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Lawyers as Whistleblowers Under the Dodd-Frank Wall Street Reform Act

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Ethical Conflicts Under the Rules of Professional Conduct and SEC Rules

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Introduction

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), which seeks to regulate the financial markets in order to prevent a recurrence of the financial crisis of 2008–2009. Section 922 of Dodd-Frank added new section 21F to the Securities Exchange Act of 1934 (Exchange Act), creating a whistleblower bounty program under which individuals who voluntarily provide original information leading to successful Securities and Exchange Commission (SEC or the Commission) enforcement actions may receive bounty payments based on penalties assessed against respondents. Whistleblowers who report wrongdoing to the U.S. Commodity Futures Trading Commission (CFTC) may also recover under the Dodd-Frank whistleblower provisions.

The exact amount awarded will be determined by the SEC and will be paid by a new Investor Protection Fund funded by monetary sanctions. Section 21F of the Exchange Act also creates a new private right of action for whistleblowers against retaliating employers. Whistleblowers can bring their claims in federal court seeking reinstatement, double back pay with interest, and attorney fees.

As discussed below, the general rule is that whistleblowers who voluntarily furnish original information to the SEC or CFTC that results in a successful prosecution netting monetary penalties in excess of $1 million are entitled, with some exceptions, to bounties of 10% to 30% of the amount recovered in the government enforcement actions. Lawyers, whether in-house or outside, are generally ineligible for Dodd-Frank whistleblower bounties. However, the rules promulgated under Dodd-Frank offer exceptions. To the extent that a lawyer possesses confidential information that may be disclosed to the SEC pursuant to its regulations or state ethics rules, the Commission's rules appear to permit paying bounties to attorney-whistleblowers. Under SEC regulations promulgated under the Sarbanes-Oxley Act (SOX), a lawyer may disclose to the Commission confidential client information to prevent "a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors."[1] In addition, SEC regulations promulgated under Dodd-Frank permit attorneys to blow the whistle, disclose client confidences and collect bounties to the extent permitted by state ethics rules.

The SEC rules governing attorney conduct differ in some significant respects from the controlling ethics laws in effect in some jurisdictions, notably New York, the District of Columbia, and California, and, in addition, are not entirely consistent with the confidentiality provisions of the ABA Model Rules of Professional Conduct (which, in any event, are merely model rules, and not enforceable through professional discipline). Most state ethics codes include some form of exception to their general confidentiality rules and permit reporting out by attorneys where client fraud has been perpetrated with the assistance of the attorney. Therefore, an attorney whose services have been used to perpetrate client fraud would be permitted to take remedial action in most jurisdictions. In the event of known client perjury, the attorney's duty to take remedial action is even stronger. Several jurisdictions even *require* lawyers to report out fraudulent, criminal, or illegal client conduct.[2] What is prohibited under the rules of every jurisdiction is the general disclosure of confidential information relating to a material violation of the securities laws, or client fraud committed without the assistance of the attorney, disclosures that are permitted by SOX and, through incorporation of the SOX rules, the Commission's whistleblower rules.

While the SEC may have authority to determine the qualifications of lawyers who practice before it, it does not grant plenary law licenses, and, therefore, it is unclear that the minimum confidentiality standards it sets provide a definitive safe harbor for New York or California lawyers to rely upon when revealing secrets and confidences of their clients to beckoning regulators and prosecutors. Thus, for example, a New York lawyer that adheres to SEC (or even ABA) guidelines in reporting client fraud to regulators in hope of receiving a Dodd-Frank bounty could run afoul of state Rules of Professional Conduct, and, at least theoretically, subject himself or herself to professional discipline.

As a result, the SEC's whistleblower regulations potentially encroach on state regulation of attorney ethics and could unintentionally but insidiously erode confidential attorney-client communications. Moreover, as mentioned above, some (but not all) of this confidential information is arguably protected from disclosure by state ethics rules.

Aside from the potential discrepancy among SEC, ABA, and state codes regulating attorney conduct, the prospect of a corporate attorney under any circumstances claiming a whistleblower bounty could give rise to a potential personal conflict of interest. A lawyer for a corporation is a fiduciary and must exercise independent professional judgment on the client's behalf. This professional judgment includes determining whether there is evidence of a material violation of law, whether the legal violation poses a threat to the company, whether to report the wrongdoing to the board of directors or chief legal officer of the entity, whether to commence an investigation, whether to bring in outside counsel, etc. The lawyer must skillfully navigate a web of internal personal and political relationships, and objectively analyze the company's legal obligations while simultaneously minding the lawyer's own professional responsibilities. These complex and potentially disparate considerations are sufficiently challenging to the most diligent and experienced corporate counsel without adding the additional temptation of a substantial personal monetary bounty. The prospect that lawyers may personally benefit by reporting out alleged corporate misconduct could cloud their professional judgment. Such bounties could also cause a conflict of interest between the lawyer's personal interests and those of the client within the meaning of the professional conflict rule, ABA Model Rule of Professional Conduct 1.7 and its parallel in state codes of ethics. Further, as a personal conflict, it may not be waivable by the impacted client, and, as discussed below, the potential for an attorney bounty inevitably complicates an already complex relationship between corporate lawyer and client.

The Dodd-Frank Whistleblower Rules

To be eligible for an award under Dodd-Frank whistleblower rules, the whistleblower must provide original information. To qualify as original, information must not become known to the SEC from any source other than the whistleblower and must be the whistleblower's independent information or the product of the whistleblower's own analysis. Therefore, information obtained solely from an allegation made in a hearing, government report, or other publicly available document would not qualify for a Dodd-Frank bounty.

Additionally, SEC Rule 21F-3 and CFTC Rule 165.5 state that awards will be paid to whistleblowers who voluntarily provide "original information" that "leads to the successful enforcement by the [SEC] of a federal court or administrative action" or "leads to the successful resolution of a covered [CFTC] judicial or administrative action or successful enforcement of a related action." Information provided in response to a subpoena or information request does not qualify as voluntary.

A whistleblower becomes eligible to receive an award if the SEC collects more than $1 million in monetary sanctions. The reward to be given to the whistleblower must fall within 10% to 30% of the aggregate amount recovered, which includes disgorgement, penalties, and interest. Once the SEC surpasses the $1 million threshold necessary to enable the whistleblower to recover, the basis of the sanction may also include fines and penalties assessed and collected by the Department of Justice, self-regulatory organizations, and state attorneys general.

