The Attorney As Gatekeeper: An Agenda for the SEC

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Abstract

Section 307 of the Sarbanes-Oxley Act authorizes the SEC to prescribe “minimum standards of professional conduct” for attorneys “appearing or practicing” before it. This brief statutory provision frames a much larger question: What is the role of the corporate attorney in securities transactions in the public markets? Is the attorney's role that of (a) an advocate, (b) a transaction cost engineer, or, more broadly, (c) a gatekeeper - - that is, a reputational intermediary with some responsibility to monitor the accuracy of corporate disclosures? The bar has long divided over this question, with the bar associations resisting any such obligation. Yet, Section 307 now “federalizes” this issue.

Skeptics of a gatekeeper role for attorneys have long argued that (a) such a role conflicts with the traditional obligations of loyalty that the attorney owe their clients; and (b) imposing gatekeeping obligations on attorneys will chill attorney/client communications and thereby reduce law compliance. Thus, they have resisted a pending SEC proposal that would require an attorney to make a “noisy withdrawal” when the attorney is unable to stop or prevent certain ongoing material violations of law by the corporate client. This comment examines these arguments that attorneys make interior gatekeepers and replies that (i) securities attorneys can and do perform a “gatekeeping” function; (ii) the differences between attorneys and auditors are less fundamental than bar associations maintain; (iii) in some respects, it is easier to impose gatekeeper obligations on attorneys than on auditors; and (iv) imposing such obligations on attorneys should neither chill socially desirable client communications nor reduce the attorney's influence over the client (and probably will increase that leverage). Finally, this comments examines specific standards and obligations that the SEC might adopt to recognize the securities attorney's role as a gatekeeper. Going beyond the narrow “noisy withdrawal” issue, it proposes both limited certification and independence
standards.
The spotlight is now focused on lawyers. In the post-Enron, post-Sarbanes-Oxley debate over the U.S.’s seemingly dysfunctional system of corporate governance, Congress, the SEC, and the public at large all suspect that, when sophisticated financial chicanery occurs, lawyers are typically present “at the scene of the crime.” So too does Professor Susan Koniak, whose

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This was said in very blunt terms by two of the principal draftsmen of Section 307 (“Rules of Professional Responsibility for Attorneys”) of the Sarbanes-Oxley Act of 2002. Public Law 107-204, 107th Congress. Reviewing the recent scandals and explaining his support for Section 307, Senator Michael Enzi (R-Wyo.) commented:

“[O]ne of the thoughts that occurred to me was that probably in almost every transaction there was a lawyer who drew up the documents involved in that procedure.”

148 Cong. Rec. S6554 (daily ed. July 10, 2002) (Statement of Senator Enzi). His statement was quickly followed by the statement of co-sponsor Senator John Corzine (D-N.J.), the former chief executive of Goldman Sachs, who said:

“In fact, in our corporate world today - - and I can verify this by my own experience - - executives and accountants work day to day with lawyers. They gave advice on almost each and every transaction. That means when executive and accountants have engaged in wrongdoing, there have been some folks at the scene of the crime - - and generally they are lawyers.”

Id. at S6556 (Statement of Senator Corzine).

This comment focuses on how to change the behavior of lawyers in this position.
contribution to this Symposium drives home the point, with the unrelenting persistence of a jackhammer, that lawyers have behaved badly.\(^2\) In response both to the enactment of Sarbanes-Oxley Act last year and to the SEC’s promulgation this year of rules under Section 307 of that Act designed to force “up the ladder” reporting of material violations of law,\(^3\) the bar associations, themselves, still seem locked in denial. Reacting with the same shocked alacrity of a patient in the dental chair when the dental drill hits an exposed nerve, they have answered: “You don’t understand; lawyers can’t undertake the obligations that you are proposing because they conflict with our duties to our clients.”\(^4\) Evan Davis’s contribution to this Symposium is representative. A distinguished litigator, Mr. Davis asserts that the role of the attorney is to

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\(^2\) See Susan Koniak, [title], 103 Colum. L. Rev. __, __ (2003). I agree with many of Professor Koniak’s comments about the deficiencies in the SEC’s rules under Section 307, but I am not convinced that the bar has been as corrupted as she feels it has. In any event, the relevant question is how to structure the relationship between lawyer and client in this field to enhance the independence, integrity, and influence of the attorney. Here, I attempt to take a wider-angled examination that she does of what the SEC could do under Section 307.

\(^3\) On November 21, 2002, the SEC proposed rules under Section 307 of the Sarbanes-Oxley Act to mandate “up-the-ladder” reporting. See Securities Act Release No. 33-8150 (December 2, 2002) [67 FR 1670]. On January 23, 2003, the Committee voted to approve an “up-the-ladder” reporting system under which attorneys must report evidence of material violations of certain laws to the corporation’s chief legal officer and, when that attorney fails to respond appropriately, to the corporation’s audit committee. See Securities Act Release No. 33-8185 (January 29, 2003). However, the Commission delayed for further review its original proposal that mandated attorney resignation and a report to the SEC when the corporate client refused to correct or rectify an ongoing material violation of law that threatened serious injury to the corporation or its securityholders. See Securities Act No. 33-8186 (January 29, 2003).

\(^4\) In a December 18, 2002 letter from ABA President Alfred P. Carlton, Jr. to the Securities and Exchange Commission, the ABA expressed its view that the SEC’s proposed rules would “adversely affect issuers’ ability to obtain sound legal advice....” Id. at p. 2.
serve as “a bulwark between the client and an oppressive state.”\(^5\) He is no doubt right about the role of the litigator, but the question remains whether his description of the attorney’s role applies as well - - or at all - - to the securities attorney. As a result, the debate has had the character of two ships passing in the night - - with neither side truly engaging the claims of the other. Both sides are shocked - - in one case about attorney misconduct; in the other, about regulatory intrusions into the quiet world of the professions - - but neither side has focused fully on the scope of the transformation of the legal profession that the SEC could effect under Section 307.

