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Research Study

The Effectiveness of Corporate Gatekeeper Liability in Canada

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May 19, 2006

Commissioned by the Task Force to Modernize Securities Legislation in Canada

Strengthening Credibility and Integrity

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1. **Executive Summary**

This paper analyzes the effectiveness of the corporate gatekeeper liability regime in Canada. In particular, seven gatekeepers are considered, namely:

i. Auditors;
ii. Credit Rating Agencies;
iii. Financial Analysts;
iv. Lawyers;
v. Directors;
vi. Retail Investment Advisors; and
vii. Underwriters.

The objective of this research is to provide recommendations for modernizing securities legislation and improving the competitiveness of Canadian capital markets. The goals of this research in contributing to this overall objective are two-fold. First, given that a series of significant reforms with respect to the legal treatment of corporate gatekeepers have taken place over the last five years, this research serves as a taking stock exercise of the current gatekeeper liability regime in Canada. Second, given the options for dealing with corporate gatekeepers presented in other jurisdictions, most notably the U.S. and the U.K., and Canada's willingness to reassess its own choices, a number of recommendations and issues for further exploration are put forward.

This paper is the second of two papers prepared by the author on the subject of corporate gatekeeper liability. Both papers focus on corporate gatekeepers of public companies. The first paper, "A Survey of Corporate Gatekeeper Liability in Canada," presented a detailed examination of Canadian gatekeeper liability for 11 corporate gatekeepers. The current paper focuses on 7 of these 11 corporate gatekeepers. In consultation with the Task Force, it was agreed that these 7 gatekeepers - most often singled out in the literature - would be reviewed in greater detail in this paper. While it is not necessary to reference the first paper in reading the second paper, it may be helpful for the reader who would like a detailed analysis of the current Canadian position or is interested in exploring the liability that other corporate gatekeepers are subject to in Canada.

Under the current Canadian regime, corporate gatekeepers are open to civil liability, but in practice, investors' ability to impose civil liability on corporate gatekeepers is quite limited. Both substantive and procedural obstacles limit common law civil liability. The application of the business judgment rule and a range of statutory defences, in addition to procedural obstacles, limit statutory (corporate and securities) civil liability, including the new secondary market civil liability regime found in Ontario's securities legislation. The rules of professional conduct provided by gatekeepers' Self-Regulatory Organizations (SROs) or industry bodies either do not provide for or are unlikely to result in liability to third parties. Taken together, the Canadian approach to civil liability for corporate gatekeepers is consistent with the U.S. and U.K. models, to the extent that it has been informed by concerns relating to the promotion of investor confidence in the fairness of the market. The harm perpetrated against individual investors has been seen as a matter of secondary importance.

With respect to administrative liability for Canadian corporate gatekeepers, the provincial securities commissions have a broad ability to impose sanctions on corporate gatekeepers. In addition, SROs and industry bodies have emerged as a significant source of "law" in this context, with detailed codes of conduct, specific to the gatekeepers they regulate, that give rise to administrative sanctions that can have far-reaching consequences for gatekeepers, such as the inability to continue in their profession. The development of these self-regulatory patterns has allowed for a system of divergent liability rules to operate within Canada. That is, rather than a centralized scheme for gatekeeper liability with a uniform degree of oversight by a "meta-regulator," which comes closer to the U.S. and U.K. models, a decentralized system of varying levels of self-regulation exists. In this model, the boundaries between law and professional practice are somewhat blurred and subsystems of liability that apply to various gatekeepers differ both from gatekeeper to gatekeeper and also geographically. Overall, this polycentric legal environment for gatekeeper liability appears to be developing in a manner that provides gatekeepers with guidance and incentives to perform their gatekeeping function and at the same time facilitates the competitiveness of Canadian capital markets. While the possibility for liability exists in this context, SROs, industry bodies, securities commissions, and courts have taken into account the nature of each gatekeeper's function, associated tensions and conflicts in imposing liability. Only in exceptional instances has gatekeeper liability been imposed. In the discussion that follows, areas where reforms to existing regulation may enhance these developments is discussed with respect to the particular gatekeepers under consideration. The conclusion raises a concern with market participants' and the public understandings of the current liability framework, and makes a suggestion for improving access to this information.

While the gatekeeper liability literature does not generally focus on criminal liability, it is important to highlight that in Canada there have been two recent attempts to expand criminal liability, for both gatekeepers as individuals and as organizations. Bill C-13 increased the penalties for market-related offences, created a list of aggravating factors that would impose stiffer penalties, and also created a whistle-blowing provision with criminal sanctions for employers. Bill C-45 has expanded corporate criminal liability to include a wide range of "organizations" and broadened the circumstances when such liability would attach. It does appear, however, that mere failure to withhold support, without other aggravating circumstances, will not result in criminal liability, even in its expanded form for corporate gatekeepers. The possibility for quasi-criminal gatekeeper liability provided by corporate and securities legislation is similarly limited by the due diligence defences available under this legislation.

What follows is a summary of the recommendations that are made in this paper. The recommendations are based on a detailed review of the Canadian position, a review of the academic literature, and a review of current reforms and proposals in the U.S. and the U.K.. An exhaustive review of the U.S. and U.K. regimes for gatekeeper liability was outside of the scope of this paper. While it is clear from the literature that gatekeeper liability plays a significant role in determining the effectiveness of the role of corporate gatekeepers, which in turn impacts market confidence and competitiveness, no consensus exists on how best to achieve this. Accordingly, the approach that is taken in this paper is that only where a strong case is made in the literature and the comparative analysis, is a recommendation for amending securities legislation, broadly defined to include rules put forward by industry bodies and SROs, put forward. In addition to the recommendations put forward, a key contribution that this paper makes is the detailed synthesis of a large amount of academic literature and technical regulation from quite different underlying legal systems. Accordingly, even if the recommendations put forward ultimately are not supported, the foundation is in place to develop and debate alternate recommendations.

2. Summary of Recommendations

Recommendation #1: Consideration should be given to conferring on the CPAB the status of an SRO that is subject to oversight by each of the provincial securities regulators.

Recommendation #2: To address concerns with increasing liability for auditors and a corresponding increase in the cost to issuers for auditing, consideration should be given to the U.K. proposal for "liability limitation agreements" with auditors.

Recommendation #3: CRAs' activities should fall under the jurisdiction of the provincial securities commissions and CRAs should be required to register with the provincial securities commissions.

Recommendation #4: The disclosure obligations formulated by the IOSCO should be a condition of registration with the provincial securities commissions.

Recommendation #5: Mechanisms should be put into place to improve competition among CRAs.

Recommendation #6: IDA Policy No. 11 ["Research Restrictions and Disclosure Requirements"] should be amended to require: 1) a statement by the analyst that the research truly reflects the analyst's opinion, and 2) a prohibition on an analyst being subject to supervision or control by the investment banking department where applicable.

Recommendation #7: Joint task forces should be struck in each of the provinces with members from the securities commission and the law society to consider the law society's rules of professional conduct that address lawyers' corporate gatekeeping function.

Recommendation #8: The current regime for gatekeeper liability for directors should be reviewed following a period of at least one year of experience with the new Ontario secondary market civil liability regime.

Recommendation #9: Following consultation with industry and non-industry groups, the IDA should develop a policy similar to IDA Policy No. 11 ["Research Restrictions and Disclosure Requirements"] imposing restrictions and disclosure requirements for investment advisors with liability attached.

<u>Recommendation #10:</u> The academic literature and approaches to reform in the U.S. and the U.K. suggest that no reforms to the gatekeeper liability that underwriters are subject to in Canada are warranted at this time.

<u>Recommendation #11:</u> A study that reviews the disclosure that is provided under National Instrument 33-105 and evaluates the impact of the level of independence disclosed on IPO pricing should be undertaken.