Continued on Page 14

Continued from Page 12

While the SEC has discretion as to what percentage within the range to award, there are some guidelines. The SEC must consider: (1) the significance of the information provided relative to the success of the SEC's action; (2) the degree of assistance provided by the whistleblower in the SEC's action; and (3) the SEC's interest in deterring securities law violations by rewarding whistleblowers.

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Dodd-Frank defines which individuals may qualify as whistleblowers. The law does not require that an award recipient be a U.S. national, but rather allows foreigners to be eligible whistleblowers as well. Certain individuals, however, are not eligible to collect an award, such as employees of securities regulators and auditors. Additionally, individuals convicted of a criminal violation related to the underlying securities violations that were disclosed by the whistleblower are also barred from receiving awards. Thus, whether an individual implicated in the underlying conduct can obtain a whistleblower reward will depend, in part, on whether the individual is ultimately convicted on related criminal charges.

Attorney as Whistleblower

Under SEC and CFTC rules, attorneys generally cannot be whistleblowers because the new rules exclude from the definition of "original information" most material that lawyers, in-house or private, are likely to gain in the course of their professional representation of clients. The categories excluded from whistleblower bounty include: (1) confidential communications subject to the attorney-client privilege; (2) information that came from the legal representation of a client; (3) information that came from persons in a compliance, legal, audit, supervisory or governance role for the entity; and (4) information from the entity's legal, compliance, audit, or related functions for dealing with violations, unless the entity did not disclose the information to the SEC or CFTC within a reasonable time or acted in bad faith.[3] The new rules deny whistleblower status to attorneys whose knowledge originated as a result of the "legal representation of a client," even if that knowledge did not come from a privileged communication or a client confidence or even from the client at all. Most of a practicing attorney's knowledge about a client would come from legal representation, so this is a very broad exclusion.

There are exceptions to the SEC's and CFTC's general rule against attorneys acting as whistleblowers. Attorney whistleblowers may use attorney-client communications and information obtained as a result of legal representation of a client when such disclosure is permitted by SEC Rule 205.3(d)(2), which was promulgated pursuant to SOX.[4] This provision allows attorneys practicing before the SEC in the representation of an issuer to reveal confidential information related to the representation in some circumstances. These circumstances occur when the attorney reasonably believes disclosure is necessary (1) to prevent the issuer from committing a material violation of securities laws which is likely to cause substantial financial injury to the interests or property of the issuer or investors; (2) to rectify the consequences of a material violation of securities laws in which the attorney's services have been used; or (3) to prevent the issuer from committing or suborning perjury in an SEC proceeding.[5] In addition, SEC rules permit disclosing client confidences to regulators, when the issuer fails to act reasonably in response to a complaint or acts in bad faith. Finally, the SEC permits reporting out where permissible under state ethics rules.

The CFTC considers attorney-client privileged communications and information obtained as a result of legal representation of clients to be derived from "independent knowledge" (and therefore would allow an attorney to be a whistleblower) if the disclosure is permitted "by the applicable federal or state attorney conduct rules."[6]

Under SEC Rule 205, the disclosure of client confidences outside the organization is permitted as a last resort, not a first step. The rule requires lawyers practicing before the Commission to report evidence of material violations of the securities laws to the company's chief legal officer (CLO), who is required to investigate the claim and report back to the lawyer who originally made the report. In the event that the CLO finds credible evidence of a material violation, the CLO must report the wrongdoing up the proverbial corporate ladder including, if necessary, to the audit committee, qualified legal compliance committee or full board of directors. If all else fails, and if necessary to prevent further harm to the corporation or to investors, the CLO is authorized to disclose client confidences outside the company. The junior reporting lawyer may report disclosures outside the organization if the CLO fails to act.

Thus, under SEC Rule 205, a lawyer must first report corporate wrongdoing up the corporate ladder. If that fails, the lawyer may, if necessary, report outside the organization to regulators, i.e., reporting out. Reporting up the corporate ladder is mandatory. Reporting out is *permissive* under Rule 205.[7] However, a lawyer may be subject to discipline by the SEC for failing to correct or

Continued on Page 16

Continued from Page 14

prevent the wrongdoing of a client in which the lawyer was complicit.[8]

SEC/CFTC rules are not entirely consistent with the ABA Model Rules of Professional Conduct. The ABA rules, in turn, do not entirely agree with the rules of various states, such as (notably) New York, California, Washington State, or the District of Columbia. Lawyers practicing before the SEC and CFTC should be mindful of both federal and state rules, because most cases are intensely fact-specific.

Comparison With ABA and State Ethics Rules

The ABA Model Rules require lawyers to maintain the confidentiality of information learned by the lawyer in the course of the representation.[9] However, ABA Model Rule 1.6 permits disclosure of confidential information in six circumstances: (1) to prevent death or substantial bodily harm; (2) to prevent crime or fraud "that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services"; (3) to prevent or rectify financial injury from client crime/fraud "in furtherance of which the client has used the lawyer's services"; (4) to obtain advice about the lawyer's own compliance with the ethics rules; (5) for the lawyer to defend himself or herself against a claim relating to the representation; and (6) to comply with law or a court order. Exceptions (2) and (3) to Model Rule 1.6(b) were added in 2003 in the wake of the Enron and Worldcom financial scandals.[10] The ABA Model Rules, unlike the former Canons and Code, do not require mandatory reporting out of client fraud.[11]

The New York Rules of Professional Conduct (RPC) are different from their ABA counterparts. The New York Rules prevent a lawyer from disclosing client confidential material, but provide exceptions: (1) to prevent reasonably certain death or substantial bodily harm; (2) to prevent a client from committing a crime; (3) to withdraw a lawyer's opinion or representation that was based on inaccurate information or which is being used to further a crime or fraud; (4) to get legal advice about the lawyer's own conduct; (5) for the lawyer to defend himself or herself; (6) to collect a fee; and (7) when permitted to reveal confidences under the RPC, such as to comply with law or a court order.[12]

