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Professional Responsibility, Due Diligence and Rule 415: Another Dilemma

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I. INTRODUCTION

The federal securities laws[1] were enacted to provide, among other things, full and fair disclosure to the public concerning issuers and their securities. The Securities and Exchange Commission (SEC) and the federal courts have focused with confusion upon the duties and responsibilities of attorneys who play a central role in this disclosure process.[2] In the wake of major securities scandals,[3] the SEC attempted to promulgate its own standards of professional responsibility for attorneys, generally conceded to be more complex, more stringent and steeped in the "public interest."[4] These suggested levels of professional responsibility created conflicts with the Code of Professional Responsibility (Code)[5] and elicited strong favorable and unfavorable responses.[6] At the peak of this concern for the public interest, securities attorneys, issuers, and underwriters were in a dilemma with respect to the attorney-client relationship, the duty to disclose, a public mandate to "blow

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1. The federal securities laws are generally considered to include the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976); the Securities Exchange Act of 1934; 15 U.S.C. §§ 78a-78kk (1976); the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79z-6 (1976); the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1976); and the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1976).

2. One commentator has noted:

> [T]he professional judgment of the attorney is often the "passkey" to securities transactions. If he gives an opinion that an exemption is available, securities get sold; if he doesn't give the opinion, they don't get sold. If he judges that certain information must be included in a registration statement, it gets included. . .; if he concludes it need not be included, it doesn't get included.

Sommer, *The Emerging Responsibilities of the Securities Lawyer,* [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,631, at 83,689 (January, 1974).

3. Names such as BarChris, National Student Marketing, Penn Central, Equity Funding, IOS, Stirling Homex, Four Seasons, and Westec became well known far beyond Wall Street. *See* Cheek, *Professional Responsibility and Self-Regulation of the Securities Lawyer,* 32 WASH. & LEE L. REV. 597, 600 (1975).

4. For an excellent analysis of the development of this trend, written at the time that it was occurring, see Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties,* 74 COLUM. L. REV. 412 (1974).

5. MODEL CODE OF PROFESSIONAL RESPONSIBILITY (1979).

6. Perhaps the strongest position in favor of expanded responsibilities was taken by Commissioner Sommer. *See supra* note 2. Interestingly, Roberta S. Karmel represented a strong spokesperson for the other point of view before she became an SEC commissioner. *See* Daley & Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC,* 24 EMORY L.J. 747 (1975).

the whistle," and the appropriateness of withdrawal by the attorney.[7]

The SEC itself, in February, 1981, admitted that clearly enunciated standards of professional responsibility did not exist throughout the 1970's:

> The ethical and professional responsibilities of lawyers who become aware that their client is engaging in violations of the securities laws have not been so firmly and unambiguously established that we believe all practicing lawyers can be held to an awareness of generally recognized norms. We also recognize that the Commission has never articulated or endorsed any such standards.[8]

In addition, the question of whether the attorney was required to report improper client conduct to the SEC was not squarely addressed in actual litigation.[9]

RULE 2(E)

As part of its rules of practice, the SEC promulgated Rule 2(e), which in its most recent amended form provides:

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7. As Sommer observed:

> It means [the attorney] 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 he will have to adopt the healthy skepticism toward the representations of management which a good auditor must adopt. It means he will have to do the same thing the auditor does when confronted with an intransigent client—resign.

Sommer, *supra* note 2, at 83,689-90.

An attorney formerly with the Division of Enforcement of the SEC went further:

> In serving a corporate-client, a lawyer must be acutely cognizant of the client's responsibilities to its shareholders. . . .
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> . . . The obligations which corporations have to their shareholders must, to some degree, be shouldered by the lawyer-adviser who counsels the corporations. There may even be circumstances so serious that the lawyer may have to take some action on his own so as not to frustrate the ends sought to be achieved by the law.

Gruenbaum, *Corporate/Securities Lawyers: Disclosure, Responsibility, Liability to Investors and* National Student Marketing Corp., 54 NOTRE DAME LAW. 795, 827-28 (1979).

8. *In re* Carter [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶82,847, at 84,170 (S.E.C. Feb. 28, 1981) (footnote omitted).

9. *See* SEC v. National Student Mktg Corp., 457 F. Supp. 682 (D.D.C. 1978); Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). Even *Meyerhofer,* where an attorney submitted an affidavit to the SEC upon discovering inadequate disclosure, did not consider whether the lawyer has any *duty* to disclose any information to the SEC without his client's consent. Meyerhofer v. Empire Fire & Marine Ins. Co., 497 F.2d 1190 (2d Cir.), *cert. denied,* 419 U.S. 998 (1974).

> 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 of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws, . . . or the rules and regulations thereunder.[10]

Rule 2(e) may be applied when an attorney is disciplined by local authorities or convicted of a crime.[11] The rule may also be applied where the attorney has been enjoined by a federal court or found to have violated or aided and abetted a violation of securities laws.[12] Finally, the rule may be applied when the SEC initiates an administrative proceeding before an administrative law judge.[13]In some forty-six years of the SEC's history, only a little more than one hundred Rule 2(e) proceedings have been initiated by the SEC against attorneys, most of which have not been litigated.[14] The SEC has never brought a disciplinary proceeding against an attorney based solely on a failure to meet ethical or professional standards.[15] Generally, Rule 2(e) proceedings, other than willful violations, have been based on aiding and abetting violations.[16] It could be maintained that this has been so because it is difficult to draw a line between improper conduct and aiding and abetting.[17] However, it is equally maintainable that aiding and abetting allegations, if proven, could provide stronger sanctions, more readily recognized and understood by the investing public, than sanctions imposed for improper conduct.[18] The SEC's position, in part, re-

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10. 17 C.F.R. § 201.2(e)(1) (1981).

11. Greene, *Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶83,089, at 84,800 (Jan. 13, 1982).

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* at 84,802.