The SEC has also contributed to the non-conceptual character of the current debate. Understandably eager to minimize controversy, it has presented its “up-the-ladder” reporting rules under Section 307 as intended to protect only the attorney’s client, the corporation. Yet, particularly in the case of the SEC’s proposals for a “noisy withdrawal” obligation, this is disingenuous. The real issue is: To what degree, can or should the securities attorney serve as a gatekeeper with guardian-like responsibilities to investors who rely upon the disclosures that the securities attorney typically prepares or at least reviews. Because the bar associations simply deny that attorneys have any mandatory gatekeeper obligations\(^6\) and because the SEC finds it

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\(^5\) See Evan Davis, [title], 103 Colum. L. Rev. __, __ (2003).

\(^6\) The American Bar Association has historically favored the “hired gun” model of the attorney under which even the securities attorney generally has no duty or right to make disclosure, absent the client’s consent. See American Bar Association, Statement of Policy Regarding Responsibilities and Liabilities of Lawyers in Advising with Respect to the Compliance By Clients with Laws Administered by the Securities and Exchange Commission, 31 Bus. Law. 543, 545 (1975) (“[T]he lawyer has neither the obligation nor the right to make disclosure when any reasonable doubt exists concerning the client’s obligation of disclosure....”).
impolitic to assert that they do (even as they indirectly impose them), this debate has not yet been fully joined. Yet, this debate must ultimately focus on how much the role of the attorney should change, at least in the case of the securities lawyer.

Clearly, non-trivial arguments can be advanced that securities attorneys will not make good gatekeepers. Chiefly, skeptics object either that (i) the responsibilities of a gatekeeper conflict with the traditional obligations of loyalty that the attorneys owe to their clients, or (ii) imposing gatekeeping obligations on attorneys will chill attorney/client communications that also serve to promote law compliance. In response, this brief comment will reply that (a) securities attorneys have long recognized gatekeeper-like obligations (and thus differ from their litigator colleagues in a profession that is considerably more heterogenous than is generally recognized); (b) the differences between attorneys and auditors are less fundamental and more marginal than opponents of the SEC’s proposed “noisy withdrawal” standard have recognized; (c) in some respects, it may be easier to impose gatekeepers obligations on attorneys than on auditors; and (d) imposing gatekeeper obligations on attorneys is likely neither to chill socially desirable client communications nor to reduce attorneys’ influence over their clients, but may actually increase attorneys’ leverage over their most intransigent clients. Finally, this comment will examine the critical question that the SEC has not yet begun to consider: now that the SEC has the power to promulgate “minimum standards of professional conduct” for securities attorneys under Section 307, what standards make sense if we believe it necessary that the legal profession assume some responsibility as a guardian of the market’s integrity? It will propose some other obligations that could overshadow, and prove more beneficial to investors than, a duty of “noisy withdrawal.”
Part I What Is a Gatekeeper?

The term “gatekeeper” has been frequently used to describe independent professionals who serve investors, preparing, verifying, or assessing the disclosures that they receive. Examples of gatekeepers include: (1) the auditor who provides its certification that the issuer’s financial statements comply with generally accepted accounting principles; (2) the debt rating agency that evaluates the issuer’s creditworthiness; (3) the securities analyst who communicates an assessment of the corporation’s technology, competitiveness, or earnings prospects; (4) the investment banker who furnishes its “fairness opinion” as to the pricing of a merger; and (5) the securities attorney for the issuer who delivers an opinion to the underwriters that all material information of which the attorney is aware concerning the issuer has been properly disclosed. The underwriter in an initial public offering also performs a gatekeeping function, in the sense that its reputation is implicitly pledged and it is expected to perform due diligence services.

Structurally, gatekeepers are independent professionals who are so positioned that, if they withhold their consent, approval or rating, the corporation may be unable to effect some transaction or to maintain some desired status. For example, institutional investors may be able

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8 Professor Reinier Kraakman originally defined “gatekeepers” as private parties who were able to prevent corporate misconduct by withholding their cooperation from wrongdoers. See Reinier Kraakman, Gatekeepers: The Anatomy of a Third Party Enforcement Strategy, 2 J.L. Econ. & Org. 53 (1986). See also Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857 (1984).
to purchase the corporation’s bonds only if an independent debt rating agency rates them as of investment grade.\textsuperscript{9} Similarly, a “clean” opinion from an auditor may be required by stock exchanges and the SEC if the corporation is to remain publicly traded. From a law compliance perspective, the existence of the gatekeeper offers an effective strategy for deterrence. Because the gatekeeper will receive little, if anything, from corporate involvement in crime or misconduct, it can be more easily deterred than the corporation or its managers, who may profit handsomely from crime or who may be tempted to engage in criminal activities to achieve goals or standards that allow them to remain in office.

The gatekeeper’s relative credibility derives in part from its lesser incentive to lie or dissemble, but even more so from the fact that the gatekeeper in effect pledges a reputational capital that it has built up over many years and many clients to secure its representations about the particular client or transaction.\textsuperscript{10} At least in theory, a gatekeeper would not rationally sacrifice this reputational capital for a single client who accounts for only a small portion of its

\textsuperscript{9} A debt rating agency must be recognized by the SEC as a “nationally recognized statistical rating organization” (or a “NRSRO”) before its ratings carry meaningful consequences. Thus, the SEC has de facto licensing control over this form of gatekeeper. See Rule 15c3-1(c)(2)(vi)(E), (F), and (H) under the Securities Exchange Act of 1934. 17 C.F.R. 240.15(c)(3)-1. State “legal investment” laws often limit certain regulated institutions to investments in “investment grade” debt securities as rated by NRSRO, or restrict the percentage of the institution’s portfolio that can be invested in non-complying securities.

\textsuperscript{10} The idea that a gatekeeper is an “informational intermediary” whose presence or certification makes the issuer’s representations credible was probably first articulated by Professors Ronald Gilson and Reinier Kraakman with respect to underwriters. See Ronald Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 612-21 (1984).
Attorneys resemble gatekeepers in that they usually have reputational capital and are often in a position to block or delay transactions or governmental approvals that are vital to their corporate client. This is truest in the case of securities attorneys, who could potentially block the effectiveness of a registration statement or the consummation of a merger simply by signaling their displeasure to the SEC. In the past, the SEC has strongly suggested that the attorney who is aware of a disclosure violation has a duty to seek to block or delay the consummation of any transaction, at least until properly informed shareholder approval is obtained. At times (although inconsistently), the SEC has even said that the attorney has an affirmative obligation to cause the client to comply with the federal securities laws.