In some respects the New York exceptions to RPC 1.6 are broader than their ABA counterparts, since a lawyer may disclose client confidences "to prevent a crime," whereas the Model Rules have no direct correlating provision. While Model Rule 1.6(b) permits disclosure of client confidential material to prevent or rectify client fraud, this may be done only in situations in which the client has used the lawyer's services to perpetrate the fraud.[13] The District of Columbia's crime-fraud exception similarly applies only where the crime or fraud is perpetrated by means of the attorney's services.[14]

The exception in New York RPC 1.6(b)(2), which permits (but does not require) the lawyer to reveal confidences "to prevent the client from committing a crime," is not consonant with the "material violation" of the securities laws described in SEC Rule 205. A material violation of federal securities laws can be civil or criminal. A *criminal* material violation of the securities law is probably permissively discloseable outside the company pursuant to both the New York and SEC rules, whereas a civil violation caused by the same facts may be reportable by a New York lawyer only if another exception under RPC 1.6(b) applies.[15] SEC rules would permit disclosure to the Commission of client confidential information establishing a civil material violation of federal securities laws. Thus, a New York lawyer who reports out client confidences under the authority of SEC Rule 205 would, under some circumstances, violate state ethics rules.

A comparison of ethics rules in certain other jurisdictions further complicates the analysis. For example, while New York lawyers are *permitted* to report out client confidences to prevent a crime, New Jersey lawyers are *required* to do so. According to New Jersey RPC 1.6:

> (b) A lawyer *shall* reveal [confidential] information to the proper authorities, as soon as, and to the extent the lawyer reasonably believes necessary, to prevent the client or another person:
> (1) from committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm or substantial injury to the financial interest or property of another;
> (2) from committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to perpetrate a fraud upon a tribunal.
> (c) If a lawyer reveals information pursuant to RPC 1.6(b), the lawyer also may reveal the information to the person threatened to the extent the lawyer reasonably believes is necessary to protect that person from death, substantial bodily harm, substantial financial injury, or substantial property loss.
> (d) A lawyer *may* reveal such information to the extent the lawyer reasonably believes necessary:
> (1) to rectify the consequences of a client's criminal, illegal or fraudulent act in the furtherance of which the lawyer's services had been used;
> (2) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, or to establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer based upon the conduct in which the client was involved; or
> (3) to comply with other law.[16]

Thus, unlike in New York (or under the ABA Model Rules), a New Jersey lawyer may be subject to professional discipline for failing to report client confidences reasonably necessary to prevent a client's

crime or fraud that is likely to result in substantial injury to the financial interest or property of another, regardless of whether the lawyer's services were used to further the fraud. New Jersey's rule is even more aggressive than the SEC's, in that the latter first requires reporting up the ladder, and only secondarily permits reporting out. Because New Jersey RPC 1.6 contemplates reporting out a "criminal, illegal or fraudulent act" that causes financial injury, it would seem to apply only to those securities law violations that rise to fraud or illegality. With that qualification, the New Jersey formulation is not coextensive with, and, in fact, is at once both more permissive and more restrictive than the SEC rule, since a material violation of the securities laws, per SEC Rule 205, may not rise to the level of fraud or illegality. For example, the unregistered sale of securities might be a material violation of the securities laws but not amount to fraud. It might, however, be considered an "illegal" act within the meaning of New Jersey RPC 1.6.[17] Moreover, New Jersey's rules, unlike the ABA Model Rules, and those of New York, require reporting out of client fraud or crime regardless of whether the lawyer's services were used to implement the fraud.[18]

Not all securities violations rise to the level of a crime. Lawyers have been prosecuted for registration and record-keeping violations that do not amount to fraud or a crime. For example, in *In re Isselman*, a general counsel improperly failed to correct his client's misperception of foreign law.[19] In *In re Drummond*, the SEC successfully prosecuted the general counsel of Google for failing to report that a grant of stock options would cause the company to cross a reporting threshold.[20] In both *Isselman* and *Drummond*, general counsels were prosecuted for securities law violations. However, it is arguable that the lawyers' conduct in these cases, even if violations of securities law, did not rise to the level of crime or fraud for the purpose of state ethics rules. These are the types of technical violations that illustrate the disconnect between the SEC conduct rules under Sarbanes-Oxley on the one hand and state rules of professional conduct on the other. Moreover, these prosecutions show that these discrepancies are not merely theoretical but can have real, career-ending consequences.[21]

Other exceptions in state ethics rules may apply. For example, New York RPC 1.6(b) permits a lawyer to reveal client confidences "to withdraw a written or oral opinion or representation previously given by the lawyer and reasonably believed by the lawyer still to be relied upon by a third person," where the lawyer's opinion was incorrect or being used to perpetrate a fraud or crime. This New York exception, in turn, is different from the ABA Model Rules, which merely require the use of the attorney's services to perpetrate the fraud, and do not require an opinion or representation by the lawyer in order to trigger the exception permitting disclosure. And that's just comparing New York and New Jersey rules with those of the ABA and SEC. Other jurisdictions have differing approaches and are too numerous to recount in this article.

> While New York lawyers are *permitted* to report out client confidences to prevent a crime, New Jersey lawyers are *required* to do so.

California's ethics rules are broader, and bar disclosure of client confidential information, even in cases of fraud. The California Business and Professions Code provides that attorneys must "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."[22] This broad, sweeping provision does not include the nuanced exceptions of the ABA or New York formulations and places California squarely at variance with SEC Rule 205. California lawyers, in particular, must exercise extreme caution before considering disclosures of client confidential information.

According to one law review survey, 41 states permit and four require lawyers to disclose confidential information to prevent a client's ongoing criminal or fraudulent act.[23] Thus, significant conflicts exist among the SEC, ABA, and various state formulations providing exceptions to the confidentiality provisions.

Model Rule 1.6 and its state counterparts speak only to reporting out; they do not govern up-the-ladder reporting by corporate lawyers. Up-the-ladder reporting – as required by SEC Rule 205 – is governed by ABA Model Rule 1.13 and its state counterparts. These provisions generally require up-the-ladder reporting by corporate lawyers who discover corporate wrongdoing; but, other than the Model Rule's formulation, the state variations all stand in contrast to the SEC's provision and do not include an independent basis for permissive reporting out.