16. *Id.*

17. *Id.*

18. "For example, even if a lawyer is justified in not disclosing his client's violation of the securities laws under the Code, he may nonetheless find himself named as a defendant in an SEC civil enforcement action as an aider and abettor of the violation." Lipman, *The SEC's Reluctant Police Force: A New Role for Lawyers*, 49 N.Y.U.L. REV. 437, 460 (1974). Sanctions for improper conduct as defined by the Code generally involve censure, suspension, and, infrequently, disbarment. *See* MODEL CODE, *supra* note 5, Preamble and Prelimi-

flects the assumption that increasing the liabilities of securities lawyers will result in greater protection of the investing public.[19]

In 1976 the Supreme Court in *Ernst & Ernst v. Hochfelder* held that *scienter* is required as proof of aiding and abetting violations of securities laws.[20] However, the holding in *Hochfelder* was applied to private damage actions and the SEC took the position that this action was inapplicable to administrative proceedings.[21] In *Aaron v. SEC*,[22] the Supreme Court extended the *Hochfelder* test to include other civil actions, but held that *scienter* is not required in civil enforcement actions under Section 17(a)(2) or Section 17(a)(3) of the Securities Act of 1933.[23] Nonetheless, reckless conduct has been held to be proof of *scienter*.[24] In addition, violations can be proved by a preponderance of the evidence standard as opposed to a clear and convincing test.[25] This reduced evidentiary standard of proof facilitates disciplinary proceedings whether or not 2(e) proceedings will ultimately be confirmed as in fact circumventing *scienter* requirements.[26] Negligence has been used as a test

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nary Statement. Aiding and abetting sanctions include injunctions, prohibitions, disqualifications, remedial conduct decrees and severe practice penalties secured through settlements. *See* Downing & Miller, *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME LAW. 774 (1979). Disqualification from practice before the SEC can lead to loss of livelihood in other professional endeavors. An SEC injunction can increase a person's exposure to civil liabilities in private damage actions. Lowenfels, *Scienter or Negligence Required For SEC Injunctions Under Section 10(b) and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW, 789, 806-07 (1978).

19. Lipman, *supra* note 18, at 465.

20. 425 U.S. 185 (1976). '*[S]cienter*' refers to a mental state embracing intent to deceive, manipulate or defraud." *Id.* at 193 n.12.

21. Downing & Miller, *supra* note 18, at 783 (citing *In re* Haskins & Sells, Accounting Series Release No. 73 (1952), 5 FED. SEC. L. REP. (CCH) ¶72,088). Downing & Miller also discuss the SEC's maneuvers in this regard at 783-84.

22. 446 U.S. 680 (1980).

23. Section 17(a)(1) clearly requires scienter. That section makes it illegal "to employ any device, scheme, or artifice to defraud." Section 17(a)(2) prohibits a person from obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact." Section 17(a)(3) prohibits a person from engaging "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit." This language focuses on results, not culpability. *Id.* at 696-97. The Court was citing Securities Act of 1933, § 17 (a)(1)-(3). 15 U.S.C. § 77q(a)(1)-(3)(c)(1976) (emphasis omitted).

24. *In re* Gibson [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶83,068 at 84,710, 84,713 (S.E.C. Dec. 7, 1981); McLean v. Alexander, 599 F.2d 1190 (3rd Cir. 1979). *McLean* adopted the *Sundstrand* definition of recklessness. "[It] presents a danger of misleading . . . that is either known to the defendant or is so obvious that the actor must have been aware of it." Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977) (citing Franke v. Midwestern Oklahoma Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976)).

25. Steadman v. SEC, 450 U.S. 91,102 (1981).

26. *See generally* Gruenbaum, *supra* note 7, at 820-21; Robins, *Policeman, Conscience*

in place of reckless conduct even in non-2(e) proceedings.[27] Therefore, the reckless, and in some cases negligent, standard could roughly equate to the standard of proof required in an allegation of improper conduct.[28] Paradoxically, less egregious conduct can result in stricter sanctions. The SEC's Rule 2(e) proceedings have, in effect, been its disciplinary weapon against improper conduct.

THE CODE

In order to put Rule 2(e) within the framework of the Code, an analysis of applicable Code provisions is in order. The Code contains nine canons, each of which is accompanied by a number of ethical considerations (EC) and disciplinary rules (DR). Ethical considerations represent goals or objectives and are aspirational in character. The disciplinary rules are enunciated as mandatory levels of minimal conduct.[29] The American Bar Association (ABA) Committee on Ethics and Professional Responsibility supplements these with formal opinions in problem areas.[30] Historically, these opinions and principles have focused on the courtroom lawyer and have paid little homage to the attorney as adviser, his principal function in securities matters.[31] Canon 5 provides that "a lawyer should exercise independent professional judgment on behalf of a client."[32] This canon requires uncompromising loyalty to the client,[33] and suggests sole allegience to the corporate client.[34] It was not until recently that the SEC acknowledged this important aspect of the canons.[35]

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or Confidant: Thoughts on the Appropriate Response of a Securities Attorney Who Suspects Client Violations of the Federal Securities Laws, 15 J. MAR. L. REV. 373, 389-91 (1982).

27. SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973). In *Spectrum,* the court held that the lawyer's ignorance was the result of his own negligence, and reasoned that the lawyer's role was sufficiently important to hold him to a duty of reasonable care. *Id.* at 542. *BarChris* laid the groundwork for the court's approach in *Spectrum.* Robbins, *supra* note 28, at 389 n.62. *See also* SEC v. Frank, 388 F.2d 486 (2d Cir. 1968) (lawyer not mere scrivener for client, bearing no responsibility for accuracy of statements).

28. *See* SEC v. Management Dynamics, Inc., 515 F.2d 801, 811 (2d Cir. 1975).

29. Cheek, *supra* note 3, at 621.

30. *Id.*

31. *See* Gruenbaum, *supra* note 7, at 800. *See also* Cheek, *supra* note 3, at 620-21.

