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THE ATTORNEY AND EXEMPTIONS FROM REGISTRATION

An Address By

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Each time the Commission proposes a new exemptive rule, it poses new challenges for practicioners, since usually transactions under the exemption, to be accomplished, will, somewhere, involve an attorney giving an opinion to someone concerning the availability of the rule and the reasonableness of reliance in the particular situation upon the claimed exemption. Consideration of the conduct of counsel in the specific exemptive situation, of course, occurs in a broader context, namely, the role of the attorney in commercial, and more particularly, securities matters in general.

I think we all know that lawyers, like everyone else these days with professional responsibilities, are under fire. If you read the Wall Street Journal recently, the lead article concerned the turmoil in which the profession is involved at the present time, and some of the criticisms which have been voiced recently were set forth there. The Spectrum case, _/ which was decided recently by the Second Circuit, has been the source of considerable concern and controversy because there the Courts indicated that a lawyer who gave an opinion negligently in connection with the availability of an exemption might be liable in an injunctive proceeding brought by the Commission. There has recently been other litigation commenced by the Commission involving attorneys; in addition to that there have been civil suits brought arising out of

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* The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or speech by any of its members or employees. The views expressed here are my own and do not necessarily reflect the views of the Commission or of my fellow Commissioners.

_/ SEC v. Spectrum, Ltd., 489 F. 2nd 535 [2nd Cir. 1973]

the same sort of facts. These events, I think, all indicate that we cannot be indifferent to the standards that should guide lawyers when they are dealing with complicated matters of federal securities law.

Questions about the commitments of corporation lawyers are not new. In 1934 Justice Stone said in a speech:

> "Steadily the best skill and capacity of the profession has been drawn into the exacting and highly specialized service of business and finance. At its best the changed system has brought to the command of the business world loyalty and a source of superb proficiency and technical skill. At its worst, it has made the learned profession of an earlier day the obsequious servant of business, and tainted it with the morals and manners of the market place in its most anti-social manifestations. In any case we must conclude that it has given us a Bar... whose energy and talent for public service and for bringing the law into harmony with changed conditions has been largely absorbed in the advancement of the interest of clients."

I think in a sense the topic I'm going to talk about is whether that kind of a statement about the legal profession and its relationship with its business clients is still justified or whether perhaps we have risen from the point that was spoken of by Justice Stone.

I think we all know that in this age of consumerism there are greater demands made upon everybody with responsibilities that affect the public. Manufacturers can no longer hide behind the limitations of their warranties; they can no longer contend that they have no liability to ultimate consumers; there has been a steady expansion of their responsibility, resulting in many cases in potentially ruinous litigation. Similarly accountants are being called upon to assume new obligations and adopt higher standards. Directors, particularly outside directors whose main business is not running the company, are being required to assume greater responsibility and to carry out what I think

has always been their responsibility with a greater sense of awareness and a greater sense of responsibility towards the public.

Interestingly enough, as long ago as 1935 the problems of the lawyer under the federal securities laws were rather well stated. Marshall Small has recently noted in an article concerning an attorney's responsibilities under the federal securities laws:

> "In 1935 Professor Nathan Isaacs of the Harvard Graduate School of Business Administration suggested that the Securities Act of 1933 may serve to broaden the responsibility and liability of lawyers to the investing public. Professor Isaacs prophesized that the courts would come to place greater emphasis upon an attorney's professional status than on the contractual relationship with his client as the basis for a formulation of his duties and liabilities. He foresaw no radical change in the attorney's responsibilities resulting from this shift, but predicted a restatement of the attorney's answerability to the court and to society and a reminder that he is not an ordinary employee of his client."

That was said in 1935 - nearly 40 years ago. When you consider that, I wonder what all the uproar is about when there is talk about the expansion of attorney's responsibilities with respect to the public. The California Supreme Court stated it somewhat more succinctly. It said that as more individuals come to depend on the attorney, his responsibility must broaden and deepen. That is what we're talking about today - the extent to which the reliance of the public upon the opinions of counsel has expanded and become more meaningful.

I would suggest that a case that is extremely important in this regard is the recent case of White v. Abrams [1] that was decided by the

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[1] CCH Fed.Sec.L.Rep. Para. 94,457 (9th Cir., March 15, 1974)

Ninth Circuit. I regard this case as important, I suppose, because it reflects some of my own thinking as I have dwelt upon the concepts of negligence, recklessness, knowing disregard, and so on as they apply to securities law problems. In that case, the Court said that the problem of determining responsibility in complicated cases under Rule 10b-5 cannot be decided on the basis of conceptual analysis of the notions of negligence, recklessness, knowledge and the like. Rather, the Court emphasized that " the proper analysis... is not only to focus on the duty of the defendant, but to allow a flexible standard to meet the varied factual contexts without inhibiting the standard with traditional fault concepts which tend to cloud rather than clarify."

