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# United States Regulation of Canadian Securities Attorneys under Sarbanes-Oxley: Exploring Costs and Finding an Optimal Allocation of Authority

Lauren M. Harper\*

## I. INTRODUCTION

In reaction to a series of corporate scandals, starting with the collapse of the energy giant Enron,<sup>1</sup> the United States enacted the landmark Public Company Accounting Reform and Investor Protection Act of 2002 [hereinafter "the Act"].<sup>2</sup> The Act, more commonly known as the Sarbanes-Oxley Act, creates a new disclosure and corporate governance regime that imposes a framework of oversight upon corporate officers, accountants, and attorneys.<sup>3</sup>

In an unprecedented attempt to federalize the norms of securities attorneys,<sup>4</sup> Section 307 of the Act requires the United States

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\* Juris Doctor Candidate, May 2005, University of Miami School of Law. The author would like to thank Professor Robert E. Rosen for his insights regarding the writing of this Comment and all the members of the *Inter-American Law Review* who helped edit this Comment. The author would like to dedicate this Comment to her father who had a brilliant mind for economics.

1. Enron Corporation was listed as the seventh largest company in the United States at the time of its collapse. See Janis Sarra, *Rose-Colored Glasses, Opaque Financial Reporting, and Investor Blues: Enron as Con and the Vulnerability of Canadian Corporate Law*, 76 ST. JOHN'S L. REV. 715, 715-16 (2002). Since its demise, shareholders have lost more than \$60 billion in market value, thousands of employees have lost their jobs, and creditors have lost billions in trade and other credit. *Id.* The failed governance of Enron was quickly followed by the collapse of WorldCom, Global Crossing and many other large corporations. *Id.* See also Marianne M. Jennings, *A Primer on Enron: Lessons from a Perfect Storm of Financial Reporting Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163, 164 n.1 (2003).

2. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201-7266). As President George W. Bush signed this legislation into law he exclaimed that the Act contained "the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt." President George W. Bush, Policy in Focus: Corporate Responsibility. Remarks at the Signing of the Corporate Corruption Bill (July 30, 2002), available at <http://www.whitehouse.gov/news/releases/2002/07/print/20020730.html> (July 30, 2002) (last visited Oct. 26, 2004).

3. See Larry Cata Backer, *The Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer, and Accountant Behavior*, 76 ST. JOHN'S L. REV. 897 (2002).

4. *Id.* Many were stunned that the U.S. attempted to impose ethics rules upon a profession that historically enjoyed virtually unfettered self-regulation. See Otis Bilodeau, *Vinson Partner Defends His Firm, His Integrity*, THE RECORDER, Mar. 21, 2002, at 3 (stating that one commentator noted that no one could remember a hearing

Securities and Exchange Commission [hereinafter "SEC" or "Commission"] to develop rules establishing minimum standards of professional conduct for attorneys appearing before the Commission. This includes an affirmative obligation for lawyers to report evidence of corporate misconduct "up-the-ladder" within the company first to the chief executive officer ["CEO"] or chief legal officer ["CLO"], and then, if the CEO or CLO does not respond appropriately, to the board of directors.<sup>5</sup> Promulgated by the SEC in August of 2003, the final rule [hereinafter "Rule 205" or "the Rule"]<sup>6</sup> also permits lawyers to report misconduct to the SEC when substantial financial harm is likely to result from an issuer's violations.<sup>7</sup> A more controversial provision, however, was included in the proposed Rule 205. That provision requires lawyers to withdraw and report such withdrawal to the SEC when substantial financial harm is likely to result from an issuer's violations.<sup>8</sup> Although the "noisy withdrawal" is not embodied in the final Rule, the SEC may choose to adopt it at a later date.<sup>9</sup>

According to the SEC's comments, Rule 205 is designed to

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specifically focusing on the lawyer's role before the Congressional hearing questioning a panel of Enron's in-house and outside counsel). The courts claim an inherent right to regulate the legal profession, but have delegated much of this authority to the state bar associations. *See generally* DEBORAH L. RHODE & GEOFFREY C. HAZARD, JR., PROFESSIONAL RESPONSIBILITY AND REGULATION 41 (2002). The justification for the American lawyers' privileged self-regulation is phrased in the Preamble to the American Bar Association's Model Rules of Professional Conduct: "An independent legal profession is an important force in preserving government under law, for abuse of legal authority is more readily challenged by a profession whose members are not dependent on government for the right to practice." MODEL RULES OF PROF'L CONDUCT pmbl. As such, many U.S. attorneys oppose Section 307 of the Sarbanes-Oxley Act. *See* David J. Beck, *The Legal Profession at the Crossroads: Who Will Write the Future Rules Governing the Conduct of Lawyers Representing Corporations?*, 34 ST. MARY'S L.J. 873, 906-14 (2003).

5. *See* Sarbanes-Oxley Act of 2002, *supra* note 2, §307.

6. 17 C.F.R. §§ 205.1-205.7 (2003).

7. *Id.* at § 205.3(d)(2)(i).

8. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. § 205.3(d)(i)(A-C)) (noting this as the first proposed release setting forth the proposed steps of the "noisy withdrawal"). *See* Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. § 205 (2003) ("[W]e are extending the comment period on the "noisy withdrawal" and related provisions of the proposed rules and are issuing a separate release soliciting comment on this issue."), *available at* <http://www.sec.gov/rules/final/33-8185.htm> (last visited Sept. 26, 2004).

9. *Id.* *See* Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. § 205 (2003) ("[W]e are extending the comment period on the "noisy withdrawal" and related provisions of the proposed rules and are issuing a separate release soliciting comment on this issue."), *available at* <http://www.sec.gov/rules/final/33-8185.htm> (last visited Sept. 26, 2004).

protect investors by helping to increase investor confidence, prevent and deter corporate misconduct and fraud, improve corporate governance by providing a process to identify and remedy material violations of law, and give guidance and clarity to securities lawyers regarding their ethical obligations.<sup>10</sup> The SEC contends that such benefits outweigh the costs upon issuers and the law firms that represent them – costs so minimal that they do not dissuade businesses to offer or list securities in U.S. markets.<sup>11</sup>

The SEC also recognized that non-U.S. lawyers play significant roles in connection with Commission filings by both foreign and United States issuers.<sup>12</sup> Consequently, the SEC imposed the Rule, with certain exceptions,<sup>13</sup> upon foreign securities attorneys practicing before the Commission.<sup>14</sup> Despite the exceptions added

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10. See Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. §§ 205.1-205.7 (2003) (discussed in Costs and Benefits section), *available at* <http://www.sec.gov/rules.final.33-8185> (last visited Sept. 26, 2004). *Cf.* United States Securities and Exchange Commissioner, Paul S. Atkins, Address at the University of Cologne, Germany (February 5, 2003) ("Fundamentally, the [Sarbanes-Oxley Act] acknowledges the importance of stockholder value. Without equity investors and their confidence, our economic growth and continued technological innovations would be slowed."), *available at* <http://www.sec.gov/news/speech/spch020503psa.htm> (last visited Sept. 26, 2004).

11. See Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. §§ 205.1-205.7 (2003) (discussed in Costs and Benefits section), *available at* <http://www.sec.gov/rules/final/33-8185.htm> (last visited Sept. 26, 2004). See also Atkins, *supra* note 10 (exclaiming that a primary goal of SEC is to make it inviting for global businesses to offer and list their securities in U.S. markets and that Sarbanes-Oxley does not interfere with this goal).

12. See Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. §§ 205.1-205.7 (2003) (discussed in Section-by-Section Discussion for non-appearing foreign attorney exception), *available at* <http://www.sec.gov/rules.final.33-8185> (last visited Sept. 26, 2004). *Cf.* Atkins, *supra* note 10 (noting that over 1,300 non-U.S. corporations from 59 countries file reports with the SEC).

13. Although the Act generally does not make distinctions between U.S. and non-U.S. issuers, the SEC has softened some of the Act's more controversial provisions by providing limited exceptions for foreign issuers. See Atkins, *supra* note 10. See also Kenji Taneda, *Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation*, 2003 COLUM. BUS. L. REV. 715, 716-17 (2003). Rule 205 epitomizes such accommodations. After the proposed rule was released, the Commission received over forty comment letters from foreign parties and hosted a special Roundtable on the International Impact of the Proposed Rules Regarding Attorney Conduct. See Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. §§ 205.1-205.7 (2003) (discussed in Section-by-Section Discussion for non-appearing foreign attorney exception), *available at* <http://www.sec.gov/rules.final.33-8185> (last visited Sept. 26, 2004). To accommodate concerns that surfaced during this contentious comment period, the Commission adjusted the final rule and provided certain safe-harbors for foreign attorneys. *Id.* See also discussion *infra* Part III.A (discussing non-appearing foreign attorney exception and conflict of law preemption).

