Attorney Responsibility and Carter under SEC Rule 2(e): The Powers That Be and teh Fear of the Flock

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COMMENTS

ATTORNEY RESPONSIBILITY AND CARTER UNDER SEC RULE 2(e): THE POWERS THAT BE AND THE FEAR OF THE FLOCK

by William Kenneth C. Dippel

All of these [regulatory] measures, of course, merely check or control rather than cure a fundamental condition which underlies the whole problem. That condition has been reflected by the amazing absence of social consciousness on the part of directors and business executives and by their lack of any awareness of the implications and results of many practices which flourished in recent years. It has not been so much a matter of depravity and of evil intent as the consequence of cutting as close to the mythical legal line as possible. This lack of social mindedness has not been wholly or largely that of business. It has been equally shared by lawyers.¹

In February 1981 the Securities and Exchange Commission (SEC) issued a prospective ruling defining what it considered to be unprofessional and unethical conduct for which the Commission can discipline and suspend the practicing attorney from appearance before the SEC.²

The ruling opened a floodgate of criticism and comment, primarily because of the ruling’s prospectivity and its apparently broad scope.³ The SEC ruled that an attorney engages in improper professional conduct when, in the discharge of significant responsibilities as to corporate compliance with security disclosure requirements, he becomes aware of noncompliance and fails to take prompt steps to terminate the noncompliance.⁴ The SEC subsequently requested comment on the ruling in order to refine its regulation of security attorney ethical conduct.

¹. Douglas, Directors Who Do Not Direct, 47 Harv. L. Rev. 1305, 1328-29 (1934). Similar theories were argued virtually simultaneously in Mr. Justice Stone’s famous address delivered at the University of Michigan Law Quadrangle dedication. Stone, The Public Influence of the Bar, 48 Harv. L. Rev. 1, 6-7 (1934).
The ruling sparked controversy over both the SEC's power to promulgate ethical conduct regulations and the manner in which this ruling proposed to discipline under the preexisting authority of SEC Rule 2(e). This Comment examines the history and application of SEC Rule 2(e), the Commission's power to adopt its own standards of ethical conduct, and the effects of recent Commission decisions concerning attorney responsibility under SEC Rule 2(e). This Comment then proposes clarifications to the prospective ruling of In re Carter, a decision that supports SEC authority, vis-a-vis the authority of state bar associations, to regulate attorney conduct and liability in the area of securities law disclosure. This Comment concludes that attorneys practicing in the securities area, a predominantly nonadversarial arena, should be held to a higher standard of ethical conduct than attorneys engaging in other practices of the law.

I. THE DEVELOPMENT OF SEC RULE 2(e) AND THE POWERS THAT BE

Congress has never expressly delegated to the SEC the power to regulate the attorneys who practice before it. Nevertheless, this regulatory power has consistently been held as inherent in the Commission's rulemaking authority. As such, an examination of the history, purpose, and operation of rule 2(e) should serve as a guide in interpreting the ultimate scope of its application. The discussion that follows, however, does not purport to be an exhaustive treatment of the historical development of rule 2(e); it merely presents an overview of those occurrences that may be critical when examining attorney liability before the SEC.

A. The History

Rules of Practice adopted by the Commission were originally promulgated pursuant to section 19(a) of the Securities Act of 1933. Rule 2(e) of the Rules of Practice set specific requirements for admitting attorneys to

8. 15 U.S.C. §§ 77a-77aa (1976 & Supp. IV 1980). The Act grants the Commission the power "to make, amend and rescind such rules and regulations as may be necessary to carry out the provisions of this title . . . ." Id. § 77s(a) (1976).
practice before the Commission and provided the SEC with the authority to suspend or disbar any person who did not possess the requisite qualification or character for that practice. 9 Rule 2(e) has been equated with the formation of an "SEC bar." 10 Rule 2(e) was amended in 1938 to remove the mandatory requirement that an attorney could not practice before the Commission without first filing an application with the SEC. 11 Nevertheless, the Commission maintained the power to discipline and deny practice to any person appearing before it. 12

Rule 2(e) was altered for a second time in 1970 to provide for suspension from appearance or practice before the SEC by a person who: (1) does not possess the requisite qualifications to represent others; or (2) lacks in integrity or character or who has engaged in unethical or improper professional conduct; or (3) has willfully aided and abetted the violation of a federal securities law or who has willfully violated such a law. 13 While the Commission has argued that attorney suspension is automatic upon a Commission finding of liability, 14 a close reading of rule 2(e) provisions indicates the authority to suspend is discretionary in nature. 15 The SEC's deliberate expansion of attorney liability 16 and simultaneous reduction of the admin-

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9. September 1935 was the effective date of the rule. Subsequent revisions of rule 2(e) have also been justified as inherent in § 23(a) of the Securities Exchange Act, which empowers the Commission "to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title . . . ."


12. The 1938 amendment also terminated the SEC practice of maintaining a register of those persons admitted to practice under the original rule. Subsequent to the 1938 restrictions, rule 2(e) provided that:

(e) The Commission may disqualify, and 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 hearing in the matter

(1) Not to possess the requisite qualifications to represent others; or

(2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct.

Securities Act Release No. 1761 (June 27, 1938). Although the 1938 amendment streamlined the Commission's power over its regulatory duties, the authority to discipline attorneys practicing before it was left substantially intact.

13. Securities Act Release No. 5088 (Sept. 24, 1970); see also 17 C.F.R. § 201.2(e) (1981). The third category of potential suspension, providing for suspension for "willful" violation or "willful" aiding and abetting, appears to be redundant, because such activity would be covered in the "unethical or improper professional conduct" provision of the 1938 amendments. Id.


15. The suspension and disbarment preface to the type of conduct for which an attorney may be disciplined states "[i]t is the Commission may 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 . . . ." 17 C.F.R. § 201.2(e) (1981) (emphasis added). Use of the conditional term "may," as well as extensive alternatives as to specific types of discipline ("temporarily or permanently," for example), clearly indicates discretionary equitable powers, as do rule 2(e) provisions that provide the SEC with an extensive array of reinstatement procedures subsequent to disciplinary action. See id.

administrative requirements for admission to SEC practice illustrates the policy position of the Commission that regulation of practicing securities attorneys is of the utmost importance.

B. The Purpose

The SEC has stated unequivocally that the driving force behind the creation and enforcement of rule 2(e) is the necessity of “protect[ing] the integrity of [the Commission’s] processes.” Asserting that rule 2(e) represents a balancing of interests, the Commission has narrowed the focus of its purpose to that of professional misconduct. This purpose is to establish protective measures required to shield both the SEC and the investing public. Implicit within the Commission’s rationale is the twofold theory that: (1) practice before the SEC is a privilege, not a right; and (2) a predominate portion of a securities lawyer’s work is not adversarial in nature. Judge Friendly’s oft-quoted statement that “the lawyer’s opinion can be [an] instrument for inflicting pecuniary loss more potent than the chisel or the crowbar” recognizes the disease the SEC is trying to cure. While emphasizing that impropriety by a securities attorney creates damaging implications extending beyond the particular transactions involved, the Commission nevertheless maintains that such a potential effect does not necessarily impose “duties to the public on lawyers where

18. Carter, supra note 2, at N-3; see Touche Ross & Co. v. SEC, 609 F.2d 570, 582 (2d Cir. 1979).
20. Id.
21. Id. Rule 2(e) explicitly states that “[t]he Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it . . . . ” 17 C.F.R. §201.2(e) (1981) (emphasis added). See Johnson, supra note 6, at 629. The idea of the “privilege” vis-à-vis the “right” to appear before the SEC apparently stems from the pre-1938 power of the Commission to regulate admissions of practicing attorneys before it. As that authority has now been eradicated, a serious question arises as to whether practice before the Commission varies from practice in any other legal arena, at least in regard to the distinction of privilege and right.
22. “[T]he task of enforcing the securities laws rests in overwhelming measure on the bar’s shoulders . . . . Very little of a securities lawyer’s work is adversary in character. He doesn’t work in courtrooms where the pressure of vigilant adversaries and alert [sic] judges check him.” In re Emanuel Fields, 45 S.E.C. 262, 266 n.20 (1973), aff’d without opinion, 495 F.2d 1075 (D.D.C. 1974); see SEC v. Spectrum, Ltd., 489 F.2d 535, 541-42 (2d Cir. 1973). For criticism of the Commission’s position, see Cooney, The Registration Process: The Role of the Lawyer in Disclosure, 33 BUS. LAW. 1329, 1333-37 (1978); Sonde, The Responsibility of Professionals Under the Federal Securities Laws—Some Observations, 68 NW. U.L. REV. 1, 8-15 (1973). Assuming the invalidity of the Commission’s “privilege” argument, the question concerning the degree of adversarial content within the securities area may ultimately be dispositive of the need for SEC regulations beyond state bar canons of professional conduct. If the securities lawyer is an advocate, the Commission should not have the privilege of control beyond that of other judicial branches over similarly situated advocates. See infra Section IV for a discussion of this privilege/right issue.
24. Carter, supra note 2, at N-3. “[W]rongdoing by a lawyer or an accountant raises the spectre of a replication of that conduct with other clients.” Id.
such duties would not otherwise exist.”