Historically, bar associations have resisted these SEC pronouncements, insisting that the attorneys owe no mandatory obligations to public investors. The securities bar has, however,
been far more equivocal.\textsuperscript{15} Although litigators have often asserted (as Evan Davis asserts in this Symposium) that lawyers owe a duty only to their clients and cannot assume other responsibilities, prominent securities attorneys have long endorsed the idea that they owe a duty to the public — one that requires them to be skeptical of, and independent from, their client. A classic expression of this view was stated in 1974 by A.A. Sommer, Jr., a long-time leader of the securities bar and of the time an SEC Commissioner. In a speech entitled, “The Emerging Responsibilities of the Securities Lawyer,” he succinctly summarized the key elements of this duty:

“I would suggest that in securities matters (other than those where advocacy is clearly proper) the attorney will have to function in a manner more akin to that of auditor than to that of the attorney. This means several things. It means that he will have to exercise a measure of independence that is perhaps uncomfortable if he is also the close counselor of management in other matters, often including business decisions. It means he will have to be acutely cognizant of his responsibility to the public who engage in securities transactions that would never have come about were it not for his professional presence. It means that he will have to adopt the healthy skepticism toward the representation of management which a good auditor must adopt. It means that he will have to do the same thing the auditor does when confronted

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\textsuperscript{15} A considerable literature has discussed the conceptions that corporate lawyers have of themselves. See, e.g., Robert W. Gordon, Corporate Law Practice As a Public Calling, 49 Md. L. Rev. 255, 258 (1990); Ronald J. Gilson, The Devolution of the Legal Profession: A Demand Side Perspective, 49 Md. L. Rev. 869, 884 (1990) (“A lawyer functions “as a kind of buffer between the illegitimate desires of his client’s and the social interest”). One commentator has noted that the bar has long divided between two competing visions of the attorney: (1) the hired gun or “total commitment” model, and (2) the gatekeeper model. See Paul G. Haskell, WHY LAWYERS BEHAVE AS THEY DO 85-86 (1998).
In overview, Sommer’s definition of the securities attorney’s ethical responsibilities stresses precisely the elements that define a gatekeeper: (1) independence from the client; (2) professional skepticism of the client’s representations;17 (3) a duty to the public investor; and (4) a duty to resign when the attorney’s integrity would otherwise be compromised.

Of course, other securities attorneys may well disagree with Commissioner Sommer, and his commanding presence in the field still does not prove that his policy analysis is inherently correct. But even an ambivalence on the part of securities attorneys about their gatekeeper role contrasts sharply with the unqualified assertions of litigators that attorneys are essentially advocates. The litigators’ certainty seems attributable to a “center-of-the-universe” fallacy under which litigators assume that their experience and their typical relationships with clients also necessarily characterize the experiences of other branches of the bar.

Part II What Happened to Gatekeepers During the 1990s

A 2002 study by the General Accounting Office (“GAO”) found that approximately 10% of all publicly listed U.S. companies restated their financial statements at least once between


17 Late Harvard Law School Professor Louis Loss, the unquestioned dean of securities law academics before his death, similarly took the position that the securities lawyer’s job inherently involved asking “searching questions” of the client about its proposed disclosures. See Louis Loss & Joel Seligman, FUNDAMENTALS OF SECURITIES REGULATION 1384 (4th ed. 2001).
The GAO study also shows that the annual rate of financial restatements soared between 1997 and June 2002. The GAO study also shows that the annual rate of financial restatements soared between 1997 and June 2002. Specifically, the GAO study finds that there were 919 announced restatements over the period from 1997 to June 2002, involving some 845 different companies, which comes to 10 percent of all those listed.

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18 See United States General Accounting Office, Report to the Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, FINANCIAL STATEMENT RESTATEMENTS: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges (October 2002) (GAO-03-138) at 4. Specifically, the GAO study finds that there were 919 announced restatements over the period from 1997 to June 2002, involving some 845 different companies, which comes to 10 percent of all those listed.

19 Id. at 15.
This sudden spike in financial restatements strongly suggests that auditors became compromised during the 1990s and acquiesced in risky and questionable accounting policies favored by corporate managements. But auditors were neither the only profession that dealt with financial disclosures nor that seemed to have become compromised during the 1990s. Securities analysts present an even clearer case in which conflicts of interest caused once cautious and objective analysts to behave more like cheerleaders than neutral umpires, at least when the corporation under review was an underwriting client of the investment banking firm that employed them.

Both quantitative, as well as qualitative, data suggest that the behavior and incentives of securities analysts changed during the 1990s.

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20 This author has elsewhere made the case in more detail that during the 1990's auditors became compromised by a combination of reduced legal risks for acquiescing in financial irregularities and heightened benefits that corporate managements could bestow on acquiescent auditors in the form of highly lucrative consulting work. See John C. Coffee, Jr. Understanding Enron: “It’s About the Gatekeepers, Stupid,” 57 Bus. Law 1403 (2002).

21 For a general overview of this scandal, which was largely brought to the public’s attention by New York Attorney General Eliot Spitzer, see Gretchen Morgenson, “Wall Street Analysts: Requiem for an Honorable Profession,” New York Times, May 5, 2002, at Section 3-1 (concluding that major changes in the profession date from around 1996).

22 Professors Hong and Kubik find that optimism was more important than accuracy during the 1990s in predicting a security analyst’s advancement within the industry. See Harrison Hong and Jeffrey Kubik, Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts, 58 J. Fin. 313 (2003); see also Roni Michaely & Kent Womack, Conflict of Interest and the Credibility of Underwriter Analysts Recommendations, 12 Review of Financial Studies 653 (1999) (finding that analysts employed by underwriting firms behaved differently - - and less accurately - - than independent analysts).