14. See Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. §§ 205.1-205.7 (2003) (discussed in Section-by-Section Discussion for non-

in the final Rule, many foreign attorneys are opposed to the Rule because they believe that the United States should not be able to exercise any jurisdiction over the legal profession outside of its borders.<sup>15</sup> As the Law Society of Upper Canada aptly elaborates in its comment to the Commission regarding the proposed rule:

It seems inappropriate for the Commission to purport to extend its authority into foreign jurisdictions in order to regulate a purely domestic matter – the professional conduct of lawyers – simply because foreign lawyers may in the course of their practices from time to time act on behalf of clients that are subject to the jurisdiction of the Commission.<sup>16</sup>

Considering that Canada is the largest foreign issuer in the U.S. exchanges, it is particularly important to understand the impact of the Rule upon Canadian securities lawyers.<sup>17</sup> Such an analysis can serve as an indicator as to whether any such extraterritorial application of the Rule is appropriate or effective.

This comment analyzes the effects of imposing Rule 205 upon Canadian securities attorneys and concludes that the benefits of the Rule are outweighed by the costs. Although the Rule is stricter than most Canadian regulations governing securities attorney conduct, it does not effectively minimize transaction costs, and thus transactions under the Rule are not predictable. Since the Rule is unpredictable, this increases the fear of liability among both Canadian securities attorneys and their corporate clients. The resulting fear of liability deters investment in U.S. markets and creates various possible scenarios each of which do very little to protect U.S. investors. It is not the author's contention, however, that the existing Canadian attorney regulations are sufficient, but rather that an altered rule should be imposed upon Canadian corporate attorneys, such that the protections to investors are not outweighed by the costs of imposition.

Part II of this comment will provide an economic framework for analyzing whether institutions effectively minimize transactions costs in an international context. Part III will employ the framework to analyze the transaction costs resulting from the

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appearing foreign attorney exception), available at <http://www.sec.gov/rules.final.33-8185> (last visited Sept. 26, 2004).

15. *Id.*

16. Comment from The Law Society of Upper Canada, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002), available at <http://www.sec.gov/rules/proposed/s74502/vkrishna1.htm> (Dec. 6, 2002).

17. See Atkins, *supra* note 10.

U.S. imposition of Rule 205 upon Canada, and illustrate how Rule 205 is unpredictable. Part IV will explore the various scenarios that can result due to the unpredictability of the Rule and will show how in each of the scenarios U.S. investors receive little protection. Part V will establish a framework that enhances the predictability of the Rule and allocates authority so that both the United States and Canada can maximize their achievements of social policy.

## PART II: UNDERSTANDING TRANSACTION COSTS FROM AN INTERNATIONAL INSTITUTIONAL PERSPECTIVE

### A. *Minimizing Transaction Costs Through Institutions*

In the 1930s, Ronald Coase brought the importance of transaction costs to the forefront of understanding both social and economic processes.<sup>18</sup> Academic research and empirical evidence has confirmed his theorem [hereinafter "the Coase Theorem"]:

Where bargaining is relatively costless, an efficient allocation of the relevant property right (i.e., the one that maximizes the value of production) will be achieved regardless of the initial allocation of that right. But the distribution of this maximized value will differ from one initial allocation to another.<sup>19</sup>

In other words, the Coase Theorem contends that, absent transaction costs, the initial distribution of property rights will not have efficiency ramifications because people will engage in reallocative transactions that yield efficient results.<sup>20</sup> But, as Coase himself stressed, the real world is one of uncertainty and incomplete knowledge, creating transaction costs and it is necessary to gain a better understanding of this world so that policy making can be more efficient.<sup>21</sup> Of particular note in his work is the role of institutions, or combinations of formal and informal rules and sanctions,<sup>22</sup> in reducing transactions costs by making human behavior

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18. SVETOZAR PEJOVICH, *ECONOMIC ANALYSIS OF INSTITUTIONS AND SYSTEMS* 9 (rev. 2d ed. 1998).

19. *Id.* at 12.

20. Joel P. Trachtman, *Reflections on the Nature of the State: Sovereignty, Power and Responsibility*, 20 CAN.-U.S. L.J. 399, 409 (1994).

21. Pejovich, *supra* note 18, at 12.

22. Trachtman, *supra* note 20, at 402 n.9 ("Institutions are the humanly devised constraints that structure political, economic and social interaction.").

predictable.<sup>23</sup> Institutions can accomplish this by being both credible and stable.<sup>24</sup>

For rules to be credible, they must be well defined and strictly and consistently enforced.<sup>25</sup> If rules are loosely enforced, they do not encourage predictable behavior.<sup>26</sup> The result is ultimately higher transaction costs and fewer transactions.<sup>27</sup> For rules to be stable they must not foster renegotiation; in other words, there is an efficient allocation of authority. If potential parties to a transaction are not confident in the stability of their rights under a rule because they are under the impression that the rules may change, they are less likely to transact.<sup>28</sup>

There are two main components to attaining a stable allocation of authority.<sup>29</sup> First, authority should be granted proportionally according to whose constituents are most affected; shared effects indicate a need for shared authority.<sup>30</sup> This encompasses a broad definition of "affected" that includes not only the effects directly related to the rule established, but also externalities.<sup>31</sup> Second, authority should be granted to the government that holds a comparative advantage in regulating the particular subject matter at issue.<sup>32</sup> For instance, a governmental agency with more experience with a certain regulatory problem, or one with a superior regulatory mechanism would ultimately have a comparative advantage.

Additionally, imperfect information and bounded rationality should be taken into account when analyzing the credibility and stability of an institution. For example, the rule maker may not have knowledge of the informal rules and norms that influence the way people interact.<sup>33</sup> Lack of such information reduces the

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23. *Id.* at 405. See also Pejovich, *supra* note 18, at 24.

24. See Pejovich, *supra* note 18, at 24-26. See also Trachtman, *supra* note 20, at 410-12.

25. See Pejovich, *supra* note 18, at 24.

26. *Id.*

27. *Id.*

28. *Id.* at 25 (stating that a study presented convincing evidence that by denying investors' confidence in the stability of private property rights, the New Deal contributed significantly to prolonging the Great Depression).

29. See Trachtman, *supra* note 20, at 410-12.

30. *Id.* at 411.

31. *Id.*

32. *Id.* at 412.

33. See Richard W. Painter, *A New Institutional Economics Perspective on the Limits to U.S. Regulation of Non-U.S. Securities Lawyers* 10 (unpublished manuscript, on file with author) (Presented at Harvard University, Center for European Studies (Mar. 11, 2004) & Wasdea University, Institute for Corporation

rule maker's ability to consistently enforce the rules and yield predictable results. Rule makers also suffer from bounded rationality.<sup>34</sup> This occurs where multiple goals and interests exist and the rule maker inadvertently advances one group's interests over another's.

*B. Allocating Jurisdiction Over International Transactions by Assessing the Effectiveness of Institutions in Minimizing Transaction Costs*

The above discussion focuses on the role of institutions in reducing transaction costs within a particular state, i.e., from a vertical sovereignty perspective. But, what happens when one state exerts horizontal sovereignty and imposes certain rules upon a different state, which has its own set of institutions and rules? It is necessary to determine whether this extraterritorial imposition is efficient in reducing transaction costs. One approach to achieve efficiency is to employ an "effects test," allocating jurisdiction in proportion to effects:

Prescriptive jurisdiction over a transaction should be allocated to the government(s) whose constituents are affected by the transaction, pro rata in proportion to the relative magnitude of such effects, as accurately as is merited given transaction costs in allocation of prescriptive jurisdiction.<sup>35</sup>

This test is a measure to determine *how much* jurisdiction should exist, rather than a strict test that determines whether jurisdiction should exist at all.<sup>36</sup>

To employ this "effects test" it is necessary to determine the effects of an extraterritorial imposition in relation to transaction costs. Furthermore, to maximize the effect of social policy of both states involved in the transactions, it is necessary to determine whether the legislation effectively minimizes transaction costs. As stated previously, transaction costs can be assessed by looking at whether the rule is credible and stable, and also by determining to what extent rule makers suffer from imperfect information and bounded rationality.

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Law & Society, International, Symposium: "The Role of Lawyer in Corporate Behavior: Past & Future" (Mar. 18, 2004)).