That statement in itself perhaps is somewhat terrifying, since all of us recoil from the uncertainties that are implied by it. Let's see what the Court was talking about when it spoke of applying this flexible standard. Here are some of the considerations it said should be taken into account: the relationship of the defendant to the plaintiff; the defendant's access to the information as compared to the plaintiff's access; the benefit that the defendant derives from the relationship; the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions; and the defendant's activity in initiating the securities transaction in question. The Court indicated this did not exhaust the circumstances and conditions that should be taken into account, but indicated that these were representative of them.

This is in rather significant contrast in a way to the decision of the Second Circuit in the Spectrum case. The Spectrum case was a case that was brought by the Commission seeking an injunction. The lower court had denied the Commission's request for a preliminary injunction without a hearing; on appeal the Court of Appeals reversed and sent the case back for an evidenciary hearing in the lower court. The Court indicated that it felt it should give guidelines to the lower court as to the manner in which it should approach the problem of an attorney's liability who had rendered an opinion with regard to the availability of an exemption from registration.

The Court said this:

> "The legal profession plays a unique pivotal role in the effective implemention of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously distrubed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters."

The Court went on. It said;

> "In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience. The public trust demands more of its legal advisers [its referring back to public trust] than 'customary' activities which prove too careless." (Emphasis supplied)

Morgan Shipman has referred to the position of the lawyer with respect to exemptions under the federal securities law as similar to a pass key. His opinion is the means by which the securities pass through the door of the exemption. I don't think that is an inexact

description of the role of the lawyer. If the lawyer says that there is an exemption available, securities get passed into the marketplace where they will be traded eventually and they will remain outstanding for years and years and years. On the other hand, if the lawyer refuses the opinion, unless another lawyer is willing to tread where the other would not and in many cases by so doing sacrifice his integrity, those securities either do not get sold or they get registered with all of the disclosure requirements that are attendant upon that process.

All this is nothing new, in my estimation. The indications of the Commission's ideas with regard to the responsibility of attorneys have been pretty clear. In 1962 the Commission published a release which was referred to in a footnote in a later release which said this: "If an attorney furnishes an opinion based solely upon hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct." That sort of statement by the Commission has raised a number of eyebrows and arched a few backs. As one result of this, the Committee on Ethics and Professional Responsibility of the American Bar Association recently issued Opinion No. 335. While I think I and perhaps other people associated with the Commission might question some of the particulars of it, nonetheless I think it is a significant statement of what the responsibility of an attorney is from a professional standpoint, and I would caution that with the increasing development of implied liability concepts, professional responsibilities and the failure to

abide them are increasingly susceptible to becoming the bases for civil action. This Opinion says that depending upon the circumstances, the lawyer may or may not need to go beyond directing questions to his client and checking the answers by reviewing such appropriate documents as are available. The Opinion stresses the importance of proper, complete, adequate, well-understood communication between the lawyer and his client. It suggests that the attorney ought to take reasonable steps to make sure that his client understands exactly what are the facts he has requested information about, and he must then make sure that the client has understood this in a fashion that has resulted in responsive answers to the questions he puts. And the lawyer must also be sure that he understands what the client is saying. If the client engages in the shorthand that many clients do, he ought to make sure that they're talking the same shorthand.

What are the circumstances under which a lawyer ought to go beyond what his client tells him? This obviously poses great problems. No lawyer likes to suggest to his client that he doesn't trust him, that he cannot rely upon what his client says to him, or that the representations made may be subject to question. When is it then that he ought to go beyond what the client says to him? Well, he asks about relevant facts and he gets answers. If the facts or the alleged facts that are stated by the client appear in any respect to be suspect, if they appear to be inconsistent internally or with other information the lawyer has, if on their face or on the basis of other information he has concerning the transaction or the client they appear in any way to be open to question, then the lawyer has the duty of making further inquiry, and if not satisfied, decline to give an opinion. I

will state here again this is not the Commission, this is not the Second Circuit that is stating these standards. This is the American Bar Association Committee on Ethics and Professional Responsibility.