3. <u>Introduction</u>

In the 1980s, Reinier Kraakman published two articles that expanded on a concept he referred to as "gatekeeper liability", which he defined as liability imposed on private parties who are able to disrupt misconduct by withholding their support from wrongdoers.[1] This support – which might include a specialized good, service or form of certification that is essential for a wrongdoer to succeed – "is the 'gate' that the gatekeeper keeps."[2] He pointed out that true gatekeeper liability is designed to enlist the support of outside participants in the firm when controlling managers commit offences; the first requisite for gatekeeper liability is an outsider who can influence controlling managers to forgo offences.[3] As outsiders to the firm, these professionals are less likely to risk their reputations over fraudulent or suspicious transactions. Kraakman identified outside directors, accountants, lawyers and underwriters as potential targets for gatekeeper liability strategies: they each have access to information about firm misconduct, they already perform a private monitoring service on behalf of the capital markets, and they face incentives that differ from those of managers (that is, they are likely to have less to gain and more to lose from firm misconduct than inside managers).[4] Like other liability regimes, gatekeeping imposes costs; Kraakman examines whether legal rules can induce gatekeepers to prevent misconduct at an "acceptable price."[5] After outlining possible costs of a gatekeeping model, Kraakman suggests ways to adjust these costs, such as limiting penalties that gatekeepers face for breach of duty or selecting prescribed duties for gatekeepers to undertake.[6] Finally, Kraakman canvasses other enforcement strategies and concludes that gatekeepers' response to misconduct, by withholding support, has significant advantages over other third-party enforcement duties.

For Kraakman, due to defects in the ability of parties to contract or ascertain the reputation of different intermediaries, in certain markets legal duties should be imposed on intermediaries to act as gatekeepers.[7] Stephen Choi, however, argues that Kraakman's argument "…fails to take into account the impact of different screening accuracies in the market, the incentives of intermediaries to invest in accuracy, the ex ante response of producers to the possibility of certification, and potential market defects".[8] Choi argues

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[1] Reinier H. Kraakman, "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy" (1986) 2 J. L. Econ. & Org. 53 at 54 [Kraakman, "Gatekeepers"]. See also Reinier H. Kraakman, "Corporate Liability and the Costs of Legal Controls" (1984) 93 Yale L.J. 857 [Kraakman, "Corporate Liability"].
[2] Kraakman, "Gatekeepers," *ibid.* at 54.
[3] Kraakman, "Corporate Liability," *supra* note 1 at 890.
[4] *Ibid.* at 891.
[5] Kraakman, "Gatekeepers," *supra* note 1 at 75.
[6] *Ibid.* at 79-81.
[7] *Ibid.* at 93-100.
[8] Stephen Choi, "Market Lessons for Gatekeepers" (1998) 92 N.W.U. L. Rev. 916 at 918.

that gatekeeper liability is too "heavy-handed" a response and instead advocates for less intervention through a system of self-tailored liability, a regime where "…lawmakers may allow intermediaries to choose for themselves the specific duties that they will be held accountable…"[9]

More recently, John C. Coffee Jr. has expounded on Kraakman's concept in the aftermath of Enron and other corporate scandals. Coffee has blamed such scandals on the failure of gatekeepers, whom he asserts allowed management to engage in fraud.[10] Coffee has defined gatekeepers as independent professionals who act as reputational intermediaries, providing verification or certification services to investors.[11] Gatekeepers have less incentive to deceive; therefore the market views gatekeepers' assurances as more credible. Their credibility also stems from the fact that gatekeepers pledge their reputational capital.[12] Theoretically, a gatekeeper would not sacrifice the reputational capital, built up over many years of performing services, for a single client or a modest fee. However, there are instances where reliance on gatekeepers may be misplaced, such as where there is a sudden decline in the deterrent threat facing gatekeepers and they are thus more willing to take risks, where greater inducements are offered to gatekeepers to breach their duties, or where certain market scenarios lessen injury to a gatekeeper's reputation.[13] Included amongst Coffee's list of gatekeepers are auditors, credit rating agencies, securities analysts, investment bankers, and securities lawyers.[14] Coffee concludes that the creation of excessive liability might cause the market for gatekeeping services to fail; instead, he advocates a shift towards stricter liability standards with a ceiling on gatekeeper liability adequate to deter misconduct.[15]

Whereas Coffee's proposed system is essentially regulatory, Frank Partnoy advocates a contractual system based on a percentage of the issuer's liability.[16] Under Partnoy's proposed regime, gatekeepers

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[9] *Ibid.* at 951.
[10] John C. Coffee Jr., "Understanding Enron: 'It's about the gatekeepers, stupid" (2002) 57 Bus. Lawyer 1403; John C. Coffee Jr., "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms," Columbia Law School, The Center for Law and Economic Studies, Working Paper No. 237 (September 2003) [Coffee, "Gatekeeper Failure and Reform"]. Coffee attributes the corporate failures of the 1990s to a decline in exposure to gatekeeper liability and the increase of acquiescence in clients' demands.
[11] Coffee, "Gatekeeper Failure and Reform," *ibid.* at 12.
[12] *Ibid.* at 13.
[13] *Ibid.* See the article for more detail with regard to reasons for gatekeeper failure. See also John C. Coffee Jr., "The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting," Columbia Law School, The Center for Law and Economic Studies, Working Paper No. 191 (May 21, 2001), where the author expands on why gatekeepers might be under motivated to protect their reputations [Coffee, "The Acquiescent Gatekeeper"].
[14] Coffee, "Gatekeeper Failure and Reform," *supra* note 10.
[15] *Ibid.* at 67-73.
[16] Frank Partnoy, "Strict Liability for Gatekeepers: A Reply to Professor Coffee," University of San Diego School of Law, Law and Economics Research Paper Series, Paper 5 (2004), online: <https://bepress.com/sandiegolwps/le/art5>.

would be strictly liable for any of the issuer's securities fraud damages pursuant to a settlement or judgment. Although gatekeepers would not have due diligence defences available to them, they could limit their liability by agreeing to and disclosing a percentage limitation on the scope of their liability.[17] Authors such as Larry Ribstein oppose mandatory personal liability for professionals as a relatively ineffective way to encourage professional firms to perform their duties to clients and others.[18] Ribstein argues that this liability is based on "an attenuated notion of responsibility and unrealistic assumptions about firm members' ability to monitor".[19] Furthermore, he suggests, imposing personal liability on professionals may increase agency costs between professionals and their clients; affect professional firm size, structure and scope; and reduce desirable liability of the firm.[20] In relation to auditors, Lawrence Cunningham prescribes a framework that uses financial statement insurance as an alternative to financial statement auditing backed by auditor liability.[21] In his proposed framework, companies could opt for either model, subject to investor approval. Financial statement insurance polices would cover damages arising from audit failure (damages due to financial misstatements that auditors did not discover), replacing auditor and issuer liability.[22]

In the broader context of the regulation of gatekeepers, Richard Painter stresses the balancing act that this type of regulation entails. Gatekeeper regulation, he argues, is pointless if it impairs information flow to gatekeepers: "Any improvement in gatekeeper response to risk that comes from these rules has to be weighed against potential reduction in gatekeeper information and consequent impairment of gatekeeper evaluation of risk."[23] In order to optimize the regulation of gatekeepers, he suggests that experimentation with divergent rules, for example American and European rules for auditor and lawyer intervention, rather than convergence of legal rules, will facilitate the learning process.[24]

As was demonstrated in the first paper, the Canadian model for gatekeeper liability reflects Painter's suggestion for resisting a convergence of legal rules, as there remains a high degree of divergence in the nature of the liability for each corporate gatekeeper. In addition, Choi and others' concerns with an excessively heavy-handed or interventionist liability scheme have been largely limited in the Canadian