Up-the-Ladder Reporting

Under ABA Model Rule 1.13, a corporate lawyer with knowledge of wrongdoing that poses a substantial risk of injury to the organization must report the violation up the corporate ladder. If a corporate lawyer knows that

an officer or employee of the organization has engaged in illegal conduct related to the representation which is likely to result in substantial injury to the organization, he or she "shall proceed as is reasonably necessary in the best interest of the organization."[24] Up-the-ladder reporting, including to the board of directors, is ethically mandated: "Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer *shall* refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law."[25]

> An attorney considering whether to become a Dodd-Frank whistleblower must determine whether it is ethical to do so. But which rules apply?

Outside disclosure of client confidences is permitted, but not mandated, under the Model Rules. If the corporation's board fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law. If the lawyer reasonably believes that the violation is "reasonably certain to result in substantial injury to the organization," then the lawyer may (but is not obligated to) report outside the corporation "whether or not Rule 1.6 permits such disclosure," but only to the extent necessary to prevent substantial injury to the organization. Thus, the ABA formulation, which was influenced by the passage of the Sarbanes-Oxley Act of 2002 and the proposed SEC rules thereunder, permits a corporate lawyer to report out evidence of corporate wrongdoing.

New York RPC 1.13, on the other hand, contains no further exception to RPC 1.6, and does not, in and of itself, permit reporting out. According to New York RPC 1.13:

> If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly in violation of law and is likely to result in a substantial injury to the organization, the lawyer may reveal confidential information *only if permitted by Rule 1.6*, and may resign in accordance with Rule 1.16.[26]

Moreover, in New York, up-the-ladder reporting is not presumptively required under its Rule 1.6. California's rule is similar to New York's. Thus, there is a disconnect between the ABA/SEC rule and state rules, since the former permits reporting out by corporate lawyers under different circumstances from the latter.

Just to illustrate the complexity of this, New Jersey takes yet another approach, permitting (but not requiring) reporting out where the corporate board fails to remedy reported wrongdoing and the disclosure of client confidences is in the company's best interests:

> (c) When the organization's highest authority insists upon action, or refuses to take action, that is clearly a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer may take further remedial action that the lawyer reasonably believes to be in the best interest of the organization. Such action may include revealing information otherwise protected by RPC 1.6 only if the lawyer reasonably believes that:
> (1) the highest authority in the organization has acted to further the personal or financial interests of members of that authority which are in conflict with the interests of the organization; and
> (2) revealing the information is necessary in the best interest of the organization.[27]

Of course, RPC 1.13 must be read together with RPC 1.6. For example, if the corporate wrongdoing constitutes a crime as well as a material violation of securities laws, then any distinction among the three rules is irrelevant, as it would be permissively reportable under SEC, New York, and ABA formulations. And, as mentioned, participation in a crime or fraud must be reported by New Jersey lawyers, if preventable, regardless of whether the lawyer's services have been utilized to further the scheme.[28] Thus, a lawyer confronted with client misconduct must analyze and balance potentially conflicting ethical considerations.

State Versus Federal Rules: Prior Cases Resolving Conflicting Rules

An attorney considering whether to become a Dodd-Frank whistleblower must determine whether it is ethical to do so. But which rules apply? Clearly, the CFTC and SEC have authority to regulate the conduct of attorneys who practice before them, and those agencies can discipline lawyers who act unprofessionally. The U.S. Supreme Court has long held, for example, that the U.S. Patent and Trademark Office may grant licenses to non-lawyers to practice before it and that a state may not proscribe or regulate such practice as unauthorized practice of law.[29]

But federal agencies do not grant plenary law licenses, and lawyers must also comply with state ethics rules. And, as we have seen, state ethics rules are inconsistent with SEC regulations. Moreover, the Supreme Court has not given the federal government the right to interfere with attorney-client confidential communications, which are protected by state law.[30]

Which rules govern in the event of a conflict? SEC Rule 205, which was promulgated pursuant to the authority of the Sarbanes-Oxley Act of 2002, proclaims its supremacy over state ethics rules. According to SOX, "[w]here the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with these standards, these standards shall govern."[31] The "predominant effect of the conduct" is the standard under Model Rule 8.5(b) for conflict purposes. A predominant effect in a state jurisdiction would favor state ethics rules under RPC 8.5. A predominant effect on federal law might yield a different result, depending on the facts.

Some scholars (and regulators) have argued that federal law reigns supreme, and that regulations promulgated under SOX preempt inconsistent state regulations. For example, in their 2004 article Professors Cramton, Cohen and Koniak argue that the SEC has been too lenient on securities lawyers, and that it should step up its regulation of big firm securities lawyers. Their article posits that "the SEC had authority to, and did in fact, draft rules that preempt state ethics rules that prohibit or restrict disclosure of material violations of law,"[32] opining that the legislative history of Sarbanes-Oxley suggests that Congress intended to regulate the legal profession and, specifically, reporting up the corporate ladder. Asserting that other federal agencies have the right to control and regulate practice before them, Cramton, Cohen, and Koniak argue that "[t]here is no basis for singling out the securities bar, among all lawyers engaged in federal practice areas, as being entitled to immunity from federal regulation."[33]

The problem with their pro-preemption argument is that it erroneously conflates a federal agency's right to restrict or permit lawyers or non-lawyers to practice in a federal forum, which may be regulated by the relevant federal agency, with its authority to create a parallel set of conflicting in-state lawyer confidentiality rules, an area of regulation that has long been exercised by the states. It is one thing for the federal government to say who can appear before the Internal Revenue Service or the Patent and Trademark Office; it is usurpation of a different order for federal agencies to define permissive circumstances under which a state-licensed lawyer may reveal client confidences to the federal government, irrespective of state ethics rules. States have no interest in preventing non-lawyers from prosecuting patent applications. But they do have an interest in protecting the confidentiality of their citizens' communications with lawyers. Cramton, Cohen, and Koniak, who believe that securities lawyers need to be reined in by the SEC, elide over this important distinction.

It feels disquieting, and is perhaps unconstitutional, for the federal government to arrogate to itself the power to purport to regulate state attorney ethics. While the concept of a federal law license has been floated, it is still in the pipe-dream phase. It is one thing for the SEC to bar a lawyer for unprofessional conduct in an SEC proceeding; it is quite another for the federal government to seek to regulate attorney-client confidential communications. The Constitution does not give the federal government the right to license or regulate the practice of law.

