

**Federal Express**

December 17, 2002

Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

File No. 33-8150.wp

Re: Proposed Rules: Implementation of Standards of Professional Conduct for Attorneys,  
17 CFR 205

Dear Mr. Katz:

This letter addresses the proposed rules announced by the Commission in Securities Act Release No. 33-8150 in order to implement Section 307 of the Sarbanes-Oxley Act (the "Act"). I write as a law professor who has taught securities law for over twenty-five years and who participated, both as a witness before Congressional committees and as adviser, in the drafting of the Act.

Although I agree in the main with the letter of comments submitted by Professors Koniak, Cramton and Cohen, I write as a securities law professor to address one critical area where the Commission's proposed rules deviate significantly and, in my judgment, unjustifiably from the long and established definition of materiality under the federal securities laws. The focus of my concern is with the triggering level for the attorney's initial obligation to report evidence of a material violation to the corporation's chief legal officer ("CLO").

Release No. 33-8150 accurately summarizes the operation of Section 205.3(b) by stating:

"The rule's reporting obligation is triggered only when an attorney becomes aware of information that would lead a reasonable attorney to believe a material violation has occurred, is occurring or is about to occur, thus limiting the instances in which the reporting duty prescribed by the rule will arise to those where it is appropriate to protect investors." 2002 SEC LEXIS 3004 at \* 27 to \*28 (emphasis added).

The suggestion here that the corporate client (and indirectly investors) need protection only when an attorney reasonably determines that it is probable that a material violation has occurred may be the most undefended and indefensible conclusion in any recent SEC release or statement. It simply assumes what is to be proved: namely, that corporations (and their investors) do not need the same level of protection and loyalty that an individual client would receive (and expect) from his or her own attorney.

To understand what this quoted statement means in context, it is useful to focus on the case where the attorney becomes aware of credible evidence suggesting a material violation but has not had the opportunity (or the incentive) to investigate further. Assume that, if pressed, the attorney could honestly state that he or she would then estimate the likelihood of a material violation at 40%. However, the magnitude of this potential violation could be sufficiently severe as to bankrupt the corporation and wipe out the investments of its security holders. Yet, under the language of proposed Section 205.3(b), the attorney does not on these facts have an obligation to report the evidence of which the attorney is aware. This conclusion follows because the language of Section 205.3(b)(1) triggers the obligation to report only when the “attorney is aware of evidence of a material violation,” and Section 205.2(e) defines “evidence of a material violation” to mean “information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur.” As a result, the reasonable attorney who is less than 50% convinced that a material violation has occurred has no duty to report.

Worse yet, there is a negative pregnant in the last sentence of Section 205.3(b) because it recognizes that there is no waiver of the attorney/client privilege or violation of ethical norms forbidding the release of client confidences when an attorney communicates “such information” to the issuer’s officers or directors. Because “such information” here refers back to “information that would lead an attorney reasonably to believe that a material violation has occurred,” the seeming implication is that information of only a reasonable suspicion would not necessarily be similarly protected. Hopefully, this is not the Commission’s intent, but the Commission should realize that those wishing to dissuade an attorney from reporting evidence in any specific case will predictably make this argument in order to suggest that reporting suspicions, even reasonable suspicions, is improper and unprotected - - under the Commission’s own rule.

The absurdity of this position under which the attorney is instructed to report when the attorney concludes that there is a probability of a violation, but not when the attorney estimates that there is slightly less than a probability that a violation has occurred, comes into clearest focus when we contrast the positions of an attorney representing a corporate client and one representing an individual client. It is inconceivable that an attorney would not advise an individual client that the attorney suspected (but did not know) that the client was the victim of a material fraud (even if the probability was only 25%). It is conceivable, however, that the same attorney would not disclose the same information or suspicions to a corporate client. Yet, this disparity is not justifiable, and it arises precisely because the attorney is often subject to a conflict of interests. Hence, from a policy perspective, the appropriate goal of the SEC’s efforts under Section 307 should be to end this disparity and encourage and instruct the corporate

counsel to behave in the same fashion as would the responsible attorney representing an individual client.

From the perspective of securities regulation, there is another, possibly more compelling reason for lowering the reporting threshold to a level well below that set forth in proposed Section 205.3(b)(1). As earlier noted, Section 205.3(b)(1) uses a probability test for requiring the reporting of a material violation of law. Risks of material violation that fall below the 50% likelihood threshold do not have to be reported, even if the attorney possesses credible evidence that could easily be investigated further in order to reach a more definite conclusion. Yet, the normal standard of materiality under the federal securities laws does not use any such probability standard. Rather, the federal securities laws have long used the probability/magnitude balancing approach that was endorsed by the Supreme Court in Basic, Inc. v. Levinson, 485 U.S. 224, 238 (1988).<sup>1</sup> That test provides that, at least with respect to contingent or speculative information, materiality will normally depend upon a balancing of the “indicated probability” of a risk with its “anticipated magnitude,” all assessed in light of the totality of the company’s activities. Thus, from a traditional materiality perspective, a 20% chance that a corporation will be injured by a price-fixing conspiracy, which could expose it to an enormous liability, could easily be material, if this 20% probability were associated with damages of a high magnitude. Release No. 33-8150 never even attempts to explain why the Commission should depart from its traditional approach to materiality assessments by adopting the rigid probability cutoff that is built into Section 205.2(e).