34. *Id.*

35. Trachtman, *supra* note 20, at 408.

36. *Id.*



PART III: ASSESSING TRANSACTION COSTS RESULTING FROM  
THE UNITED STATES IMPOSITION OF RULE 205 UPON  
CANADIAN ATTORNEYS

If the application of a state's rule is unpredictable, then fears of the unknown discourage people from transacting under the rule. This concept is elucidated from the perspective of a Canadian securities lawyer practicing in Alberta:

Lawyers practicing in the area of securities laws want certainty. They want to know and need to know whether they have a duty to prospective investors and the public in general. They need to know whether they must conduct an independent due diligence of all facts relating to their clients' affairs before they take on an engagement no matter how restricted. They need to know whether they must ensure whether every document and every process fully complies with securities laws. *They need to know the time and cost required to effect an engagement and the inherent risk of being sued . . .*<sup>37</sup>

The foregoing will employ the framework of the "effects test" established in the previous section to illustrate how Rule 205 is far from predictable, and thus does not reduce transaction costs because it is neither credible nor stable.

A. *Credibility*

If a state's rules are not properly defined and are not enforced strictly and consistently, they lack credibility.<sup>38</sup> Rule 205 is not credible because, as explained below, it contains ambiguous exceptions and standards. With these ambiguities, it is unlikely that the SEC will enforce the Rule consistently. As a result, both domestic and foreign attorneys, especially foreign attorneys, will fear liability no matter what their actions. Such fear increases costs to corporations and deters transactions.

For the purposes of the application of the Rule to foreign and Canadian lawyers, the most notable lack of clarity is found in the definition of "non-appearing foreign attorney."<sup>39</sup> This important definition provides a safe-harbor to foreign and Canadian lawyers from the requirement to comply with the Rule.

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37. Comment from Gregory J. Leia, to Jonathan Katz, Secretary, United States Securities and Exchange Commission (Dec. 29, 2002), at <http://www.sec.gov/rules/proposed/s74502/gjleia1.htm> (last visited Oct. 5, 2004) (emphasis added).

38. See Pejovich, *supra* note 18, at 24.

39. 17 C.F.R. § 205.2(j) (2002).

In order for a Canadian attorney to qualify as a non-appearing foreign attorney, he or she must meet three criteria. First, the attorney must be admitted to practice law in a jurisdiction outside the United States.<sup>40</sup> Second, the attorney cannot hold him or herself out as practicing, or giving legal advice regarding U.S. federal or state securities or other laws.<sup>41</sup> The third criterion is bifurcated. The first prong of the third criterion is met when an attorney appears and practices before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside of the United States.<sup>42</sup> Alternatively, the second prong is met when the attorney appears and practices before the Commission in consultation with an attorney licensed to practice in the United States.<sup>43</sup>

The first criterion for the non-appearing foreign attorney safe-harbor is very straightforward, but the clarity ends there. Regarding the second criterion, Canadian attorneys will have difficulty determining whether they are "holding themselves out" as practicing or advising in U.S. legal matters. This phrase can be a derivation of the "shingle theory" that is well established in U.S. securities law relating to underwriters, brokers, and dealers. The concept, however, while recognizable in the United States, may not be familiar to Canadian attorneys, and the Rule provides no guidance to foreign issuers regarding this. Furthermore, the third criterion leaves much to be questioned. First, Canadian attorneys are given no compass to determine what is "incidental" U.S. securities legal advice.<sup>44</sup> Moreover, the SEC does not clarify to what extent a U.S. attorney needs to collaborate with a Canadian attorney in order to be exempt from this Rule.

Not only are there ambiguities in the non-appearing foreign attorney safe-harbor, but they also exist in another important exemption opportunity for Canadian lawyers. Under the sanctions and discipline section, the Rule states that attorneys practicing outside of the United States do not have to comply with the Rule if compliance is prohibited by applicable foreign law.<sup>45</sup> In the

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40. *Id.* at § 205.2(j)(1).

41. *Id.* at § 205.2(j)(2).

42. *Id.* at § 205.2(j)(3)(i).

43. *Id.* at § 205.2(j)(3)(ii).

44. Garfield Emerson, Q.C., *Canadian Lawyers: Responding to the SEC's Standards of Professional Conduct and Becoming a "Non-Appearing Foreign Attorney,"* in SECURITIES AND MERGERS & ACQUISITIONS BULLETIN, March 2003, at 4, available at [http://www.fasken.com/WEB/fmdwebsite.nsf/AllDoc/02191420C7B897AC85256CEE00551222/\\$File/SECMA\\_MAR03.PDF](http://www.fasken.com/WEB/fmdwebsite.nsf/AllDoc/02191420C7B897AC85256CEE00551222/$File/SECMA_MAR03.PDF) (last visited Oct. 26, 2004).

45. 17 C.F.R. § 205.6(d) (2002).

context of Canada, it is unclear whether the codes of professional conduct established by the law societies of the Canadian provinces and territories would be considered "applicable foreign law" under this exemption. The relevant conflicts between the Canadian Law Societies' codes of professional conduct and Rule 205 will be discussed *infra*. If an "applicable law" conflicts only with certain portions of the Rule, it is also unclear whether the foreign attorney will be exempt from the entire Rule or just the portion that conflicts.

If a Canadian attorney does somehow establish that he or she is not exempt from Rule 205 amidst the ambiguous safe harbors, he or she will still have difficulty knowing at what point it is necessary to start reporting "up the ladder" within a company. The Rule provides that "up-the-ladder" reporting duties are triggered when there is credible evidence of a material violation by the issuer (or any officer, director, employee, or agent of the issuer) of applicable U.S. federal or state securities law, or material breach of fiduciary duty, or a similar violation of law.<sup>46</sup> The standard is whether a prudent and competent attorney is reasonably likely to become aware of the material violation.<sup>47</sup>

As succinctly stated by a securities lawyer practicing in Ontario:

Determining whether or not a state of fact is, for a "prudent and competent attorney" "reasonably likely" to be a "material violation" under United States federal or state law or a material breach of fiduciary duty . . . arising under state law is not an area in respect of which Canadian lawyers may be considered to have the requisite professional expertise.<sup>48</sup>

In other words, Canadian attorneys may not be in a position to make the appropriate professional judgment in order to comply with the Rule.<sup>49</sup> It is also relevant to note that Canadian attorneys that represent issuers in U.S. markets will be discouraged from researching U.S. securities law so that they may possess the necessary professional judgment to advise their clients adequately; conducting such research would preclude them from qualifying as a non-appearing foreign attorney.<sup>50</sup> Additionally, the

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46. *Id.* at § 205.3(b).

47. *Id.* at § 205.2(e).

48. Emerson, *supra* note 44, at 5.

49. *Id.*

50. Canadian attorneys will be considered to be advising on U.S. law if they conduct research for foreign issuers regarding what would be a material violation of

inability of a Canadian lawyer to make a professional judgment about whether it is reasonably likely that credible evidence of a material violation exists is unlikely to be a defense to a violation of the Rule.<sup>51</sup> This depends on how the SEC applies the standard of a “prudent and competent attorney;” but even so, the likely failure of foreign attorneys to achieve this standard, increases the risk of liability under the Rule. Additionally, Rule 205 also fails to provide all attorneys with guidance as to what constitutes an “appropriate” corporate response after the attorney initially reports “up the ladder” to the CEO or the CLO of the corporation.<sup>52</sup>

In sum, the ambiguous “non-appearing foreign attorney” safe-harbor, the conflict of law preemption exception, triggering standard, and the nature of the “appropriate” corporate response all contribute to the lack of credibility and hence the unpredictability of Rule 205. As discussed *infra*, that the SEC is given much discretion in the enforcement of the Rule also detracts from the credibility of the Rule.<sup>53</sup>

### B. Stability

Svetozar Pejovich, an Economics Professor at Texas A&M University, compares the consequences of unstable institutions with a football game.<sup>54</sup> He states that frequent changes in the rules of the game would raise the costs of the game downstream, noting, “Football fans would not be able to enjoy the game, players would not know how to prepare for it, and football clubs would seek coaches who are better at getting rules changed than at coaching the players.”<sup>55</sup> Similarly, if Rule 205 is unstable, investors in public corporations will not be able to benefit from becoming better acquainted with the Rule and identifying the best

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the U.S. securities laws and then advise their clients based on the research. See 17 C.F.R. §§ 205.2(iv)(a)(iii)-(iv) (2002). If they provide advice regarding U.S. law, they are considered to be appearing and practicing before the Commission and would be subject to the Rule. See 17 C.F.R. § 205.2(j)(2) (2002).