Moreover, federal prosecutors under the McDade Amendment are subject to state ethics rules. The McDade Amendment provides that "an attorney for the Government shall be subject to State laws and rules, and local Federal court rules, governing attorneys in each State where such attorney engages in that attorney's duties, to the same extent and in the same manner as other attorneys in that State."[34] State ethics rules bind federal lawyers, including SEC staff attorneys. It would be anomalous for SEC lawyers, who must obey state ethics rules, to argue that private practitioners, who are licensed by the state, must defer to SEC ethics rules, when such conduct may affect the rights of clients.

Indeed, no court has found that state ethics rules governing lawyers' communications with their clients are preempted by SEC regulations. After all, the states, not the federal government, issue plenary law licenses. Moreover, state ethics regulators have not been unanimous in deferring to federal regulation of attorney conduct. For example, the organized bar in California refused to take a backseat to the SEC, warning that "portions of [Rule 205] seemingly conflict with our statutory duty to protect

confidential client information."[35] The California bar wrote in response to SEC regulations under SOX that "[a]n attorney faced with choosing between potentially irreparable harm to a client's interests arising from disclosure of a confidence or the cost of a good faith, well founded objection to the SEC's rules is virtually duty-bound to select the latter."[36]

Similarly, in response to the implementation of Rule 205, the Washington State Bar Association issued a Formal Ethics Opinion advising Washington attorneys to "not reveal [client] confidences and secrets unless authorized to do so under the RPCs."[37] The Washington opinion also noted that because of the "current lack of case law on the pre-emption issue, a Washington attorney cannot as a defense against an RPC violation fairly claim to be complying in 'good faith' with the SEC Regulations, as that term is used in [Rule 205]."[38]

By contrast, North Carolina took a more deferential approach to the SEC Rule. In a 2005 Formal Ethics Opinion, the North Carolina bar commented that there is a presumption that Rule 205 is a valid exercise of the SEC's authority and, therefore, "a North Carolina attorney may, without violating the North Carolina [RPCs], disclose confidential information as permitted by Rule 205 although such disclosure would not otherwise be permitted by the NC Rule."[39]

In some jurisdictions, the dispute over federal preemption may be more theoretical than practical. ABA Model Rule 1.6(b)(6) permits disclosure of client confidential material "where permitted by law or court order." New York RPC 1.6(b)(6) similarly permits disclosure "to comply with other law or court order."[40] While not compelling, it could be argued that a disclosure permitted by the federal securities laws is a disclosure made "to comply with other law" within the meaning of RPC 1.6. In other jurisdictions, however, notably California and Washington State, a lawyer who discloses client confidential information to the SEC may well run afoul of state ethics laws.[41]

Since the Dodd-Frank whistleblower provisions went into effect on August 12, 2011, there has been little authority directly interpreting its provisions, particularly with respect to the interplay of state and federal attorney ethics rules. However, the limited authority on these rules has not by any means assumed federal preemption of state ethics rules.

Some guidance, at least by analogy, is provided by a recent federal opinion in a qui tam whistleblower case brought and decided under the False Claims Act. The plaintiffs in *United States ex rel. Fair Laboratory Practices Associates v. Quest Diagnostics Inc.* brought a qui tam action claiming that the defendant diagnostic laboratory engaged in kickbacks by underpricing some services in order to garner other, federally paid-for and more lucrative business.[42] The plaintiffs had excellent intelligence about the defendant's illegal conduct, since its principal, a lawyer named Mark Bibi, had served for five years as general counsel for the defendant's predecessor. Armed with an expert affidavit from legal ethics guru Steven Gillers, the defendant claimed that Bibi had breached his ethical duty of confidentiality to his former client by using confidential information to bring the qui tam claim. Bibi and his co-plaintiffs demurred, arguing that state ethics rules permitted the revelation in order to prevent or rectify client fraud. The district court rejected the plaintiffs' arguments, disqualified Bibi and dismissed the qui tam case in its entirety. The court reasoned that state ethics rules did apply, at least in the case before it; Bibi's disclosures vastly surpassed what was necessary to remedy the fraud; and the revelation of client confidences infected the entire prosecution. The court wrote that if a state ethics rule is "inconsistent with or antithetical to federal interests, a federal court interpreting that rule must do so in a way that balances the varying *federal* interests at stake."[43] According to the court, "Counsel for [the relators] are privy to [the defendant's] . . . confidential information and are in a position to use that information to give present or subsequent clients an unfair, and unethical, advantage."[44] The federal interest in preventing kickbacks, on the facts of that case, was outweighed by the state interest in protecting client confidences.

Other federal courts have applied a totality of the circumstances analysis to weigh the conflicting interests presented by attorney-whistleblower claims. For example, the Ninth Circuit Court of Appeals, in *Van Asdale v. International Game Technology*, upheld the right of terminated in-house lawyers to bring a retaliation suit under the whistleblower provisions of the Sarbanes-Oxley Act.[45] In that case, the plaintiffs were in-house intellectual property lawyers for a publicly traded slot machine distributor. In the course of due diligence for a

proposed merger, the in-house lawyers for the acquiring company (a brother and sister team) learned that a patent infringement claim was the major asset of the acquired company. Following the merger, the lawyers learned that the patent was probably invalid due to prior art, and that high-ranking company officers may have been aware of this fact. As a result, investors were potentially misled by public disclosures about the value of the merger. Shortly after the corporate IP lawyers brought this matter to the attention of the company's president, they were fired.

The sacked lawyers brought a wrongful discharge claim under SOX, which prevents retaliation against any person alleging discrimination based on conduct protected under the act.[46] The reporting of securities fraud was protected conduct. The defendant corporation moved to dismiss, arguing that the plaintiff-lawyers could not prove their case without revealing protected client confidences and waiving privileges. The Ninth Circuit rejected this argument, reasoning that the court could permit the case to proceed while taking precautions to limit the disclosure of confidential information. The court wrote that "concerns about the disclosure of client confidences in suits by in-house counsel" did not, without more, require dismissal of the case, observing that the district court could take protective measures by which it could balance the terminated lawyers' claim against the company's right to preserve the confidentiality of attorney-client protected material.[47] The court further noted that nothing in the Sarbanes-Oxley Act "indicates that in-house attorneys are not also protected from retaliation under this section, even though Congress plainly considered the role attorneys might play in reporting possible securities fraud."[48] Without announcing any broad, bright-line rules, the Ninth Circuit held that the plaintiffs had adduced sufficient evidence to reverse a grant of summary judgment in favor of the employer. Thus, under the *Van Asdale* standard, a whistle-blowing lawyer may bring a retaliation claim under SOX, and concerns about disclosure of confidential information can be accommodated by balancing the plaintiff's need to bring the claim against the client's confidentiality concern.