Another source of evidence is the marked shift in the ratio of buy to sell recommendations made by analysts, which ratio went from 6:1 in 1990 to 100:1 in 2000. This study by Thompson Financial First Call further found that less than one percent of the 28,000 stock recommendations issued by brokerage firm
Responding to these problems with both auditors and analysts, Sarbanes-Oxley sought to restore the independence of both gatekeepers by different strategies. In the case of auditors, Congress decreed a divorce, separating the consultant role from the auditing role.\textsuperscript{23} In the case of analysts, it authorized the SEC to engage in broad rule-making designed to “address conflicts of interest that can arise when securities analysts recommend equity securities ... in order to improve the objectivity of research.”\textsuperscript{24}

This leaves the attorney as the lone remaining agent with responsibilities for the disclosure process who has not yet been subjected to prophylactic rules affecting its professional structure or independence. To be sure, Sarbanes-Oxley did not ignore attorneys, but it was less certain about how to treat them. Section 307 authorizes the SEC to promulgate “minimum standards of professional conduct” for attorneys appearing or practicing before the SEC. In their statements in the Congressional Record, the Senate co-sponsors of Section 307 clearly expressed their view that attorneys were at least as implicated as auditors and investment bankers in the financial and accounting irregularities that produced the collapse of Enron, WorldCom, et al.\textsuperscript{25}

\textsuperscript{23} Section 201 of the Sarbanes-Oxley Act prohibits accounting firms from providing a variety of non-audit services to an audit client that is a publicly held company. This section of the Act has been codified as Section 10A(g) of the Securities Exchange Act of 1934.

\textsuperscript{24} See Section 501 of the Sarbanes-Oxley Act, which has been codified as a new Section 15D to the Securities Exchange Act of 1934 (15 U.S.C. § 78a et seq.).

\textsuperscript{25} See text and note supra at note 1.
Although the only specific reform mandated by Section 307 was “up-the-ladder” reporting, the breadth of the phrase “minimum standards of professional conduct” sweeps far more broadly and could easily encompass other, potentially more extensive gatekeeping duties, at least to the extent that any such duty can be fairly characterized as a “minimum standard of professional conduct.”

The issue then is whether attorneys are a sufficiently distinctive profession that they should be treated differently from auditors and analysts, whose objectivity and independence Sarbanes-Oxley expressly sought to upgrade. Plausible arguments can, of course, always be made that any profession is different. Balanced against these attempts to distinguish the legal profession, however, is a countervailing consideration: Can investor confidence in our equity markets be restored without imposing on attorneys, as the profession typically having the principal role in the drafting of disclosure documents, some greater responsibility for protecting the integrity of the disclosure process? If not, the social cost of exempting attorneys from gatekeeping responsibilities would include a higher cost of equity capital for corporate issuers, more reliance upon debt and resulting higher corporate leverage, and reduced economic growth; all these potential costs are impossible to measure with any precision, but nonetheless their macro-economic impact would be real and adverse.

Part III Can Attorneys Be Gatekeepers?

How are attorneys different from more classic gatekeepers, such as auditors? Two differences are usually identified:

First, attorneys are not predominantly gatekeepers, as auditors and analysts in theory are. Rather, they play multiple roles with respect to the corporate client: (1) advocate; (2) transaction
engineer; and (3) disclosure supervisor - - or gatekeeper. Critics of the SEC’s proposed rules have thus been quick to assert that imposing gatekeeper-like duties on the attorney would compromise the attorney’s loyalty to the client, thereby subordinating the attorney’s primary role to the secondary role of gatekeeper.\textsuperscript{26}

Second, public policy has uniquely favored free and open communications between the attorney and the client, deeming them to be legally privileged in order to maximize the incentive for the client to communicate freely with the attorney. Once again, critics assert that such communications will “dry-up” under the SEC’s proposed rules on noisy withdrawal, with the result that the end goal of law compliance could actually be impeded because of reduced communications.

A third and countervailing consideration must also be noted: the other principal gatekeepers are each regulated today by a public body that at least in theory seeks to protect the interests of the public. For example, after Sarbanes-Oxley, auditors are regulated by the Public Company Accounting Oversight Board (“PCAOB”), which is expressly charged with setting ethical standards for auditors,\textsuperscript{27} while securities analysts are subject to regulation by the NASD and the NYSE, as self-regulatory bodies monitored by the SEC, and by the SEC itself. Only attorneys stand apart, regulated by private state bar associations. Such “guild-like” regulation

\textsuperscript{26} For a good statement of this position, see Jill E. Fisch and Kenneth M. Rosen, “Is There a Role of Lawyers in Preventing Future Enrons?,” (forthcoming in Villanova Law Review) (available on SSRN Electronic Library at id= 367661).

\textsuperscript{27} Section 101(a) of the Sarbanes-Oxley Act empowers the PCAOB “to oversee the audit of public companies that are subject to the securities laws... in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports....”
has little incentive to be aggressive, to fund enforcement, or to place the interests of the public above those of its members (as the SEC has, itself, complained).  

A. The Multiple Roles of Attorneys. For the sake of argument, let us assume that business lawyers are primarily transaction cost engineers, who only secondarily oversee the disclosure process. How real is the conflict between these two roles? Unsurprisingly, it has long been the law that an attorney who knowingly files a false disclosure document with the SEC can be held liable by that agency as an “aider and abetter” of the primary violation by the corporate client. Thus, some obligation to play a gatekeeper role already exists. The major difference between current law and a “noisy withdrawal” obligation is that today an attorney could arguably stand aside and not object when the issuer made a disclosure violation of which the attorney was aware but did not actively assist. If “noisy withdrawal” were mandated, however, at least some


29 See SEC v. Fehn, 97 F.3d 1276 (9th Cir. 1995) (upholding SEC “aiding and abetting” action against an attorney).

30 In In re Carter, Fed. Sec. L. Rep. (CCH) Para. 82, 847 (1981), the SEC announced that a lawyer who is aware of serious and continuing violations of law by a corporate client has an obligation to “take prompt steps to end his client’s noncompliance.” However, the SEC retreated one year later from this aggressive stance when its general counsel indicated that in the future the Commission would exercise greater prosecutorial restraint in bringing administrative proceedings under SEC Rule 102(e) and would bring such proceedings generally only when a
instances would arise in which the attorney could not remain passive without violating this rule. Thus, the conflict already exists, but in fairness it would be exacerbated by subjecting the attorney to gatekeeper duties.

