initiate up-the-ladder reporting. The SEC commentary defines “reasonably likely” as more than a mere possibility, but it can be less than a fifty percent chance. This means that under the Model Rule 1.6 standard of “reasonably certain,” an attorney needs to be more than fifty percent certain that financial injury will result from the fraud whereas the SEC rule will require an attorney to report the violation even if the attorney is less than fifty percent certain that a substantial financial injury will result. As a result, if an attorney finds evidence that she believes might cause financial injury, then the SEC would permit disclosure whereas the Model Rules would forbid it. To avoid state disciplinary action, assuming the jurisdiction has adopted the amended Model Rule 1.6, the attorney would need to disregard the SEC’s permitted disclosure and keep the information regarding the possible violation secret.

B. Model Rule 1.13

Model Rule 1.13 was also revised at the recommendation of the Cheek Report. Rule 1.13 is the ABA’s version of an up-the-ladder reporting requirement and instructs lawyers how to respond when a violation is

discovered.¹² The amendments to Model Rule 1.13 include: (a) establishing an objective “reasonable lawyer” standard for determining whether the violation will result in injury to the organization; (b) requiring a lawyer to report “up the ladder” unless he “reasonably believes” that it is not in the organization’s best interests; and (c) requiring a lawyer be discharged because he acted under the rule to inform the “organization’s highest authority.”¹³ Although Model Rule 1.13 was amended to conform with SEC Rule 205, some differences still exist between the two rules.

First, while the SEC rule is mandatory, Model Rule 1.13 is merely permissive.¹⁴ Model Rule 1.13 only requires the attorney to consider the circumstances and determine whether it is “reasonably necessary in the best

¹²Model Rule 1.13(b) as revised reads in relevant part:

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

¹³See Felman, *supra* note 3, at 5.

¹⁴For an in-depth comparison of Model Rule 1.13 and SEC Rule 205 see *Securities Law, Section 307 of the Sarbanes-Oxley Act: Irreconcilable Conflict with the ABA’s Model Rules and the Oklahoma Rules of Professional Conduct*?, 56 OKLA. L. REV. 461 (2003).

interest of the organization” to report the violation to a “higher authority.”¹⁵ If not, then the attorney may choose not to report the violation. Therefore, although it is encouraged, “up-the-ladder” reporting remains an option under Model Rule 1.13 even though it is required by SEC Rule 205.

Furthermore, Model Rule 1.13 only applies when an attorney knows of a violation and the violation *relates to the attorney’s representation* of the client. For example, if a litigator is hired to defend a corporation in an employment discrimination case and during discovery the attorney comes across certain securities documents that have been filed with the SEC that he knows are misleading, under Model Rule 1.13 the attorney is *not* required to report the violation up-the-ladder because he is only retained for purposes of the discrimination case and not as a securities lawyer. In contrast, Rule 205 would mandate the litigator to report such evidence up-the-ladder because Rule 205 requires an attorney to report any information obtained during an attorney-client relationship even if unrelated to his or her representation.

Finally, under Model Rule 1.13, an attorney must “know” of the illegal action as opposed to being “aware of credible evidence” of such a violation

¹⁵See MODEL RULES OF PROF’L CONDUCT R. 1.13, cmt. 4. The comment states that the lawyer should consider the seriousness of the violation and its consequences, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations. Although ordinarily referral to a higher authority would be necessary, in some circumstances, it may be appropriate for the lawyer to ask the constituent to reconsider the matter. However, any measures taken should, to the extent practicable, minimize the risk of revealing information *outside* the organization.

under Rule 205. Model Rule 1.13 establishes a higher evidentiary standard than that imposed by Rule 205. Consider the following example: A young attorney unfamiliar with the intricacies of securities laws comes across an SEC filing that he believes may be misleading but is unsure since he is unfamiliar with the securities laws. Under SEC Rule 205 this attorney is probably “aware of credible evidence of a material violation” and should report the possible violation up-the-ladder. Under Model Rule 1.13, however, because the young attorney does not “know” that it is a violation, but merely suspects that it may be, he is likely *not* required to report the information up-the-ladder.

Although the amended Model Rules have not been adopted by every state bar, an analysis of their recent amendments shows that the SEC rules are much more aggressive in pushing attorneys to disclose possible violations of securities laws both within the corporate client and outside the client entity.

III. STATE BAR ETHICAL REQUIREMENTS – THE CALIFORNIA DILEMMA

The State Bar of California has the most stringent client confidentiality rules of any state. This can put California attorneys’ duties in conflict with SEC Rule 205. Under California law, “it is the duty of an attorney ... (e) to maintain inviolate the confidence, and at every peril to

himself or herself to preserve the secrets, of his or her client.”¹⁶ This has been a statutory duty of California attorneys for over 130 years and was first limited in July 2004 when the California legislature carved out an exception permitting disclosure of confidential information if necessary to prevent death or substantial bodily harm.¹⁷ However, there is no exception which would allow disclosure to prevent financial harm such as in Model Rule 1.6. As a result, although Rule 205.3(d)(2) permits an attorney to reveal confidential information without the issuer’s consent to prevent an issuer from committing a material violation, California law forbids any such disclosures regardless of the amount of injury the non-disclosure may cause the issuer or investors. Due to this conflict, California attorneys choosing to disclose confidential information pursuant to SEC Rule 205 could be subject to disciplinary actions by the state bar and breach of fiduciary duty claims under California law.