What do these authorities portend for the future of Dodd-Frank whistleblower claims? The message of *Van Asdale* is that a terminated lawyer with a valid federal retaliation claim will garner some sympathy from the courts, which will try to fashion a way to permit the claim while minimizing disclosure of confidential information. On the other hand, the court's holding in *Fair Laboratory* suggests that a lawyer who affirmatively and aggressively seeks to exploit confidential information for personal benefit is likely to be subjected to a higher standard. Under either standard, both federal courts were receptive to arguments based on lawyers' ethical obligations under state law, and balanced the state and federal interests. Neither case presented the perfect storm posed by the disconnect between SEC Rule 205 and state ethics rules. But neither case held that state ethics rules were federally preempted. Accordingly, it is unlikely that a federal court would plainly find that the SEC regulations promulgated under Dodd-Frank that explicitly pay homage to the various state ethics rules preempt or override those same rules.

Conflict of Interest Rules

In addition, a personal conflict is posed by the Dodd-Frank whistleblower bounties for corporate lawyers. A lawyer confronted with potential corporate wrongdoing must make some difficult, gut-wrenching decisions. A corporate lawyer, whether in-house or in private practice, must decide whether to report wrongdoing up the corporate ladder. In so doing, the lawyer may be ending the career of his or her principal contact within the organization. The whistleblowing lawyer may have to go over the head of the principal contact, including, potentially, the corporation's general counsel. The lawyer must decide whether the potential violation is material, and, in some states, whether it amounts to a crime. The lawyer must evaluate and consider varying requirements under SEC and state ethics rules. The reporting lawyer may get fired, and end up bringing a retaliation claim.

These complex and potentially inconsistent considerations call for the exercise of objective, dispassionate professional judgment. A lawyer whistleblower faces a once-in-a-lifetime ethical dilemma, a potentially career-ending conflict. A misjudgment in either direction could result in a malpractice claim or professional discipline. A lawyer who blows the whistle prematurely could harm the client and be professionally responsible for the precipitous disclosure of client confidences. A lawyer who fails to report up the ladder credible evidence of corporate wrongdoing could be prosecuted by securities regulators, subject to professional discipline by the SEC, and subject to reciprocal discipline by state bar counsel.[49]

Under these delicate circumstances, the last thing lawyers need is a financial incentive to cloud their

A lawyer whistleblower faces a once-in-a-lifetime ethical dilemma, a potentially career-ending conflict; a misjudgment could result in a malpractice claim or professional discipline.

professional judgment. Yet Dodd-Frank provides lawyers with potential bounties that range from $100,000 to literally millions of dollars in larger cases. Since lawyers are fallible, imperfect people, these bounties could tend to place their personal interests in potential conflict with those of their clients, thereby clouding lawyers' professional judgment.

ABA Model Rule 1.7 provides some guidance in the event of a conflict raised by such personal interests. According to that rule, a lawyer may not ethically represent a client, absent a valid waiver, if "there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person *or by a personal interest of the lawyer*."[50] New York's formulation provides:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if a reasonable lawyer would conclude that either:
> (1) the representation will involve the lawyer in representing differing interests; or
> (2) there is a significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal interests.[51]

A lawyer's professional judgment may be clouded by the prospect of a bounty award.

In either formulation, a lawyer must obtain a valid written waiver under Rule 1.7(b) in the event of a "significant risk" that the lawyer's professional judgment or representation will be adversely affected by the lawyer's personal interest. This raises three difficult and potentially unanswerable questions. First, wouldn't just about any lawyer's professional judgment be affected by a potential six- or seven-figure bounty award? Second, how would a lawyer obtain a conflict waiver under these circumstances? Third, would a written waiver be enforceable?

In the first instance, almost any lawyer's professional judgment is likely to be affected, consciously or otherwise, by the prospect of a significant bounty payment. While all lawyers undoubtedly value their professional licenses, at some point a million-dollar bounty can be tempting.

Second, it is difficult to imagine a whistleblower simultaneously deciding whether to report wrongdoing up the corporate ladder while asking the client for informed consent to the conflict waiver. Almost by definition, the would-be whistleblower would be acknowledging a defect or weakness in professional judgment by requesting the waiver. By the very act of requesting the waiver, the lawyer would implicitly be informing the client of his intention to profit from a future whistleblower claim. Let's imagine such a hypothetical conversation. It might go something like this:

> Lawyer: I wish to inform you that I have uncovered credible evidence of a material violation of the federal securities laws that I am obligated to report up the ladder, over your head, to the full board of directors.
> Client: That's terrible. We should investigate this matter promptly.
> Lawyer: That's not all. In the event that the full board does not act promptly or decisively to remedy the wrongdoing, I may seek to file a whistleblower claim under the Dodd-Frank Act, for which I may be entitled to a bounty of 10% to 30% of the penalty that the SEC may exact against the company. Based on what I know so far, I anticipate that this case could result in a $30 million fine. My share would be approximately $3 million to $10 million. While this could affect my professional judgment, I don't believe it will, and I want you to agree to permit me to continue as the company's lawyer.
> Client: Wait a minute. Are you telling me you might, under some circumstances, report confidential information to regulators?
> Lawyer: Yes. But I can still represent the company diligently.
> Client: How can I trust you to continue as the company's lawyer if you may seek to blow the whistle on our company for your personal profit and implicate me and everyone else you have worked with?
> Lawyer: I represent the company, not you. I have to comply with my ethical obligations under SEC Rule 205.
> Client: You are fired.
> Lawyer: You can't fire me. I am protected from retaliation by Dodd-Frank.
> Client: I am not firing you for reporting up or reporting out. I am firing you because you have a personal conflict of interest and can no longer give me or the company objective, disinterested advice.