51. *Id.*

52. 17 C.F.R. § 205.3(b)(3) (2003). See also Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1114 (2003) (“Will some level of corporate response short of accepting the attorney’s recommendations ever be sufficient? In cases involving the exercise of political judgment or in which reasonable minds can disagree, what sort of corporate decision-making record is sufficient to demonstrate that the attorney’s information has been delivered, considered and rationally rejected?”).

53. See *infra* Part III.C.

54. See Pejovich, *supra* note 18, at 26.

55. *Id.*

investment opportunities. Securities lawyers will not know how to prepare to be effective gatekeepers or for potential liabilities. Moreover, foreign issuers in U.S. exchanges will seek out corporate attorneys and firms who are better at encouraging a change in the rules than at actually preventing corporate fraud.

The following discussion will illustrate how Rule 205 is not completely stable. A rule is unstable and likely to change where it fails to accord an appropriate amount of authority to a government whose constituents are affected by the circumstance in question, and where it allocates authority to a government other than the government that holds a "comparative advantage" in regulating the subject matter.<sup>56</sup> It is debatable whether Canada's or the United States' constituents are most affected by the Rule and whether Canada or the United States has a comparative advantage in the regulation of securities attorneys. Since neither the United States nor Canada can be said to be effected the most by the Rule or to possess a distinct comparative advantage in regulating attorneys, it would be inefficient for the United States to monopolize attorney regulation in Canada. Similarly, it would be inefficient for the United States to refrain from regulating altogether.

### 1. Affected Constituents

It can be argued that Rule 205 affects very few Canadians both because of the Rules' safe-harbors for attorneys and the current trends in Canada, including the growth of trans-border law firms and the private placement of Canadian subsidiaries of U.S. companies. Because of the "non-appearing foreign attorney" safe-harbor, Rule 205 primarily applies only to Canadian and non-U.S. lawyers who advise on compliance with U.S. law without assistance from U.S. co-counsel.<sup>57</sup> Moreover, there has been a consoli-

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56. See Trachtman, *supra* note 20, at 410-412.

57. See Painter, *supra* note 33, at 1. There are exceptions to Rule 205 that are strictly for foreign attorneys and exceptions that are for all attorneys. For foreign and Canadian attorneys, there is the non-appearing foreign attorney exception, and the conflicts of law preemption exception. See *infra* Part III.A. Additionally, any attorney would not be considered to be appearing and practicing before the Commission and hence exempt from the rule, if he or she is appearing and practicing other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship. See 17 C.F.R. §§ 205.2(a)(2)(i), 205.3(1) (2003). Also, any attorney that (1) is retained or directed by the issuers' CLO or Qualified Legal Compliance Committee [hereinafter "QLCC"] to investigate evidence of a material violation; or (2) is retained or directed by the issuers' CLO or QLCC to assert a colorable defense on behalf of the issuer - or the issuer's officer, director, employee or

dation and internationalization of large Canadian law firms where many Canadian law firms have integrated or established alliances with U.S. law firms, making it easier for Canadian issuers to obtain assistance from U.S. co-counsel and be exempt from Rule 205.<sup>58</sup> Additionally, the fact that most Canadian subsidiaries, which represent a major share of the Canadian financial market, have been privatized indicates a reduction of Canadian issuers in U.S. public markets and hence the number of Canadians affected by the Rule.<sup>59</sup>

It can be argued that this minimal affect upon Canadians is overshadowed by the Rule's affect upon Americans. The Rule is meant to protect U.S. investors and restore investor confidence in U.S. markets, both of which are necessary for the United States to compete effectively in the context of international exchanges.<sup>60</sup> Aside from maintaining a competitive advantage among new high disclosure exchanges, it can also be argued that the United States especially needs to impose stricter professional regulations upon Canadian attorneys to protect U.S. investors. This is because the market for legal services in Canada is highly competitive, giving lawyers incentives not to report the misconduct of management.<sup>61</sup>

Alternatively, it can be argued that the effect of the Rule upon Canadians is greater than the effect of the Rule upon Americans. First, although the Rule does provide safe-harbors for Canadian attorneys, it remains to be seen how they will be enforced, espe-

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agent – in any investigation or judicial or administrative proceeding relating to evidence of a material violation, is not subject to the rule. See 17 C.F.R. §§ 205.3(b)(6)(i)(A-B), 205.3(b)(6)(ii), 205.3(b)(7)(i-iii) (2003).

58. See E-mail from Harry W. Arthurs, Professor of Law at Osgoode Hall Law School at York University, to Lauren Harper (April 13, 2004, 4:14 EST) [hereinafter Arthurs e-mail] (on file with author); Harry W. Arthurs, *The State We're in: Legal Education in Canada's New Political Economy*, 20 WINDSOR Y.B. OF ACCESS TO JUST. 35, 45-48 (2001) [hereinafter *The State We're in*]; Harry W. Arthurs, *Lawyer in Canada in the 21st Century*, 15 WINDSOR Y.B. ACCESS TO JUST. 202, 211, 216 (1996).

59. See Arthurs e-mail, *supra* note 58.

60. Since the 1990s, cross-listing by foreign issuers into U.S. exchanges has accelerated because of the "bonding" opportunity it provides: by voluntarily subjecting themselves to the higher disclosure standards and greater threat of enforcement of the U.S., foreign issuers achieve a higher market valuation. See generally John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (2002). Other countries, however, have created some competition by creating "high disclosure" exchanges. *Id.* Hence, it is important for the United States to ensure its bonding opportunities after the corporate scandals of Enron and those that followed, through more stringent rules to maintain its competitive advantage. *Id.*

61. See *infra* Part III.C.

cially considering the many ambiguities in the safe harbors<sup>62</sup> and the likelihood of inconsistent enforcement of the Rule.<sup>63</sup> The SEC's discretion in enforcement may result in many more Canadian attorneys being subject to the Rule.<sup>64</sup> Second, due to the less ambiguous "non-appearing foreign attorney" safe-harbor regarding the retaining of U.S. counsel, Canadian corporations may incur the extra costs of hiring U.S. counsel in addition to their Canadian counsel.<sup>65</sup>

Third, the Rule also conflicts with Canadian laws, which may result in Canadian attorneys being subject to liability or disciplinary action in Canada if they comply with the Rule. The most notable conflict would be between Rule 205's proposed "noisy withdrawal" and Canadian law societies' codes of professional conduct regarding confidentiality. As aforementioned, the "noisy withdrawal" requires disclosure of a client's illegal conduct when substantial financial harm is likely to result from an issuer's violation. Contrarily, the confidentiality provisions of the Canadian law societies prohibit disclosure of a client's illegal conduct if the only harm that will result is financial, however serious it may be.<sup>66</sup>

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62. *See supra* Part III.A.

63. *See infra* Part III.C.

64. *Id.*

65. This deduction is based on the notion that as parties to a transaction become better acquainted with the rules they learn how to adjust to the system and exploit the most beneficial opportunities. The most beneficial opportunity under Rule 205 for foreign attorneys would be to gain exemption from the most predictable safe harbor – obtaining assistance from U.S. counsel. *See* Pejovich, *supra* note 18, at 25.

66. Out of 13 Canadian provinces and territories, 5 use the Canadian Bar Association ("CBA") Code and the others use variations; however, in all of the codes a lawyer may disclose illegal conduct by a client only where there is an imminent risk to an identifiable person or group of persons of death or serious bodily or psychological harm and then only if the lawyer first obtains a court order permitting such disclosure. *See* CODE OF PROF'L CONDUCT, Chapter IV (Ottawa: The Can. Bar Ass'n 1988), available at <http://cba.org/CBA/activities/code/> [hereinafter "the CBA Code"] (last visited Oct. 26, 2004). *See also, e.g.*, CODE OF PROF'L CONDUCT R. 2.03 (The Law Soc'y of Upper Can. 1987) (amended 2004), available at [http://www.lsuc.on.ca/services/RulesProfCondpage\\_en.jsp](http://www.lsuc.on.ca/services/RulesProfCondpage_en.jsp) (last visited Oct. 26, 2004); CODE OF PROF'L CONDUCT R. 7.8 (The Law Soc'y of Alta. 2001) (amended 2004), available at <http://www.lawsocietyalberta.com/files/code.pdf> (last visited Oct. 26, 2004); CODE OF PROF'L CONDUCT R. 4.11 (The Law Soc'y of Sask. 1991), available at <http://www.lawsociety.sk.ca/code.htm> (last visited Oct. 26, 2004). *See also* Interview by Doug Harris, Capital Market Institute (CMI) Director, with Philip Anisman, author of the *Policy Comment*, available at [www.utcmi.ca](http://www.utcmi.ca) (last visited Oct. 26, 2004).