[17] Frank Partnoy, "Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime" (2001) 79 Wash. U. L. Quarterly 491.
[18] Larry Ribstein, "Limited Liability of Professional Firms after Enron" (2004) 29 J. Corp. Law 427 at 428.
[19] *Ibid.*
[20] *Ibid.*
[21] Lawrence A. Cunningham, "Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability" (2004) 52 UCLA L. Rev. 413.
[22] *Ibid.* at 415.
[23] Richard W. Painter, "Convergence and Competition in Rules Governing Lawyers and Auditors" (2004) 29 J. Corp. L. 397 at 407.
[24] *Ibid.* at 425.

context. Rather, relying heavily on self-regulation, but resisting the contractual and insurance models proposed by Choi and Cunningham, the Canadian system has attempted to achieve the balance called for by Coffee. Part 4 of this paper considers in greater detail the liability regime as it applies to the specific corporate gatekeepers under consideration. The discussion of each gatekeeper is broken down into the following components:

a. a summary of recent academic writing on gatekeeper liability;
b. a discussion of recent U.S. reforms and academic commentary on the reforms;
c. a discussion of recent U.K. reforms and academic commentary on the reforms; and
d. recommendations on gatekeeper liability with the objective of modernizing securities legislation and improving the competitiveness of Canadian capital markets.

Part 5 of this paper concludes with a brief summary of the findings in this paper and highlights an issue that merits further consideration.

4. Liability of Specific Corporate Gatekeepers

i. Auditors

The general role of an external auditor is to control and deliver a company's financial statements, acting as a gatekeeper to ensure full and accurate disclosure of information.[25] Corporate management has an incentive to prepare financial statements that meet earnings projections set by analysts, and to affirm that management has been performing well.[26] An auditor, on the other hand, theoretically is an arms-length party not subject to management pressures, who has "little to gain (and much to lose) from misrepresenting financial information provided to shareholders."[27]

a) Summary of Literature

Writing prior to the corporate scandals of the 1990s, Victor P. Goldberg argued that holding accountants liable (for negligence) to third parties under tort or securities law did not make sense; accountants would have to act as guarantors against "an elastically defined set of unfortunate events", and the cost of the guaranty would exceed its benefits so that parties would choose to forgo the protection.[28]

The rationale for imposing personal liability on gatekeepers such as auditors is that they have an opportunity to identify misconduct before harm is caused to the marketplace.[29] Stephanie Ben-Ishai and Poonam Puri point out that auditors ensure a greater degree of accountability of management to shareholders by reviewing the financial statements prepared by a company's management. The authors argue that in Canada, the narrowing of auditor liability through legislation and common law has reduced the effectiveness of auditors as gatekeepers.[30] Ben-Ishai and Puri put these arguments forward prior to the subsequent and heightened regulation of the accounting profession in Canada.

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[25] For a more detailed discussion see Lara Khoury, "The Liability of Auditors beyond Their Clients: A Comparative Study" (2001) 46 McGill L.J. 413.
[26] Anita Indira Anand, "Shareholder Isolation and the Regulation of Auditors" (2004) 54 U. Toronto L.J. 1 at 3.
[27] *Ibid.* at 5.
[28] Victor P. Goldberg, "Accountable Accountants: Is Third-Party Liability Necessary?" (1988) 17 J. Legal Stud. 295 at 296-297.
[29] Stephanie Ben-Ishai & Poonam Puri, "Proportionate Liability Under the CBCA in the Context of Recent Corporate Governance Reform: Canadian Auditors in the Wrong Place at the Wrong Time?" (2003) 39 Can. Bus. L. J. 36 at 39.
[30] *Ibid.* at 45.

Ben-Ishai and Puri draw parallels in the Canadian experience from the American context. In a 2001 article, Coffee identified conditions under which the gatekeeper model is likely to be most successful: where the gatekeeper provides a legally mandatory certification whose accuracy the protected class can directly observe; where the gatekeeper is engaged in repeat transactions and whose reputational capital is effectively a pledge to secure its faithful performance; and where the gatekeeper expects nominal fees from any individual client.[31] When these elements are present, Coffee argued, the expected gains of the gatekeeper who acquiesces in fraud or misconduct are outweighed by the expected costs of this behaviour.[32] For auditors, Coffee suggested that the costs of acquiescence had declined while the benefits had increased, pointing to how legislation had diminished auditors' liability; the big accounting firms had increasingly marketed non-auditing services to its clients (and the high fees garnered through these services offset threats of liability); incentives to engage in earnings management had increased; and the governance of the accounting profession lacked meaningful professional discipline.[33] Coffee offered various suggestions, such as reforming the profession's governance structure and refining the definition of auditor independence.[34] Coffee made these recommendations prior to the enactment of *Sarbanes-Oxley Act of 2002* [*Sarbanes-Oxley*] and the subsequent heightened regulation of the accounting profession.[35]

Sarbanes-Oxley has prompted much discussion with regard to the regulation of auditors.[36] While much of the discussion centres on the effectiveness of the new regulatory environment, some have advocated a reconceptualization of corporate accountability. A recent article by Anita Anand, for example, draws attention to the assumption underlying the debate that heightened auditor independence and better financial reporting could have prevented investors' losses.[37] Anand posits that an enhanced role for shareholders in the selection, retention and monitoring of a firm's auditor, can achieve greater auditor

[31] Coffee, "The Acquiescent Gatekeeper" *supra* note 13 at 9.
[32] *Ibid.* at 10.
[33] *Ibid.* at 42-43.
[34] *Ibid.* at 46-57.
[35] The Public Company Accounting Reform and Investor Protection Act [*Sarbanes-Oxley Act*], 18 USC. §§ 1514A(a) (2002). The act is available online at <http://www.sarbanes-oxley.com/section.php?level=1&pub_id=Sarbanes-Oxley>.
[36] See, for example: Erica Beecher-Monas, "Corporate governance in the wake of Enron: an examination of the audit committee solution to corporate fraud" (2003) 55 Admin. L. Rev. 357; David F. Birke, "The Toothless Watchdog: Corporate Fraud and the Independent Audit – How Can the Public's Confidence Be Restored?" (2004) 58 U. Miami L. Rev. 891; Lawrence A. Cunningham, "Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability and Safe Harbours" (2004) 55 Hast. L. J. 1449; Lawrence A. Cunningham, "Choosing Gatekeepers," *supra* note 21; Richard L. Kaplan, "The Mother of All Conflicts: Auditors and Their Clients" (2004) 29 J. Corp. L. 363; Patricia A. McCoy, "Realigning Auditors' Incentives" (2003) 35 Conn. L. Rev. 989; Amy Shapiro, "Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients' Incentives" (2005) 35 Seton Hall L. Rev. 1029; Melvyn I. Weiss & Elizabeth A. Berney. "Restoring Investor Trust in Auditing Standards and Accounting Principles" (2004) 41 Harvard J. on Leg. 29.
[37] Anand *supra* note 26.

independence. For Anand, "greater shareholder voice is not an end in itself but a means to heightened corporate accountability."[38] Anand asserts that shareholders suffer because auditors are not accountable to them – auditors' contractual obligation is to the corporation, yet in theory they report to the shareholders.[39] She questions whether the reforms adopted by *Sarbanes-Oxley* sufficiently address independence, noting that they make existing requirements more onerous rather than recasting the relationship between auditors and shareholders.[40] Anand's recommendations for reform focus on transferring oversight power to shareholders, rather than to the board and its appointed audit committee.