In the foregoing hypothetical example, the lawyer advises the client that he must report wrongdoing up the corporate ladder, and possibly out to regulators. The lawyer simultaneously requests a waiver in order to permit ongoing representation. The client discharges the lawyer because she has reason to question the lawyer's professional judgment, not because of protected activity under Dodd-Frank. But the client needn't discharge the lawyer to get to the same point. The client can merely decline to consent to the waiver. Under those circumstances (and a slight tweak of the hypothetical), the lawyer must withdraw from the representation, because the client refuses to waive a conceded conflict. In the event of an in-house corporate lawyer, this could, depending on the facts, require the lawyer to withdraw, i.e., quit his or her job.

How is a court to sort this out? An in-house corporate lawyer who is wrongly discharged under Dodd-Frank may bring a retaliation case, and such a lawyer is likely to cite *Van Asdale* in support. On the other hand, Dodd-Frank does not explicitly or implicitly preempt or supersede state ethics rules, and a lawyer with a conflict of interest may not be able to obtain a valid waiver. Such a lawyer may need to voluntarily resign under RPC 1.16.

Lawyers whose representation conflicts with their personal interests are not new. Consider, for example, the decision of the Second Circuit Court of Appeals in *United States v. Schwarz,* which upended an on-the-record conflict waiver conducted in open court in a criminal prosecution.[52] In the Abner Louima police brutality scandal of the 1990s, NYPD Officer Justin Volpe pleaded guilty to sexually assaulting Louima with a broomstick in a Brooklyn police precinct bathroom. While swearing that Volpe had an accomplice who held him down during the attack, Louima couldn't make a definitive identification. The government prosecuted Police Officer Charles Schwarz, Volpe's partner, as the accomplice, based largely on circumstantial evidence. However, substantial evidence placed other police officers in the vicinity of the precinct bathroom at the time of the assault. Those officers were also high-ranking members of the Patrolmen's Benevolent Association (PBA), the police officers' union.

Prior to trial, Steven Worth, Schwarz's lawyer, signed a $10 million two-year contract with the PBA. One potential strategy would have been for Schwarz to argue that he wasn't the accomplice and to point the finger at one of several other police officers, each of whom had positions of power and influence with the PBA. Worth and Schwarz elected not to pursue that strategy. Upon learning of the potential conflict, the district judge held a formal, on-the-record, conflict waiver hearing at which Schwarz was fully apprised in open court of his attorney's potential conflict. Schwarz waived the conflict, and proceeded to be convicted at a trial in which he denied being Volpe's accomplice, yet refused to point the finger at any other (PBA delegate) cop.

The Second Circuit reversed, holding that Worth's conflict was unwaivable as a matter of law, and that no rational person in Schwarz's situation would have waived that conflict or pursued that defense. The court wrote that Worth's representation of Schwarz "was in conflict not only with his ethical obligation to the PBA as his client, but also with his own substantial self-interest in the two-year, $10 million retainer agreement his newly formed firm had entered into with the PBA." As a result, the court announced the following test:

> An actual or potential conflict cannot be waived if, in the circumstances of the case, the conflict is of such a serious nature that no rational defendant would knowingly and intelligently desire that attorney's representation. Under such circumstances, the attorney must be disqualified, regardless of whether the defendant is willing to waive his right to conflict-free counsel.[53]

Thus, not all conflicts are waivable, particularly when they involve a conflict with the lawyer's personal interest. Given Worth's $10 million contract with the PBA, and the restrictions that deal imposed on his representation of Schwarz on the facts of the Louima case, "no rational defendant" would knowingly have desired his representation. In short, a conflict with the lawyer's personal interests can be profound and, in some circumstances, unwaivable.

It does not require much imagination to apply the *Schwarz* ruling to potential conflicts under Dodd-Frank. A prospective whistleblower may hope to claim close to a $10 million bounty by reporting a securities fraud of $30 million or more. Such a lawyer's professional judgment may be clouded by the prospect of a bounty award, which could tilt the lawyer in favor of reporting out a violation that otherwise perhaps should be reported up the ladder.

In fact, precipitous reporting out could violate state ethics rules, and corporate lawyers may find themselves in a conflict situation because of the potential of a whistleblower bounty. Such a conflict can tend to cloud a lawyer's professional judgment, and furthermore, it may be unwaivable.

Conclusion

Securities lawyers confronted with evidence of corporate wrongdoing are faced with conflicting ethical and fiduciary responsibilities. Would-be whistleblowers are well advised to consider the varying and potentially conflicting obligations of SEC and state ethics regulations.

Lawyers who report out corporate wrongdoing may run afoul of state ethics regulations and could, at least theoretically, be subject to state discipline. State ethics rules are inconsistent with each other and with SEC Rules.

Courts faced with conflicts between state and federal ethics rules are unlikely to apply a blanket preemption analysis; indeed, they cannot. If precedent is a guide, federal courts will apply a fact-specific totality-of-the-circumstances analysis in balancing state and federal interests in evaluating the validity of whistleblower claims under Dodd-Frank implicating state attorney ethics rules. Indeed, the McDade Amendment indicates that federal lawyers must adhere to state ethics rules. It is highly unlikely that lawyers can ethically disregard state ethics rules. Moreover, lawyers should be mindful of the potential that their professional judgment could be influenced by the prospect of collecting a bounty from the government under the Dodd-Frank Act. ■

1. 17 C.F.R. § 205.3(d)(2)(i).

2. *See* Roger Cramton, George Cohen & Susan Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes Oxley*, 49 Vill. L. Rev. 725, 782 (2004).

3. SEC Rule 21F-4(b)(iv)–(v), 17 C.F.R. § 240.21F-4(b)(4)(iv)–(v).

4. 15 U.S.C. § 7245, 17 C.F.R. § 205.3(d)(2).

5. SEC Rule 205.3(d)(2), 17 C.F.R. § 205.3(d)(2), states:

> An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:
>
> (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
>
> (ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or
>
> (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

6. CFTC Rule 165.2(g)(2)–(3), 17 C.F.R. § 165.2(g)(2)–(3).

7. Cramton, Cohen & Koniak, *supra* note 2, at 791.

8. *See In re Don Hershman*, Securities Act Release No. 9180 (Feb. 2, 2011).