Still, other professions also perform multiple roles - - or at least did until recently. Immediately prior to the enactment of Sarbanes-Oxley, one survey found that the “Big Five” auditing firms received on average over three times as much in consulting income from their audit clients as they received from them in audit fees.\(^3\) Obviously, this imbalance reduces the incentive of the auditor to detect or report violations of law if such conduct could cause the audit firm to forfeit even more lucrative consulting revenues.\(^2\) Economically then, the auditor had at

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\(^1\) See Janet Kidd Stewart and Andrew Countryman, “Local Audit Conflicts Add Up: Consulting Deals, Hiring Practices in Question,” Chicago Tribune, February 24, 2002 at C-1 (surveying the one hundred largest corporations in the Chicago area in terms of how they compensated their auditors and the breakdown between audit and consulting fees). Probably, the focus should not be on the average ratio, but on the extreme cases. This study found one large corporate issuer (Motorola) that had over a 16:1 ratio between the consulting fees and the audit fees it paid to its auditor.

\(^2\) Even more importantly, the client could silently cancel or revoke consulting relationships and revenues if the auditor exhibits excessive integrity in resisting questionable accounting policies. In contrast, firing the auditor is a dangerous strategy because of SEC disclosure rules that permit the auditor to explain the nature of its disagreement with the client. See Coffee, Understanding Enron: “Its About the Gatekeepers, Stupid,” 57 Bus. Law 1403, 1411-12 (2002).
least as much disincentive to “blow the whistle” on a major client.

Similarly, the securities analyst is an employee within a larger investment banking firm, whose compensation and advancement often depended upon publishing highly favorable and optimistic research about underwriting clients of the firm. Again, the investment banking firm has multiple relationships with the corporate client that compromise the objectivity of its analysts’ recommendations.

Of course, Sarbanes-Oxley has restricted such conflicts in the case of the auditor and the analyst. Yet, precisely for this reason, reformers could logically propose a corresponding policy proposal for the attorney: to prevent conflicts that compromise the attorney, a corporation should be required to use a different counsel for “transaction engineering” tasks than it used for “gatekeeping responsibilities.” That is, the corporation could use one law firm to plan and structure a merger and another to handle all disclosure responsibilities pertaining to the merger. To be sure, this would involve costly duplicative and redundant work. But cost considerations are not necessarily dispositive. For example, in preventing the auditor from serving its client as a consultant, Sarbanes-Oxley may have also precluded the corporate client from similarly realizing cost-efficient synergies. The difference between the auditor and the attorney is then one of degree, not of kind. In all likelihood, the synergies in permitting one law firm to serve as both transaction engineer and disclosure counsel are greater than the synergies in permitting an auditor also to serve as a software consultant. Still, this is debatable on a case by case basis. In short, those who point to the multiple roles played by the attorney as a reason for not holding it responsible as a gatekeeper are making the same argument unsuccessfully made by auditors prior to Sarbanes-Oxley’s severance of auditing from consulting. Possibly, a complete divorce of
these multiple (and potentially conflicting) roles is less feasible in the case of attorneys; but, if so, this may only suggest that other, less restrictive means of dealing with the same conflicts need to be found. As will be suggested, Section 307 offers a path to this end.

In some respects, it may even be easier to impose gatekeeper obligations on the attorney than on the auditor. The individual audit partner often has a “one client” practice, at least when the audit partner serves a large firm (such as Enron). Lose that client, and the partner probably has no future with his or her firm. Although a “one client” practice is also possible in the case of partners in a law firm, this pattern has become far less common. General counsel have learned to move their legal business around to foster price competition among law firms; increasingly, recurring and/or less specialized activities are cheaper for the corporate client to internalize by moving “in house.” In short, because corporations make the same “make or buy” decision with respect to legal services as they do with respect to other commodities and services, the law firm partner has increasingly become a specialist - - one with high reputational capital who markets his or her services to multiple clients (for example, the “M&A” or bankruptcy specialist who typically has a “one shot” relationship with the corporate client and then moves onto the next client). In contrast, neither the auditor nor the investment banking firm has the same “one shot,” non-recurring relationship with its corporate clients that law firms increasingly have. In overview, this “one shot” relationship is precisely the profile of the professional who can best serve as a gatekeeper, because the professional remains more independent of the client and suffers less from a single client’s dismissal.

33 For an overview of these developments, see Ronald J. Gilson, The Devolution of the Legal Profession: A Demand Side Perspective, 49 Md. L. Rev. 869 (1990).
Nonetheless, some argue that the attorney’s mindset as an advocate for the client blinds the attorney to signs of illegality. The answer here is: compared to what? The auditor or the investment banker has little expertise in spotting or identifying violations of law, while the attorney is far more capable of detecting them. Although it may be true that the attorney does not want to find legal violations, why is that a defense? The more we suspect that attorneys will avert their gaze, the more we need to raise the penalties to deter them from so doing.

The claim that auditors make good gatekeepers, and attorneys bad ones, is also undercut by the limited empirical evidence. Since the passage of the Private Securities Law Reform Act in 1995, auditors have been under a statutory obligation to report to the SEC any material violations of law that they uncover in the course of their work for publicly-held corporate clients. The limited evidence to date suggests that they reported such violations on very few occasions. This could conceivably be read to mean that there have been very few such

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34 For this argument that there are cognitive constraints on the corporate attorney that cause the attorney to overlook fraud, see Donald C. Langevoort, Where Were the Lawyers?: A Behavioral Inquiry into Lawyers’ Responsibility for Clients Fraud, 46 Vand. L. Rev. 75, 95 (1993).

35 See Section 10A(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78jA (specifying steps that an independent public accountant must take when it “detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred”). Section 10A’s coverage is far broader than that of the SEC’s rules under Section 307, because it requires the auditor to respond to even apparently immaterial illegal acts.