The "noisy withdrawal" provision, if adopted by the SEC, requires a lawyer to withdraw from a representation, inform the SEC that the withdrawal was based on "professional considerations" and promptly disaffirm to the SEC any opinion, document or representation in a document in the preparation of which the lawyer assisted that he reasonably believes "is or may be materially false or misleading."

Conflicts also exist between Canadian legal principles and Rule 205 regarding security commissions' authority to regulate the legal profession. Various cases in the provinces of Alberta and Ontario stand for the proposition that the provincial securities commissions do not have the inherent jurisdiction to issue a code of conduct for lawyers and cannot issue remedial sanctions against lawyers.<sup>67</sup> These conflict arguments are, however, dependent upon whether the SEC will deem Canadian provincial securities commission laws and law societies' rules of professional conduct, to be "applicable foreign law" under the Rule's conflicts of law preemption provision.<sup>68</sup> If these laws are considered "applicable foreign law," then they will preempt Rule 205 and reduce the effect of the rule upon Canadian attorneys.

Fourth, the *mandatory* "up the ladder" reporting imposes a more stringent standard upon most Canadian provinces' and territories' codes of professional conduct. Only the Law Society of Upper Canada, which regulates the attorneys of Ontario, requires lawyers to report any evidence of corporate wrongdoing up the corporate ladder.<sup>69</sup> Fifth, a Canadian lawyer who violates any provision of the Rule is subject to the disciplinary authority of the SEC, regardless of whether the lawyer may also be subject to sanctions

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Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. § 205.3(d)(i)(A-C) (2003)) (setting forth the proposed steps of the "noisy withdrawal"). The SEC's new alternative proposal, however, commonly referred to as the "silent withdrawal," would not conflict with Canadian professional rules because it permits, but not does not require, a lawyer to notify the SEC. It would only require the attorney to report to the CEO and would then obligate the issuer to publicly disclose to the SEC a withdrawal and the circumstances relating to it. A lawyer would be obligated to take the steps outlined in either of these withdrawal requirements (if either one is adopted) when he or she has reported up-the-ladder to the highest authority within the company, and does not receive an appropriate response and reasonably believes that a material violation is ongoing or is likely to result in substantial harm to the financial interest or property of the issuer or investors.

67. See *Henderson v. Alta. Secs. Comm'n*, [2002] A.B.C.A. 264; *Ainsley Fin. Corp. v. Ont. Secs. Comm'n*, [1994] 121 D.L.R. (4th) 79. For a discussion of these cases see Comment from Gregory J. Leisa, Barrister and Solicitor, to Jonathan Katz, Secretary, U.S. Securities and Exchange Commission, at <http://www.sec.gov/rules/proposed/s74502/gjleia1.htm>. See also Philip Anisman, *Regulation of Lawyers by Securities Commissions: Sarbanes-Oxley in Canada* (2003) (unpublished policy paper for the University of Toronto Capital Markets Institute), available at <http://www.sec.gov/rules/proposed/s74502/panisman1.htm> (last visited Oct. 26, 2004) (stating that the Ontario Securities Commission lacks the authority to prohibit a lawyer from appearing before it in any capacity).

68. 17 C.F.R. § 205.6(d) (2002). See also *supra* Part III.A.

69. See RULES OF PROF'L CONDUCT R. 2.02 (The Law Soc'y of Upper Can. 1987) (amended 2004). The other provinces will only permit such reporting, but may not say so expressly in the rules.



for the same conduct in a jurisdiction where the lawyer is admitted to practice.<sup>70</sup> In short, Canadian lawyers may be subject to liability in both jurisdictions.

Finally, in response to continuing pressures from regulatory groups, such as the Ontario Securities Commission and the SEC, the Law Society of Upper Canada has recently harmonized its professional codes of conduct with the mandatory "up the ladder" reporting of Rule 205.<sup>71</sup> Gavin McKenzie, a member of the working group that drew up the new rules, stated: "What we have done is changed it from guidance in the commentary [which accompanies and explains the regulations] to being mandatory. As a result, Ontario now has the highest standards of corporate governance for lawyers in all of Canada."<sup>72</sup> The new rules, however, do not change the confidentiality standard of the Law Society of Upper Canada.<sup>73</sup>

This is evidence that despite the conflict in the "up the ladder" reporting, at least one Canadian province was willing to incur the extra costs of harmonizing its rules, at least partially, to facilitate transactions with the United States. As of yet, no other Canadian province or territory has adopted similar rules.<sup>74</sup> If other provinces harmonize their laws,<sup>75</sup> then Canadians could be negatively

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70. See Emerson, *supra* note 44.

71. See Terrence Belford, *New Rules Spur Legal Whistle Blowers: But Lawyers are Divided on The Effects of Laws Forcing Them to Report*, THE GLOBE AND MAIL (Mar. 22, 2004), available at <http://theglobeandmail.com> (last visited (Oct. 26, 2004)).

72. See Terrence Belford, *New Whistle Blower Rule Approved*, THE GLOBE AND MAIL (Mar. 29, 2004), available at <http://theglobeandmail.com> (last visited Oct. 26, 2004). See also RULES OF PROF'L CONDUCT R. 2.02 (The Law Soc'y of Upper Can. 1987) (amended 2004).

73. According to the Professional Regulation Committee of the Law Society of Upper Canada that drafted the new "up the ladder" rules: "[T]he confidentiality standard is central to the integrity of the "up-the-ladder" reporting regime. If the openness and candour of the lawyer and client relationship is compromised, the lawyer is much less likely to become aware of improper conduct and to be in a position to counsel the client against it or take appropriate steps to address it." See The Law Society of Upper Canada Report to Convocation by the Professional Regulation Committee 13 (Mar. 25, 2004), available at [http://www.lsuc.on.ca/news/pdf/convmar04\\_prc\\_report.pdf](http://www.lsuc.on.ca/news/pdf/convmar04_prc_report.pdf) (last visited Oct. 26, 2004).

74. The executive director of the Federation of Law Societies of Canada in Montreal is not aware of any other jurisdiction in Canada that is taking similar actions to the Law Society of Upper Canada in harmonizing its rules with Rule 205. See Belford, *supra* note 72.

75. Even though Canadian law societies have no present intentions to harmonize their laws with that of Rule 205, it is probable that they will eventually. Canada is very much export dependent with the United States being its dominant trading partner. See Harry W. Arthurs, *Globalization of the Mind: Canadian Elites and the Restructuring of Legal Fields* 12 CAN. J. L. SOC'Y. 219, 223-24 (1997) [hereinafter

impacted. Since the harmonized laws reflect the interests of the principle players of the global economy, in this case the United States, they often ignore the interests of Canadian local communities, consumers, businesses, and workers.<sup>76</sup> Harmonizing can also contravene Canadian national law or policy.<sup>77</sup>

In conclusion, it can be deduced that if Rule 205's conflict of law preemption applies to the Codes of Professional Conduct of the Canadian law societies or if the other law societies of Canada will harmonize their laws with that of Rule 205, then less Canadian constituents would be directly affected by the Rule. This notion is bolstered by the many exceptions the Rule provides for foreign attorneys. In this case, the effects of the Rule upon Canadians are minimal. Moreover, these effects are outweighed by the effects of the Rule upon the United States, a country that needs to protect its investors from Canadian corporate misconduct and maintain its competitive position among international high-disclosure foreign exchanges. However, an argument could be made that harmonization could negatively impact Canadians.

Alternatively, if Rule 205's conflict of law preemption does not apply to the Canadian law societies' codes of professional conduct and there is no harmonization, then it can be deduced that many more Canadian constituents would be affected. This view is bolstered by the ambiguous exceptions for foreign attorneys, which, depending on the SEC's interpretation and enforcement of the

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*Globalization of the Mind*]. Canada usually aligns its laws with the U.S. so it is easier to do business. See *The State We're In*, *supra* note 58, at 40-41. This is exemplified by Canada's harmonization with other Sarbanes-Oxley provisions regarding corporate governance. See PriceWaterhouseCoopers, *Companies Energized by Need to Change Practices*, available at <http://www.pwc.com/extweb/manissue.nsf/docid/FEFB0CCF4F1960F085256E8C0068AAFD> (last visited Oct. 26, 2004). For a summary of the new investor protection rules see Canadian Securities Administrators News Release, *New Rules Promote Investor Confidence, Change Issuers' Disclosure and Governance Practices* (Mar. 29, 2004), available at [http://www.csa-acvm.ca/html\\_CSA/news/04\\_05\\_new\\_disclosure.htm](http://www.csa-acvm.ca/html_CSA/news/04_05_new_disclosure.htm) (last visited Oct. 26, 2004). For a discussion regarding the debates Canadian security commissions' encounter when deciding whether to harmonize see David Brown, Chair of the Ontario Securities Commission, *Address to the Investment Funds Institute of Canada* (Sept. 19, 2002) ("If we are going to attract Canadian and international investors, they need to have confidence in the safety of our markets. If we are going to attract issuers, we need a regulatory system that is not too burdensome or costly; we need a system that allows our markets to be competitive."), available at [http://www.osc.gov.on.ca/About/Speeches/sp\\_20020919\\_ific-annual-conf.jsp](http://www.osc.gov.on.ca/About/Speeches/sp_20020919_ific-annual-conf.jsp) (last visited Oct. 26, 2004).