25. The issue of whether rule 2(e) enlarges the duties of the securities attorney beyond the duties of others in the legal community, particularly litigators, must, however, be viewed in the historical context of the operation of the rule.

C. The Operation

Although rule 2(e) was adopted shortly after formation of the SEC in 1933, the Commission did not officially pursue potential violators until 1950. In In re Fleishmann the SEC suspended a practicing attorney from appearing before the Commission due to improper professional conduct in the preparation and filing of false declarations on behalf of a stockholder's committee. Noting that the attorney was actually engaged in a ploy to defraud the Commission, the SEC nevertheless failed to articulate a definition of "unethical and improper professional conduct." The use of rule 2(e) following Fleishmann quickly began to increase, however, and between 1950 and 1959 four additional rule 2(e) proceedings against attorneys were recorded. The Commission initiated eleven more proceedings during the following decade. In the following five-year period of 1969-1974, eleven more attorneys were suspended from appearing before the SEC, while another was censured for federal securities violations. Multiplication of rule 2(e) proceedings continues, with over sev-

25. Id. at N-4. While the Commission maintains the position that the securities lawyer's responsibilities as to the public are not enlarged, the question still remains whether regulations such as rule 2(e) impose a higher duty upon the securities lawyer as to his own client. The latter issue is the more important, at least to the securities attorney who seeks guidance.

26. Little comment has been made concerning why the Commission did not pursue rule 2(e) violations until 15 years following the rule's promulgation.

27. 37 S.E.C. 832 (1950).

28. Id. at 836.

29. Id.

30. Id. Subsection (1)(ii) of rule 2(e) is the most frequently relied upon provision of the rule, providing for suspension of an attorney solely for engaging in "unethical or improper professional conduct."


32. Id.; see also Johnson, supra note 6, at 632.

enty suits initiated against attorneys since 1974. A cursory inspection of the number of alleged violations demonstrates an obvious attempt by the SEC to police improper conduct by members of its own bar.

Accentuating the increasing number of alleged rule 2(e) violations is the SEC's institution of minimal requirements of proof in a disciplinary action against the unethical attorney. While the Commission has consistently asserted that not every violation of the law will be sufficient to invoke the plenary sanctions of rule 2(e), the SEC has nevertheless implemented relaxed rules of evidence and correspondingly low burdens of proof in an attempt to secure suspensions of those attorneys whose improper conduct is adjudged of the magnitude to activate rule 2(e). Indeed, early commentators have argued that past decisions allow indefinite suspension based solely upon circumstantial testimony.

The SEC has justified its use of a low burden of proof through two theories. Initially, the most severe sanction the Commission can impose upon the attorney is suspension from securities practice, not total disbarment from the practice of law. While this argument superficially supports a lesser burden of proof, it nevertheless ignores the practical result of the suspension of an attorney from the securities area of the law. Such a decision would have a damaging effect upon an attorney's overall practice and reputation. Once an attorney has been suspended from the SEC bar, he may no longer benefit from the securities practice of his firm. Addition-


35. SEC prosecution of unethical conduct continues. In December 1981 a senior partner in a California law firm, pursuant to a rule 2(e) proceeding, agreed to a nine-month suspension from practice before the SEC. News & Comment, [1981] 634 SEC. REG. & L. REP. (BNA) A-2. The rule 2(e) proceeding alleged violation of the 1933 Securities Act registration and antifraud provisions. The SEC claimed the attorney advised that the removal of restrictive legends from pledged securities, for the purpose of hypothecation, would not constitute a distribution requiring registration. Id. Without admitting or denying the rule 2(e) charges and findings, the attorney accepted the recommended suspension. Id.

36. Carter, supra note 2, at N-4. "The violation must be of a character that threatens the integrity of the Commission's processes in the way that the activities of unqualified or unethical professionals do." Id.


40. Johnson, supra note 6, at 635.

41. The SEC has determined that the partners of an attorney who has been suspended from securities practice pursuant to rule 2(e) are not allowed to permit the suspended practitioner to: (1) take part in SEC securities matters; (2) create the appearance to third parties that he is entitled to practice before the Commission; or (3) receive profits from the firm based upon a proportion of the firm's securities work. SEC Securities Act Release No. 5147 (May 10, 1971). Some question still remains as to whether the partners of the suspended attorney have an affirmative duty to prevent these listed activities or are to be held to a lesser
ally, rule 2(e) has been construed to be of such broad scope that a firm as an entity, vis-à-vis the individual attorney, may be suspended under the standards of rule 2(e). The suspension of a firm would thus prohibit "[p]artners and associates of a disqualified firm [from practicing] before the Commission so long as they remain members or are associated with the firm." Thus the Commission's argument that suspension merely from the securities area is only a piecemeal prevention of the practice of law refuses to acknowledge that such disciplinary action may have the practical effect of total disbarment.

The Commission's second argument in support of a lesser burden of proof under rule 2(e) stems from the long-revered SEC belief that an attorney's ability to practice in the securities area before the Commission is a privilege rather than a right. As such, no constitutional safeguards are attached to the revocation of a granted privilege. This theory rests on the presumption, however, that the Commission has correctly determined that practice before it is a privilege. A finding that practice before the SEC is instead a right inherent in the general privilege of practicing law negates such a theory and weakens the lesser burden of proof rationale. Indeed, one circuit court has stated that practice before the Commission is to be viewed as a right, but that this classification does not require a more restrictive burden of proof. Nevertheless, the majority of circuit courts have either failed to address this issue uniformly in SEC disciplinary appeals or are not cognizant of its importance.

standard of good faith. Some question also remains whether the SEC can suspend or even discipline partners of the suspended attorney without some higher burden of proof than that required in usual rule 2(e) proceedings. Indeed, an action against partners of a suspended attorney is once-removed from the initial primary violation, and the SEC should perhaps, without evidence of scienter, be held to a higher burden of proof than that required to suspend the attorney.

42. Id.
43. Id. at 3.
44. 17 C.F.R. § 201.2(e) (1975); see In re Schwebel, 40 S.E.C. 347, 371 (1960).
45. Johnson, supra note 6, at 632 n.12.
46. See supra note 21 and accompanying text.
47. Because one must meet certain licensing prerequisites before being allowed to practice law in state or federal court, the ability to practice law generally can be viewed as a "privilege." See, e.g., TEX. REV. CIV. STAT. ANN. art. 305a-c (Vernon 1973 & Supp. 1982); see also supra note 21 and accompanying text.
48. Kivitz v. SEC, 475 F.2d 956, 962 (D.C. Cir. 1973). The court characterized a lawyer's ability to appear before the SEC as "an attorney's license to practice as a 'right' which can not lightly or capriciously be taken from him." Id. (citation omitted).
49. Id.
50. While the Kivitz case is often cited as an attempt by the SEC to declare explicitly a lesser prosecutorial burden of proof for rule 2(e) violations, the District of Columbia Circuit reversed the SEC finding of Kivitz's liability for the improper securing of a registration statement. Id. at 962. In reversing the Commission's final decision, the court made several attempts to clarify the application of rule 2(e). Although ignoring the differences in standards of proof that might be applied in the distinction between a right and a privilege, the court reversed the Commission due to its failure to base the suspension of the licensed attorney upon "substantial evidence." Id. at 962. This finding is commensurate with the general rule that administrative proceedings are conclusive upon review if supported by the substantial evidence standard. 15 U.S.C. § 78y (1976); see, e.g., Hugh v. SEC, 174 F.2d 969, 974 (D.C. Cir. 1949). Moreover, the court emphasized that considerable weight should be given
Questions concerning the burden of proof standard imposed by the SEC in rule 2(e) proceedings have multiplied since the Commission's initial articulation of the lower threshold of proof of improper conduct.\textsuperscript{51} Intensi-

\textsuperscript{51} In re Kauffman, 44 S.E.C. 374 (1970). Paralleling the SEC's attempt to broaden attorney responsibility through a relaxation of the standard of proof required for suspension has been the apparent expansion of liability of the attorney for violation of federal securities laws while acting in a professional capacity, such as corporation board member or director. See Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), where two attorneys, one an officer of the corporation and the other a director, were held liable for failure to reasonably investigate statements on a registration form signed by both men. \textit{Id}. at 698. The standard of reasonableness used in determining liability, not unlike that of general tort law, is defined by the 1933 Act as the amount of care expected of a prudent man in the management of his own property. 15 U.S.C. \textsection 77k(c) (1976). The attorneys in \textit{BarChris} were found liable in their professional capacity not for mispreparation of the registration statements, but merely for authorizing their release by signature. 283 F. Supp. at 698. The text of the opinion does not address the issue of whether such a negligence-based standard might also be applied in the situation where the registration statement itself is prepared by outside counsel. See \textit{SEC v. Frank}, 388 F.2d 486 (2d Cir. 1968) (liability of attorney in professional capacity with actual knowledge of misrepresentations); \textit{cf.} \textit{Affiliated Ute Citizens v. United States}, 406 U.S. 128 (1972) (attorney's good faith may not free him from liability); \textit{Feit v. Leasco Data Processing Equip. Corp.}, 332 F. Supp. 544 (E.D.N.Y. 1971) (definition of materiality of violation expanded to whether reasonable man might have acted otherwise).