36 Richard Walker, then the Director of the SEC’s Enforcement Division, told an AICPA National Conference in 1999, that the SEC had received fewer than a dozen Section 10A reports since that section was enacted as part of the PSLRA in 1995. See Richard H. Walker, “Behind the Numbers of the SEC’s Recent Financial Fraud Cases, Remarks before the 27th Annual National AICPA Conference on current SEC Developments (Dec. 7, 1999) available at http://www.sec.gov/news/speecharchive/1999/spch334.htm. Addressing the same
violations to report or, more realistically, that human beings will predictably rationalize and find reasons for avoiding what is not in their self interest to do. Both attorneys and auditors are subject to this same urge, and hence generalizing the obligation to report so that it applies to the attorney as well as the auditor increases the chance that material violations will come to light. Also, from a deterrence perspective, the corporate client may be more apprehensive that the attorney will obey legal rules than that the auditor will.

B. Attorney/Client Communications. The most important argument against imposing “gatekeeper” obligations on securities attorneys is that attorneys may be less able to communicate freely with their clients if such obligations - - and, in particular, a “noisy withdrawal” requirement - - were imposed. In response to this claim, it is first necessary to recognize that the ultimate goal of the law is to achieve law compliance, not to maximize uninhibited communications between the attorney and the client. Client confidentiality is a means to an end, not an end in itself. Thus, the law has long placed some limitations on attorney/client communications (such as the crime/fraud exception).\(^\text{37}\)

conference a year later, Walker noted that his “concern remain[ed]. We have received only a handful of additional reports - - fewer than five during the past year.” See Richard H. Walker, “Remarks Before the AICPA National Conference on Current SEC Developments (Dec. 5, 2000) available at http://www.sec.gov/news/speeches/spch446.htm. Mr. Walker concluded that this low response rate suggested that auditors were “failing to fulfill their 10A responsibilities.” Id. See also, Darin Bartholomew, Is Silence Golden When It Comes to Auditing? 36 J. Marshall L. Rev. 57 (2002).

\(^{37}\) Some believe that prosecutors have already so expanded the “crime/fraud exception” to the attorney/client privilege in the corporate context as to make the existence of the privilege uncertain. See David N. Zarnow and Keith Krakaur, On the Brink of A Brave New World: The Death of Privilege in Corporate Criminal Investigations, 37 Am. Crim. L. Rev. 147 (2000). But see In re Richard Roe, Inc., 168 F.3d 69 (2d Cir. 1999) (defining crime/fraud exception more narrowly than
Still, even with this concession, it remains true that lawyers can counsel most effectively when there is open, relatively unconstrained communication between their clients and themselves.\textsuperscript{38} Hence, the practical issue becomes whether gatekeeper obligations would necessary chill desirable attorney/client communications. The stress here should be on the word “desirable.” What would be the likely impact of the SEC’s proposed “noisy withdrawal” standards on such communications? A starting point for this analysis should be the recognition that the client knows little law and will almost always want to know if contemplated action is illegal. From this premise, it follows that the corporate official contemplating prospective action will still inquire of counsel whether the course of action under consideration is lawful. Indeed, the more the government pursues white-collar criminal prosecutions and punitive regulatory actions in the contemporary post-Enron environment, the more, in turn, that corporate officers are likely to inquire before they act. When then will communications be most likely to be chilled? The logical answer is that the officer who has already acted may fear inquiring of an attorney if the officer’s conduct was lawful - - precisely because the officer fears that the attorney may be under an obligation to report unlawful actions to higher authorities or, indirectly, to the SEC. In short, it is the “ex post” inquiry by the client of the attorney that is most likely to be chilled.

If one accepts this premise that \textit{ex ante} communications between counsel and the client prosecutors requested). Given this uncertainty, those who predict a sudden decrease in lawyer/client communications following the adoption of any “noisy withdrawal” rule have some obligation to explain why it has not already occurred.

\textsuperscript{38} See \textit{Upjohn Co. v. United States}, 449 U.S. 383 (1981) (recognizing the importance of candid dialogue between corporate officers and counsel in defining the scope of the attorney/client privilege).
are less likely to be chilled than ex post communications, several implications follow: First, the impact of imposing gatekeeper obligations on attorneys may be socially desirable. In a well-known article, Professors Kaplow and Shavell have argued that the case for protecting ex ante communications between attorneys and clients is far stronger than the case for protecting ex post communications.\textsuperscript{39} Advice before action leads individuals to comply with the law, they argue, whereas ex post advice does not provide a guide for action; rather, it may simply allow the defendant to discuss defense strategies and means of evasion, thereby reducing the expected penalty costs and encouraging illegality. It is not necessary to accept fully the Kaplow/Shavell analysis, which might curtail the attorney/client privilege to “ex ante” advice, to see that its core distinction between ex ante and ex post advice suggests that we should be more concerned about chilling “ex ante” communications between attorney and client. Yet, this is not what most gatekeeper obligations do; rather, they may induce such communications by making “ex post” advice less possible.

Second, requiring “noisy withdrawals” and “up-the-ladder” reporting also has a deterrent value that is independent of this issue of whether the initial corporate actor will still consult counsel. Few significant actions within a corporation can be taken by a single actor.\textsuperscript{40} Decisions


\textsuperscript{40} This point was made by Senator Corzine when he co-sponsored Section 307. See text and note supra at note 1. Within the modern corporation, lawyers are always being consulted by someone, and the fact that multiple actors consult them implies that a wrongdoer cannot anticipate that his or her own silence implies that the organization’s lawyers will not learn of the conduct in question.
made by one person still need to be implemented by others. Thus, even after the initial corporate actor has taken an irrevocable step (and will thereafter be arguably less willing to consult with counsel ex post), other corporate actors must be convinced to cooperate with the initial actor. They will have every incentive to consult with counsel because they are still at the “ex ante” stage. In turn, knowledge that others are necessarily likely to learn of the original actor’s conduct and also to consult with counsel about its legality may deter the original actor. The modern public corporation is embedded with in-house attorneys, and even the possibility that they will report “up the ladder” should deter some illegal conduct. Accordingly, even if under some conditions there may be less direct communication between corporate actors and counsel, the knowledge that sooner or later counsel is likely to learn ex post (because of the multiple parties likely to consult counsel) may still deter corporate actors ex ante.