32. MODEL CODE, *supra* note 5, at Canon 5.

33. *Id.* at EC 5-1.

34. *Id.* at EC 5-18.

35. "We are mindful that, when a lawyer represents a corporate client, the client—and the entity to which he owes his allegiance—is the corporation itself and not management or any other individual connected with the corporation." *In re* Carter [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶82,847, at 84,171 (S.E.C. Feb. 28, 1981) (footnote omitted).

Canon 7 provides that "a lawyer should represent a client zealously within the bounds of the law."[36] This canon points out that as adviser, the attorney, in appropriate circumstances, should give his professional opinion as to future consequences of proposed activities.[37] The attorney should inform his client of the practical effects of the client's conduct and may continue the representation of the client, even though future conduct is contrary to his advice, so long as it does not involve illegal conduct.[38] Also, Canon 7 suggests that the decision to forego legally available alternatives is ultimately the client's decision and the lawyer should exert his best efforts to insure his client's decisions are made only after being fully informed of relevant considerations.[39] While providing an interesting philosophical backdrop, these aspirational statements provide insufficient guidance for the practicing attorney.

One disciplinary rule provides that a lawyer shall not "[e]ngage in conduct involving dishonesty, fraud, deceit, or misrepresentation."[40] This can be related to willful violations of securities laws. Knowingly engaging in fraudulent misrepresentation would meet the *Hochfelder* test and certainly 2(e) requirements as well.[41] Another disciplinary rule provides instructions with regard to withdrawal from employment.[42] Resignation does not operate to correct continuing violations and the SEC has acknowledged that such action is frequently inappropriate.[43] Other rules give contradictory instructions with respect to the preservation of confidences and secrets of clients[44] and highlight the conflict with "whistle-blowing

36. MODEL CODE, *supra* note 5, at Canon 7.

37. *Id.* at EC 7-3.

38. *Id.* at EC 7-5.

39. *Id.* at EC 7-8.

40. *Id.* at DR 1-102(A)(4).

41. *Hochfelder*, 425 U.S. at 193 n. 12. Active participation in fraud subjects the attorney to liability under federal securities laws. *See* Patterson, *The Limits of the Lawyer's Discretion and the Law of Legal Ethics:* National Student Marketing *Revisited,* 1979 DUKE L.J. 1251, 1256-57.

42. MODEL CODE, *supra* note 5, at 2-110.

43. In *Carter* the court stated:

> Premature resignation serves neither the end of an effective lawyer-client relationship nor, in most cases, the effective administration of the securities laws. The lawyer's continued interaction with his client will ordinarily hold the greatest promise of corrective action. . . . In general, the best result is that which promotes the continued, strong-minded and independent participation by the lawyer.

In re Carter, *supra* note 8, at 84,172-73. (Evans, C., concurring and dissenting).

44. "A lawyer may reveal:. . . (2) Confidences or secrets when permitted under [DR's] or required by law or court order. (3) The intention of his client to commit a crime and the information necessary to prevent the crime." MODEL CODE, *supra* note 5, at DR 4-101(c)(2)

standards" urged by the SEC.[45] Lawyers have been in a quandry when attempting to reconcile this rule with the SEC's position on the matter.[46]

One rule admonishes the attorney to accept employment only when competent to do so.[47] This is consistent with the SEC's Rule 2(e)(1), which provides that disciplinary action attaches when competence is lacking.[48] Rules within Canon 7 provide direct instructions to the attorney with respect to actions which may bear on *scienter*.[49] Another rule admonishes the attorney not to accept employment if it would be likely to involve him in representing differing interests.[50] However, this rule is too general to provide the attorney with any clear direction in the course of his securities work.

In summary then, the fraud[51] and *scienter*[52] rules appear to embody prohibitions sufficiently fundamental in nature that their coverage plainly falls within the area of conduct prohibited by Rule 2(e).[53] In this respect Rule 2(e) can be considered consistent with and embodied in the Code. This embodiment should be taken into consideration in the context of EC 5-18 (allegiance to corpo-

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and (3) (footnotes omitted). Contrary directions are found in DR 7-102:

> A lawyer who receives information clearly establishing that: (1) His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal, except when the information is protected as a privileged communication. (2) A person other than his client has perpetrated a fraud upon a tribunal shall promptly reveal the fraud to the tribunal.

MODEL CODE, *supra* note 5, at DR 7-102(B) (footnotes omitted).

45. *See* Sommer, *supra* note 2; Gruenbaum, *supra* note 7, at 827-28.

46. The ABA defined "privileged communications" and "fraud" in such a broad fashion that the SEC would term the approach causistic. *See ABA Comm. On Ethics and Professional Responsibility, Formal Op. 341,* (1975). With respect to attorney-client relationships, the ABA further stated: "We do not believe that the policy of disclosure as embodied in the SEC laws warrants an exception to the basic confidentiality of the attorney-client relationship. Such exceptions have to date been carefully reserved by the [Code] for far more critical and limited situations." *Statement of Policy Adopted by American Bar Association 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, 547 (1975).

47. *See* MODEL CODE, *supra* note 5, at DR 6-101 (A).

48. 17 C.F.R. § 201.2(e)(1) (1981).

49. "In his representation of a client, a lawyer shall not:. . . (4) Knowingly use perjured testimony or false evidence. (5) Knowingly make a false statement of law or fact. . . . (7) Counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent." MODEL CODE, *supra* note 5, at DR 7-102(A).

50. *Id.* at DR 5-105(a).

51. MODEL CODE, *supra* note 5, at DR 1-102(A)(4).

52. *Id.* at DR 7-102(A).