In a recent report prepared for the Fraser Institute, Poonam Puri and Adam C. Pritchard provide an overview of the American and Canadian responses to accounting regulation, noting that both market and legal mechanisms play a role in ensuring auditors perform high quality audits; finding the appropriate balance between the different mechanisms, the authors indicate, is a "delicate task."[41] In their comparison of the U.S.'s Public Company Accounting Oversight Board (PCAOB) and Canada's Canadian Public Accountability Board (CPAB), Puri and Pritchard point out that the Canadian system is largely self-regulatory, while the American system is one of government regulation. In order to enhance the effectiveness and efficiency of the CPAB, they suggest conferring carefully circumscribed statutory authority on the CPAB to enhance its legitimacy and provide the board with powers normally granted to other government regulators. Their recommendations include: creating greater independence for the CPAB by revising its governance structure and heightening independence requirements for its directors; changing the funding structure of the board so it is not funded by accounting firms; enhancing enforcement effectiveness by providing immunity for the board's staff and backing up the imposition of fines by statutory authority; and increasing transparency by increasing public awareness of CPAB's findings.[42]

b) U.S. Reforms

Sarbanes-Oxley imposed extensive federal regulation on the accounting profession.[43] The act created the PCAOB to oversee the audit of public companies.[44] Accounting firms must register with the PCAOB.

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[38] *Ibid.* at 2.
[39] *Ibid.* at 13.
[40] *Ibid.* at 28.
[41] Adam C. Pritchard & Poonam Puri, "The Regulation of Public Auditing in Canada and the U.S.: Self-Regulation or Government Regulation?" Fraser Institute Digital Publication, (February 2006) at 2.
[42] For a summary of the authors' recommendations, see *ibid.* at 4-6.
[43] *Sarbanes-Oxley*, *supra* note 35.
[44] *Ibid.*, § 101.

The PCAOB has broad powers to promulgate rules and standards binding upon auditors, as well as conduct investigations and impose discipline. By shifting control of the accounting profession to a new body, the PCAOB aims to address the problem of accounting irregularities by establishing auditing standards and imposing professional discipline.[45]

In addition to the PCAOB, *Sarbanes-Oxley* implemented various measures to increase auditor effectiveness and accountability. Under Title II of the Act, for example, the U.S. Securities and Exchange Commission (SEC) has adopted final rules that impose new independence requirements for accounting firms that conduct audits of a reporting company's financial statements.[46] The rules include a requirement that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer; they also require disclosures to investors of information related to audit and non-audit services provided by, and fees paid to, the auditor of the issuer's financial statements.[47] On June 26, 2003, the SEC adopted rules prohibiting officers and directors of an issuer, and persons acting under their direction, from taking any action to influence the audit of the issuer's financial statements if that person knew or should have known that such action, if successful, could result in rendering the financial statements materially misleading.[48]

Under *Sarbanes-Oxley*, if a registered accounting firm or associated person refuses to cooperate with investigations, the PCAOB may suspend or revoke the registration of the accounting firm.[49] If the PCAOB finds that a registered public accounting firm or associated person has engaged in any act, or omitted to act, in violation of the Act, the rules of the board, the provisions of the securities laws relating to audit, or professional standards, the PCAOB's disciplinary powers include:

- temporary suspension or permanent revocation of registration;
- temporary suspension or permanent revocation of a person from further association with any registered accounting firm;
- temporary or permanent limitation on the activities, functions or operations of the firm or person;

[45] Coffee, "Gatekeeper Failure and Reform," *supra* note 10 at 50.
[46] Ben-Ishai & Puri, *supra* note 29 at 46. In January 2003, the Commission adopted amendments to strengthen requirements regarding auditor independence and enhance disclosure regarding fees paid to auditors. SEC, "Strengthening the Commission's Requirements Regarding Auditor Independence" (28 January 2003), online: <http://www.sec.gov/rules/final/33-8183.htm>.
[47] *Ibid.*
[48] SEC, "Improper Influence on Conduct of Audits" (26 June 2003), online: <http://www.sec.gov/rules/final/34-47890.htm>.
[49] *Supra* note 35, § 105.

- civil penalties for each violation, not more than $100,000 for a natural person and $2,000,000 for any other person;
- censure;
- required additional professional education or training; or
- any other sanction deemed appropriate by the board.[50]

Since *Sarbanes-Oxley* was enacted, much has been written with regard to the reform of the accounting profession. Some have pointed out that measures introduced by *Sarbanes-Oxley* have left "the two-master problem unresolved": auditors are asked to treat the public as master but continue to be paid by the corporation.[51] Amy Shapiro argues that the U.S.'s securities law structure creates incentives for the auditor to serve the client, while its purpose calls for the auditor to serve the public: "…the law should be reformed so that auditors recognize proper incentives and serve only one master, a master whose own interests are aligned with those of the investing public."[52] Similarly, Patricia McCoy argues that reforms have not addressed the main problem afflicting the industry: accounting firms work for the companies they audit, a relationship that is incongruent with auditor independence.[53] In the author's opinion, the employment tie between auditor and management must be reconsidered. Approaches for reform advocated by McCoy include mandatory rotation of audit firms, a system of statutory auditors (such as those found in Europe and Latin American, where auditors are hired by shareholders, not the board, and auditors form a separate organ within the corporation), or requiring auditors to work for their malpractice insurers, rather than the companies they audit.[54]

Like Shapiro and McCoy, Melvyn Weiss and Elizabeth Berney argue that legislation has failed to effectively address the threat of fraud.[55] The authors put forward several proposals for reform, including expanding the scope of audits, so that looking for fraud is an affirmative audit obligation[56]; enhancing

[50] *Ibid.*, § 105(4).
[51] Shapiro, *supra* note 36.
[52] *Ibid.* at 1031.
[53] McCoy, *supra* note 36 at 990.
[54] *Ibid.* at 1008-1010.
[55] Weiss & Berney, *supra* note 36. The authors assert that *Sarbanes-Oxley* left liability standards intact making it difficult to hold wrongdoers accountable, the PCAOB is self-destructing, the board's sparse inspection schedule of accounting firms is unlikely to uncover fraud, the act's requirement that the lead audit partner be rotated does not go far enough, and the whistle-blowing protections have been watered down: (*ibid.* at 45-46).
[56] Proposed standards include the creation of minimum procedures to detect fraud, such as making inquiries of management. The authors argue that auditors' duties should be expanded to ask probing questions and make inquires beyond the most senior personnel. *Ibid.* at 48.

regulatory oversight by the PCAOB[57]; implementing training for auditors to enhance their ability to detect fraud; increasing auditor independence such as rotating auditing personnel, and prohibiting auditors from advising both a company and its executives on any matter;[58] and improving legal accountability by providing shareholders with the procedural rights limited by the *Private Securities Litigation Reform Act* (which aimed to reduce the number of securities fraud class actions by raising the pleading standards for private securities litigation and strictly limiting discovery pending a motion to dismiss).[59]

c) U.K. Reforms

The U.K. has embarked on recent legislative reform regarding the regulation of auditors through amendments to the *Companies Act,* by way of the *Companies (Audit, Investigations, Communications and Enterprise) Act 2004* (*C(AICE) Act*).[60] Under the framework adopted by the Act, a company auditor must be a member of a recognized supervisory body and hold a recognized supervisory qualification. The U.K.'s five supervisory bodies are responsible for the day-to-day supervision of auditors and audit firms. The legislation places new requirements on the supervisory bodies, "…designed to ensure the independence of the regulation of major public interest audit work."[61]

The Financial Reporting Council (FRC) is the U.K.'s independent regulator for corporate reporting and governance, created in April 2004 under the authority of the *C(AICE) Act*. The functions of the FRC include establishing, monitoring and enforcing accounting and auditing standards; statutory oversight and regulation of auditors; operating an independent investigation and discipline scheme for public interest cases; overseeing the regulatory activities of professional accountancy bodies; and promoting high standards of corporate governance.[62] The FRC's functions are exercised by its operating bodies, which include an Accounting Standards Board, Auditing Practices Board and Accountancy Investigation and Discipline Board.