Two central questions were also left unanswered by the \textit{BarChris} court in the wake of attorneys' fears over the potentially dangerous high standard of conduct: (1) Is the attorney's duty of reasonably independent investigation for truth limited solely to matters involving registration statements, or does it extend to other less encompassing securities activities; (2) Is the attorney who discovers potentially improper conduct on the part of his client under a duty to either the SEC or perhaps even the public to disclose such conduct? Two subsequent decisions attempt to resolve these issues. In \textit{SEC v. Spectrum}, 489 F.2d 535 (2d Cir. 1973), the Second Circuit Court of Appeals ruled that an attorney could be held liable based upon a standard of negligence. The court reasoned that since the typical investor is usually in a less than arms-length negotiating posture and thus must rely to a great degree upon the skills of the attorney, the imposition of a negligence standard is not overly onerous. \textit{Id}. at 541-42. \textit{"The smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters." Id}. at 542. Consequently, an attorney who participates in any securities transaction may be enjoined or suspended from the securities practice for improper professional conduct, regardless of actual knowledge of the violative transaction.

\textit{SEC v. National Student Marketing Corp.}, 360 F. Supp. 284 (D.D.C. 1973), mandated that the securities attorney has an affirmative duty to insist that his client disclose new financial information, or, in the alternative, both withdraw as counsel and notify the SEC of potential security violations. \textit{Id}. at 290. The thrust of the opinion was to force attorneys to police their own clients on behalf of the SEC and the public. \textit{Id}. The case involved 10b-5 violations, however, and it is uncertain how the application of \textit{National Student Marketing} would have affected a 2(e) proceeding, especially in terms of self-policing on behalf of the SEC. For a review of similar actions filed immediately in the wake of \textit{National Student Marketing}, see \textit{SEC v. Universal Major Indus. Corp.}, \textit{SEC Litigation Release No. 6041} (Aug. 28, 1973) (S.D.N.Y. filed Aug. 21, 1973) (negligence because lawyers "should have known"); \textit{SEC v. Allegheny Beverage Corp.}, \textit{SEC Litigation Release No. 5888} (May 14, 1973) (D.D.C. filed May 11, 1973) (attorneys named in professional capacity rather than as corporation principals); \textit{SEC v. R.D. Philpot Indus., Inc.}, \textit{SEC Litigation Release No. 5724} (Feb. 6, 1973) (S.D.N.Y. filed Feb. 5, 1973) ("should have known" liability base used again);
fying this difficulty has been the Commission’s periodic modification of rule 2(e) in an attempt to increase regulatory leverage over the attorney.\textsuperscript{52} Confusion as to the SEC’s burden of proof combined with the Commission’s increasing attempts to facilitate prosecution methods has resulted in uncertainty as to the day-to-day operations of the securities lawyer, and possible impairment of the attorney’s ability to represent his client properly.\textsuperscript{53} In addition, a hostile situation between the Commission and the securities bar has resulted.\textsuperscript{54} This confrontation has led to the question central to any discussion of SEC regulatory power: Does the Commission have the authority to promulgate and enforce its own standards of ethical conduct?

II. SEC AUTHORITY TO ADOPT RULE 2(e): THE REPUTATION OF POWER IS POWER

Recent rule 2(e) proceedings have confronted the issue of whether the Commission has the jurisdictional authority to establish what is essentially a code of ethical conduct for the securities bar.\textsuperscript{55} Four main arguments are made in attempting to refute SEC control in this area. First, because the Commission has never been given the express authority to regulate ethical conduct, the SEC usurps the control of state bars by implying power of such magnitude.\textsuperscript{56} Second, the Administrative Practices Act (APA) expressly forbids the de facto establishment of a specialized legal bar;\textsuperscript{57}

\textsuperscript{52} Prior to \textit{Kauffman}, subsection (2) of rule 2(e) had not yet been added to provide for the possibility of an automatic suspension of an attorney convicted of willfully violating federal securities laws. \textit{See supra} notes 13-15 and accompanying text. In \textit{Kauffman} a lawyer who had been convicted of willful securities violations nevertheless continued to practice before the Commission for almost a year before the SEC could manipulate the regulatory machinery to suspend him. Thus, subsection (2) was adopted to provide automatic suspension for convicted willful violators. \textit{See} 35 Fed. Reg. 15,440, 15,441 (1970). Likewise, subsection (3) was adopted providing for suspension, albeit not automatic, of attorneys who have been permanently enjoined by a court of proper jurisdiction, for similar violations of securities laws. The Commission may suspend an attorney-violator “without preliminary hearing” merely by serving the attorney with proper notice as specified. As such, the SEC essentially adopts the finding of a “competent” court and is not required to review those findings in either substance or procedure. 17 C.F.R. \S 201.2(e)(2), (3) (1981).

\textsuperscript{53} The argument is that restrictive Commission controls over the day-to-day decisions of the securities attorney will force the attorney to subordinate the needs of his client to the needs of the SEC and the public, leaving the corporate client to fend for himself. “[T]he Commission has seized almost absolute power over lawyers . . . . In effect, the license of counsel to practice before the Commission has come to hang by a thread.” Johnson, \textit{supra} note 6, at 640.

\textsuperscript{54} \textit{Carter}, \textit{supra} note 2, at N-3 to -4.

\textsuperscript{55} \textit{Id}. at N-1.

\textsuperscript{56} \textit{Id}. at N-1 to -3.

\textsuperscript{57} The Administrative Practice Act, 5 U.S.C. \S 500(b) (1976), provides:

An individual who is a member in good standing of the bar of the highest court of a State may represent a person before an agency on filing with the agency a written declaration that he is currently qualified as provided by this
therefore, rule 2(e) violates the APA. Third, as a basic policy matter, an entity exercising prosecutorial discretion over an attorney should not also be empowered to regulate ethical conduct through disciplinary action, especially when professional judgments of the attorney are required. Fourth, the Commission does not have the wisdom or the expertise to regulate ethical conduct effectively.

Conceding that authority to promulgate rule 2(e) and similar regulations is not expressly granted to the SEC, the Commission has nevertheless relied upon legal precedent in support of its authority to effectuate rule 2(e). The Second Circuit Court of Appeals most recently confronted this question. In Touche Ross & Co. v. SEC the Second Circuit articulated the Commission's authority in this regard as a "necessary adjunct to the Commission's power to protect the integrity of its administrative procedures and the public in general." Noting that rule 2(e) was promulgated in the SEC's attempt to police itself and maintain its own integrity, the court in Touche Ross asserted that rule 2(e) walked the precarious line of assuring the public of competent securities attorneys while simultaneously allowing counsel to perform adequately for clients. This issue appears resolved in favor of the SEC.

Attacks that rule 2(e) conflicts with the Administrative Practice Act have likewise been refuted, usually based upon interpretive readings of the APA's legislative history. Emphasizing APA language that does not attempt to limit the discipline of attorneys who practice or appear before the Commission, the SEC has consistently argued that this neutral language, read in conjunction with the APA's legislative history, does not preclude SEC action in rule 2(e) proceedings. Possible procedural due process re-

subsection and is authorized to represent the particular person in whose behalf he acts.
58. Carter, supra note 2, at N-1 to -3.
59. Id.
60. Id.
61. See supra notes 6-7 and accompanying text.
62. "No court, having considered the question, has found the Commission not to have the authority to adopt Rule 2(e)." Carter, supra note 2, at N-2; see SEC v. Csapo, 533 F.2d 7 (D.C. Cir. 1976); Kivitz v. SEC, 475 F.2d 956 (D.C. Cir. 1973).
63. 609 F.2d 570 (2d Cir. 1979).
64. Id. at 582.
65. Id.
66. Id.; see also Mourning v. Family Publications Serv., Inc., 411 U.S. 356 (1973) (rule "reasonably related to the purposes of the enabling legislation"); Goldsmith v. Board of Tax Appeals, 270 U.S. 117 (1926) (rule may be valid as necessary adjunct to protect administrative procedures and public).
67. Carter, supra note 2, at N-1 to -3. Section 500(b) is the APA provision usually cited in this vein. See supra note 57.
68. The Commission argues that APA § 500(b) was intended to abolish admission requirements for practice before the SEC in an attempt to allow clients a choice in securities attorneys. See H.R. REP. NO. 1141, 89th Cong., 1st Sess., reprinted in 1965 U.S. CODE CONG. & AD. NEWS 4170, 4171.
69. 5 U.S.C. § 500(d)(2) (1976) provides that the Act does not "authorize or limit the discipline, including disbarment, of individuals who appear in a representative capacity before an agency."
70. See Carter, supra note 2, at N-2. "[T]he supporting legislative history makes clear
verberations stemming from the requirements of the Administrative Practice Act, however, have in large part been ignored.71