53. *In re* Carter, *supra* note 8, at 84,170 n.65.

rate client) and EC 7-8 (informed decisions). This recent SEC position is more circumspect than that enunciated in the 1970's and harmonious with the ABA's stated position on the matter.[54]

THE MODEL RULES

The ABA's Commission on Evaluation of Professional Standards is preparing a revised and more practice-oriented code of responsibility.[55] The Model Rules of Professional Conduct (Final Draft) specifically addresses the duties of advisers to corporations.[56] One proposed rule seeks to clarify the identity of the client, indicates that the attorney's duty is to the organization and highlights the factors that a lawyer should consider in selecting a course of action.[57] Significantly, the proposed rule outlines steps that may be taken to minimize the disruption of the organization and to prevent the risk of revealing confidential information when an attorney knows a violation of securities laws has occurred or will occur. They are:

> (1) asking for reconsideration of the matter;
> (2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and
> (3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.[58]

If a lawyer is aware of a violation of a securities law, but believes that the violation will go undetected unless he discloses it, the correct response may be for him not to disclose it.[59] Clear justification must exist for going over the head of the person responsible for such activities.[60]

In the Final Draft, a proposed rule eliminates ambiguities in the Code with respect to "crimes" and "fraud" in past and future activities.[61] Another rule of the Final Draft is also helpful:

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54. *Opinion 341*, *supra* note 46.
55. MODEL RULES OF PROFESSIONAL CONDUCT (Proposed Final Draft, May 30, 1981).
56. *Id.* at Rule 1.13. *See* Robins, *supra* note 26, at 399.
57. MODEL RULES, *supra* note 55, at Rule 1.13; Robins, *supra* note 26, at 399.
58. MODEL RULES, *supra* note 55, at Rule 1.13.
59. *Id.*; Robins, *supra* note 26, at 400.
60. MODEL RULES, *supra* note 55, at Rule 1.13 comment.
61. *Id.* at Rule 1.6 and comment.

> A lawyer shall not counsel or assist a client in conduct that the lawyer knows or reasonably should know is criminal or fraudulent, or in the preparation of an instrument containing terms the lawyer knows or reasonably should know are legally prohibited, but a lawyer may counsel or assist a client in a good faith effort to determine the validity, scope, meaning or application of the law.[62]

The commentary indicates that the lawyer should withdraw if his continued involvement assists the client's unlawful activity.[63] Another part of the Final Draft explains this rule further and suggests that the rule is activated when a client's activity renders the lawyer's prior statements untrue.[64]

The Final Draft provides more direction for the securities practitioner and appears to be more closely allied with the SEC's implementation of 2(e).[65] Under the Final Draft, a securities lawyer must attempt to stop the violation he uncovers, refrain from activity that would contribute to the violation, seek assistance from higher authority, resign if met with continual refusal to cease unlawful activities and disclose the wrongdoing if the activity continues with the client making use of the attorney's prior involvement.[66]

The SEC recently formulated its own standards for determining unethical or improper professional conduct:

> 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.[67]

The Commission held that this was a prospective ruling,[68] principally because standards had not previously been promulgated.[69]

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62. *Id.* at Rule 1.2(d).

63. *Id.* at Rule 1.2 comment.

64. *Id.* at Rule 4.1(b)(2). It provides: "In the course of representing a client a lawyer shall not:. . .(b) knowingly fail to disclose a fact to a third person when:. . . (2) disclosure is necessary to prevent assisting a criminal or fraudulent act, as required by Rule 1.2(d)." *Id.*

65. *See National Student Mktg.*, 457 F. Supp. 682.

66. Robins, *supra* note 26, at 406.

67. *In re* Carter, *supra* note 8, at 84,172.

68. *Id.*

69. *Id.* at 84,170. *See also supra* text accompanying note 8. Perhaps the first time that

Rule 2(e) is a powerful SEC weapon which can result in strict sanctions. While it is true that no attorney has ever been held liable under traditional malpractice concepts to a group as large and remote as the investing public,[70] the SEC can use Rule 2(e) to impose sanctions for any improper conduct which adversely affects the investing public. Therefore, even if traditional tort concepts[71] and lack of privity[72] do not result in large financial malpractice damages for the attorney, the severity of the economic impact on his practice through Rule 2(e) sanctions is a deterrent to cursory practice.[73]

RULE 415

Just as clearer direction with respect to professional responsibilty in securities practice has begun to crystallize, another dilemma has been created. The SEC has recently instituted an experimental rule originally proposed as Rule 462(A)[74] and adopted as Rule 415 (Shelf Registration),[75] the effects of which will create a new dilemma with respect to the attorney's professional responsibilities.[76] The issues in this rule concerning market volatility, pricing, institutional market participation and industry trading practices are beyond the scope of this article.[77] Here we are concerned with the techniques of performing due diligence[78] pursuant to Section 11 of the Securities Act of 1933,[79] how this due diligence will

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this new standard was applied was *In re Gibson* where a nine-month suspension was agreed to in a settlement offer. What was enunciated as a code of professional responsibility standard produced an aiding and abetting violation-type of settlement. *In re* Gibson [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶83,068 (S.E.C. Dec. 7, 1981).

70. Cheek, *supra* note 3, at 604.

71. *Id.* at 603-04.

72. *Id.* at 602.

73. *Id.* at 634. *See also* Downing & Miller, *supra* note 20, at 789.

74. Securities Act Release No. 6276 (Dec. 23, 1980), 46 Fed. Reg. 78-80 (1981).

75. 47 Fed. Reg. 11,380 (1982) (to be codified at 17 C.F.R. § 230.415).

76. Securities Act Release No. 6391 (Mar. 12, 1982), 47 Fed. Reg. 11,701 (1982), contains a list of issues to be considered during the rule's experimental life. Important among these are the due diligence problems facing the securities attorney.

77. *See id.*

78. "Due diligence" generally refers to the analytical and investigatory processes conducted by counsel and underwriters prior to reaching a decision to purchase an issuer's securities for distribution or placement. In securities law, a lack of due diligence is negligence. SEC v. Geotek, [1976-1977 Transfer Binder], FED. SEC. L. REP. (CCH) ¶95,756, at 90,723-24 (N.D. Cal. Nov. 11, 1976).