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[57] The authors suggest, for example, the GAAP and GAAS determinations should be made by the board, not by an organization dominated by the accounting profession and industry. *Ibid.* at 51.
[58] *Ibid.* at 55.
[59] *Ibid*. at 56.
[60] *Companies (Audit, Investigations and Community Enterprise)* Act 2004 (U.K.), 2004, c. 27 [C(AICE) Act 2004].
[61] "Explanatory Notes to Companies (Audit, Investigations And Community Enterprise) Act 2004, online: <http://www.opsi.gov.uk/acts/en2004/2004en27.htm>.
[62] FRC, online: <http://www.frc.org.uk/about/>.

A recent White Paper, released in March 2005, has made recommendations with regard to auditor liability.[63] The U.K. government published the new *Company Law Reform Bill* on November 3, 2005; the bill is expected to come into force in late 2006 or early 2007. The bill permits a company to limit its auditor's liability by entering into a "liability limitation agreement" with the auditor. Any agreement must be approved by a company's shareholders, can only apply to the audit for one year, and can only limit an auditor's liability to an amount that is "fair and reasonable in all the circumstances." In addition, the bill introduces a new offence of knowingly or recklessly providing an auditor's report that includes anything which is materially misleading, false or deceptive.[64]

d) Recommendations

<u>Recommendation #1</u>: Consideration should be given to conferring on the CPAB the status of a SRO that is subject to oversight by each of the provincial securities regulators.

<u>Recommendation #2:</u> To address concerns of increasing liability for auditors and a corresponding increase in the cost to issuers for auditing, consideration should be given to the U.K. proposal for "liability limitation agreements" with auditors.

While it is widely acknowledged that a "two-master" problem presents a challenge for the gatekeeping function preformed by auditors paid by the corporation that they are auditing, there is insufficient evidence to support the need for a complete overhaul of the current Canadian system at this point in time. As is demonstrated in the first paper and also in this paper, much has happened in Canada, the U.S., and the U.K. in the context of oversight of auditors over the last five years. Accordingly, it is justifiable at this point to resist making further changes and to allow the current system to "gel" while continuing to monitor it. In particular, the recent expansion of the number of accountants who may perform public audits should continue to be monitored. The benefits of increased competition amongst accounting firms that do public company audits may be a factor in future regulatory decisions.

At the same time, the development of the CPAB provides an opportunity to improve the current gatekeeper liability regime for auditors. The current model where the CPAB relies on the ethical

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[63] "Company Law Reform," presented to Parliament by the Secretary of State for Trade and Industry (March 2005), online: <http://www.dti.gov.uk/cld/chapter3.pdf at 25>.
[64] "U.K. Government's new Company Law Reform Bill," online: <http://www.mallesons.com/publications/2005/Dec/8221850W.htm>. For text of the bill, see Bill 34, *Company Law Reform Bill*, 2005-06 Sess., 2005, pt. 16, c. 6, "Auditor's Liability," online: <http://www.publications.parliament.uk/pa/ld200506/ldbills/034/06034.241-247.html#R001>.

standards imposed by the industry bodies that have jurisdiction over auditors is consistent with the current Canadian self-regulatory approach. However, the status of the CPAB, as a creature of contract, is distinct from other similar organizations, creating issues with the legitimacy, fairness and effectiveness. Currently, three SROs are recognized by the OSC and most other provincial securities regulators: the Investment Dealers Association of Canada (IDA), the Mutual Fund Dealers Association of Canada (MFDA) and Market Regulation Services Inc. (RS). An SRO is an entity that represents registrants and is organized for the purpose of regulating the operations and the standards of practice and business conduct of its members and their representatives with a view to promoting the protection of investors and the public interest. It is recommended that the CPAB be accorded SRO status. This will improve investor confidence in the CPAB as regulator and auditors as gatekeepers because their chief regulator – the provincial securities commission – will be perceived to be more legitimate and fair. At the same time this change will bring the Canadian position more in line with the U.S. and U.K. positions. In its capacity as a SRO, the CPAB will be in a better position to work with the industry bodies that regulate the accounting profession to ensure that the ideal level and form of gatekeeper liability for auditors is in place.

In order to address concerns from the accounting profession with the possibility of increased liability and the corresponding concerns of issuers with increased costs associated with auditing, further consideration should be given to statutory recognition of contracts limiting auditors' liability and corresponding limits (discussed above) as has been done in the U.K..

ii. Credit Rating Agencies

Credit Rating Agencies (CRAs) provide an evaluation of creditworthiness of issuers; they assess the likelihood that issuers will make timely payments on their debts.[65] Like other gatekeepers, CRAs act as certifying agents by offering their reputation to supplement that of the issuer as a guarantee of quality.[66] As intermediaries, CRAs wield influential power over both issuers and investors,[67] and although they exercise considerable influence, CRAs are not regulated in Canada. On one hand, they influence investors' portfolio decisions while on the other hand, they influence the conditions under which issuers

[65] Stephane Rousseau, "Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach," Capital Markets Institute Policy Series (August 2005), online: <http://www.rotman.utoronto.ca/cmi/papers/CRA_Study_Rousseau.pdf>.
[66] *Ibid.* at 9.
[67] *Ibid.* at 14.

access capital markets and the conditions of their relationships with lenders and their transactions.[68] As such, CRAs play an important role in capital markets as gatekeepers.

Unlike financial analysts, CRAs do not express opinions as to whether the particular debt securities should be bought or sold, but report on the relative safety of the securities. Issuers are charged fees for the rating process.[69] The CRA's analyst gathers information from issuer and non-issuer sources and meetings are conducted. The analyst then submits a report to the rating committee, based upon which a credit rating is then issued. Further, subsequent to the issue, the CRA continues to monitor the issuer and its securities by reviewing corporate filings, monitoring industry trends and maintaining contact with corporate management.

a) Summary of Literature

Although CRAs are subject to general civil liability, Stephane Rousseau posits that a potential accountability gap exists; pointing out that it is difficult to hold CRAs accountable for their actions.[70] After providing an overview of the current international proposals that have been raised to enhance the accountability of CRAs - such as ensuring the independence of CRAs' analysts and employees and increasing their transparency and timeliness of ratings disclosure - Rousseau advocates a tailored approach to regulation that emphasizes disclosure. He suggests that regulation should seek to reinforce the effectiveness of reputation as a constraint on the behaviour of CRAs by imposing the disclosure obligations formulated by the International Organization of Securities Commissions (IOSCO). CRAs would also be required to disclose the mechanisms in place to ensure the enforcement of their codes of conduct.[71] With regard to the question as to who should be in charge of regulating CRAs, Rousseau suggests that their activities should fall under the jurisdiction of securities commissions.[72]

Frank Partnoy refers to CRAs as "the least understood gatekeeper."[73] Partnoy points out that CRAs clearly belong within the broad classification of financial market gatekeepers: they play a verification function in the fixed income markets by providing debt ratings; they pledge reputational capital in the

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[68] *Ibid.* at 7-10.
[69] Christopher C. Nicholls, "Public and Private Uses of Credit Ratings", online: <http://www.rotman.utoronto.ca/cmi/papers/CRA_Study_Nicholls.pdf>.at 11-12.
[70] *Ibid.* at 37.
[71] *Ibid.* at 58.
[72] *Ibid.* at 59-62.
[73] Frank Partnoy, "How and Why Credit-Rating Agencies Are Not Like Other Gatekeepers" (2005) online: <http://www.tcf.or.jp/data/20050928_Frank_Partnoy.pdf>.