Another conflict arises with the up-the-ladder reporting required by SEC Rule 205.3(b)(1). As previously mentioned, Rule 205 requires up-the-ladder reporting for any attorney who becomes aware of evidence of a material violation. California Rule of Professional Conduct 3-600(A), the up-the-ladder equivalent, provides that a lawyer’s duties of confidentiality

¹⁶CAL. BUS. & PROF. CODE § 6068(e).

¹⁷See California State Bar, Corporations Committee of the Business Law Section and Committee on Professional Responsibility and Conduct, *Ethics Alert: The New SEC Attorney Conduct Rules v. California’s Duty of Confidentiality* (2004) available at <http://calbar.ca.gov/calbar/pdfs/SEC-ethics-alert.pdf> [hereinafter *Ethics Alert*].

are owed to the organization as a whole — and not to its constituents. Furthermore, similar to Model Rule 1.13, when a lawyer discovers a possible violation of the law, the lawyer may, but is not required, to take such actions as they appear to be “in the best lawful interests of the organization.”¹⁸ This may include up-the-ladder reporting or other options. However, regardless of which option is chosen, the attorney is required to maintain all client confidences as provided by BUS. & PROF. CODE § 6068(e). This means that if any attorney (whether outside or in-house counsel) reports up-the-ladder and finds that the CEO persists in illegal conduct, the attorney has the right or even the duty to resign but does not have the option to report the violation to an outside authority as the SEC rules would permit.¹⁹

Another conflict may arise when an attorney is representing a subsidiary of a corporation and reasonably believes that the subsidiary is engaged in illegal conduct. Under Rule 205, the attorney would be required to report up-the-ladder within the subsidiary and if no appropriate response is made, up to the parent corporation’s board of directors. Under California law, however, the attorney may owe his duty of confidentiality only to the subsidiary because California recognizes that a duty runs to the organization not its constituents. Therefore, while mandated under Rule 205 to report the possible violation to the parent’s board of directors, under California law

¹⁸CALIFORNIA RULE OF PROFESSIONAL CONDUCT R. 3-600(A).

¹⁹*See Ethics Alert, supra* note 17.

such action may violate Section 6068(e) because the duty is owed to the subsidiary and not the parent.²⁰ Consequently, given California's strict confidentiality rules California attorneys may find it difficult at times to comply with both the SEC rules and the California Rules of Professional Conduct.

IV. RECONCILING SEC RULE 205 AND STATE CONFIDENTIALITY RULES

State bars have been rather vocal in their opposition to SEC Rule 205, arguing that the new federal rules conflict with traditional state ethical regulations. Much of the discussion has focused on the SEC's assertion of federal preemption, which it argues overrides conflicting state rules and its good faith defense rule which provides a safe harbor for attorneys who comply with the SEC rules in violation of their obligations under state law.

A. Federal Preemption

Despite sizable opposition to the SEC's proposed preemption of state ethical laws with Rule 205, the SEC, nonetheless, chose to adopt the preemption policy.²¹ In its Final Rule action, the SEC clarified that although Rule 205 does not preempt more rigorous state ethical obligations,

²⁰*See id.*

²¹17 C.F.R. 205.1 states in relevant 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."

the rules “shall prevail over any conflicting or inconsistent laws of a state.”²²

In essence, this federalizes the SEC rules on client confidentiality, an area that has traditionally been governed exclusively by individual states.

Several state bars have questioned whether Congress intended to extend the SEC’s power to allow it to establish conflicting ethical rules regulating client confidentiality. First, in drafting Section 307 of the Sarbanes-Oxley Act, the Congressional Record shows that the rules’ sponsors, Senators Enzi and Edwards, intended that an attorney only be required to report violations to the corporate client, not to the SEC.²³ Moreover, in adopting the final rules the SEC cited to several statutory provisions²⁴ not one of which showed Congress’s intent to grant the SEC

²²Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8185, 34-47276, Part II (effective date August 5, 2003) *available at* <http://www.sec.gov/rules/final/33-8185.htm>.

²³The Congressional Record show that both sponsors Senators Enzi and Edwards of Section 307 amendment regarding up-the-ladder reporting intended that the attorney only report within the corporation. 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.” 148 Cong. Rec. S6555 (July 10, 2002). Similarly Senator Edwards remarked that “it is my understanding that [Section 307], which places responsibility upon the lawyer for the corporation to report up the ladder, only involves going up within the corporate structure. He doesn’t go outside of the corporate structure There is no obligation to report anything outside the client – the corporation.” 148 Cong. Rec. S6557 (July 10, 2002). *See also* Dechert Submits Comment Letter to SEC on Proposed Rules for Professional Conduct (Dec. 20, 2002), *available at* <http://www.dechert.com/library/Corp%20%20Sec%2012-02%20SA.PDF>.