How far should the attorney go in making these inquires? Again this is going to depend upon the circumstances in which the attorney makes the judgment. Where the lawyer has had a long relationship which has imbued him with confidence in the integrity of his client, the standard of investigation is different because he has a history upon which he can rely. When he has been recently engaged, then I think the responsibility for checking is much broader. It's interesting in this respect to look at the facts discussed in the Court's opinion in the Spectrum case. The lawyer in Spectrum walked into a broker's office and there he met a gentleman whom he had met once before in the office. That gentleman said, in effect, I'd like you to give a friend an opinion with regard to whether an exemption from registration is available for some stock." They then made a phone call to the friend, one of the over 50 people who received the stock in a merger, and he stated he would prepare an opinion. He then looked at the opinion another lawyer had given and, with little more, gave his opinion, the effect of which was to free up almost two million shares of stock held by 56 different individuals who were named in the opinion. That was the apparent extent of his investigation. Why in heaven's name some people at the Bar have been so shocked by the fact that the Court seemed to indicate that there was a basis upon which an injunction should be ordered against that attorney is an absolute mystery to me. In any event, the attorney wrote the opinion on December the 4th, gave it--he didn't even know the address of his client,

so he delivered it to the broker's office -- and four days later he suddenly decided that it might be a good idea to put a stop on the use of the opinion, so he wrote a second letter saying, in effect,"By the way, I don't want you to use my December 4th opinion as a basis upon which to sell any securities." I don't know what he thought they were going to do with that December 4th opinion. Interestingly enough, in the December 8th letter he reminded his client about his fee. That may be the most significant fact of the whole episode! I might note that on remand the attorney consented to the issuance of a permanent injunction, without admitting or denying the allegations.

In any event, I think these problems require what I would call a "situational analysis." The lawyer has to look at the position in which he is, the relationship he has with the client, the nature of the answers which have been forthcoming from the inquiries he has made, the implications of the documents he examines. And that will determine the scope of the inquiry he must make. If a lawyer on the basis of his investigation comes to the conclusion that he simply cannot confidently give an opinion, then I think the answer is pretty simple. He doesn't give the opinion. If his investigation suggests attempted deceit on the part of his client, he should also consider throwing the client out. Please note: I do not suggest a trip to the SEC is also necessary.

If, on the other hand, the facts noted are not inherently inconsistent, if they are not open to question, if he has confidence in his client, if he has checked into the documents and nothing appears to indicate that the facts represented to him are incorrect, I see no

reason why he cannot give an opinion. He is not an insurer, he is not intended to be an auditor of his client's affairs. There are practical limitations beyond which no one should responsibly ask an attorney to go in making this investigation.

Now, as an example, it seems to me that when an attorney is giving an opinion under Section 4(2), putting aside Rule 146 for the moment, if he says to his client, "Are all the people to whom you wish to make this offering sophisticated investors?" and the client says, "Oh, yes, my God, they're all sophisticated. These guys are the best poker players I've ever seen," then I think he has to find out whether his conception of sophistication is the same as his clent's conception of sophistication. And he cannot say to the client, "Have you given all these people the information that would be in a registration statement?" because the average client doesn't know what is in a registration statement. So, if you're going to use that as a criterion for determining the availability of the Section 4(2) exemption, as the Supreme Court indicated in the Ralston Purina case you must, then you have to make an investigation item-by-item as to whether appropriate information has been furnished.

In the final analysis, a lawyer has the ultimate responsibility of exercising a completely independent judgment. Any equation of his role in rendering an opinion with regard to an exemption under the securities laws to the role of an advocate is completely inadequate and is an absolute invitation to trouble.

In a recent speech, Monroe Freedman, Dean of the Hofstra Law School, had this to say: "I was genuinely shocked with the implications of securities regulation practices and policies as they affect two inseparable concepts that must be of concern to all of us -- the rights of individuals in a free society, and the independence of the bar." He further said. "A second justification is often asserted for compelling the SEC lawyer to work for the Government rather than for his or her client is the notion that there is an essential distinction between the litigating attorney and the office attorney. What that argument ignores is that our legal system is basically an adversarial one, and every lawyer -- whether drafting a contract, counselling in a business venture, writing a will, or performing any other service on behalf of a client -- acts in such a way as to protect the client from being at a disadvantage in potential future litigation. Particularly should that be so, in a free society, when the potential adversary is the government itself. In that sense, and it is a crucial one, every lawyer is an advocate, irrespective of whether he or she ever enters a court room." I think Dean Freedman is wrong when he says that and I think anybody who relies on that article and his advice is courting disaster.