event they are found to have performed poorly; and they act as agents, not principals, paid a fraction of the proceeds of the debt issues.[74] Partnoy distinguishes CRAs from other gatekeepers, however, noting that during the past five years their market values have skyrocketed. They continue to face serious conflicts of interest in that they are paid directly by issuers, they give unsolicited ratings that potentially pressure issuers to pay them fees, and they market ancillary consulting services related to ratings.[75] In addition, CRAs have largely escaped civil and criminal liability for malfeasance.[76] Partnoy sees CRAs as possessing little informational value. That is, he argues that while initial credit ratings provide guidance on purchases, he is not convinced that they provide any information beyond that already reflected in the "price talk" before a fixed instrument is issued. As such the best reforms should create incentives for CRAs to generate greater informational value while reducing the impact of ratings on markets.[77] Partnoy argues that CRAs are valuable not because they offer valuable information, but because they grant issuers "regulatory licenses" - that is, a good rating entitles the issuer to certain advantages related to regulation. "Once regulation is passed that incorporates ratings, rating agencies will begin to sell not only information but also the valuable property rights associated with compliance with that regulation."[78] Partnoy's proposals include reducing the benefits associated with regulatory licenses, such as removing the Nationally Recognized Statistical Rating Organization (NRSRO) designation or finding a replacement for NRSROs (see the discussion below),[79] and making CRAs liable for malfeasance.[80]

b) International Reforms

In his paper, Rousseau summarizes the IOSCO Code, published in December 2004.[81] Rather than acting as a code of conduct to which CRAs are expected to adhere, the IOSCO Code contains a set of provisions that the IOSCO expects all CRAs will incorporate and give full effect to in their codes of conduct. The Code contains provisions to ensure the quality of opinions expressed by CRAs, provisions to enforce the integrity of the ratings process, and provisions to avoid conflicts of interest and maintain independence.[82] The Code for example, advocates a whistle-blowing duty on employees to report unethical or illegal

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[74] *Ibid.* at 2.
[75] *Ibid.*
[76] *Ibid.* at 3.
[77] *Ibid.* at 4.
[78] *Ibid.* at 28.
[79] *Ibid.* at 37.
[80] *Ibid.* at 45.
[81] IOSCO, "Code of Conduct Fundamentals for Credit Rating Agencies" (December 2004) online: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>.
[82] Rousseau, *supra* note 65 at 43-44.

conduct, and suggests structuring compensation agreements to eliminate conflicts of interest.[83] In Europe, the Committee of European Securities Regulators (CESR) has recently favoured the self-regulation of CRAs based upon the IOSCO Code. Neither the IOSCO Code nor CESR regulations, however, are binding on CRAs, or carry with them sanctions for violations of their provisions.

c) U.S. Reforms

In the U.S., many investors are required to hold a certain percentage of their portfolios in investment grade securities, and this requirement is only satisfied when the rating agency providing the rating is designated by the SEC as an NRSRO.[84] Historically, obtaining a NRSRO rating has proved difficult, and until 2003, only three agencies existed with this designation.[85] After Enron, a report to the Senate Committee on Governmental Affairs sharply criticized the three rating agencies for their actions late in 2001: although the agencies had downgraded Enron's debt, they had continued to rank its debt at investment grade level. The report chastised the agencies for taking Enron at its word, adopting a narrow focus on Enron's problems, and not viewing themselves accountable considering the enormous market power they held.[86]

Pursuant to s. 702 of *Sarbanes-Oxley*, on January 24, 2003, the SEC released its "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets under Section 702(d) of Sarbanes-Oxley."[87] Noting that a previous government report had recommended imposing standards on CRAs due to their poor performance in relation to Enron, this report indicated that CRAs themselves offered a more "limited view" of their role in the verifying of information received in the credit rating process.[88] The CRAs pointed out that they rely on issuers to provide them accurate information, and generally do not audit the accuracy of this information. They suggested that their reputational concerns were sufficient to ensure they exercised an appropriate level of diligence.[89] The report identified several areas of concern: the transparency of the rating process, conflicts of interest, the development of rating agencies' ancillary businesses, access to entry, and oversight. The SEC followed with a concept release in June 2003, "Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws", to

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[83] *Ibid.* at 44 and 46.
[84] Claire A. Hill, "Rating Agencies Behaving Badly: The Case of Enron" (2003) 35 Conn. L. Rev. 1145 at 1146-47.
[85] *Ibid.* at 1147.
[86] *Ibid.* at 1149.
[87] SEC, "Report on the Role and Function of Credit Rating Agencies in the Operation of Securities Markets" (January 2003), online: <http://www.sec.gov/news/studies/credratingreport0103.pdf>.
[88] *Ibid.* at 32.
[89] *Ibid.*

solicit comments on potential reforms and regulations.[90] Recently introduced legislation, whose stated purpose is "to improve ratings quality by fostering competition, transparency, and accountability in the credit rating agency industry", would require CRAs to register with the SEC.[91] The bill would also eliminate the NRSRO, in favour of a more transparent registration process to stimulate competition.

Claire Hill has recently canvassed several recommendations for the CRA industry: greater competition, greater regulation by the SEC, and removal of the ratings agencies' exemption from liability under s. 11 of the *Securities Act of 1933*.[92] Hill cautions against jumping into legislative reform until a broad inquiry has been undertaken to look at the more fundamental question of what role credit ratings agencies should play.[93] In another article Hill suggests that the government minimize or eliminate regulatory barriers to entry (such as gradual elimination of the NRSRO designation).[94] Hill advocates against greater accountability for rating agencies in court, arguing that this would invite frivolous litigation (suggesting that there is no evidence that ratings agencies have acted fraudulently).[95]

d) Recommendations

Recommendation #3: CRAs' activities should fall under the jurisdiction of the provincial securities commissions, and CRAs should be required to register with the provincial securities commissions.

Recommendation #4: The disclosure obligations formulated by the IOSCO should be a condition of registration with the provincial securities commissions.

Recommendation #5: Mechanisms should be put into place to improve competition among CRAs.

The effectiveness of CRAs' gatekeeping role remains an open question. However, both public perception and academic writing suggest that the existing liability regime does not instil confidence in capital markets and that there is room for modernizing Canadian securities legislation to improve the current situation. A recent Bond Market Association survey indicated that two-thirds of bond issuers are worried

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[90] SEC, "Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws" (4 June 2003), online: <http://www.sec.gov/rules/concept/33-8236.htm>.
[91] *Credit Rating Agency Duopoly Relief Act*, online: <http://www.govtrack.us/congress/billtext.xpd?bill=h109-2990>. The legislation was introduced to Congress on June 20, 2005.
[92] *Supra* note 84 at 1152-1153.
[93] *Ibid.* at 1154.
[94] Claire A. Hill, "Regulating the Rating Agencies" (2004) 82 Wash. U. L. Q. 43.
[95] *Ibid.* at 89.

about a lack of competition among CRAs, and almost half are concerned about the way potential conflicts of interest are tackled.[96] Accordingly, reforms to the current regime should focus on creating incentives for CRAs to generate informational value and reducing the impact of ratings from a small group of CRAs on the market.

Given the uncertainty around CRAs' role and the fact that there is no Canadian SRO or industry body charged with regulating CRAs, the securities commissions could play a critical role. Securities legislation should be amended to create a mandatory registration requirement for all CRAs, and the provincial securities commissions should have the power to revoke or suspend registration of a wayward registrant. The disclosure obligations formulated by the IOSCO should be a condition of registration with the provincial securities commissions. The registration requirement would bring the treatment of CRAs more in line with the spirit of Canadian securities legislation as it relates to oversight of corporate gatekeepers. Registration would also create a threat of liability for rating malfeasance. Given the concerns articulated in the literature with imposing civil liability on CRAs, the ideal gatekeeper liability scheme should be focused on administrative liability. The IOSCO Code, which CRAs have already generally adopted, presents a good model for imposing liability on CRAs.