79. 15 U.S.C. § 77k (1976). An issuer's directors or partners, the underwriters, the accountants and certain other persons are civilly liable for any untrue statement or omission of a material fact contained in a registration statement, or omissions required to avoid making the statements misleading. Securities Act Release No. 6335 (Aug. 6, 1981), 46 Fed. Reg.

vary from practices currently utilized by issuers, underwriters, and their counsel in connection with registration requirements and related documents, and its impact on problems of professional responsibility.

BACKGROUND

Rule 415 was proposed by the SEC in December 1980.[80] The rule became effective in February 1982, on a temporary basis, until December 10, 1982.[81] Hearings on the proposed impact of the new rule were held on June 28, 1982.[82] On September 1, 1982, the Commission voted to extend the rule until December 31, 1983.[83] The rule was adopted as part of the SEC's integrated disclosure system and was designed to allow corporations that meet certain criteria to take advantage of the process to raise capital through both debt and equity offerings.[84] The rule allows a company to register an offering and market it over the ensuing two years, permitting sale when market rates and conditions are deemed to be most favorable.[85]

Historically, shelf registration has been the accepted procedure in limited circumstances,[86] but the reach of Rule 415 is without precedent.[87] Shelf registrations have been permitted on: securities involved in continuing acquisition programs of other companies;[88]

42,017 (1981).

80. 46 Fed. Reg. 78, *supra* note 74.

81. 47 Fed. Reg. 11,439 (1982) (to be codified at 17 C.F.R. § 230.415(c)).

82. Wall St. J., June 30, 1982, at 2, col. 4.

83. Securities Act Release No. 6423 (Sept. 9, 1982), 47 Fed. Reg. 39,799 (1982).

84. 47 Fed. Reg. 11,380 *supra* note 75.

85. 46 Fed. Reg. 78, *supra* note 74.

> The Rule codifies staff practice concerning shelf offerings which have occurred to date, such as securities to be offered in a continuing acquisition program. Under certain circumstances, it contemplates shelf registration for primary offerings of equity securities which the registrant intends to sell on a non-fixed price basis over time depending on market conditions. Also, the Rule contemplates an issuer's selling the securities registered on the shelf in a succession of different kinds of offerings. . . . Rule 415 . . . permits registration of any security on a shelf registration statement in an amount that is reasonably expected to be offered and sold within two years of the registration statement's effective date.

47 Fed. Reg. 11,380 *supra* note 75, at 11,394-95, (footnote omitted).

86. *See* 17 C.F.R. § 231.4936 (1976). Guide 4 of the SEC's *Guides for Preparation and Filing of Registration Statements Under the Securities Act of 1933* interpreted the rules as to permissive shelf registrations. Guide 4 has been replaced by Rule 415. 47 Fed. Reg. 11,380, *supra* note 75, at 11,394 n.75.

87. Pitt & Williams, *Should SEC's 'Shelf Rule' Be Shelved?* Nat'l L.J., May 17, 1982, at 21, col. 2.

88. Guide 4, *supra* note 86.

securities pledged by persons controlling the issuer, to facilitate sale in the event of default;[89] securities underlying options, rights or convertible securities, if presently exercisible;[90] and securities received as underwriting compensation, or to recipients deemed underwriters, including securities underlying options, rights or convertible securities.[91] In addition, the SEC has permitted shelf registration of continuous offerings of securities pursuant to employee benefit plans and dividend or interest reinvestment plans.[92]

Under the new rule, permitted registrations include securities expected to be sold within two years from the effective date of the registration statement for the benefit of the registrant[93] and secondary offerings,[94] as well as those listed above.[95]

The SEC's stated objectives in promulgating the new rule include the assurance of a bona fide intention to offer and sell, to provide current and accurate information about the security, and to afford investors full liability protection under the Securities Act.[96] Rule 415 permits securities to be registered for an offering to be made on a continuous or delayed basis subject to certain conditions designed to achieve these objectives.[97]

In order that "investors receive adequate current information,"[98] a post-effective amendment is required.[99] However, a sticker may be used rather than a post-effective amendment to update information to disclose the addition or deletion of a managing underwriter as co-manager.[100]

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89. *Id.*
90. *Id.*
91. *Id.*
92. 46 Fed. Reg. 78, *supra* note 74, at 87-88.
93. 47 Fed. Reg. 11,438 (1982) (to be codified at 17 C.F.R. § 230.415 (a)(1)(i)).
94. *Id.* at (a)(1)(ii).
95. *Id.* at (a)(1)(iii)-(vi). While continuous acquisition programs and underwriters as recipients are not specifically referred to, these earlier classifications are covered under new subsections (a)(1)(i) and (ii). 46 Fed. Reg. 78, *supra* note 74, at 88 n.74. Also, the new rule covers certain securities of foreign issuers, such as American Depository Receipts. 47 Fed. Reg. 11,438 (1982) (to be codified at 17 C.F.R. § 230.415 (a)(1)(vii)).
96. 46 Fed. Reg. 78, *supra* note 74, at 88.
97. *Id.*
98. *Id.* at 89.
99. 47 Fed. Reg. 11,427 (1982) (to be codified at 17 C.F.R. § 229.512).
100. 47 Fed. Reg. 11,396 (1982). *See also* 47 Fed. Reg. 11,427 (1982) (to be codified at 17 C.F.R. § 229.512). A sticker, containing supplemental or revised information may be attached to the prospectus prior to circulation without submission to the SEC's post-effective amendment filing and review process:

> Material changes that can be stated accurately and succinctly in a short sticker will . . . be permitted. . . . If the registration statement names several underwriters who may participate in the shelf-registered offering, the selection of any one or

The issuer can thus name a group of potential managing underwriters and choose from among them at the time of offering.[101] If the distribution is contemplated by syndication, changes in the members of the syndicate need only be indicated by sticker.[102] The issuer need not use an underwriter for at the market offerings of debt securities.[103]