²⁴Including Sections 3, 307, and 404 of the Sarbanes-Oxley Act; Section 19 of the Securities Act of 1933; Section 3(b), 4(C), 13 and 23 of the Securities Exchange Act of 1934, Section 38 and 39 of the Investment Company Act of 1940, and Section 211 of the Investment Advisers Act of 1940.

broad authority to permit lawyers to disclose confidential information.²⁵ Furthermore, as an administrative agency the SEC does not have the authority to make laws; it has only the “power to adopt regulations to carry into effect the will of Congress as expressed by the statute.”²⁶ Because the Sarbanes-Oxley Act makes no mention of preemption, Congress likely never granted the SEC the power to preempt state ethical laws.

For now it is still unclear whether the SEC’s preemption policy will be enforced by the courts. The California state bar asserts that according to the state’s Constitution, it is not permitted to refuse to enforce its ethics rules on the basis of federal preemption until an order or judgment allowing such action has been affirmed by an appellate court.²⁷ Because no courts have ruled on the preemption issue, California attorneys must continue to abide by the state rules to avoid disciplinary action.

B. Good Faith Defense

In its attempt to buttress its preemption policy, the SEC also adopted the good faith defense which provides a safe harbor for attorneys who, while

²⁵See Letter Re: Public Statement by SEC Official: Letter dated July 23, 2003 Regarding Washington State Bar Association’s Proposed Opinion on the Effect of the SEC’s Attorney Conduct Rules, available at <http://www.ethicsandlawyering.com/Issues/files/CalSeclettertoSEC.pdf> [hereinafter *Washington Letter*].

²⁶See *id.* (citing to *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 134 (1936)).

²⁷See *Washington Letter*, *supra* note 25.

complying with the SEC rules, violate inconsistent state ethical obligations.²⁸ Consider, for example, an attorney licensed in California who reports a client's material violation to the SEC without the client's consent. Although such action violates California confidentiality rules, under the SEC rules the attorney would be free from disciplinary action by the state bar under the good faith defense. However, the California State Bar has warned its attorneys that given the apparent conflict between Rule 205 and California attorneys' fiduciary duties, it is safer for California attorneys not to comply with the SEC's invitation to disclose client confidences.²⁹ Given the lack of case law, it is doubtful that the SEC's good faith defense will be a viable defense for attorneys facing state disciplinary actions, especially in California.

C. Recommendations

For attorneys attempting to determine their ethical obligations given the SEC's new rules and their state ethical obligations, it is important to remember that the SEC's rules have yet to be tested. The SEC's attempt to federalize the client confidentiality rules and its assertion of preemption and the good faith defense have not been analyzed by the courts. But, to avoid

²⁸See 17 C.F.R. 205.6(c), available at <http://www.sec.gov/rules/final/33-8185.htm>. Rule 205.6(c) reads: "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*Ethics Alert*, *supra* note 17.

being the test case, attorneys should fully comply with *mandatory* SEC rules. For the permissive SEC rules,³⁰ especially those requiring outside disclosure of confidential information, attorneys may choose not to comply with these rules when they are in conflict with their state ethical obligations. Furthermore, although reporting confidential information regarding a possible violation may be unethical in California, other states' rules are more lenient and will cause less conflict with the SEC rules. Pennsylvania, for example, allows disclosure of confidential information to prevent the client from committing a crime that would harm the financial interests of another.³¹ Florida mandates disclosure of a client's crime³² and Ohio even mandates disclosing a client's fraud to the persons affected by it.³³ Attorneys practicing in these states may not find a conflict between their state ethics rules and the SEC rules. Therefore, it is recommended that attorneys review their state's ethical codes and the new SEC rules to determine where the conflicts, if any, exist. Where a conflict exists, an attorney should decline the SEC's invitation to reveal confidences.

³⁰Permissive rules include SEC Rule 205.3(d) which provides three instances where an attorney is permitted to report the violation to the SEC and both noisy withdrawal provisions.

³¹See PENNSYLVANIA RULES OF PROFESSIONAL CONDUCT R. 1.6(c)(1).

³²See FLORIDA RULES OF PROFESSIONAL CONDUCT R. 4-1.6(b)(1).

³³See OHIO DISCIPLINARY CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102(B)(1).

CONCLUSION

Despite the initial uproar over the SEC's attorney conduct rules, it seems clear that given the recent corporate scandals, government intrusion into the attorney-client relationship is here to stay. In order to restore the public's confidence, the federal government has found it necessary to regulate the gatekeepers of Corporate America, including attorneys. In its efforts, the SEC has encroached upon the states' long-standing authority to regulate attorney conduct. But this intrusion may not be as substantial as initially thought. Direct conflicts with state ethics rules will primarily arise in states with very strict confidentiality standards such as California. Furthermore, attorneys may opt out of disclosure that SEC has determined is permissible rather than required.