The registration requirements suggested by the recommendations are not onerous. A key reason behind this is that onerous registration requirements would lead to the U.S. model that has inhibited competition. Along the same lines, efforts should be undertaken to improve competition among CRAs, which holds the potential of contributing to the implementation of higher standards of conduct based on market demand. The result will be an in incentive for CRAs to provide greater informational value. For example, currently, National Instrument 44-101 of the Canadian Securities Administrators prescribes the following CRAs as "Approved Rating Organizations": CBRS Inc., Dominion Bond Rating Service Limited, Duff & Phelps Credit Rating Co., Fitch IBCA, Inc., Moody's Investors Service, Inc., Standard & Poor's Corporation, Thomson BankWatch, Inc. and any of their successors. Further thought should be given to amending this provision to provide that "Approved Rating Organizations" include all CRAs registered with a provincial securities commission.

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[96] Quiton Webb, "Issuers Leery of Credit Raters" *Globe and Mail* (24 February 2006), online: Insider Edition <http://www.theglobeandmail.com/servlet/story/LAC.20060224.RRATINGS24/TPStory/Business> at B9.

iii. Financial Analysts

Financial analysts perform a variety of functions within the securities industry, including gathering information, assembling spreadsheets, writing reports and reviewing all non-legal pertinent information about prospective deals.[97] Sell-side analysts work at full-service investment dealers, while buy-side analysts are employed by institutional investors. Analysts may also work independently. As outlined in the Securities Industry Committee on Analyst Standard's Report "Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts" (SICAS *Report*), conflicts often arise between an analyst's duty to provide independent, objective advice to investor clients and pressures to support investment banking revenues because of their unique intermediary role in capital markets.[98] In the current context, buy-side pressures on financial analysts are taking on increasing significance. For example, a mutual fund with large holdings in a stock has an incentive to persuade an analyst not to put a "sell" recommendation on the stock that could contribute to a decline in its price.

a) Summary of Literature

Coffee identifies key differences between auditors and financial analysts: while auditors are generally bound by rules, analysts make predictions and are frequently wrong. Imposing strict liability on analysts, he argues, "given their necessarily higher rate of error, represents a virtual death sentence…"[99]

b) U.S. Reforms

In August of 2000, the SEC adopted Regulation FD (Fair Disclosure) with the intention of preventing companies from selectively disclosing information to analysts and to "level the playing field between analysts and individual investors."[100] Companies are now required to publicly disclose material non-public information that they provide to analysts. Section 501 of *Sarbanes-Oxley* required the promulgation of rules governing analyst conflicts. Thus, SEC Regulation AC (Analyst Certification),

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[97] Securities Industry Committee on Analyst Standards, "Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts" (October 2001) [SICAS *Report*] at 29-30.
[98] *Ibid*. at 30.
[99] Coffee, "Gatekeeper Failure and Reform," *supra* note 10 at 73.
[100] David J. Labhart, "Securities Analysts: Why These Gatekeepers Have Abandoned Their Post" (2004) 79 Indiana L.J. 1037 at 1052. See SEC, "Final Rule: Selective Disclosure and Insider Trading" (23 October 2000), online: <http://www.sec.gov/rules/final/33-7881.htm>.

effective April 2003, requires that when a broker, dealer or covered person furnishes research prepared by a research analyst, the research must include a statement by the research analyst that the research truly reflects the analyst's opinion, and disclose whether or not an analyst received compensation in connection with his or her specific recommendations or views.[101] Regulation AC is to complement the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD) rules.

The commentary pertaining to Regulation AC states that the regulation "…does not alter any other existing obligation under the federal securities laws for research analysts or broker-dealers," but rather "…makes explicit the representations that are already implicit when an analyst publishes his or her views - that the analysis of a security published by the analyst reflects the analyst's honestly held views".[102] Even without Regulation AC, analysts may be found to violate the anti-fraud provisions of the federal securities laws if they make baseless or dishonest recommendations.[103] Penalties under the *Securities Act* (or rules or regulations promulgated under the act, such as Regulation AC) may amount to fines of $10,000 or under, or imprisonment of five years or under.[104] In addition, s. 10(b) of the Exchange Act prohibits fraud in connection with the purchase or sale of securities, although debate exists as to an investor's likelihood of success in establishing the liability of an analyst under this section.[105]

As noted above, s. 501 of *Sarbanes-Oxley* required rules limiting the supervision and compensatory evaluation of securities analysts to certain officials; defining periods in which brokers or dealers engaged in a public offering of a security as an underwriter or dealer may not publish research on such security; and requiring securities analysts and brokers to disclose specified conflicts of interest.[106] To satisfy these requirements, the NYSE and NASD submitted proposed rule changes to the SEC in 2002.[107] The rule changes include a prohibition on research analysts being subject to the supervision or control of any

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[101] Labhart, *ibid.* at 1054. See SEC, "Regulation Analyst Certification" (14 April 2003), online: <http://www.sec.gov/rules/final/33-8193.htm> [Regulation Analyst Certification].
[102] Regulation Analyst Certification, *ibid.*
[103] See *e.g. Securities Act*, ss. 17(a) and 17(b), 15 U.S.C. 77q; *Securities and Exchange Act*, s. 10(b), 15 U.S.C. 78j(b), and Rule 10b-5, 17 CFR 240.10b-5.
[104] *Securities Act*, *ibid.*, s. 24.
[105] See Elizabeth A. Nowicki, "A Response to Professor John Coffee: Analyst Liability Under Section 10(b) of the Securities Exchange Act of 1934" (2004) 72 Univ. Cincinnati L. Rev. 1305. Under s. 10(b), it is unlawful for any person to "…use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered… any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."
[106] SEC, "NASD and NYSE Rulemaking," online: <http://www.sec.gov/rules/sro/34-48252.htm>.
[107] NYSE Rule 472, NASD Rule 2711.

employee of a member's investment banking department, and require legal or compliance personnel to act as intermediaries for certain communications between research and investment banking personnel.[108]

c) U.K. Reforms

In March 2004, the U.K.'s Financial Services Authority (FSA) published in final form its rules relating to investment research and conflicts of interest. The FSA is an independent non-governmental body, given statutory powers by the *Financial Services and Markets Act 2000* (FSMA 2000), that regulates the financial services industry in the U.K. (including insurance, mortgage and investment businesses). Its objectives are to maintain confidence in the financial system; promote public understanding and awareness of the financial system; ensure adequate protection for consumers; and reduce financial crime.[109] The FSA has extensive investigatory and enforcement powers under ss. 165-169 and s. 284 of the act. The FSMA 2000 market abuse regime was substantially remodelled in July 2005 following adoption of changes to the FSA's handbook, which implemented the larger European Market Abuse Directive (MAD), discussed further below.

Section 118 of the FSMA 2000 created the offence of market abuse and institutes regulatory penalties, instead of criminal sanctions. If the FSA finds a person has engaged in market abuse or has induced another to do so, it may impose unlimited monetary sanctions or other administrative penalties on that person and on those employing or supervising such persons.[110]

The FSA may also initiate criminal proceedings. Section 397 of the FSMA 2000 creates quasi-criminal offences with the possibility of imprisonment for up to seven years, a fine, or both. Section 397(1) and (2) makes it an offence for a person to make misleading, false or deceptive statements, promises or forecasts in a material particular; dishonestly conceal material facts; or to recklessly make misleading, false or deceptive statements.[111] Under s. 397(3), it is an offence for a person to act or engage in a course of conduct that creates a false or misleading impression in respect of the market in the price or value of any relevant investments, where the act was done or in the course of conduct engaged in for the purpose of creating that impression and by doing so, induces another person to acquire, dispose of, subscribe for

[108] *Ibid.*
[109] *Financial Services and Markets Act 2000* (U.K.), 2000, c. 8, s. 2(2) [FSMA 2000].
[110] Emilios E. Avgouleas, *Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis* (Oxford: Oxford University Press, 2005) at 310; see pp. 371-388 for an extensive discussion of remedies. See also FSMA 2000, *ibid.*, s. 118.
[111] FSMA 2000, *ibid.*, s. 397(1) and (2).