The issue of potential abuse when an agency is empowered with both prosecutorial discretion and disciplinary authority has largely been dismissed by the SEC.72 Asserting sensitivity to these potential abuses,73 the Commission has nevertheless engaged in a cost-benefit analysis, pitting protection of the Commission's processes and the public's interests against potential future abuse.74 The balance has fallen clearly in favor of protection over potential abuse.75 Thorough analysis of the abuse question, however, may not be possible within this balancing approach, at least not without directly addressing the question of preventive measures that can be used in anticipation of abuse.76

Perhaps the most serious challenge to the SEC's authority to regulate ethical conduct surfaces in a confrontation over the Commission's expertise in this area. The SEC has consistently asserted that rule 2(e) applies only to "securities lawyers performing disclosure-related professional services, an area within our responsibility and our expertise."77 This explanation ignores the fact that despite the presence of substantive securities law, the SEC engages in both the procedural regulation of ethical conduct and the substantive area of professional responsibility. Yet, the Commission has held firm to the position that it is not attempting to supersede recodification attempts of various state bar disciplinary bodies.78 In fact, the SEC claims to rely upon private sector initiatives as "generally applicable standards governing lawyers in the discharge of their professional responsibilities,"79 while still exerting its own rigorous standards of application.80

71. 5 U.S.C. § 558(c) (1976) provides that "[e]xcept in cases of willfulness or those in which public health, interest, or safety requires otherwise, the withdrawal, suspension, revocation, or annulment of a license is lawful only if, before the institution of agency proceedings therefor, the licensee has been given both notice in writing of conduct or facts which constitute the basis for regulatory action, as well as an opportunity to demonstrate or achieve compliance with all lawful requirements." Id. (footnote omitted).

72. See Keating, supra note 34, at 1165.
73. See Carter, supra note 2, at N-2.
74. Keating, supra note 34, at 1165-66.
75. "Rule 2(e) should not be utilized as an enforcement tool against those who violate the federal securities laws and happen coincidentally also to be lawyers or accountants. But where such individuals engage in professional misconduct which impairs the integrity of the Commission's processes, the Commission has an obligation to respond through the application of Rule 2(e) [regardless of potential abuses]." Id.
77. Carter, supra note 2, at N-3.
78. Id.
79. Id.
80. See supra notes 36-54 and accompanying text.
Serious question exists whether this rationale can be consistently applied. In the Code of Professional Responsibility that became effective for American Bar Association members in 1970, the attorney’s duty to his client is defined in general terms as a fiduciary duty. More specifically, the attorney is required to preserve secrets obtained from the client in a professional relationship that “the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client.” If the SEC view of such liberal holdings as National Student Marketing prevails, requiring the attorney either to resign or to “blow the whistle” on his nondisclosing client, the lawyer may be conjunctively subject to: (1) criminal prosecution, (2) SEC disciplinary regulation under rule 2(e), (3) SEC injunctive action, and (4) a suit for damages for failure to disclose under the federal securities laws. Moreover, disclosure of client confidences in order to avoid any of the above listed liabilities may require the attorney to breach applicable state bar ethical rules, thus creating the potential for disciplinary action by the state bar and a suit for damages by the client. Advocates of rule 2(e) proceedings, however, argue that all state ethical codes have provisions to reconcile these apparent conflicts, thus avoiding a confrontation between the SEC and the local bar.

The more important question is whether the securities lawyer should be held to the same standard of conduct as that of other legal advocates, based upon theories of the noncompetitive nature of the securities practice. The determination of the SEC’s expertise to regulate ethical conduct of practicing attorneys is not nearly as simplistic as the Commission would assert, especially in light of varying state bar conduct code provisions and recent Supreme Court expansion of the attorney-client privi-

81. See generally Hoffman, On Learning of a Corporate Client’s Crime or Fraud—The Lawyer’s Dilemma, 33 BUS. LAW. 1389 (1978).
82. See AMERICAN BAR ASSOCIATION CODE OF PROFESSIONAL RESPONSIBILITY Canon 4 [hereinafter cited as ABA CPR].
83. Id. DR 4-101. The attorney’s duty to keep the confidences of his client is not absolute under the ABA CPR. The duty may be absolute, however, under the scope of the judicially created attorney-client privilege. Disciplinary Rule 4-101(c) provides that the attorney may breach client confidence to defend himself against accusation of wrongful conduct or to prevent the commission of a future crime, but not to reveal the commission of a past crime.
84. See supra note 51.
86. See supra notes 26-54 and accompanying text.
lege in the corporate context.\textsuperscript{93}

Despite assaults on the SEC's authority to assert control over the ethical conduct of its practitioners, the courts have clearly supported the Commission\textsuperscript{94} and have overruled the general objections made to the SEC's authority.\textsuperscript{95} Nevertheless, one additional objection to the SEC's regulation of ethical conduct should be addressed in light of the Supreme Court's recent decision concerning the attorney-client privilege in the corporate context in \textit{Upjohn Co. v. United States.}\textsuperscript{96} The Court in \textit{Upjohn} purported to extend the privilege not only to those members of the "control group" such as directors and large shareholders, but also to potentially any members of the corporation who communicate with counsel concerning the "subject matter" of the asserted privileged discussions. While some doubt exists as to the precedential value of \textit{Upjohn} in varying factual circumstances,\textsuperscript{97} policy-based expansion of the attorney-client privilege, rather than restrictions of state bar ethical codes, create the most potential for conflict in rule 2(e) proceedings. This is because the attorney-client privilege has long been recognized as a stricter, more absolute rule than the general standards set forth in local ethical guidelines.\textsuperscript{98} Strict construction of the privilege, combined with a pervasive judicial tendency to decide privilege cases on a fact-by-fact basis,\textsuperscript{99} reduces the certainty with which lawyers can predict when certain communications will be deemed confidential and complicates the determination of whether rule 2(e) contradicts or is superfluous to current law.\textsuperscript{100} A resolution of the problem is at best tentative, at least until the repercussions of \textit{Upjohn} are calmed by subse-
quent judicial clarification. Meanwhile, the SEC's authority to regulate ethical conduct continues to be exercised with judicial approval.101 The reputation of power is indeed power itself.

III. In re Carter: Expansion of Attorney Liability and the Fear of the Flock

One of the most recent and volatile of the SEC's rulings concerning rule 2(e) proceedings occurred in In re Carter.102 The decision is not important in its result; the attorneys prosecuted were found not to have violated the standards of rule 2(e) at the time of the alleged improprieties.103 The Commission issued a prospective ruling, however, that an attorney who is aware of his client's violations of federal securities disclosure laws may violate rule 2(e) professional standards unless the attorney takes prompt steps to terminate the noncompliance.104 In effect, the SEC defined the general boundaries of "unethical and improper conduct," thus perpetuating SEC bar fears of extensive liability for the securities attorney.105

The Carter opinion focused on the activities of National Telephone Company, Inc. from late 1974 to mid 1975 and during subsequent Commission proceedings.106 In early 1978 the SEC instituted injunctive proceedings against National's directors and auditors, alleging violations of antifraud provisions due to their failure to disclose the company's worsening financial condition in a timely manner.107 The SEC simultaneously filed suit against acting counsel for National under the authority vested in rule 2(e).108 The two attorneys who allegedly engaged in improper conduct were William R. Carter and Charles J. Johnson, Jr.109 An adminis-

101. See Carter, supra note 2, at N-1 to -3.
102. Carter, supra note 2.
103. Id. at N-17. "Our review of the record, which includes respondents' [Carter's and Johnson's] periodic exhortations to [their client] to improve the quality of National's disclosure, leads us to believe that respondents did not intend to assist the violations by their inaction or silence. Rather, they seemed to be at a loss for how to deal with a difficult client." Id. "[N]o finding of unethical or unprofessional conduct would be appropriate." Id. at N-19.
104. Id. The Commission, in attempting to achieve fairness to the defendants, delineated the ruling prospective in application from the date of the opinion, Feb. 28, 1981. Id.
105. Id.
106. National was founded in 1971. The company was formed to lease sophisticated telephone systems to corporate customers based upon long-term leases of five to ten years. Consequently, as is commonly true with companies that lease extensive amounts of expensive equipment, the greater proportion of overhead costs in connection with new leases (including equipment, installation, and marketing expenses) is incurred prior to the commencement of rental payments. As rental payments were the only significant source of revenues for the young company, National's cash flow situation slowly worsened with each new lease, necessitating external financing of operations to sustain continued growth. Id. at N-14.
109. Carter and Johnson had been retained by National in 1974 to assist in sophisticated
trative law judge found that Carter and Johnson willfully violated and aided and abetted violations of sections 10(b) and 13(a) of the Securities Exchange Act of 1934. The violations stemmed not from the affirmative acts of the attorneys in violating disclosure requirements, but rather from their failure to act in light of the corporation's failure to disclose. The thrust of the administrative opinion was that the two attorneys could be held liable not only for directly violating securities laws by their affirmative actions, but also for indirectly failing to adhere to SEC guidelines through an inability to force corporate disclosure. Pursuant to rule 2(e), Carter and Johnson were suspended from practice before the SEC for periods of one year and nine months respectively.