76. See *The State We're In*, *supra* note 58, at 40-42.

77. *Id.* (stating that Canada is willing to acquiesce to forces of global legal order by harmonizing and actively enforcing the harmonized laws, despite the fact that the global regime may contravene or undermine Canadian national law or policy).

exceptions, may increase the number of attorneys covered by the Rule. The effects upon Canadians in this situation may very well outweigh the affects upon Americans.

It is clear that both Canadians and Americans are affected by the Rule, but there are still many unknowns. However, there will be more certainty regarding the Rule's true direct effects when it is clear which Canadian attorneys are subject to the Rule. Such a determination can only be made after the SEC clarifies its ambiguous exceptions for foreign attorneys through enforcement proceedings.

## 2. Comparative Advantage

If a state is more experienced or is more successful in regulating a certain area, then it has a comparative advantage in regulation. Furthermore, if a country with such a comparative advantage creates and imposes certain laws upon another country that relate to its comparative advantage, then it is less likely that the rules will be unstable and susceptible to change. The comparative advantages of U.S. law versus the comparative advantages of Canadian law in regulating securities lawyers will be explored in this discussion.

It can be argued that both the United States and Canada have different comparative advantages in regulating securities lawyers. The United States can be said to have the comparative advantage because both its laws and social, cultural, and ideological norms regarding lawyer regulation have been emulated by Canada.<sup>78</sup> One such explanation is that Canadian influences of legal and professional culture tend to give way before the forces of political economy.<sup>79</sup> This explanation, however, does not necessarily indicate that U.S. regulation is superior. That there is a dearth of literature, discourse, and education regarding legal ethics in Canada, when compared to the United States, may indicate that the United States is better equipped to regulate in this area.<sup>80</sup>

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78. See *Globalization of the Mind*, *supra* note 75, at 222.

79. Canada is unusually export-dependent. The United States is its largest market. Therefore, Canada's prosperity largely depends upon its capacity to stimulate American investment in Canada and demand for Canadian goods and services in the United States. *Id.* at 223-24; Arthurs e-mail, *supra* note 58.

80. See generally Adam M. Dodek, *Canadian Legal Ethics: A Subject in Search of Scholarship*, 50 U. TORONTO L. J. 115 (2000). See also Alice Woolley, *Integrity in Zealousness: Comparing the Standard Conceptions of the Canadian and American Lawyer*, 9 CAN. J. L. AND JURIS. 61 (1996) ("In contrast with . . . American proliferation of critical perspectives of legal ethics, little Canadian scholarship on the subject of lawyers' ethics exists.").

The argument for the United States' comparative advantage is furthered by empirical evidence suggesting that very few Ontario lawyers rely on the professional codes for the purposes of resolving ethical issues, and that the ethical deliberations of those who do rely on the codes are inhibited.<sup>81</sup> In addition to the questionable effectiveness of the Canadian law societies' codes of professional conduct in maintaining standards of conduct for Canadian attorneys, it is also questionable whether the Canadian law societies, at least in Saskatchewan, can be effective in enforcing attorney misconduct that also qualifies as criminal conduct.<sup>82</sup>

On the other hand, it is important to note that it is the United States and not Canada that has experienced the corporate scandals epitomized by Enron, where lawyers remained silent in the face of blatant misconduct by corporate officers.<sup>83</sup> U.S. legal ethics scholars, such as Deborah Rhode, claim that the self-regulation of the legal profession through the state bars is to blame: "The problem is not that bar policies are self-serving . . . [r]ather the difficulty is one of tunnel vision, compounded by inadequate accountability."<sup>84</sup> Through its authority under Rule 102(e), how-

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81. See generally Margaret Ann Wilkinson, Christa Walker & Peter Mercer, *Do Codes of Ethics Actually Shape Legal Practice?*, 45 MCGILL L. J. 645 (2000) (discussing the results of a research initiative undertaken by legal scholars at the University of Western Ontario, that examines the effectiveness of codes of ethics in maintaining standards of behaviors within the legal profession in Ontario).

82. See Graeme G. Mitchell, *Disciplining Lawyers for Serious Professional Misconduct—Is it Possible after Stromberg v. Law Society (Saskatchewan)?*, 36 ADMIN. L.R. (2d) 213, 214 (1996) (contending that *Stromberg* precludes the law society's discipline committee from assessing professional misconduct which also qualifies as criminal conduct, until the criminal justice system has run its course). But see Caroline Murdoch & Joan Brockman, *Who's On First? Disciplinary Proceedings by Self-Regulating Professions and Other Agencies for "Criminal" Behaviour*, 64 SASK. L. REV. 29, 39-40 (2001) (stating that Graeme G. Mitchell "has taken *Stromberg* to its widest possible interpretation").

83. However, it has been suggested that Canada is equally as vulnerable to Enron-like securities scandals. For example, Canadian boards of directors are "vulnerable to the incentives for shirking and self-dealing" that were characteristic of Enron's board of directors and that played a critical role in the company's failure. See Sarra, *supra* note 1, at 718.

84. DEBORAH L. RHODE, IN THE INTERESTS OF JUSTICE: REFORMING THE LEGAL PROFESSION 143-45 (2000). In all Canadian provinces and territories the bar is self-governing as well, but unlike the United States bar it is under a statutory mandate. See Federation of Law Societies of Canada, *The Practice of Law in Canada*, at <http://www.flsc.ca/lawsocieties/lawsocieties.asp>. The Canadian Bar conducts its own discipline procedures, including disbarment, subject to a limited right of appeal to the courts for legal error, which differs somewhat from province to province. *Id.* The provincial law societies can and do enact and enforce disciplinary codes. *Id.* The fact that Canadian lawyers also enjoy such self-regulation may give rise to the same problems that Rhode expressed. However, the author found no evidence supporting

ever, the SEC has done little to correct the deficiencies of the state bars and the inconsistent enforcement that is characteristic of the SEC's regulation of securities attorneys.<sup>85</sup> This may not change with its newfound power and discretion under Rule 205. Additionally, the SEC, like the U.S. state bar associations, is self-regulated and is plagued by "tunnel vision," or bounded rationality.<sup>86</sup>

In addition to the above United States regulatory deficiencies, the Canadian comparative advantage can be evidenced by the emphasis on integrity within the Canadian codes of professional conduct.<sup>87</sup> Alice Woolley states that the commitment to personal integrity is a unique tradition of Canadian lawyer ethics and is something that American lawyer ethics lack.<sup>88</sup> Woolley also contends that unlike the American Bar Association's Model Rules, the exhortatory tone of the Canadian Bar Association's Code looks beyond the principle of partisanship and encourages Canadian lawyers to act in the interest of the community or of people other than the client.<sup>89</sup> Such contentions, however, do nothing to show the relationship between the superior quality of the rules, and the rules in practice. Hence, these rules do not prove the effectiveness of Canadian regulation of attorneys.

In conclusion, the United States and Canada have different comparative advantages in the regulation of securities lawyers. Despite the fact that there is a dearth of literature on legal ethics in Canada, there is evidence that U.S. regulation of securities lawyers is less effective than that of their Canadian counterparts. But, just because Enron-like corruption has not yet surfaced in Canada, there is no indication that it does not exist. Thus, it is not necessarily an indication that Canadian regulation is any more effective.

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this contention in her research. *But see infra* Part III.C (discussing bounded rationality).

85. *See infra* Part III.C.

86. *See infra* Part III.C.

87. *See* Woolley, *supra* note 80, at 73-77. The CBA Code states that the principle of integrity "underlies the entire code" of professional responsibility. *Id.* at 73. Integrity is defined in the CBA Code as "soundness of moral principles . . . especially in relation to truth and fair dealing, uprightness, honesty, sincerity." *Id.*

88. The contentions that the ABA Model Rules do not adhere to principles of integrity or do not extend past the pure partisanship model of lawyer representation, can be rebutted. Woolley even states "the underlying principle of integrity may be less strong than [she has] suggested." *Id.* However, such a discussion is beyond the scope of this comment.