9. *See* Model Rules of Prof'l Conduct R. 1.6.

10. New York City Bar, Report of the Task Force on the Lawyers Role in Corp. Governance 80 (2006) (Task Force Report).

11. *Id.* at 76–80.

12. N.Y. Rules of Prof'l Conduct R. 1.6(b).

13. Model Rules of Prof'l Conduct R. 1.6(b).

14. Lynne Bernabei & Alan Kabat, *The SEC Properly Expanded Protection for Attorney Whistleblowers*, Nat'l L.J., Aug. 9, 2011, http://www.law.com/jsp/nlj/PubArticlePrinterFriendlyNLJ.jsp?id=1202510464836.

15. *But see* Task Force Report, *supra* note 10, at 12.

16. N.J. Rules of Prof'l Conduct R. 1.6(b)–(d).

17. *See* Task Force Report, *supra* note 10, at 47 (citing *In re Isselman*, Securities Act Release No. 50428 (Sept. 23, 2004)).

18. California, on the other hand, requires a lawyer to remonstrate with the client before revealing confidences and prevents prosecution of the lawyer for not revealing client confidences. *See* Stephen Gillers, Roy D. Simon Jr. & Andrew M. Perlman, Regulation of Lawyers 82 (Aspen 2010).

19. *In re Isselman*, Securities Act Release No. 50428 (Sept. 23, 2004).

20. *In re Drummond*, Securities Act Release No. 8523 (Jan. 13, 2005).

21. *See also In re Weiss*, Securities Act Release No. 52875 (Dec. 2, 2005) (bond counsel prosecuted by SEC under negligence standard for failing to exercise reasonable prudence in advising school board about tax-exempt status).

22. Cal. Bus. & Prof. Code 6068 (e).

23. *See* Cramton, Cohen & Koniak, *supra* note 2, at 782.

24. Model Rule of Prof'l Conduct R. 1.13.

25. *Id.*

26. N.Y. Rules of Prof'l Conduct R. 1.13.

27. N.J. Rules of Prof'l Conduct R. 1.13.

28. *See* N.J. Rules of Prof'l Conduct R. 1.6.

29. *See Sperry v. State of Florida*, 373 U.S. 379 (1963).

30. *See, e.g.*, *Swidler & Berlin v. United States*, 524 U.S. 399 (1998).

31. Sarbanes-Oxley Act, 15 U.S.C. §§ 7245 *et seq.*

32. *See* Cramton, Cohen & Koniak, *supra* note 2, at 788.

33. *Id.* at 795.

34. 28 U.S.C. § 530B (2004); *see* Lisa G. Lerman & Philip G. Schrag, Ethical Problems in the Practice of Law 716–17 (Aspen 2008).

35. *See* Ethics Alert, Ethics Hotliner, Corporations Committee of the Business Law Section and Committee on Professional Responsibility and Conduct, California State Bar, http://www.calbar.ca.gov/portals/0/documents/SEC-ethics-alert.pdf.

36. Letter from the Corporations Committee, Business Law Section of the State Bar of California to Giovanni P. Prezioso, General Counsel of the SEC (Aug. 13, 2003) at 6, *available at* http://www.dwalliance.com/sbar/SEC.PDF.

37. Wash. State Bar Assoc., Interim Formal Ethic Opinion re: *The Effect of the SEC's Sarbanes-Oxley Regulations on Washington Attorneys' Obligations Under the RPCs*, http://www.ethicsandlawyering.com/Issues/files/WashOpinion.pdf.

38. *Id.*

39. N.C. State Bar, Formal Ethics Op. 9 (2005).

40. N.Y. Rules of Prof'l Conduct R. 1.6(b)(6).

41. *See* Cramton, Cohen & Koniak, *supra* note 2, at 807 ("California lawyers are therefore at some risk if they seek to take advantage of Section 205.6(c).").

42. No. 5393, 2011 WL 1330542 (S.D.N.Y. Apr. 5, 2011).

43. *Id.* at *6 (quoting *Grievance Committee for the S.D.N.Y. v. Simels*, 48 F.3d 640, 646 (2d Cir. 1995)).

44. *Id.* at *13.

45. 577 F.3d 989 (9th Cir. 2009).

46. *See id.* at 996 (citing 15 U.S.C. § 7245).

47. *Id.* at 995 (quoting *Kachmar v. SunGard Data Sys.*, 109 F.3d 173, 181 (3d Cir. 1997)).

48. 577 F.3d at 996 (citations omitted).

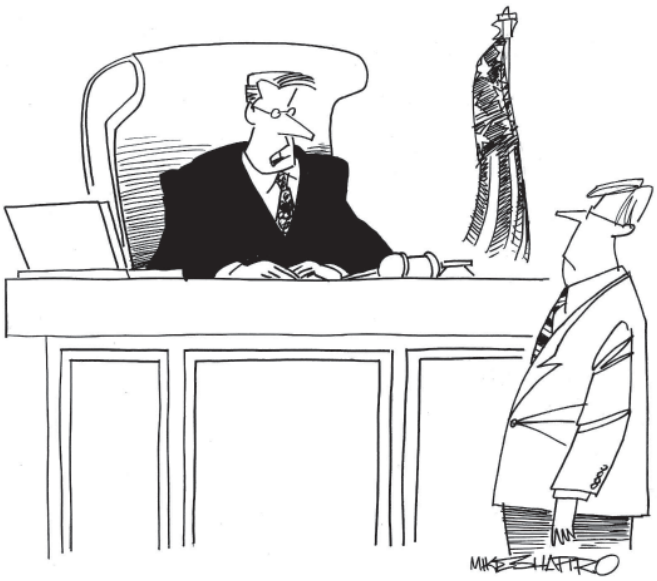
49. *See, e.g.*, Task Force Report, *supra* note 10, at 46 (collecting 74 SEC enforcement actions against lawyers).

50. Model Rules of Prof'l Conduct R. 1.7(a) (emphasis added).

51. N.Y. Rules of Prof'l Conduct R. 1.7.

52. 283 F.3d 76 (2d Cir. 2002).

53. *Id.* at 95–96 (citations omitted).



"Hey, I'm all about being reasonable."