Reaction from the bar was immediate, as securities lawyers attacked the decision as overbroad and oppressive. Displeasure with the ruling stemmed in large part from the ambiguity of the standards articulated in the opinion and from fear that a finding of liability without the requirement of scienter would lead to indiscriminate SEC policing of security lawyers. Financing efforts in order to keep the financially troubled company afloat. The attorneys' allegedly violative conduct largely centered around National's securing of a $21 million bank loan. The loan contract provided that, if the company failed to maintain a specified cash liquidity, National had to "terminate all sales activities, dismiss all sales personnel, and limit its operations to those necessary to service existing leases." Two months after finalization of the loan, National had failed to maintain the specified cash liquidity required in the loan agreement. As a result, Carter and Johnson advised corporate management to commence the curtailment plan specified in the original loan contract and effect public disclosure of the company's financial situation. Management ignored the advice, and both Carter and Johnson continued in their previous capacities as legal counsel.

In re Carter, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175, at 82,168 n.5.

Inaction was thus the evil. Overtones of liability based upon Carter and Johnson's preparation of certain documents were also evident. The administrative law judge specifically found that: (1) Carter had revised a December 1974 press release that was false and misleading in that it failed to explain adequately the nature of promised scale-down operations of the company; (2) neither attorney took action to correct a misleading letter sent to National shareholders by the president and controlling shareholder of National; (3) National's January 1975 8-K form was false and misleading in failing to disclose adequately certain requirements of the loan agreement; (4) Carter and Johnson failed to ensure adequate disclosure through the board of directors in lieu of National's president and controlling stockholder; and (5) Carter and Johnson failed to inform the board of directors of National management's unwillingness to heed legal advice concerning required disclosure.

Dockery, supra note 34, at 90.

The SEC has long taken the position that scienter need not be shown in rule 2(e) proceedings. See In Re Haskins & Sells, Accounting Series Release No. 73 (1952), 5 FED. SEC. L. REP. (CCH) ¶ 72,092. Whether the Carter decision requiring no scienter for rule 2(e) violations will affect rule 10b-5 requirements of scienter remains to be seen. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (concurring opinion; negligence sufficient for 10b-5 violation); but see SEC v. Blatt, 583 F.2d 1325, 1333 (5th Cir. 1978) (2d Circuit theory rejected; scienter required to establish rule 10b-5 violation). While SEC authority under rule 2(e) to discipline without scienter has never been successfully challenged, commentators allege such lax standards of conduct no longer protect the attorney from discipline for good-faith judgmental errors.
In reviewing the administrative law judge’s suspensions of Carter and Johnson, the Commission distinguished between liability based upon primary violations of securities laws, and aiding and abetting. The Commission summarily ruled that neither attorney primarily violated securities laws and was thus not subject to liability under rule 10b-5. The focus of the review, therefore, was the possibility that the attorneys aided and abetted National’s violations, thus subjecting them to the disciplinary measures of rule 2(e).

Whether an attorney has aided and abetted primary violations, as defined by Carter, is determined through proof of three elements: (1) an independent violation by another (here National); (2) “knowing and substantial assistance” of conduct that constitutes the violation; and (3) awareness by the aider and abettor that his actions constitute part of an improper activity. The SEC found the first element, a securities law violation by another, with “no difficulty.” The second element, substantial assistance, was found in that such assistance is inherent in the factual context of a securities lawyer performing his professional duties. The securities lawyer, by the very nature of his position, works intimately with the client such that substantial assistance can almost be assumed.

The critical element in Carter and in future application of rule 2(e) is the third element of aiding and abetting, intent. In Carter the SEC held that a finding of aiding and abetting “requires a showing that respondents [Carter and Johnson] were aware or knew that their role was part of an activity that was improper or illegal.” The evidence in Carter was thus held insufficient to establish this third crucial element of intent; at the very least, an element of recklessness must be found. The SEC noted, however, that the standards for determining intent must vary depending

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117. Carter, supra note 2, at N-14.
118. Id.
119. Id. at N-15. These three elements are a codification of various circuit court decisions and represent, in the eyes of the SEC, prevailing law. See, e.g., Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir.), cert. denied, 449 U.S. 919 (1980); JET v. Cornfield, 619 F.2d 909, 922 (2d Cir. 1980); SEC v. Coven, 581 F.2d 1020, 1028 (2d Cir.), cert. denied, 440 U.S. 950 (1978); see also cases cited in Carter, supra note 2, at N-15 n.57.
120. Carter, supra note 2, at N-14, N-15.
121. Id. at N-15.
122. Id. In this regard, the Commission did not distinguish between an attorney’s professional advice given orally or in writing vis-a-vis similar advice transmitted through the drafting of SEC-required documents. “Liability in these circumstances should not turn on such artificial distinctions, particularly in light of the almost limitless range of forms which legal advice may take.” Id. The SEC was trying to circumvent the possibility of an attorney’s masking liability by avoiding the formality of participation in the required SEC drafting process.
123. Id. The SEC emphasized that intent is the distinguishing factor between those professionals who should be considered as subjects for professional discipline and those attorneys who have merely made good faith judgmental errors or who have simply been careless. Id.
124. Id.
125. Id. The requirement of recklessness smacks of a standard lower than that of negligence. Similar definitional and semantical problems exist, however, with both terms.
upon whether a direct misrepresentation or an indirect omission is involved.\textsuperscript{126} If a misrepresentation is involved, mere awareness or recklessness will suffice to establish the requirement of intent.\textsuperscript{127} Conversely, if an omission is found, intent cannot be established unless there is "conscious intent" on the part of the attorney to violate securities laws or a specific duty to disclose accompanied with some undefined degree of scienter.\textsuperscript{128} Carter and Johnson were subsequently found not to have had the degree of intent necessary to establish liability, and the administrative law judge's suspensions were accordingly reversed.\textsuperscript{129}

The Commission continued beyond the immediate question of the \textit{Carter} factual context, however, into the area of prospective ethical and professional responsibilities.\textsuperscript{130} Recognizing that a practical definition of unethical or improper professional conduct had yet to be established, making it virtually impossible for attorneys to predict what is and what is not acceptable attorney activity, the SEC attempted in \textit{Carter} to define these terms:\textsuperscript{131}

The Commission is of the view that a lawyer engages in "unethical or improper professional conduct" under the following circumstances:

\begin{quote}
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.
\end{quote}

While the lawyer is not obliged under rule 2(e) to attempt to rectify every disclosure violation regardless of its effect upon the public, \textit{Carter} nevertheless holds the lawyer to a professional duty to determine when "prompt steps" must be taken to circumvent noncompliance.\textsuperscript{132}

\textsuperscript{126} \textit{Id.} at N-16.

\textsuperscript{127} \textit{Id.} at N-16; \textit{Kerbs v. Fall River Ind., Inc.}, 502 F.2d 731, 740 (10th Cir. 1974); \textit{Strong v. France}, 474 F.2d 747, 752 (9th Cir. 1973); \textit{SEC v. National Student Marketing Corp.}, 457 F. Supp. 682, 713 (D.D.C. 1978).

\textsuperscript{128} \textit{Woodward v. Metro Bank}, 522 F.2d 84, 97 (5th Cir. 1975); \textit{see also} cases cited in \textit{Carter, supra} note 2, at N-16 n.64. "When it is impossible to find any duty of disclosure, an aider and abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved. When some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter." 522 F.2d at 97. In this regard, an implied connection between rule 10b-5 violations and disciplinary proceedings brought pursuant to SEC rule 2(e) exists. The Commission may intend that rule 2(e), not necessarily requiring the classic element of scienter, supplement rule 10b-5, which requires scienter. The result is that regardless of the existence of attorney intent to violate the federal securities laws, attorney liability via the securities laws becomes a very real possibility. \textit{See supra} note 115.

\textsuperscript{129} \textit{Carter, supra} note 2, at N-17, N-20.

\textsuperscript{130} \textit{Id.} at N-17 to -19.

\textsuperscript{131} Although the decision purports to define these terms absolutely, the Commission nevertheless stated that it "intends to issue a release soliciting comment from the public as to whether this interpretation should be expanded or modified." \textit{Id.} at N-17. \textit{Carter} thus does not speak conclusively upon the definitions of proper and improper rule 2(e) conduct. \textit{See SEC Request for Comment on Standards of Conduct for Professionals, [1981] 621 SEC. REG. & L. REP. (BNA) G-1.}

\textsuperscript{132} \textit{Carter, supra} note 2, at N-19.