89. *Id.*

### C. Other Predictability Problems

Lack of credibility and stability of rules are exacerbated by other problems that contribute to a rule's unpredictability.<sup>90</sup> Richard Painter claims that there are three such problems that have particular significance for the regulation of securities lawyers and are thus relevant to Rule 205.<sup>91</sup>

First, rule makers have imperfect information, particularly when they deal with complex subjects such as lawyer-client informational asymmetries, agency problems, and psychological forces that affect how securities lawyers do their jobs. For example, the SEC does not know, or at least does not effectively evaluate in its rule-making and may not effectively evaluate in enforcement, how the market for legal services affects the relationship between corporations and their lawyers.<sup>92</sup> Therefore, it is probable that the United States does not know how equivalent market forces operate in Canada.<sup>93</sup> Additionally, the SEC fails to understand the

90. See Painter, *supra* note 33, at 10; Pejovich, *supra* note 18, at 15.

91. See Painter, *supra* note 33, at 11-12.

92. The literature regarding organizational behavior and its connection to corporate lawyering is underutilized, especially in the areas of disclosure and corporate compliance. See Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629 (1997). It has been opined that Rule 205 will be unlikely to result in better information flows within the corporate hierarchies because it fails to take into account the inherent incentive for lawyers, to overlook management wrongdoing. See Stephen M. Bainbridge and Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley §307*, 2004 MICH. ST. L. REV. 299, 306-10. This "inherent incentive" for managerial bias is due to the nature of the market for corporate legal services in the United States. *Id.* See also, Fisch & Rosen, *supra* note 52, at 1114. Although the corporate entity may be the lawyer's ultimate client, corporate managers hire lawyers and hence lawyers must please corporate management. This is compounded because of the importance of retaining and attracting clients to a lawyer's career, specifically, the interrelationship between the partnership track at law firms and the ability of attorneys to bring and keep business to the firm. *Id.* This is especially true given the fact that most large corporations utilize the services of several outside law firms, and that management, not the board of directors, allocates such service. *Id.* Furthermore, the market for legal services leads lawyers to adopt the behavioral biases of their managerial clients and limits the lawyer's ability to interpret management behavior as wrongful. *Id.* See also Langevoort, *supra* note 93, at 636-646.

93. The aforementioned problems, inhibiting the ability for U.S. lawyers to be effective gatekeepers through Rule 205, are also present in Canada. First, the structure of Canadian corporations is similar to that of U.S. corporations. See Sarra, *supra* note 1, at 727 (stating that the corporate regime of Canada mirrors much of the U.S. paradigm which includes having auditors and similar professionals as gatekeepers or protectors of the disclosure process). Additionally, there are certain trends that are "Americanizing" the legal profession in Canada, namely more aggressive competitive practices. See *Globalization of the Mind*, *supra* note 75, at

Canadian distinction between the barrister and the solicitor and how such a dichotomy affects rule making and enforcement of the professional rules in Canada.<sup>94</sup>

Painter's second problem that contributes to unpredictability is that optimal rules can change, and it may be necessary for securities laws to adapt quickly to new information to be efficient in the global economy. This is evidenced in the dramatic shift in U.S. policies after the scandals of Enron and its successors. Throughout the 1980s, the hybrid ideology of globalization and neo-liberalism dominated United States governance and transformed the political economy and legal systems of many countries.<sup>95</sup> Commonly referred to as the "Washington Consensus," neo-liberalism globalization is predicated on the principle that capital, expertise, and information must be allowed to flow across national borders, free from state regulation.<sup>96</sup> Under this theory, state activism is regarded as a dangerous force causing adverse reactions from the market, disinvestments, devaluation of the currency, and the introduction of distortion into public policy.<sup>97</sup> After the avalanche of corporate scandals, however, commencing with the collapse of Enron in 2002, it was evident that the neo-liberal globalization ideology had to be modified; the world lost confidence in the integrity of the securities markets that fuel American capitalism.<sup>98</sup>

Before Enron, the United States remained competitive in international exchanges because it maintained a low-disclosure exchange characterized by minimal governmental regulation of foreign issuers. Currently, however, the United States maintains

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237. However, the problems associated with the market for legal services in the United States may be exacerbated in Canada. Canadian corporate and securities attorneys are facing more competition than their American counterparts in the market for legal services. See Arthurs e-mail, *supra* note 58. This is because of what Harry Arthurs calls the "hollowing out of corporate Canada": most Canadian subsidiaries of U.S. corporations and firms (which represent a major share of Canada's financial markets) have either been taken private and many large Canadian corporations have been bought out by U.S. and other foreign interests. *Id.* See also Arthurs, *Lawyering in Canada in the 21st Century*, *supra* note 57, at 226-233. Less Canadian corporations translates into less jobs for Canadian corporate lawyers, which gives Canadian corporate lawyers even greater incentives to appease management in order to secure their employment.

94. See Harris, *supra* note 66.

95. See *The State We're In*, *supra* note 58, at 36.

96. *Id.* at 36-37.

97. *Id.*

98. See Sarra, *supra* note 1, at 716; Atkins, *supra* note 10, available at <http://www.sec.gov/news/speech/spch020503psa.htm>.

its competitive advantage by creating a high-disclosure exchange through governmental regulation such as the Sarbanes-Oxley Act. The pendulum may swing yet again and Rule 205, even if it were the optimal rule, would not be most favorable in such circumstances.

Third, Painter suggests that certain interest groups may exert excessive influence upon the SEC in their regulation of securities lawyers, making it even less likely that existing rules are optimal rules.<sup>99</sup> The SEC's interest group influences are evidenced by the long-standing tension between the members of the U.S. bar and the SEC regarding the scope of the SEC's authority to regulate lawyers, and the SEC's vacillation in the standards used to regulate the profession.<sup>100</sup> Prior to Section 307 of Sarbanes-Oxley and Rule 205, the SEC's authority to commence disciplinary proceedings against those practicing before the Commission was vested in Rule 102(e).<sup>101</sup> Under Rule 102(e) the SEC:

[M]ay censure a person or deny, temporarily or permanently, the privilege of appearing and practicing before it in any way to any person who is found by the [SEC] . . . to be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or to have willfully violated, or willfully aided and abetted the violation of any provision of the [securities laws].<sup>102</sup>

*In re Carter & Johnson* [hereinafter *Carter/Johnson*],<sup>103</sup> a notable Rule 102(e) proceeding in 1981, addressed the application of the "unethical or improper professional conduct" provision to attorneys. The SEC reversed an administrative judge's finding that two securities lawyers had engaged in unethical and improper professional conduct because the SEC had never before defined such a standard.<sup>104</sup> But, the SEC clarified that its interpretation of "unethical and improper professional conduct" in *Carter/Johnson* was, in effect, notice as to how Rule 102(e) would be applied prospectively:

When a lawyer with significant responsibilities in the effec-

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99. See Painter, *supra* note 33, at 11-12.

100. See Dennis J. Block & Jonathan M. Hoff, *SEC Adopts Professional Conduct Standards for Attorneys*, 229 NEW YORK LAW JOURNAL, April 24, 2003; Theodore Sonde & F. Ryan Keith, "Up the Ladder" and Over: *Regulating Securities Lawyers-Past, Present & Future*, 60 WASH. & LEE L. REV. 331 (2003).

101. *Id.*

102. 17 C.F.R. § 201.102(e) (2002).

103. *In re Carter & Johnson*, 47 S.E.C. 471 (1981).

104. *Id.* at 511-12.



tuation 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.<sup>105</sup>

The SEC elaborated that "prompt steps" can include "where appropriate, notification to the board of directors of a corporate client."<sup>106</sup>

The SEC subsequently sought comments on a proposed rule that would formalize the Carter/Johnson opinion, to which the American Bar Association submitted a lengthy comment vociferously criticizing the SEC's position.<sup>107</sup> As a result, not only did the SEC never finalize the rule, but in 1982, Edward Greene, the then-General Counsel, also retreated from the Carter/Johnson standard. Greene announced his intent to "generally limit" SEC proceedings against attorneys "to those instances that pose the most direct threat of harm."<sup>108</sup> Greene made it SEC policy not to initiate 102(e) proceedings against attorneys for improper professional conduct unless a court determined the attorney violated the federal securities laws.<sup>109</sup> Otherwise, the SEC should apply existing state law standards for administrative proceedings based upon alleged violations of ethical or professional standards.<sup>110</sup>

Since Carter/Johnson in 1981, there have been few cases brought against lawyers under Rule 102(e).<sup>111</sup> Rule 205 in 2003, however, is a return to the standards established for attorney conduct in Carter/Johnson. According to Senator John Edwards, the sponsor of Section 307, the Section "basically instructs the SEC to start doing what they were doing 20 years ago, to start enforcing this up-the-ladder principle."<sup>112</sup> There is no guarantee, however, that the SEC will enforce Rule 205 more consistently or strictly than it has in the past.

