

MEDIA BACKRGOUNDER

Capital Markets Institute *Policy Comment* recommends permitting securities lawyers to disclose serious fraudulent conduct by clients

Regulation of Lawyers by Securities Commissions: Sarbanes-Oxley in Canada was written by Philip Anisman based on a presentation that Dr. Anisman made at a roundtable held by the Capital Markets Institute at the University of Toronto in January 2003. The roundtable was an invitation-only event featuring a highly informed and informative debate among senior representatives of capital markets stakeholders, including policymakers and regulators, securities lawyers and litigators, institutional investors, issuers, intermediaries and academics.

About the Author

Philip Anisman is one of Canada's leading securities lawyers and commentators. Prior to entering law practice, he was a professor of law at Osgoode Hall Law School and the Director of the Corporate Research Branch in the Department of Consumer and Corporate Affairs (Canada). He is the author of *Takeover Bid Legislation in Canada: A Comparative Analysis* (1974), *A Catalogue of Discretionary Powers in the Revised Statutes of Canada 1970* (1975), *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives* (Australian National Companies and Securities Commission, 1986), *Insider Trading in Canada: Recommendations and Guidance on Boardroom Practice* (Institute of Corporate Directors in Canada, 1988) and the principal author of *Proposals for a Securities Market Law for Canada* (1979). He has written extensively on the jurisdiction and accountability of securities commissions and on corporate governance. In his "Dissenting Statement" in the *Final Report of the TSE Committee on Corporate Disclosure* (1997), he suggested that lawyers be held responsible for knowing or reckless participation in disclosure violations by their clients.

About the Policy Comment

The *Sarbanes-Oxley Act of 2002* ("Sarbanes-Oxley") required the Securities and Exchange Commission ("SEC") to adopt rules specifying minimum standards of professional conduct for lawyers appearing and practising before it in representing issuers, including a rule requiring "up the ladder" reporting of material violations of securities laws, breaches of fiduciary duties and similar violations. The SEC proposed rules that would have required lawyers to report evidence of a material violation by the issuer or any of its officers, directors or employees "up the ladder" to the issuer's senior officers and, if necessary, to its board of directors. In addition, if a lawyer did not receive an appropriate response, the lawyer would have been obligated to withdraw from representing the issuer, to notify the SEC that the withdrawal was based on "professional considerations" and to disaffirm any opinion or document filed with or submitted to the SEC or any statement in such a document that "is or may be" materially false or misleading (called "noisy withdrawal" in the SEC's releases).

The proposed rules received vigorous support and opposition from academic and practising lawyers, respectively, in the United States. In addition, the Chair of the Ontario Securities Commission ("OSC") wrote the Law Society of Upper Canada ("LSUC") and invited it to address the issues raised by Sarbanes-Oxley for the accountability of lawyers.

On January 23, 2003 the SEC announced the adoption of rules that withdraw, at least temporarily, from the most contentious elements of the proposed rule. The final rule requires “up the ladder” reporting by lawyers representing issuers and permits, but does not require, such lawyers to withdraw from their representation if they do not receive an appropriate response and to disclose confidential information related to the representation to the SEC. The SEC extended the comment period on its “noisy withdrawal” requirement for a further sixty days and requested comments on possible alternatives to it.

Sarbanes-Oxley and the rules proposed under it have raised issues that must be and are being considered in Canada. The Policy Comment addresses the merits of these issues and the appropriate Canadian authority to resolve them. In particular, the Policy Comment focuses on lawyers’ obligations and whether their conduct in the course of practising law on behalf of issuers and others subject to securities laws should be regulated by securities commissions or left to law society Rules of Professional Conduct and disciplinary proceedings. The analysis and recommendations contained in the Policy Comment are intended to assist in the current consideration of these issues by the LSUC and the OSC in Ontario and by law societies and securities commissions elsewhere in Canada.

Lawyers’ Current Responsibilities

The Policy Comment states that the following principles currently apply to lawyers representing issuers and others before securities commissions:

“Up the Ladder” Reporting and Withdrawal

- A lawyer cannot assist a client in pursuing illegal or dishonest activities and if a corporate client is engaged in such activities, must report them to the highest authority within the corporation, if necessary to do so in order to have them properly addressed. This includes going “up the ladder” over the head of an instructing officer to more senior officers and to the corporation’s board of directors.
- If a matter so reported is not adequately addressed within the corporation, the lawyer must withdraw from representation of the client and must also withdraw opinions and other representations previously made on the client’s behalf, if not doing so would have the effect of assisting the corporation in the pursuit of an illegal or dishonest objective.