\textsuperscript{133} \textit{Id.}.
mission explains that at least initially, “counselling accurate disclosure is sufficient” action by the attorney to avoid rule 2(e) liability. But there comes a point at which a reasonable lawyer must conclude that his advice is not being followed, or even sought in good faith, and that his client is involved in a continuing course of violating the securities laws. The lawyer is in the best position to choose his next step. The Commission enumerated potential, specific “next steps” as: (1) enlistment of aid from other members of the firm’s management; (2) a direct approach to the board of directors or any individuals therein; (3) resignation by the attorney; or (4) “prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying problem . . . .” The Commission is quick to emphasize that resignation in the face of client noncompliance is not the only permissible course of action, although it is a practical means of forcing disclosure in certain circumstances. In fact, the Carter opinion encourages a continuation of the attorney-client relationship, even in light of continued and open noncompliance, in the hope that the continued relationship will result in an opportunity for termination of the disclosure violations. “So long as a lawyer is acting in good faith and exerting reasonable efforts to prevent violations of the law by his client, his professional obligations have been met.”

IV. ESTABLISHING A TRUE STANDARD OF RULE 2(e) LIABILITY: CARTER REVISED

The Carter standard of rule 2(e) liability is an important step in helping the securities lawyer to predict what constitutes ethical conduct under SEC regulations. As such, it represents a departure from the normative judicial procedure of deciding concrete cases based upon particular factual circumstances and refusing to promulgate broad-based guidelines for future conduct. Nevertheless, the Carter standard requires revision, so that attorneys

134. Id.
135. Id.
136. Id.
137. Id. (footnote omitted).
138. “Premature resignation serves neither the end of an effective lawyer-client relationship nor, in most cases, the effective administration of the securities laws.” Id. Resignation of the attorney also raises other considerations, including foreseeable prejudice to the client. See ABA CPR, supra note 82, DR 2-110; ABA CPR, supra note 82, EC 2-32, -33.
139. The Commission concluded that if the misconduct of the client is so extreme or the involvement of the client’s board of directors so pervasive in unethically avoiding disclosure requirements, then the responsible attorney’s only alternative is resignation. The SEC anticipated such circumstances to be rare. Carter, supra note 2, at N-19.
140. Id.
141. Id. The SEC noted that in those cases in which resignation is not the only alternative available to the practicing attorney, the ultimate success of the lawyer in obtaining compliance by his client is not to be considered in rule 2(e) proceedings. Instead of a result-oriented standard, the test in this regard is means oriented. A valuation of means as opposed to ends is indeed the proper balance in an area of ethical conduct and value judgments.
can predict with more certainty the consequences of their actions. Initially, because this is an area laced with moral and ethical values, equitable notions of fairness come into play. The Commission cannot be expected to formulate an all-encompassing rule, which evaluates with utopian precision every situation that could arise dealing with ethical matters in the securities area. Nevertheless, the SEC is obligated to both the securities bar and the public to establish a practical, yet flexible, standard of conduct for the practicing attorney. This standard must be exact enough for the attorney to plan his conduct with confidence, and the standard must be flexible enough to compensate for any potential factual situation. As such, the Carter standard of ethical conduct is inadequate.

Definitional problems are immediately apparent with the Carter standard. Viewed in a practical setting, the semantic questions inherent in the standard raise more issues than the standard resolves. Focal connotative problems include the phrases:

1. “significant responsibilities”: If a lawyer must be engaged in significant responsibilities to fall under rule 2(e), are those duties to be defined in terms of quality or quantity? This problem is especially acute when more than one attorney for a specific firm acts as counsel for the corporation. Are all attorneys to be viewed together or individually to determine what constitutes significant responsibilities?

2. “aware”: The Commission requires that the attorney be aware of disclosure violations. While the Carter opinion purports to define this term in regard to whether direct (misrepresentation) or indirect (omission) violations occur, the phrase “reasonable” is also used repeatedly in reference to the duties of the attorney. Use of the adjective reasonable to define aware implies a higher negligence standard as opposed to the dual direct/indirect standard discussed earlier. Is such a complicated standard required?

3. “client”: Definitional difficulties are always raised when an attorney represents a corporate client; while the client is the corporate entity, not the individual directors, the entity itself is personified only through individuals. Thus, the issue of the client's identity must always be confronted, especially in light of the SEC's suggestion that the attorney enlist help from individual directors in order to encourage the client-entity to disclose. Is such contact with technically a third person, the individual director, permissible under the attorney-client privilege?

4. “substantial and continuing”: The failure of the client to disclose must likewise be substantial and continuing. How great

142. See supra text accompanying note 132.
143. See supra notes 126-29 and accompanying text.
144. See Carter, supra note 2, at N-18.
must the failure to disclose be to be considered substantial?
How continuous must the failures be to establish continuing
failure under this aspect of the standard?

(5) “prompt steps”: Prompt steps to end client noncompliance are
required of the attorney to avoid rule 2(e) liability. How
prompt is prompt, and to what end must the attorney go in
order to satisfy this broadly stated duty?

Of special concern is the open-ended final requirement of “prompt steps”
and its potential violation of the attorney-client privilege. This privilege
violation might very well occur if an attorney were ever required under the
good faith and reasonable efforts standards of Carter to disclose his client’s
securities violations to a third party. The Commission did, however, ac-
knowledge this potential conflict in the final paragraphs of Carter:

This case does not involve, nor do we here deal with, the additional
question of when a lawyer, aware of his client’s intention to commit
fraud or an illegal act, has a professional duty to disclose that fact
either publicly or to an affected third party. Our interpretation today
does not require such action at any point, although other existing
standards of professional conduct might be so interpreted.145

While the SEC purports not to require the attorney to disclose his client's
violative conduct to a third party, the Commission has framed the issue in
terms of the “client’s intention to commit fraud or an illegal act.”146 This
framing of the issue does not address the difficulties that the attorney may
face if his client has already engaged in the unethical conduct. In this
regard the Commission is silent. Under the Carter standard, a direct con-
flict might indeed arise between “prompt steps to end the client’s noncom-
pliance”147 involving communication of the problem to a third party and
the attorney-client privilege when either: (1) the client has no intention to
violate Commission standards but nevertheless violates them; or (2) the
client has already violated SEC standards. Such a conflict is probable in
light of the Upjohn decision.148 Unless decisions subsequent to Carter pro-
vide clarification, the securities attorney might very well be placed in a
position of choosing between his client and his career.149

In light of the above ambiguities, the Carter rule 2(e) standard should be
revised. The emphasis should be shifted from a masked standard of neglig-
gence to a more straightforward approach that focuses upon the burdens of
production and proof. This revised standard would provide a simple test
of conduct, yet one sufficiently flexible to cope with more complex situa-
tions. Initially, the SEC’s phraseology concerning “awareness” of the at-

145. Id. at N-19 n.78.
146. Id.
147. Id. at N-19.
148. See supra notes 96-100 and accompanying text.
149. The Commission has yet to officially revise the Carter standard. But see the per-
sonal remarks of General Counsel to the Securities and Exchange Commission, intimating
the SEC may soon begin to chip away at the foundation of the Carter standard. SEC Gen-
eral Counsel's Remarks on Lawyer Disciplinary Proceedings, 14 SEC. REG. & L. REP.
(BNA) 168 (1982).
torney and "prompt steps" to force compliance should be obviated. Instead, the Commission should adopt a normative tort standard of negligence against which to measure the liability of an attorney for unethical or unprofessional conduct under rule 2(e). That is, the securities attorney should be held simply to the duty of a reasonably prudent securities attorney in the same or similar circumstances.

One scholar has argued that Carter is nothing more than a paraphrasing of the typical negligence standard as it applies to securities. This argument, however, ignores the fact that the SEC articulated a dual standard to establish intent as an element of aiding and abetting. In the context of omissions rather than direct misrepresentations, "intent" as an element of aiding and abetting is not established without a conscious intent on the part of the attorney to violate the securities laws. This undefined element of scienter clearly falls outside of the realm of the classic negligence standard. Therefore, at least as to attorney omissions of action under rule 2(e) aiding and abetting provisions, scienter of some sort is required and the negligence standard is inapplicable.

Even if the Carter decision could be read to endorse an across-the-board negligence standard for rule 2(e) proceedings, the phraseology of Carter, as well as its complex prospective structure, detracts from and unduly burdens what should be a very straightforward standard of conduct. This Comment has previously noted that the Carter opinion introduces new terminology into the realm of rule 2(e) proceedings. Instead of attempting to mask what is essentially a negligence standard through the use of varied terms preceded by the adjective "reasonable," the SEC should declare that the classic tort negligence standard will now apply to attorneys in rule 2(e) disciplinary proceedings. This approach to difficult ethical problems will simplify application of the expected standard of counsel conduct and will not require voluminous attempts at defining and redefining superfluous Commission explanations of the straightforward tort negligence standard.

Thus, the dual Carter standard of omission by the attorney (requiring some element of scienter) versus misrepresentation (using a strict negligence standard) is transformed from a substantive distinction to a procedural distinction. Omission by the attorney falls within a negligence

150. "Negligence is the failure to use such care as a reasonably prudent . . . person would use under similar circumstances . . . . The prevailing view is that there are no 'degrees' of care in negligence, as a matter of law; there are only different amounts of care as a matter of fact." Black's Law Dictionary 930-31 (5th ed. 1979). Consequently, a securities attorney is held to such care as a reasonably prudent and careful securities attorney would use under similar circumstances.