Painter's three additional problems illustrating other factors

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105. *Id.* at 511.

106. *Id.* at 509-11.

107. See American Bar Association, Minutes of the Meeting of the Board of Governor's 9-10 (Nov. 20-21, 1981).

108. *Id.*

109. Caroline M. Gentile & Jill E. Fisch, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L. J. 517, 525-26 (2003).

110. Block & Hoff, *supra* note 101, at n.7.

111. *Id.* at n.8.

112. *Id.* at n.9.

that detract from Rule 205's predictability are compounded by the fact that the SEC is given complete discretion in enforcement of the Rule. Although Sarbanes-Oxley makes no distinctions between United States and foreign issuers,<sup>113</sup> the Act does provide the SEC with the discretion to determine where and how to apply the Act's provisions to foreign companies and, through Section 307 and Rule 205, their attorneys as well.<sup>114</sup> SEC Commissioner, Paul Atkins, stated in a 2003 speech: "[A]s we move forward to implement Sarbanes-Oxley, we have tried and we will continue to try to balance our responsibility to comply with the Act's mandate with the need to make reasonable accommodations to our non-U.S. issuers."<sup>115</sup>

In sum, the discretion granted to the SEC under the Act, combined with problems of incomplete information, the necessity for institutions to change in order to be optimal, and interest group political influences will result in inconsistent enforcement and detract from the predictability of Rule 205.

#### PART IV: UNPREDICTABILITY OF RULE 205 LEADS TO SCARCE INVESTOR PROTECTION

As discussed above, Rule 205 suffers from lack of stability and credibility, and the possibility of bounded rationality and incomplete knowledge. These problems make it difficult for U.S. securities lawyers and even more difficult for Canadian securities lawyers, to predict how the Rule will be enforced. The unpredictable nature of the Rule raises the fear of liability to abnormal levels. The following hypothesizes four scenarios that may result from the exacerbated sense of liability that the Rule yields and illustrates how investors receive little protection under each scenario.

The first scenario may be that Canadian attorneys do not transact at all, i.e., they do not represent Canadian companies who issue in the U.S. securities markets. In this situation, U.S. attorneys would most likely take on the job because they are better positioned to represent clients with disclosures made to U.S. investors. Canadian managers and directors, however, may be less inclined to divulge information that may reveal corporate misconduct to a U.S. attorney who has little knowledge of Canadian

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113. See Atkins, *supra* note 9.

114. *Id.*

115. *Id.*

customs and laws and who does not have a long-term relationship with the Canadian companies. This inhibition of the flow of information does not allow the U.S. attorney to be an effective gatekeeper or protector to investors.

A situation where Canadian lawyers are the only counsel to Canadian companies who issue in U.S. markets also poses problems. Corporate managers and directors may fear that with such an increased sense of liability, Canadian lawyers may over-report. In turn, like with U.S. counsel, they will not divulge important corporate confidences that would allow the lawyer to prevent or mitigate harm to investors.

It is also possible that Canadian issuers in U.S. markets will be represented by both Canadian and U.S. counsel. This possibility of dual representation is due to the fairly clear-safe harbor for Canadian attorneys representing companies issuing in U.S. markets,<sup>116</sup> so long as they are assisted by U.S. counsel. Although the U.S. lawyer may be sanctioned under the Rule, this safe-harbor allows for misconduct on the part of foreign attorneys working with the U.S. lawyers. Furthermore, considering the above two scenarios, it can be deduced that investors will still be denied adequate protection under the Rule even if Canadian and U.S. lawyers work in tandem given the ineffective communication between corporate managers and directors and their counsel.

Alternatively, it is possible that Canadian issuers in U.S. markets will seek assistance from "legal experts" who organize in consulting firms, do not "hold themselves out" to be attorneys, and hence are not liable under the Rule. In this scenario, there is no protection to investors under Rule 205.<sup>117</sup>

Although the above scenarios are speculative to a certain degree, they show that the benefits to investors are minimal and do not outweigh the costs of imposing the Rule as it stands.

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116. See *supra* Part III.A.

117. See Comment from Robert Eli Rosen, University of Miami Law Professor, to Jonathan Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 17, 2002) (stating that Rule 205 will increase the demand for non-practicing securities law consultants), available at <http://sec.gov/rules/proposed/s74502/rerosen1.htm> (last visited Oct. 26, 2004). Multidisciplinary partnerships such as the Big Four accounting firms that offer legal consulting services may be another way for Canadian companies to avoid attorney liability under the Rule. But see Geanne Rosenberg, *Big Four Auditors' Legal Services Hit By Sarbanes-Oxley*, NEW YORK LAW JOURNAL (Jan. 5, 2004), available at <http://www.nylawyer.com/news/04/01/010504b.html> (last visited Oct. 26, 2004) (stating that there are new laws that strengthen auditor independence and that three out of the four Big accounting firms have already discontinued their legal services departments).

## PART V: CREATING AN OPTIMAL ALLOCATION OF AUTHORITY

Parts III and IV discussed the transaction costs of Rule 205, the increased fear of liability that the transaction costs created, and the negative effects of the increased fear upon investor protection. This section establishes a framework to create an altered Rule 205 that reduces transaction costs and better protects investors by allocating jurisdiction horizontally across state lines and vertically within state lines.

According to Painter and his New Institutional Economic analysis, jurisdictional competition is preferable to extraterritorial imposition of legislation such as Rule 205.<sup>118</sup> He claims that, if countries experiment with different rules for securities lawyers and observe different outcomes, then each jurisdiction can change its rules after observing the results of the experimentation. Ultimately, Painter contends that such competition will lead to better rules.<sup>119</sup>

While Painter's argument has merit due to unpredictable transaction costs, a completely unmitigated competition model is not ideal in maximizing social preferences. First, competition occurs vertically within states and sub-national units.<sup>120</sup> Second, different groups within states have different preferences.<sup>121</sup> Third, the best states recognize that they cannot provide the most efficient structures without transferring sovereignty to sub-national units.<sup>122</sup> Hence, selective cooperation among states is necessary to provide the most efficient regulation.<sup>123</sup>

In light of the foregoing, this comment proposes a framework whereby there is a combination of selective cooperation and jurisdictional competition. First, similar to the effects test mentioned earlier,<sup>124</sup> the regulation of securities lawyers should be allocated proportionally to states, and specific sub-units within states, in which a greater number of constituents are affected and there is a comparative advantage in rule making. This would better ensure the stability of the law and foster predictability. In Rule 205, for

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118. See Painter, *supra* note 33, at 2.

119. *Id.*

120. See Trachtman, *supra* note 20, at 414-15.

121. *Id.*

122. *Id.*

123. *Id.*

124. "Prescriptive jurisdiction over a transaction should be allocated to the government(s) whose constituents are affected by the transaction, pro rata in proportion to the relative magnitude of such effects, as accurately as is merited given transaction costs in allocation of prescriptive jurisdiction." *Id.* at 408.

instance, minimum standards can be imposed by the United States upon other countries, such as Canada, with regards to "up the ladder" reporting. Most countries' laws do not conflict with this, and no confidentiality principles are breached. Rule 205's "up the ladder" reporting provisions still should be revised to clarify exceptions and ambiguities in the jurisdiction, and to ensure credibility in the triggering standard.

However, it is also important to recognize that imperfect information, bounded rationality, and interest group political influences cannot be avoided. Therefore, it is impossible to eliminate unpredictability merely by ensuring credibility and accuracy. There are certain aspects of securities lawyer regulation where jurisdictional competition is necessary for optimal rule making because optimal solutions are uncertain and are likely to differ across international boundaries.<sup>125</sup> For instance, the United States should not impose a noisy withdrawal because it unduly burdens Canada and other foreign countries. These countries encounter conflicts of informal and formal institutional problems some of which cannot be predicted by the United States. Such regulation should be left to the law societies of Canada or to whatever mechanism a country uses to regulate lawyers.<sup>126</sup>

Experimentation with different rules will lead to better solutions in some situations, but it is important to recognize the effects of transaction costs. To the extent that rules can minimize transaction costs by making them credible and stable, such measures should be taken and authority should be allocated accordingly.

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125. See Painter, *supra* note 33, at 2.

126. Philip Anisman states that security commissions in Canada should only control the integrity of their processes and should not legislate beyond this. See Anisman, *supra* note 67.