Nor is any good reason evident to depart from the traditional approach to materiality. A lower threshold than the proposed probability standard makes particular sense where the attorney is only reporting internally to corporate officers and will not thereby expose the corporation to damages, adverse market reaction, or the risk of loss of the attorney/client privilege.

In contrast, a high threshold for reporting material violations of law (such as the proposed probability test) enables the attorney to rationalize why the attorney cannot “reasonably believe” that a material violation of law has occurred, is occurring, or is about to occur - - on the information then known to the attorney. It also creates an incentive to look no further and avoid incriminating knowledge. Given the professional risks to the attorney from “up the ladder” reporting, rationalization is predictable, and proposed Section 205.3(b) aids and abets it. Moreover, the proposed definition of “evidence of a material violation” in Section 205.2(e) renders the Commission’s rule essentially unenforceable. No enforcement action will be brought under it without a phalanx of experienced lawyers testifying for the defendant that the evidence then known to such attorney did not yet establish a probability of a material violation.

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<sup>1</sup> This test was originally formulated by the Second Circuit in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968). To the best of my knowledge and memory this test has never been controversial within the Bar - - at least when it applied to the disclosure obligation of others.

What then should the standard be? Proposed Section 205.3(b) vacillates between terminology that sometimes requires that attorney to “become aware” (Section 205.3(b)) and sometimes requires the attorney to “reasonably believe” a material violation has occurred (Section 205.2(1)). While there are ambiguities and potential inconsistencies between these two phrasings, the more important point is that the standard should be lower. I would recommend the following as a revised formulation for Section 205.3(b)(1):

(1) If, in appearing or practicing before the Commission in the representation of an issuer, an attorney becomes aware, or should have become aware in the exercise of the prudence, diligence and foresight that a reasonable attorney would exercise under similar circumstances, of credible evidence of a material violation of law by the issuer, or by any officer, director, employee or agent of the issuer, the attorney shall report such evidence to the issuer’s chief legal officer ... [remainder of subsection is unchanged].

No definition of “evidence of a material violation of law” is strictly required, but the Commission could specify that only credible information, whether or not admissible in court, triggered the reporting obligation. I would also recommend the addition of an “unless” clause at the end of Section 205.3(b)(1), allowing the attorney not to report such evidence if, after a brief investigation, the attorney determined with reasonable certainty that a material violation of law has not occurred, is occurring, or is about to occur. This would not create an affirmative duty to investigate, but it would permit the attorney to engage in a self-protective further inquiry which might often absolve the attorney of any obligation to report. At the least, it would cancel the incentive that would otherwise arise to avoid further knowledge, once the first signs of suspicious conduct are detected.

This proposal is far more consistent with the legislative history to Section 307 than is proposed Section 205.3(b)(1). Each of the three co-sponsors of Section 307 - - Senators Edwards, Enzi, and Corzine - - commented on the Senate floor that a reporting standard well below that proposed in Section 205.3(b)(1) should apply. For example, Senator Edwards explained that their basic remedy was to insist on specific SEC rules:

“The SEC shall make one rule in particular, and it is a simple rule with two parts. No. 1, a lawyer with evidence of a material violation of the law has to report that evidence either to the chief legal counsel or the chief executive officer of the company.”<sup>2</sup>

Senator Enzi specifically explained that the co-sponsors did not intend to make actual proof of a legal violation a prerequisite to this new reporting obligation. Instead, he formulated an alternative standard:

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<sup>2</sup> See 148 Cong. Rec. S6552 (daily ed. July 10, 2002).

“Maybe it could be called the ‘smell test.’ If something smells wrong, somebody who can fix it ought to be told.”<sup>3</sup>

Senator Corzine sensibly recognized that the lawyer could avoid any problems that a “smell test” might create by conducting a further investigation. As he saw it, once a potential violation was recognized, an across-the-board duty to investigate arose:

“We should recognize that in some instances where there may be evidence of a violation, it may become apparent after a more complete investigation that there is not an actual violation. But when lawyers are aware of a potential violation, they do have a duty to investigate.”<sup>4</sup>

In short, awareness of a “potential violation,” not a probable violation, was the standard intended by Section 307’s draftsmen.

Indeed, if there were to be any deviation from the current standard for defining materiality, it should be in the direction of the even lower standard of materiality that the Commission has used in connection with its releases defining the corporation’s obligation to disclose potential risks in its Management’s Discussion and Analysis of Financial Condition and Results of Operation (the “MD&A”). Last month, in Securities Act Release No. 33-8144, the Commission has proposed to require the disclosure of “off-balance sheet arrangements” that “may have a current or future material effect” on the corporation’s financial condition or results of operations. Of course, this is well below a probability standard, but the Commission explicitly further stated in this release that the company could withhold disclosure of such potentially material transactions only when the event is “outside the realm of the reasonably possible.” In truth, the two contexts are related, and consistency should require disclosure (at least within the corporation) of evidence of material violations of law, unless the risk is remote or the potential damages, once discounted by the risk, are immaterial.

To sum up, whether one focuses on (i) seeking to make the attorney representing an organization behave like the attorney representing the individual client, or (ii) maintaining consistency with the Commission’s traditional definition of materiality (particularly in this context where less harm or injury is risked by internal disclosure), the triggering standard for disclosure proposed by Release No. 33-8150 is badly flawed and would embarrass the Commission, if adopted.

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<sup>3</sup> Id. at S6555.

<sup>4</sup> Id. at S6556 (emphasis added).

Yours truly,

John C. Coffee, Jr.  
Adolf A. Berle Professor of Law