151. See Dockery, supra note 34, at 95.
152. See supra notes 126-29 and accompanying text.
153. Carter, supra note 2, at N-16.
154. If any element of scienter or even recklessness (as opposed to negligence) is required, the "known or should have known" language of the typical negligence standard is necessarily diluted to "known." Hence, the standard is no longer one of negligence; the duty becomes a lesser one. See supra note 125.
156. See supra notes 143-49 and accompanying text.
standard with the initial rebuttable presumption that the attorney has acted properly, while misrepresentation by the attorney is included in the same negligence standard with the inverse rebuttable presumption that, via negligence per se, the attorney has acted improperly. This latter structure simplifies the *Carter* standard; only one substantive test must be absorbed by the attorney. Since the practicing attorney will look to the substance of ethics for guidance in a difficult practical setting, as opposed to the procedure of disciplinary hearings, a single substantive ethical standard is preferable.

A tort-based standard of conduct has several advantages over the standard espoused in *Carter*. First, the negligence standard is simple to apply. It does not purport to codify ethical conduct standards masked in terms of reasonableness, historically the focal point of tort-based liability. It advocates instead a simple yet flexible standard of application without introducing new terminology and the consequential need for clarification therein. Second, the negligence standard has historically proven a workable doctrine. It can be used in the most easy and most complex of circumstances. Furthermore, it is not foreign to basic fiduciary principles of corporate law. Third, the rich history of tort-based negligence can provide guidelines for the application of negligence standards to rule 2(e) proceedings. Fourth, the negligence standard for unethical conduct under rule 2(e)(1)(iii) blends well with other portions of rule 2(e). For example, direct violations of securities laws by the attorney himself can be couched in terms of negligence per se, thereby maintaining consistency within the rule and the corresponding standard of conduct. Fifth, the *Carter* standard focuses upon the various alternatives the attorney has when faced with a client who refuses to comply with disclosure laws. This standard thus concerns what the attorney should have done. A negligence standard, conversely, focuses upon what actually was done and whether the conduct engaged in was reasonable; hence, the focus is retrospective, not hypothetical. This is clearly the perspective a disciplinary proceeding should take. Sixth, the *Carter* standard lists a series of attorney alternatives to client nondisclosure. Presumably, this list is exhaustive. A negligence standard, conversely, would allow the attorney the flexibility of any conceivable alternative to nondisclosure, so long as that alternative is reasonable. In this respect, a negligence standard of ethical conduct is much less restricting to

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157. In the case of rule 2(e) violations, specifically attorney misrepresentations, negligence per se would be established by violation of the state ethical codes or by violation of federal and state securities laws. See, e.g., ABA CPR, *supra* note 82, EC 1-5, 7-26; ABA CPR, *supra* note 82, DR 1-102(3), (4), 7-102(A)(3)-(8). Assuming the SEC initiates the rule 2(e) proceeding, it is representing the class intended to be protected by state bar codes and securities laws, the public, against the foreseeable risk of unethical attorney conduct.

158. See TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976). In attempting to define "materiality" under the 1934 Securities Exchange Act in false and misleading proxy statements, the Court adopted specific "conventional tort tests" of materiality. *Id.* at 444. Materiality was thus defined as whether a reasonable man would attach importance to the fact omitted or misrepresented. *Id.*; cf. SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973) (pre-*Hochfelder* decision explicitly adopting negligence standard under rule 2(e), calling that standard not overly strict).
the practicing attorney than is the more mechanical Carter decision. Most important, however, is the fact that use of the negligence standard in lieu of the dual Carter standard of omission versus misrepresentation should be mandated for the securities lawyer due to the nature of the securities practice. Because of the nonadversarial relationship of the securities lawyer to his client and the potential for reverberations throughout society for any impropriety by the SEC bar, securities lawyers should be held to a higher standard of care than awareness or knowledge of disclosure violations. Instead, the negligence standard is the test by which the securities lawyer should be measured.

The proposed negligence standard could be criticized as placing too great a burden upon the SEC bar, especially in view of the complexities of current securities law. This criticism can be mitigated, however, through the concepts of rebuttable presumption and cost-benefit analysis. Initially, the proposed negligence-based standard of rule 2(e) liability is predicated upon the theory of a rebuttable presumption that the attorney acted in an ethical and professional manner. The theory would apply in the absence of a negligence per se situation. The presumption would place the burden of production squarely upon the shoulders of the SEC to establish impropriety by the attorney. A mere showing of some evidence by the SEC of violative conduct by an attorney would not be enough to defeat this presumption. An affirmative showing by the SEC of violative conduct by a preponderance of the evidence would initially be required for the lawyer to be required to defend himself. This presumption in favor of the attorney would both discourage frivolous complaints by the SEC and protect the SEC bar from abuse of the negligence-based standard of conduct.

Likewise, an explicit cost-benefit analysis should be instituted to weigh the respective merits of SEC and public concerns against the alleged violative conduct of the securities attorney. Judge Learned Hand defined the cost-benefit analysis in terms of the following:

The degree of care demanded of a person by an occasion is the resultant of three factors: the likelihood that his conduct will injure others, taken with the seriousness of the injury if it happens, and balanced against the interest which he must sacrifice to avoid the risk. All these are practically not susceptible of any quantitative estimate, and the second two are generally not so, even theoretically. For this reason a solution always involves some preference, or choice between incommensurables . . . .

Despite Hand's disclaimer of quantifiability, his valuation of factors has been accepted in terms of an economic cost-benefit analysis. If the product of the likelihood of injury times the seriousness of the potential

159. "[T]he risk is unreasonable and the act is negligent if the risk is of such magnitude as to outweigh what the law regards as the utility of the act or of the particular manner in which it is done." Restatement (Second) of Torts § 291 (1965).
160. Conway v. O'Brien, 111 F.2d 611, 612 (2d Cir. 1940); see also Judge Hand's opinion in United States v. Carroll Towing Co., 159 F.2d 167, 169 (2d Cir. 1947).
injury exceeds the burden of precautions, then the failure to take those precautions is negligence.\textsuperscript{162} If the cost of prevention or of curtailment—whichever cost is lower—exceeds the benefit in damage avoidance to be gained by incurring that cost, society as a whole would be better off, at least in economic terms, to forgo damage prevention.\textsuperscript{163} While there are conflicting views as to whether traditional negligence rules can be justified on the basis of pure economic efficiency,\textsuperscript{164} this structural analysis is at least helpful in focusing attention upon those aspects of an SEC-attorney conflict under rule 2(e) viewed as critical by both the Commission and the lawyer. Likewise, use of a balancing procedure is commensurate with the equitable considerations inherent in discussions of ethical conduct, allowing the administrative law judge discretion to weigh various factual considerations more heavily than other considerations. Not only is the cost-benefit analysis more flexible than the \textit{Carter} standard, but its long history (in a relative sense) makes application of the analysis more certain.

One might argue that the explicit negligence standard endorsed herein offers no more predictability or certainty to the practicing attorney faced with a difficult ethical decision surrounding disclosure than does the \textit{Carter} decision. That argument ignores, however, the fact that most attorneys have a working familiarity with negligence-based standards while being largely uninformed about local ethical promulgations.\textsuperscript{165} Familiarity with the interpretations and application of the negligence standard should lead to more certain attorney predictions of ethical judgments.\textsuperscript{166} Second, use of the traditional negligence standard avoids the necessity of defining what constitutes “prompt steps” to end client nondisclosure. While the concept of reasonability has not yet been reduced to a physical science, it nevertheless offers more precedential guidelines than does the new and potentially more far-reaching notion of “prompt steps.”\textsuperscript{167}

Third, for the SEC to adhere to a simple standard of reasonable conduct that all can understand would be better than to incorporate into rule 2(e) proceedings the inherent dual standard of conduct in \textit{Carter}. In fact, it would almost be preferable for the Commission not to promulgate guidelines concerning ethical conduct if those guidelines are incomprehensible or impractical. Doing so only lures the attorney into a false sense of confidence and detracts from the SEC goal of properly controlling professional conduct. Fourth, a negligence standard is preferable to the \textit{Carter} decision because of the very history of the former gauge of conduct. While not concrete in the abstract, torts scholars have never really advocated reform.

\begin{footnote}
\textsuperscript{162} \textit{Id.} at 32-34.
\textsuperscript{163} \textit{Id.}
\textsuperscript{166} \textit{Id.}
\textsuperscript{167} The term “prompt steps” also focuses upon temporal considerations of how fast the attorney acts. Reasonability as a concept, however, centers upon the substantive rationality of the attorney’s conduct, including the subissue of promptness. Reasonability, therefore, is a more flexible and rational standard of conduct measurement.
\end{footnote}
mation of the negligence standard to a more specific, less flexible measure of conduct. In mandating to certain groups what conduct is expected of them, particularly in the area of professional ethics, rules and regulations can only be so specific. But at the very least, the standard relied upon should be one that is easily understood and one that has withstood the test of long-term successful use. The negligence standard meets these requirements; the *Carter* standard does not.