With respect to equity offerings, Rule 415 permits shelf registration at the market offerings, but a named underwriter is required because the SEC "believes that the direct involvement of an underwriter can provide a desirable discipline upon such offerings."[104] The SEC believes that the presence of an underwriter insures timely and accurate disclosure to investors.[105] The underwriter does not have to consent to be eliminated from the managing or syndicate group.[106]

Role Reversal

In conventional underwriting practice, due diligence and preparation of registration materials would normally take weeks or months, the "passkey"[107] in the undertaking being counsel for either the underwriter, placement agent, or dealer-manager. Market-

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> more of those underwriters to be the underwriter(s) with respect to a particular portion of the shelf offering may be indicated by sticker supplement to the prospectus. . . . [A] post-effective amendment need not be filed to disclose the addition or deletion of a managing underwriter as a co-manager unless there is no longer at least one managing underwriter who was named in the registration statement or the most recent post-effective amendment thereto.

47 Fed. Reg. 11,395-96 (1982) (footnotes omitted).

101. *See* Pitt & Williams, *supra* note 87. A managing underwriter generally organizes the selling effort, maintains records of distribution, arranges overallotments and stabilization activities and receives certain compensation generally not shared with the other underwriters. 47 Fed. Reg. 11,436 (1982) (to be codified at 17 C.F.R. § 230.405) (definitions deleted, 47 Fed. Reg. 39,803 (1982)).

102. 47 Fed. Reg. 11,396 n.82 (1982). An underwriting syndicate, or purchase group, is a number of underwriters who group together and agree to share the risks, liabilities and a formal "agreement among underwriters" which specifies participation, compensation, timing and certain indemnifications. *See* Greene, *Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System*, 56 Notre Dame Law. 755, 762-63 (1981).

103. 47 Fed. Reg. 11,438 (1982) (to be codified at 17 C.F.R. § 230.415 (a)(3)). "At the market offerings" refer to offerings of securities into an established trading market for those securities at other than a fixed price. *Id.*

104. 47 Fed. Reg. 11,380, *supra* note 75, at 11,397.

105. *Id.*

106. *Id.* Under certain circumstances even an equity offering could be made without a named underwriter. *Id.* at n.88.

107. Sommer, *supra* note 2, at 83,689.

ing plans would be deferred until the completion of investigation, analysis, tentative pricing and document drafting—the last of these a comprehensive give-and-take marathon exchange between corporate executives, corporate counsel, underwriters, underwriter's counsel and, in certain matters, the issuer's auditors.[108] This process provided an atmosphere conducive to frank and open disclosure and permitted participants in the process to gain an intimate working knowledge of the issuer and its strengths and weaknesses. It also gave the underwriter an opportunity to educate its marketing force with respect to the proposed issue, in order that they might properly inform prospective purchasers.

Under the new shelf registration rule, the controlling force becomes counsel for the corporate issuer. The issuer, through its counsel, can prepare and file registration documents without the participation of any underwriter or underwriter's counsel.[109] The reversal of this conventional process, combined with the possibility of the entire offering being accelerated in an effort to meet a "window" in the market,[110] creates the danger of a cursory due diligence process to the possible detriment of the underwriter, its counsel and the investing public.[111]

The SEC has recognized this problem and has suggested that underwriters and their counsel "may elect to apply somewhat different, but equally thorough, investigatory practices and procedures."[112] For example, a suggestion has been made that underwriters and their counsel "develop in advance a reservoir of knowledge" about the issuers whose securities they may be called upon to underwrite.[113] This suggestion does not incorporate any recommendation as to who should bear the cost of this ongoing investigation where there is no assurance that an offering would be consummated or, in fact, a particular underwriter would be named. Present intent to offer is not the same as a commitment to offer and while an issuer may elect to list a group of potential under-

108. These participants were cognizant of their obligations under the federal securities laws. *See* Greene, *supra* note 102, at 781. *See also* 46 Fed. Reg. 42,017 (1981).

109. *See supra* notes 103, 106 and accompanying text.

110. *See* Greene, *supra* note 104, at 761.

111. *See* Securities Act Release No. 6335 (Aug. 6, 1981), 46 Fed. Reg. 42,015 (1981). "Significant public benefits flow from the effective performance of the securities lawyer's role. The exercise of independent, careful and informed legal judgment on difficult issues is critical to the flow of material information to the securities markets." *In re* Carter, *supra* note 8, at 84,167.

112. 46 Fed. Reg. 42,020 (1981).

113. *Id.*

writers, it does not have to choose from that list in the final analysis. In fact, an issuer could market securities without an underwriter[114] directly to large institutional investors.[115] Such a scenario not only reverses roles, it eliminates half the due diligence process.

THE DILEMMA

The SEC's new integrated disclosure system, of which Rule 415 is a part, will frequently require reliance on information contained in periodic disclosure documents which the underwriter's counsel had no hand in preparing.[116] The suggestion that underwriters and possibly their counsel attend periodic investor relations programs of the issuer[117] is not responsive to this problem, due to the superficial nature of material generally disclosed at these programs.

The SEC's suggestion that underwriters and their counsel analyze "periodic reports filed pursuant to the Exchange Act,"[118] puts them in an unclear position since they do not usually prepare the issuer's annual report and periodic financial statements.[119] The SEC has suggested that underwriters and their counsel involve themselves in the preparation of these documents on a regular and continuing basis.[120] This proposal could create drafting sessions comprised of several competing underwriters and their counsel together with corporate officers and their counsel all attempting to comply with the SEC's due diligence requirements. It might be difficult under these conditions for issuers to cooperate with underwriters and their counsel "in their efforts to satisfy their statutory obligations."[121] This expensive process could tempt those involved to take due diligence shortcuts, thereby diminishing the quality of disclosure.[122] If counsel for an underwriter is asked to participate and assist in the preparation of documents for a given shelf registration, he might be reluctant, fearful of a Rule 2(e) proceeding, to get involved or to permit his client to get involved unless the issuer

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114. *See supra* notes 103, 106 and accompanying text.