Equally important, the principal practical effect of imposing gatekeeper obligations on attorneys is that a client who has been advised by an attorney that contemplated action is unlawful now has greater reason to heed that attorney’s advice -- again precisely to the extent that the client believes that the attorney may be under a legal obligation to report any misconduct (either inside the corporation or outside). Thus, even if it were true that clients would consult less often, this impact could be more than fully offset by the fact that it would become more dangerous to disregard the lawyer’s advice. Add to this mix the likelihood that “ex ante” advice will not be chilled, and the net impact is to increase the attorney’s leverage over the client by making it more dangerous to ignore the attorney’s advice. If law compliance is the goal, such an impact seems socially desirable. Put simply, the logical remedy for gatekeeper failure is to empower the gatekeeper, and a “noisy withdrawal” obligation makes it more costly for the client
to ignore the lawyer.

Part IV. Implementing The Gatekeeper Role of Attorneys

Although, the debate over Section 307 to date has been dominated by the issue of “noisy withdrawal,” the scope of Section 307 is far broader. What else can or should the SEC do to make the attorney an effective guardian of the integrity of publicly filed disclosure documents (without imposing obligations that subordinate the attorney’s duty of loyalty to the client to this mission)? Three proposals will be made: (1) a due diligence obligation; (2) an independence requirement; and (3) an attorney certification requirement. Each is premised on A.A. Sommer’s normative claim that the securities attorney has to behave something like the way an auditor behaves41 (while simultaneously also recognizing that the attorney cannot undertake an obligation to audit its client).

A. The Due Diligence Obligation. Few norms are less controversial among securities attorneys than that they should perform some due diligence in preparing prospectuses or other disclosure documents. Yet, no SEC rule actually requires this. Thus, a logical first step would be for the SEC’s Rules of Practice to mandate due diligence by the attorney (within the time realistically available to the attorney) in the preparation of disclosure documents. Indeed, such an obligation sounds very much like a “minimum standard of professional conduct” that Section 307 authorizes. Why? Because it is semantically impossible to assert that an attorney who has behaved in a grossly negligent fashion has behaved “professionally.” Interestingly, in its existing Rules of Practice, the SEC already holds auditors to precisely such a standard and

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41 See text and note supra at note 16.
asserts the power to suspend or disbar them for merely negligent conduct. If this can be done, then it seems to follow a fortiori, after the enactment of Section 307, that the SEC could require attorneys to take reasonable steps to investigate the accuracy of statements made in documents that they prepare. The impact of such a rule is to give fair notice to the attorney that he or she cannot simply rely on the client’s assertions, but must perform at least some minimal examination to corroborate those assertions, whose depth and intensity would be basically determined by the profession’s own norms and standards.

By no means is it here suggested that negligence should support a private cause of action under Rule 10b-5 against attorneys (or others). But negligence is improper professional conduct, which can in appropriate cases justify the imposition of sanctions under Section 307. Such a tradeoff - i.e., public liability but not private liability for negligence - again seems desirable in that it enhances deterrence without threatening insolvency for law firms.

B. Independence. Auditors, of course, must be independent of their client, and SEC rules have long defined tests for auditor independence. Increasingly, a new literature has warned

See 17 C.F.R. § 201.102(e)(iv) (specifying that two forms of “negligent conduct” - either “a single instance of highly unreasonable conduct” or “repeated instances of unreasonable conduct” - that could trigger sanctions under Rule 102(e)).

The attorney would, of course, be entitled to rely on the auditor with respect to financial information certified by the auditor, as in the case of the “reliance on an expert” defense under Section 11(b)(3)(c) of the Securities Act of 1933. See 15 U.S.C. Section 77(k)(b)(3)(c).

Historically, the SEC did once hold attorneys liable for professional negligence in “aiding and abetting” cases. See SEC v. Spectrum Ltd., 489 F.2d 535, 536 (2d Cir. 1973). This is no longer possible after the Supreme Court mandated a scienter standard in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), but sanctions for professional misconduct could look to a similar negligence standard.
that attorneys are becoming too economically intertwined with their clients, as the result in part of the increasing practice of law firms taking (and even demanding) equity stakes in the client in return for professional services.\textsuperscript{45} If some level of independence is necessary for an attorney to function as a gatekeeper (as A.A. Sommer, Jr. recognized over a quarter century ago), SEC rules of professional conduct could define these limits. To illustrate, a law firm that holds in its portfolio 10% of the corporate client’s equity (or, alternatively, equity in the client equal to 10% of its own net asset value) will probably be a poor, or at least a biased, monitor.

Perhaps the context that is most sensitive and would most benefit from such rules is that of internal corporate investigations. Should the corporation’s normal outside counsel perform such an investigation? Or, should SEC rules define the level of independence necessary to conduct such a more sensitive inquiry? Absent SEC action, individual state bar associations will either do nothing (the most likely outcome) or prescribe different and inconsistent standards, thereby creating needless disparities. Uniform standards for corporate internal investigations are desirable and as a practical matter can only come from the SEC. There is no need to offer precise rules here, but only to recognize that professionals are expected to be independent of their clients. Accordingly, the SEC should read Section 307 to grant it authority to define the point at which the attorney is not sufficiently independent of the client to perform certain sensitive tasks.

C. Attorney Certification. Today, the auditor certifies the firm’s financial results, and,

under Sarbanes-Oxley, senior management certifies that the financial information in periodic reports filed with the SEC “fairly presents in all material respects” the firm’s financial condition and results of operations.46 Even the securities analysts must now certify that its recommendations reflect the analyst’s own personal views.47 Alone, the attorney escapes and need not certify in any way as to the accuracy of the client’s disclosures. Yet, traditionally, the attorney is the field marshall of the disclosure process.

More importantly, because the auditor’s certificate covers only the financial statements that it reviews, no independent professional today expresses any view that the statements made in the textual portions of a Form 10-K or a registration statement are correct or have at least been subjected to a reasonable “due diligence” examination by the professional. Yet, increasingly, the most important statements made by a corporate issuer are those set forth in its “Management Discussion and Analysis of Financial Condition and Results of Operations.”48 If after the Enron-era scandals we are concerned about quality and reliability of the financial disclosures reaching the market, one of the most obvious, logical and necessary steps would be to insert a gatekeeper into the disclosure process at exactly this stage and require some professional vetting of the issuer’s textual statements.