If the SEC bar nevertheless feels that the securities lawyer would be placed in an unfair position by this proposed negligence standard, despite application of a favorable presumptive evidentiary burden and the use of a cost-benefit analysis, other devices could be used to alleviate these apprehensions. For example, discovery on behalf of the Commission could be limited in either time or scope. Likewise, the burden of proof incumbent upon the SEC to prove rule 2(e) violations could be increased from a preponderance of evidence to clear and convincing evidence. While use of these additional roadblocks to rule 2(e) liability is currently premature and should only be instituted in an effort to circumvent possible abuses of the negligence-based standard, their institution would likely not be required. The flexible nature and encompassing scope of tort-based liability should prove to be the most practical solution.

SEC bar liability based upon this more demanding standard of negligence assumes that the securities lawyer should be held to a higher ethical standard of care than his peers. This higher standard is proper, for the securities practitioner is not an advocate in the normal sense of the term. The Commission has asserted that “[v]ery little of a securities lawyer’s work is adversary in character.”

He doesn’t work in courtrooms where the pressure of vigilant adversaries and alert judges check him. He works in his office where he prepares prospectuses, proxy statements, opinions of counsel, and other documents that we, our staff, the financial community, and the investing public must take on faith. . . . Hence we are under a duty to hold our bar to appropriately rigorous standards of professional honor.

Indeed, to argue that the securities attorney is an advocate in the same

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168. *Cf.* Steadman v. SEC, 450 U.S. 91 (1981), in which the Supreme Court ruled that the preponderance of the evidence standard as opposed to the clear and convincing standard is the proper standard of proof in administrative cases comparable to *Carter*. The Court’s opinion can be read to allow a clear and convincing standard, however; the preponderance standard is merely the minimum burden necessary for a finding of rule 2(e) violation. Compare Note, The Burden of Proof in SEC Disciplinary Proceedings: Preponderance and Beyond, 49 FORDHAM L. REV. 516 (1981), advocating that the Court, not the SEC, should raise SEC disciplinary hearing burdens of proof to the clear and convincing level. In light of the Supreme Court’s recent decision in *Steadman*, however, the SEC cannot be forced to raise the preponderance standard to clear and convincing. Whether the Commission will choose to do so of its own accord remains to be seen.

170. *Id.* at 79,407 n.20.
171. *Id.*
sense as the trial lawyer is to overlook the peculiarly intimate relationship the securities lawyer has with his client as well as the lack of a zealous opponent in securities practice. While some have argued that an advocacy relationship does exist in the securities area, even those favoring this perspective admit that this view is more hope than reality. In the final analysis, the SEC's position that the securities attorney must be held to a more rigorous standard than his legal peers pivots upon the nonadversarial scope of securities work. Thus the duty to uphold the ethics of practice falls not only upon the shoulders of the Commission, to be effected by discipline, but equally upon the shoulders of the bar, to be implemented with the utmost of care and an acceptance of professional responsibility.

The ultimate question then focuses upon what the attorney is to do when he has given his client legal disclosure advice, and the client has failed to follow that advice. Under a negligence-based standard of conduct, the attorney must act reasonably, and reasonability must focus upon the specific factual context of the noncompliance with disclosure. Consequently, virtually any attorney response to client noncompliance could under proper conditions be determined reasonable, even if initial advice is not immediately accepted. Few would argue that it is reasonable for the attorney to immediately resign or disclose noncompliance to a third party upon the first violation of disclosure advice except in the most extreme circumstances. Still, a time comes when the reasonable lawyer must conclude that his advice is not being sought or followed in good faith.

At that time, the securities attorney has three alternatives. A direct approach to the board of directors or other controlling management is one possibility. Such an action might indicate persistence of the attorney in attempting personally to rectify disclosure violations, but a question then arises whether that conduct violates the attorney-client privilege. An obviously necessary inquiry is who constitutes the corporate client. If the consulted board of directors or controlling management is adjudged to be the client, then disclosing communications would not violate the privilege. Conversely, assuming the client to be the corporate entity, approach to certain management members might violate the privilege.

Another option for the attorney whose client fails to follow disclosure

173. "Some counsel have actually described the preparation of a registration statement as involving an adversary relationship between themselves and the issuer, even if they represent the issuer. This is a healthy attitude which should be encouraged." Sonde, supra note 22, at 14 (emphasis added).
175. Carter, supra note 2, at N-19.
176. Id.
177. Id.
178. Calling disclosure noncompliance to the attention of controlling management, even to board members who are outside directors, is often encouraged in this regard. See, e.g., Cutler, The Role of the Private Law Firm, 33 BUS. LAW. 1549, 1556 (1978).
advice is resignation.179 In most circumstances this alternative will not be reasonable until the previous two alternatives are exhausted, for resignation encompasses considerations of client protection against foreseeable prejudice.180 Based upon the premise that “[t]he lawyer's continued interaction with his client will ordinarily hold the greatest promise of corrective action,”181 the Carter opinion discourages resignation. While continuing the attorney-client privilege may prove to be helpful, resignation may at times constitute a reasonable course of action and should be encouraged if disclosure advice concerning important matters is not followed. Such an option by itself potentially encourages disclosure.182

Finally, a reasonable alternative to be considered is whether the attorney should approach an outside organization, usually the SEC, about his client's failure to comply. While the Carter decision skirts this issue as not applicable to that particular factual context,183 this final option cannot be ignored. The question arises as to whether the alternative of whistle-blowing is reasonable under a tort-based standard of liability. As a policy matter, requiring the attorney to inform authorities of client noncompliance would not only violate the attorney-client privilege, but it would likewise discourage corporate willingness to seek legal advice concerning complex compliance issues.184 Moreover, requiring the attorney to inform outside authorities would place the attorney in an adversary relationship with his own client. This alternative of turning in one's client should be adjudged unreasonable per se and not required under any factual circumstance. Thus, the attorney's most drastic alternative action to client noncompliance should be resignation.185 To require otherwise would be to open a Pandora's box of attorney-client privilege violations and encourage fears of SEC abuse.186 To require less responsibility on the part of the securities attorney, conversely, serves merely to encourage an abdication of responsibility on the part of the advising securities attorney, the result of which can only be the decline and demise of an already fragile and abused system of public protection.187

180. Id.
181. Id.
182. Some have argued that threat of resignation is the most potent disclosure enforcement tool available. Directors rarely contradict sound legal advice, especially if the attorney is courageous enough to contemplate resignation. Cutler, supra note 178, at 1557.
183. Carter, supra note 2, at N-19 n.78.
184. Cutler, supra note 178, at 1557.
185. Id.
186. Carter, supra note 2, at N-19.
187. The argument can be made that regardless of the disagreement concerning whether securities lawyers should be treated differently from other advocates, any ethical regulation of attorneys can most efficiently be carried on at the state or local level. This argument ignores, however, a critical and functional benefit derived from SEC regulation of the securities attorney: uniformity of application. Consistent application of ethical rules of conduct to a uniform set of federal securities laws serves to lighten the burden of compliance on the attorney, for it obviates problems of ignorance of the law due to jurisdictional changes. Additionally, present state bar systems of self-discipline in securities matters are inadequate. As most lawyers who participate in the local disciplinary structure are unfamiliar
The SEC promulgated rule 2(e) pursuant to its general rulemaking powers in order to regulate the ethical conduct of the securities bar. While Congress never expressly granted this regulatory power to the Commission, judicial precedent has established the validity of SEC authority in this regard. Commission history has displayed the SEC's intent to exercise this power to its full degree. While the recent *Carter* decision is a valid attempt to define the broad range of Commission power to regulate the ethics of the SEC bar, that decision fails to articulate adequately future guidelines that attorneys in the securities arena can rely upon to insure that their own conduct is within prescribed bounds. Focusing upon the inherently nonadversarial nature of securities work, the SEC should instead adopt a negligence-based reasonability standard, with additional clarification as to proper burdens of production and proof, to define unethical and unprofessional conduct within the structure of rule 2(e). This standard would be more easily applied than the *Carter* decision, and tort law could be compared analogously to the standard if difficulties of application arise. Under a negligence standard of ethical conduct, the securities attorney whose client fails to comply with disclosure advise would, depending upon factual circumstances, have three alternatives to establish reasonability of conduct: (1) further encourage the client to comply; (2) obtain assistance in achieving compliance from control management; and (3) resign. As a policy matter, informing authorities of compliance violations should not be encouraged; it should be seen as unreasonable per se. Only through clarification of stricter ethical standards can the powers that be ensure to the public that securities attorney conduct is being adequately monitored. Those standards must be uniformly applied, however, so that the fears of the flock are calmed and the quality of securities practice is properly maintained.

with the problems and concerns of the SEC, much less the intricacies of the federal securities laws, it is not unusual for attorneys who have engaged in unethical securities activities to escape the wrath of local bar discipline. See Cooney, *The Registration Process: The Role of the Lawyer in Disclosure*, 33 BUS. LAW. 1329 (1978).