The Second Circuit has said, "In our complex society, the accountant's certificate and the lawyer's opinion can be instruments in afflicting pecuniary loss more potent than the chisel or the crowbar."_/ This is a clear indication of what is expected of attorneys. It has been confirmed, I think, in the ABA opinion I spoke of earlier when it suggests that while the lawyer has a responsibility to his client,

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_/ U.S. v Benjamin, 328 F.2nd 854,863 (2d.Cir.,1964)

he must not be oblivious of the extent to which others may be affected if he is derelict in fulfilling that responsiblity. I think there is a difference between an adviser and an advocate. An advocate deals with the past, and he deals with the past conduct of his client when that conduct is questioned in court. On the other hand the lawyer is serving as an adviser in looking to the future. Ordinarily you think of an adversary relationship when there are advocates on both sides. But I would ask you when you are called upon to give an opinion with regard to an exemption, where is the advocate for the public who will prevent the advocacy of the offeror's counsel from getting out of bounds? Judge Kaufman noted in the Spectrum case, "The securities laws provide a myriad of safeguards designed to protect the interests of the investing public. Effective implementation of these safeguards, however, depends in large measure upon the members of the bar who serve in an advisory capacity to those engaged in securities transactions." The Commission has spoken unmistakably, "Members of this Commission have pointed out time and time again, "-this is in the Emanual Fields' opinion-/ "that the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders. These were statements of what all who are well versed in the practicalities of the securities laws know to be a truism; i.e. that this Commission with its small staff, limited resources, and onerous tasks, is pecularily dependent on the probity and the diligence of the professionals who practice before it. Very little of the securities

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_/ In the matter of Emanuel Fields, Securities Act Release No.5404 (June 18, 1973)

lawyer's work is adversary in character. He doesn't work in court rooms where the pressure of vigilant adversaries and alert judges check him. He works in his office where he prepares prospectuses, proxy statements, opinions of counsel and other documents that we, our staff, the financial community and the investing public must take on faith. This is a field where unscrupulous lawyers can inflict irreparable harm on those who rely on the disclosure documents that they produce." As recently as 1969, a very distinguished lawyer with a career that included service on the staff of the Commission said the law so far is very clear, the lawyer's responsibility is exclusively to his own client. I think that notion is, if it was true in 1969, which I don't believe it was, singularly untrue today. There is a responsibility to the public, and it is that responsibliltiy which increasingly the courts are enforcing.

How does all this apply to exemptions under the federal securities laws? A starting point for analysis is the registration process. For all of its shortcomings, Congress has made this the foundation stone upon which it sought to build a system for the protection of investors and the courts have construed exemptions from it narrowly in recognition of its importance. Through the exemptions securities are put into the marketplace, they stay there, they pass from hand to hand. In some cases the availability of the exemptions depends upon the presence of some protections that in some measure provide safeguards bearing surface similarity to those provided by the registration process, e.g. Rule 146 and Rule 144; in other cases, virtually none of those safeguards are present (except for fraud concepts), e.g. Rule 147 and Section 3(a)(9) of the 1933 Act.

The responsibility of counsel to the public is, to my mind, more pronounced the less the conditions of the exemption incorporate disclosure requirements bearing some of the earmarks of a registration statement. Thus, an improvidently given opinion in an intrastate offering not only looses unregistered securities for purchase by innumerable buyers, but also, after a period of rest, permits their trading in the markets without the statutary safeguards of Rule 144.

Rule 146 is surrounded with numerous safeguards: information must be furnished equivalent to that in the registration statement, or at least access to it must be afforded; offerees must have sophistication or acquire it through an appropriate representative; the shares can only be sold after registration, or through a further private transaction, or under the restraints of Rule 144 which incorporates significant informational requirements. I would suggest that while the public interest in a Rule 146 matter is less pronounced, nonetheless it is there. In the simplest terms, the Congress, the courts and the Commission have determined that people are entitled to the <u>full</u> gamut of registration protection unless certain conditions are satisfied; if those conditions are not satisfied, but the securities are nonetheless sold, there is an aberration, and an abortion, of the process and that is contrary to the public interest. Once securities are issued in a private placement, notwithstanding the safeguards against their further distribution there is always the danger that they will be resold without compliance with applicable requirements or that counsel will be found to opine that the stricutres of Rule 144 are not applicable because of the passage of time or change of circumstances, and hence the securities move into the channels of commerce without accompanying restraints and that, I suggest, is subversive of the public interests.

Rule 146 is going to pose opportunities galore for the exercise of judgment and professional responsibility. I do not think I exaggerate when I say that the success of 146 in providing as we hope it will not only the benefit of certainty for issuers, but additional protections to the public is going to largely depend upon the sense of responsibility and the professional abilities of the attorneys who deal with it. And I think that your presence here this morning is evidence enough of the fact that you detect, discern and respond to that responsibility.

Thank you.