Testimony Concerning the Role of Attorneys in Corporate Governance:
SEC Rules of Professional Conduct

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I am pleased to have the opportunity to testify before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on the role of attorneys in corporate governance, with a focus on the SEC's adopted and proposed rules governing the professional conduct of attorneys representing public companies. These rules are designed to implement Section 307 of the Sarbanes-Oxley Act of 2002.

I personally have devoted a great deal of attention to this subject both in my professional capacity and with responsibility within my law firm for implementation. Until recently, I served as chair of the American Bar Association's Committee on Federal Regulation of Securities, completing my four-year term in August 2003. Thanks in part to Congress, it was, to say the least, an interesting period. I also served as a special advisor to the ABA's Task Force on Corporate Responsibility (known as the Cheek Commission) and as a liaison to the ABA's Task Force on Section 307 of the Sarbanes-Oxley Act of 2002, having a primary role in commenting on the SEC's proposals, which activity continues to this day. However, I do not appear here as a representative of the ABA, but rather in my individual capacity.

With the Sarbanes-Oxley Act, Congress took bold action to restore investor confidence in our economic system and financial markets in the face of unparalleled corporate scandals. This boldness included mandating that the SEC adopt minimum standards of professional conduct for

attorneys for public companies, including a so-called "reporting up" within the organization rule. The SEC acted with equal boldness in adopting its Part 205 rules, which include not only reporting up provisions but also permission for attorneys to report out to the SEC when necessary notwithstanding inconsistent state rules. There were some, including myself, who would have preferred that standards of lawyer conduct not become the subject of federal legal requirements but rather be left primarily to ethics rules. However, that was last year's battle, and the rules that were adopted were sufficiently in line with prevailing state ethics rules and the ABA Model Rules of Professional Conduct that they have gained widespread (even if begrudging) acceptance. Beyond that, the rules have had a clear beneficial impact by refocusing lawyers on their professional responsibilities and on their role in corporate governance, including enhancing client legal compliance.

I would like to address two related subjects: the significant changes that have taken place since (and as a result of) the Sarbanes-Oxley Act and the issues surrounding the SEC's proposals to mandate lawyer withdrawal in certain circumstances and require disclosure of that withdrawal (whether by the company or the lawyer) – so-called "noisy withdrawal." The two subjects are related because the attorney professional conduct rules are best understood and considered in the context of the corporate governance enhancements that have taken place and the need for additional SEC action at this time along the lines of the noisy withdrawal proposals should be evaluated in light of these enhancements.

There have been significant steps taken over the past year and a half to address good corporate governance and ensure legal compliance. These include:

- The rules of the stock exchanges requiring a majority of independent directors and effective committees of independent directors, including the audit committee.

- The recommendations for improved corporate governance from various groups, including the ABA's Task Force on Corporate Responsibility.
- The ABA's approval this past summer of revisions to the Model Rules of Professional Conduct to enhance the lawyer's role in ensuring legal compliance.
- The SEC's reporting up rules, which focus the lawyer's responsibility on the corporation as the client and, as I noted, have found widespread acceptance because they mesh well with prevailing ethics rules.
- The SEC's effort to override inconsistent state rules so as to permit lawyers to report out when appropriate, again substantially consistent with the ethics rules of most states and with the ABA Model Rules (notwithstanding the few dissents which I find unfortunate and shortsighted).
- The significant efforts of law firms and corporate law departments to develop policies and procedures to implement the SEC's rules.
- The commitment of the ABA and other professional groups to educate the legal community on the new rules.

These steps have already had a dramatic impact on the recognition by lawyers of their responsibilities to the corporation as the client acting through its board of directors and on the attitudes of directors, particularly independent directors, regarding their responsibilities to address the corporation's legal compliance, both as a structural matter and as to particular issues. As a result, we have achieved a system in which we can have confidence – lawyers who are vigilant and aware of their responsibility to report up within the organization, to the board if necessary, and independent directors in a position to receive and act on those reports. We should

allow this system, newly put in place, to operate before adopting additional rules, such as the SEC's proposed noisy withdrawal rules, with potentially serious adverse consequences.

Let me identify some of these adverse consequences, but first let me be clear: the concern over the SEC's proposed noisy withdrawal rule is not primarily about protecting lawyers. Rather, it is about clients and their right to effective, independent legal representation, about preserving the core values of our legal system, and about avoiding interfering with the integrity of corporate governance.

Specifically, an SEC rule mandating lawyer withdrawal and the reporting out of that withdrawal has the potential to pit lawyer against the client, thus eroding the client's trust and confidence in its lawyer and interfering with the client's access to effective legal counsel on complex issues when it is needed most. A mandatory rule is different in kind from the permissive reporting out rule that the SEC has adopted because it eliminates the professional judgment allowed by a permissive rule and puts lawyers in the position of having to consider their own interest rather than solely the client's.

Next, the lawyer's misjudgments based on incomplete information or concern over the lawyer's own legal exposure can critically injure the client and its investors. A noisy withdrawal rule is likely to encourage lawyers to prematurely withdraw rather than continue to counsel legal compliance regarding difficult issues. Even worse, because of the serious consequences that would flow from identifying a possible material violation, such a rule might prompt some lawyers to avoid asking the hard questions that enable them to counsel legal compliance.

As importantly, a noisy withdrawal rule would shift decision-making on critical business issues from the directors, who are charged with responsibility to make those decisions in the

interest of the company and its shareholders, to the lawyers, who are not usually in the best position to make those decisions.

In my judgment, there are real risks that we will end up with lawyers who do not want to know and clients who are reluctant to tell, with the result that overall legal compliance will be reduced rather than promoted, and that complex business judgments that should be made by boards will be shifted to lawyers unsuited to make those judgments.

Before taking the risks of these and other adverse consequences, we should be certain that these dramatic changes in client – lawyer relationship and decision-making authority clearly are needed, and we should give the improvements in corporate governance and lawyer professional responsibility rules that have taken place a chance to operate.

In conclusion, I believe that the SEC has taken the proper actions to implement Congress' intent[1], and that these actions, which have been taken seriously by the corporate and legal communities, should be permitted to operate before the Commission decides whether its noisy withdrawal proposals, with their potentially serious adverse consequences, are necessary.

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[1] I note the colloquy on the floor of the Senate regarding Section 307 in which Senator Edwards, responding to Senator Sarbanes' question whether it was correct that a lawyer doesn't go outside the corporate structure, stated: "Mr. President, my response to the question is 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. There is no obligation to report anything outside the client – the corporation." *See* 148 Cong. Rec. §6557 (July 10, 2002). Similarly, Senator Enzi commented: "The [Edwards] amendment. . .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." *See* 148 Cong. Rec. §6555 (July 10, 2002).