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46 Both Sections 302 and 906 of the Sarbanes-Oxley Act require certifications by both a covered corporation’s chief executive officer and chief financial officer that the “financial information included in the report ... fairly presents in all material respects the financial condition of and results of operations of the issuer ....” Section 906 has been codified as part of the federal criminal code at 18 U.S.C. § 1350 and carries up to a 20 year sentence.


Still, there is a problem with this proposal that requires it to be downsized significantly. Put simply, what can the attorney reasonably be asked to certify? It has not audited its client; nor is a law firm organizationally or logistically equipped for any form of inquiry analogous to an audit. Nonetheless, a less onerous form of certification seem possible. Based on the opinions normally delivered by attorneys in registered offerings in the securities market, it would seem justifiable to ask the attorney principally responsible for preparing a disclosure document or report filed with the SEC to certify (1) that such attorney believes the statements made in the document or report to be true and correct in all material respects, and (2) that such attorney is not aware of any additional material information whose disclosure is necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

In essence, this proposed certification simply tracks the language of Rule 10b-5. Far from intruding very far into the marketplace, this obligation only generalizes existing practices in the private market. Today, in most public underwritten offerings, issuer’s counsel delivers an opinion to the underwriters — sometimes called a “negative assurance” opinion — stating that it is not “aware” of any material information required to be disclosed that has not been disclosed.

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49 Issues could arise as to which attorney was principally responsible for preparing a document. The simplest answer to this issue is to require the corporation to disclose the identity of such attorney in the filing and then require that attorney’s certification. The real thrust of this proposal is to require the issuer to subject its principal disclosure documents to the review of an attorney, who would be subject to SEC sanctions for professional negligence. This author would not require the attorney to be an outside counsel (although others might think that such an additional requirement was also justified).

50 For a description of this standard opinion in registered public offerings, see Richard Howe, *Rethinking Legal Opinion Letters: The Duties and Liabilities of*
In this light, such a negative certification requirement would simply mandate for 1934 Act periodic filings what is already done by the private issuers in the primary market for 1933 Act disclosure documents. The marginal difference is that, in the latter case of periodic filings under the Securities Exchange Act, there is no party in a position analogous to the underwriter who can demand such an opinion or certification from the attorney. Thus, SEC action would fill this void. The one respect in which this proposal does change current practice is that it would require that some attorney - - whether inside or outside the corporation - - assume responsibility for supervising the preparation of the disclosure document. Thus, it effectively requires the involvement of a gatekeeper and precludes internal corporate personnel from filing a Form 10-K.

Attorneys in Rendering Legal Opinions, 1989 Colum. Bus. L. Rev. 283, 287 (1989). The author of this article, a partner at the New York firm of Sullivan and Cromwell, properly observes that “such opinions are not really ‘legal opinions’ at all in that they do not state any legal conclusion but only say that the attorney believed certain facts to be true.” Id. Precisely for this reason, such an opinion is more a pledge of the law firm’s reputational capital, which the underwriters demand. The counsel giving such opinion does not purport to conclude that all information required to be disclosed has been disclosed (as an auditor might by analogy), but only that it lacks personal knowledge or belief as to any such failure. See also Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L. J. 239, 291 (1984) (also describing such opinions); Richard W. Painter, Toward A Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules, 63 Geo. Wash. L. Rev. 221, 226-27 and n.19 (1991) (discussing judicial interpretation of such opinions). The American Bar Association has characterized this type of opinion as a “negative assurance” and finds such opinions to be “unique to securities offerings.” See ABA Comm. on Legal Opinions, Third-Party Opinion Report, Including the Legal Opinion Accord of the Section of Business Law, American Bar Association, 47 Bus. Law. 167, 228 (1991). Although the ABA considers it generally inappropriate for attorneys to request such “negative assurance” opinions from other attorneys, the special context of securities offerings is exempted, reflecting the fact that underwriters consider such an assurance to be necessary to them. That the ABA, as the representative of the bar, “disfavors” such opinions because of the demands they place on the attorney probably only underscores their value.
51 As part of the Private Securities Litigation Reform Act of 1995, Section 20(e) was added to the Securities Exchange Act of 1934 to expressly authorize the SEC to sue “any person who knowingly provides substantial assistance to another person in violation of this title or of any rule or regulation issued under this title.” Thus, although private persons may not sue an aider and abetter, the SEC can.

52 The attorney can be held criminally liable under the federal “aiding and abetting” statute. See 18 U.S.C. §2. Or, the attorney could be held liable for securities fraud because now the attorney has made its own “attributed statement.” Under
investors with respect to important disclosure documents.

CONCLUSION

This comment has moved from the diagnosis that gatekeepers failed investors during the late 1990s to the prescription that, in order to align the gatekeepers’ incentives with those of shareholders, two strategies need to be pursued: deterrence and empowerment. Deterrence is easy, but empowerment is more complex. The latter requires new aspirational duties and new ethical standards, even if they will be only rarely enforced. Today, it is not only anomalous, but irrational, that the auditor and analyst are closely regulated and required to certify, while the attorney is not.

Although this comment by no means advocates the federalization of most professional rules of ethics applicable to securities attorneys, it does recognize that guild-like regulation by state bar associations cannot establish the gatekeeping responsibilities of securities attorneys. Indeed, bar association enforcement of ethical rules has never deterred, and probably will never deter, the bar. Yet, unless relatively uniform norms are clearly established, gatekeeper failure is likely to remain the prevailing pattern because the client’s inevitable pressure on the gatekeeper is not matched by countervailing regularity pressure. SEC rules thus offer the best prospect for a relevant response that avoids pointless disparity. Unlike state bar associations, the SEC can

the Central Bank decision, a secondary participant can be held liable - - both civilly and criminally - - for the statements that it makes itself. See Central Bank of Denver, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 191 (1994) (“Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5 assuming all the requirements for primary liability under Rule 10b-5 are met”).

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promulgate rules for special contexts that will both have the advantages of uniformity and relative neutrality.

To paraphrase Clemenceau, professions are too important to be left to the professionals.