115. On September 20, 1982, Exxon Corp., utilizing a shelf registration, announced the planned public auction of $135,000,000 worth of 11% five-year notes, offered through its Netherland Antilles finance subsidiary, thereby bypassing underwriters and their counsel. Wall St. J., Sept. 21, 1982, at 44, col. 2.

116. 46 Fed. Reg. 42,017 (1981).

117. *Id.* at 42,021.

118. *Id.*

119. *Id.* at 42,020.

120. *Id.* at 42,021.

121. *Id.*

122. *See Id.* at 42,017; Pitt & Williams, *supra* note 87, at 23, col. 1.

were one in which counsel and his underwriter client had amassed a "reservoir of knowledge"[123] and, in fact, had substantial and current dealings with the company.[124]

When an issuer decides to offer its securities, underwriter's counsel may receive fleeting notice of the pending sale. Overnight preoccupation with price amendments and distribution plans should eliminate all but the most cursory due diligence. The underwriter will be reluctant to announce his readiness to the issuer until his counsel indicates his willingness to proceed.[125] Aggressive underwriters, taking counsel's malpractice concerns as self-motivated, might seek other counsel. Thus, it has been observed: "Lawyers who are seen by their clients as being motivated by fears for their personal liability will not be consulted on difficult issues."[126] The SEC has acknowledged this dilemma. Issuers sensing reluctance might seek other underwriters "willing to do less."[127] This appearance of vacillation could cause the issuer to place the securities directly without an underwriter,[128] thereby eliminating one half of the entire due diligence process. Issuer's counsel will be forced to accept added burdens and responsibilities, recognizing that they may not have the benefit of underwriters' counsel in a given offering. Accounting firms, already subject to the full measure of 2(e) proceedings,[129] will recognize this lack of dual due diligence and, therefore, request substantial last minute surveillance and review in their own right. Whatever due diligence procedures develop, they will be costly and require extensive ongoing surveillance.[130]

123. 46 Fed. Reg. 42,020 (1981).

124. *Id.* The SEC has recognized the important and delicate role of the securities attorney in the public offering process: "In the course of rendering securities law advice, the lawyer is called upon to make difficult judgments, often under great pressure and in areas where the legal signposts are far apart and only faintly discernible." *In re* Carter, *supra* note 8, at 84,167.

125. 46 Fed. Reg. 42,017 (1981).

126. *In re* Carter, *supra* note 8, at 84,167.

"Concern about his own liability may alter the balance of his judgment in one direction as surely as an unseemly obeisance to the wishes of his client can do so in the other. *Id.*

127. 46 Fed. Reg. 42,017 (1981).

128. *See supra* note 115.

129. *See generally* Downing & Miller, *supra* note 18 for a clear statement of 2(e)'s applicability to the accounting profession.

130. *See* 46 Fed. Reg. 42,020-21 (1981).

EFFECTS ON THE INVESTING PUBLIC

During the last several years, considerable concentration has occurred within the underwriting industry:

	1970	1981	Increase
Domestic Underwritten Public Financing	$30.5 billion	$57.8 billion	89.1%
Number of Issues	1373	1429	4.1
Average Size of Issue	22.2 million	40.4 million	81.7
Number of Managing Underwriters	410	293	(28.5)
Underwritings Managed by Ten Largest Firms	20.7 billion	47.3 billion	128.4
Market Share	67%	82%	22.4

Source: Corporate Financing Directory, Inv. Dealers Dig. (Mar. 23, 1971); Corporate Financing Directory, Inv. Dealers Dig. (Mar. 6, 1982).*

Even prior to promulgation of Rule 415, Rule 2(e) concerns led securities attorneys to gravitate to seasoned issuers and established underwriters, accentuating the trend commenced by economic and market factors. One commentator has remarked:

> Experienced securities lawyers are being forced to weigh their personal security against the limited benefits of representing small but risky accounts. In many cases, the potential liabilities exceed the benefits. The small company usually has the greatest need of experienced legal counsel, yet these clients are the ones who are most likely to be deprived of experienced counsel as a consequence of the SEC position.[131]

Differences in due diligence techniques effectively mandated by Rule 415 will increase the attorney's concerns for improper conduct allegations and cause him to avoid participation in Rule 415 offerings or to increasingly seek association with only large, high quality corporate issuers and well-financed underwriters.

An issuer's desire to move swiftly, combined with its ability to

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*SEC compilations vary for this data, principally because SEC data covers all new issues offered for cash, whereas the information presented here focuses mainly on activity in the underwriting field. The SEC data also includes offerings that are not underwritten.

131. Lipman, *supra* note 18, at 470 (footnote omitted). This concentration has also hampered the efforts of small and growing companies to raise capital. *Id.*

select managing underwriters at will and on short notice,[132] may further limit the number of underwriters available for these financings.[133] Also, the issuer will tend to deal only with those underwriters willing to make large purchases on short notice.[134] This process should bring business to firms with established distribution networks and take business away from underwriters who rely on syndication for marketing and distribution.[135] Only large corporate issuers of the highest quality[136] have sufficient in-house staff to develop information and provide it on a continuing basis to support the due diligence effort which will be required under Rule 415. Only the most sophisticated and well-financed underwriters[137] can support the research effort necessary to comply with the requirement of the rule and commit the capital necessary to purchase large blocks of securities on short notice.[138] Other corporate issuers and underwriters will be effectively precluded from utilization of Rule 415 and, therefore, a large segment of the capital markets.[139]

The investing public is not benefited by this concentration of financial power. Dissemination of financial information, essential to the formation of an intelligent investment decision is, at best, provided on short notice when an issuer decides to effectuate an offer registered under Rule 415. The swiftness with which transac-

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132. *See* 47 Fed. Reg. 11,396 (1982).