Lawyers’ Honesty and Disclosure Obligations

- A lawyer cannot mislead a securities commission or allow a client to do so, but the lawyer’s disclosure obligations to a securities commission differ depending on whether he is acting in an advisory or adversarial capacity.
- A lawyer representing a corporation in connection with an application to or filing with a securities commission must ensure that all relevant information is disclosed to the commission. If a client refuses to make full disclosure, or to correct an error previously made, the lawyer must withdraw his services and, possibly,

representations previously made by the lawyer to the commission.

- A lawyer who is acting as an advocate, representing a client in a proceeding before a commission or on an investigation of the client by staff of a commission, also cannot mislead the commission, but has no obligation to disclose information or to insist that his client do so, other than as required by law.

Whistle Blowing

- Under current rules, a lawyer may not disclose a client's illegal conduct if the only harm that will result is financial, however serious it may be.

Recommendations

The Policy Comment makes the following recommendations relating to lawyers' responsibilities and their regulation:

Whistle Blowing

- Consideration should be given to extending the current rule to permit, but not require, a lawyer to disclose illegal conduct by a client where the lawyer is representing the client in an advisory capacity, as a solicitor, but only where the lawyer knows or has sufficient information to believe with substantial certainty that the corporate client or its officers are engaging in a serious, ongoing fraudulent scheme that is intended to mislead investors and that is related to the lawyer's retainer so that continuing to provide services would have the effect of furthering the scheme, and where such disclosure is necessary to prevent a substantial risk of serious financial harm to an identifiable person or class of persons.
- In these circumstances, a lawyer acting in an adversarial capacity, as a barrister, should not be entitled to do more than withdraw from representation where continuing to act would constitute assistance to the client in dishonest or dishonourable conduct.

Regulation of Lawyers by Securities Commissions

- Securities commissions should not attempt to discipline lawyers under their "public interest" jurisdiction for conduct relating only to a lawyer's professional activities as an adviser. Securities acts should be amended, if thought necessary, to authorize commissions to initiate proceedings to prohibit a lawyer from acting in an advisory capacity on matters that come before a securities commission on the basis of knowing or reckless conduct, or at least conduct exhibiting a high degree of negligence, in his representation of corporate or other clients. The purpose of such proceedings should be limited to determining whether a lawyer is entitled to represent issuers and other market participants on applications and filings with the commission.
- Securities commissions should not have similar authority to preclude lawyers from acting as barristers on hearings or investigations before them. Discipline of lawyers

for excessive or untoward conduct in the course of a hearing or other adversarial representation should remain the responsibility of law societies.

- Rules concerning “up the ladder” reporting and withdrawal from representation should also be left to law societies, rather than securities commissions. A lawyer’s responsibility to clients, the courts and the public are best determined by law societies, as the principles on which they are based cannot be limited to securities laws and representation of corporate issuers. Lawyers’ responsibilities are best addressed by law societies acting cooperatively with securities commissions, as is now occurring in Ontario.

Regulation of Issuers

- Securities commissions may address issues relating to “up the ladder” reporting by requiring public issuers of securities to adopt policies and internal processes that facilitate such reporting by all corporate officers and employees, including in-house lawyers. They may also require issuers whose external lawyer has withdrawn to inform subsequent lawyers retained to deal with the same matters of the withdrawal and the reasons for it. And they may require issuers to disclose a withdrawal publicly, if the withdrawal is itself a material fact as defined under securities legislation.

About the Capital Markets Institute

The CMI is a joint initiative of the Faculty of Law and the Rotman School of Management at the University of Toronto. The CMI undertakes and sponsors policy research focused on the objective of developing a comprehensive capital markets strategy for Canada. The CMI leads the effort in determining how capital markets mechanisms and institutions should be designed in order to create a superior environment for investors and issuers in a small, open market like Canada.

CMI research seeks to develop a clear understanding of the challenges facing the Canadian capital markets, and the institutional tools that Canada must develop in order to turn those challenges into opportunities to be a leader among the world’s small, open capital markets. The analysis also identifies those areas in which Canada lags behind other markets, large and small, and must raise its performance to be able to compete effectively.

A previous Policy Comment by Professor Chris Nicholls, the Purdy Crawford Chair in Business Law at Dalhousie University Law School, addressed corporate governance issues associated with the Canadian response to Sarbanes-Oxley. Professor Nicholls’ Policy Comment is available at the CMI website at www.utcmi.ca. The final Policy Comment will be released later in March 2003 and will address auditor independence.