133. SEC decision to extend Rule 415 to December 31, 1983, 47 Fed. Reg. 39,803 (1982) (Thomas, C., dissenting).

134. *Id.* at 39,805.

135. *See e.g.*, Morgan Stanley & Co. Comment Letter, Feb. 2, 1982; N.Y. Stock Exchange Comment Letter, Feb. 11, 1982 (file ref. no. S7-896).

136. There are probably less than 200 large, high quality corporate issuers in the United States. Their common attributes, in addition to maintaining a sizeable in-house staff capable of providing continuing information for Rule 415 due diligence efforts, include a capability of readily filing voluminous documents for incorporation by reference, widespread market recognition and at least an "A" rating on their senior securities.

137. Underwriters fitting this description, of which there are probably less than 20 in the United States, will generally: (1) have capital sufficient to purchase a large percentage of any shelf-registered issue; (2) have an ability to absorb serious short-term trading losses against regular trading activities; (3) be well-connected to large institutional purchasers; (4) have a highly centralized marketing organization capable of acting swiftly with sizeable volumes of securities; (5) have an extensive internal research staff capable of following major companies closely on an ongoing basis; and (6) not rely on syndication for underwriting and marketing of securities.

138. 47 Fed. Reg. 39,805 (1980) (Thomas, C., dissenting). "[O]nly the largest players . . . will inevitably come to be the exclusive underwriters and selling dealers for major new issues." *Id.*

139. *Id.* Commissioner Thomas has also pointed to probable adverse effects on regional securities firms and on capital formation generally.

tions of this nature can be completed all but preclude the "average investor" from receiving information about the proposed offering, let alone receiving the material in time to make an informed decision. Underwriters, under pressure to dispose of large quantities of securities purchased on short notice under Rule 415 will naturally seek only large institutional investors capable of purchasing large blocks of securities with whom they have a well established relationship. Institutional investors, closely attuned to the marketplace for new issues, can preclude public participation (except later at higher prices) reducing the ultimate liquidity of national exchanges for public securities. Institutional investors will, in effect, have first choice among prime securities of prime issuers.[140]

COMMENTARY

Members of the industry largely ignored the proposed rule during most of the comment period,[141] but it became subject to intense criticism in the weeks prior to its adoption.[142] Morgan Stanley & Co. and Merrill Lynch, Pierce, Fenner, & Smith, Inc. urged the SEC to delay action on the rule, charging that it would undermine the current method of issuing securities through underwriters' syndications and would allow a few well-financed firms to capture large blocks of new issues.[143] The SEC refused to delay action on the shelf rule.[144] The Securities Industry Association (SIA) argued that the process is too speedy to give investors enough time to get adequate information and make decisions.[145]

On September 1, 1982, the SEC extended the life of the shelf rule at least until December 31, 1983.[146] When announced, Salomon Brothers pointed out that the decision will continue a trend which gives the largest firms a distinct advantage.[147] Since the rule was adopted, seventy-three issues totalling $15.7 billion, or an average of $215 million per issue, have been registered pursuant to

140. *See* 47 Fed. Reg. 39,806-07 (1982) (Thomas, C., dissenting).

141. 14 SEC. REG. & L. REP. (BNA) 532 (1982).

142. 47 Fed. Reg. 11,701-02 (1982).

143. 14 SEC. REG. & L. REP. (BNA) 532 (1982).

144. 47 Fed. Reg. 39,799 (1982).

145. Wall St. J., June 8, 1982, at 56, col. 2. The SIA proposed a five-day "cooling off period" from the time of filing to time of sale. If 30 days elapse without a sale, a new five-day waiting period should be required. *Id.*

146. 47 Fed. Reg. 39,799 (1982) (to be codified at 17 C.F.R. § 230.415).

147. Noble, *S.E.C., 2 to 1, Backs Shelf Registrations*, N.Y. Times, Sept. 2, 1982, at 32, col.6.

the expanded sections of the shelf rule.[148] One underwriter estimates that twenty percent of funds raised in the United States since March, 1982 have been through the use of shelf registrations.[149]

RECOMMENDATIONS

The objectives enumerated by the SEC in promulgating Rule 415[150] could be achieved under the new integrated disclosure system with broader reliance on simplified registration procedures, particularly those which do not involve indiscriminate whims with respect to underwriter selection. In addition, timely review at the SEC staff level would facilitate the market flexibility large issuers seek. This would not force reversal of the traditional roles of underwriters' and issuers' counsel and would still provide the issuer with flexibility in financing corporate requirements. The risk of improper conduct allegations would remain in perspective with all of the other risks attendant to the securities business rather than becoming counsel's primary concern.[151] Instead of Rule 2(e) operating with Rule 415 to accentuate undesirable market concentration and operating to the detriment of the investing public, Rule 2(e) would remain as a standard for improper conduct. Other competitive factors would be free to work at the forces of market concentration.

CONCLUSION

The SEC's experimental adoption of Rule 415 has occurred at a time when the securities bar is at long last receiving direction from the ABA, the Final Draft and the SEC which, taken as a whole, appear to provide objective standards of professional responsibility. Rule 415 creates another dilemma for the securities attorney with questionable side effects. The objectives sought by the SEC through the rule could be achieved without reactivating the controversy which has surrounded improper conduct standards and the unique problems of professional responsibility in securities practice.

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148. Wall St. J., Sept. 2, 1982, at 26, Col. 1-2. The average size of these issues is five times the average size of issues publicly underwritten last. *See* table *infra*.

149. Wall St. J., Nov. 2, 1982, at 44 Col. 3-4.

150. *See supra* note 96 and accompanying text.

151. "[To] permit a lawyer to avoid or reduce his liability simply by avoiding participation in the drafting process, may well have the undesirable effect of reducing the quality of the disclosure by the many to protect against the defalcations of the few." *In re* Carter *Supra* note 8, at 84167.