or underwrite those investments, or refrain from doing so, or to exercise, or refrain from exercising, any rights conferred by those investments.[112] Conviction under s. 397(1) and (2) requires proof of dishonesty or recklessness, while s. 397(3) requires misleading act and conduct.[113]

In addition to the possibility of quasi-criminal liability, financial analysts fall under s. 118(7), pertaining to the dissemination of false or misleading information.[114] The FSA's Code of Market Conduct (COMAC), which provides assistance in determining whether behaviour amounts to market abuse, includes undertaking a course of conduct in order to give a false or misleading impression about a qualifying investment as constituting market abuse.[115] The FSA has complied with the legislative changes prompted by the MAD by introducing a disclosure rules sourcebook, amending its Code of Business Handbook (at 7.17), and amending its Supervision Manual (at 15.10). The FSA's Conduct of Business Sourcebook, 7.17 (COB 7.17), for example, imposes "fair presentation" and disclosure requirements:

- producers and disseminators of recommendations are required to set out the identity of the person responsible for the production and dissemination of the research;
- producers of recommendations must reveal information about their sources and methods;
- firms must make detailed disclosures so clients can reach a view on the extent to which conflicts of interest might have impaired the objectivity of the recommendations, and firms producing the information must disclose the level of financial holdings they have in the issuer subject to the recommendation.[116]

Since July 2004, firms that publish impartial research must have in place, and publish, a policy on identifying and managing conflicts to ensure analysts' impartiality. The FSA's rules set out minimum standards for conflict management processes and procedures.[117]

As noted above, regulation of market abuse in the U.K. is part of the larger EU framework of regulation.

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[112] Avgouleas, *supra* note 110 at 316-317.
[113] *Ibid.* at 318.
[114] FSMA 2000, *supra* note 109, s. 118(7).
[115] Avgouleas, *supra* note 110 at 356. See also p. 341 for a description of the function of COMAC.
[116] *Ibid.* at 366. Note that COB 7.17 was adopted in compliance with Article 6(5) of the MAD.
[117] FSA, "Ex-post analysis of FSA's conduct of business rules on conflicts of interest in investment research" (29 September 2005), online: <http://www.fsa.gov.uk/pubs/other/post_analysis.pdf>. See also "Conflicts of interest in investment research - Feedback on CP205 and made Handbook text" (March 2004) online: <http://www.fsa.gov.uk/pubs/policy/ps04_06.pdf>.

To harmonize rules for the detection and punishment of market manipulation, the EU has implemented a Market Abuse Directive (MAD). The MAD was due to be implemented in all member states on October 12, 2004. After legislative changes, a consultation period and a three-month transition period, the market abuse regime in the U.K. went into effect on July 1, 2005. The MAD applies to all financial instruments admitted to trading on a regulated market. Market manipulation comprises three parts: transaction and orders to trade that give false or misleading signals or secure the price of a financial instrument at an artificial level; transactions or orders to trade that employ fictitious devices; and dissemination of information likely to give false or misleading signals. The MAD defines inside information as information that is precise, non-public and likely to have a significant impact on the price of a financial instrument. The directive imposes an obligation on issuers to disclose inside information as soon as possible; requires firms arranging transactions to report transactions to the FSA where there is a reasonable suspicion that market abuse might have taken place; and requires the disclosure of information about research sources and methods, and conflicts of interest that may impact on the impartiality of the research.[118]

Securities research reports prepared by investment firms and independent research institutions fall within Article 6(5) of the MAD.[119] Article 6(5) requests member states to implement regulations to oblige producers and disseminators of investment research and recommendations to fairly present research and disclose relevant conflicts of interest.[120] Article 6(9) requests member states' regulation to require that any person "professionally arranging transactions in financial instruments" promptly notify the competent authority of a transaction, where that person reasonably suspects the transaction might constitute insider dealing or market manipulation.[121] Section 15.10 of the U.K. FSA's Supervision Manual implements Article 6(9) of the MAD, regarding the notification by "market operators" of suspicious transactions.[122] An authorized firm, which arranges or executes a transaction with or for a client in a qualifying investment, must notify the FSA without delay if it has reasonable grounds to suspect that the transaction might constitute market abuse.[123]

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[118] The information in this paragraph is obtained from the FSA, "FSAP – Market Abuse Directive (MAD)," online: <http://www.fsa.gov.uk/Pages/About/What/International/EU/fsap/mad/index.shtml>. Note that Emilios Avgouleas observes that U.K. market participants will have to comply not only with the offences of insider dealing and market manipulation described in the MAD, but also with the "complex and confusing illustrations of market abuse" contained in the original s. 118 of the FSMA 2000. Avgouleas, *supra* note 110 at 312.
[119] Avgouleas, *ibid.* at 269.
[120] *Ibid.* at 267.
[121] *Ibid.* at 288.
[122] *Ibid.* at 367.
[123] *Ibid.*

d) Recommendations

<u>Recommendation #6:</u> IDA Policy No. 11 ["Research Restrictions and Disclosure Requirements"] should be amended to require: 1) a statement by the analyst that the research truly reflects the analyst's opinion; and 2) a prohibition on an analyst being subject to supervision or control by the investment banking department where applicable.

Following the SICAS *Report*, the IDA has taken significant measures to address the gatekeeping role played by analysts. However, given the recent reforms in the U.S. and the U.K. to maintain confidence in analysts' function as gatekeepers, more detailed disclosure should be required by analysts with accompanying liability for failure to disclose. Currently, Rule 2(b) requires that Members disclose their system for ratings. More specific disclosure requirements, including identification of the analyst responsible for the production and dissemination of the research and a statement by the analyst that the research truly reflects the analyst's opinion, would bolster investors' confidence in the information that is provided. This reform will address both sell-side and buy-side pressures facing financial analysts. Further, in addition to requiring Members to set policies and procedures under IDA Rule 11 to avoid conflicts of interest, put controls in place and maintain records of supervision of analysts. A specific prohibition on supervision and control of analysts by the investment banking department, where applicable, should be put into place. While this measure may appear to be outdated to the American reader, given that similar measures were introduced in the U.S. in 2003 following Eliot Spitzer's investigation of conflicts of interest at Wall Street investment firms, they are not outdated in the Canadian context. These measures will bring the Canadian approach to gatekeeper liability for analysts more in line with the U.S. and the U.K. approaches, while still maintaining the Canadian self-regulatory model.

Given that the possibility does exist for financial analysts to be held liable as experts under the new Ontario secondary market civil liability scheme, it does not appear to be necessary to follow the U.K. model and to create an obligation with liability attached to notify a securities commission or the IDA where the analysts suspects corporate misconduct. Where this is the case, the analyst is incentivized to report misconduct to avoid liability under the new secondary market civil liability scheme.

iv. Lawyers

Lawyers can act as gatekeepers to capital markets in several ways. With the increasing complexity of financial regulation, lawyers serve as "critical facilitators" for their clients. Due to this relationship, the lawyer can detect and potentially disrupt wrongful conduct. The ongoing nature of the relationship, and the high cost to both parties of ending it, has the potential to constitute lawyers as particularly effective gatekeepers. Lawyers can and do collect information from their clients that would be difficult or impossible for regulators to collect on their own. Lawyers are also in a position to advise clients about both the letter and the spirit of the law.

a) Summary of Literature

Considerable debate exists as to whether lawyers should play a gatekeeping role. Those who oppose such a role place emphasis on the sanctity of lawyer-client privilege and confidential communications; they stress the differences between lawyers and other gatekeepers such as auditors or analysts. At the heart of the debate is what precisely the lawyer's role is.[124]

Coffee has argued that lawyers should be viewed as gatekeepers.[125] Sceptics of lawyers playing a gatekeeper role assert that this role conflicts with the traditional obligations of loyalty that lawyers owe to clients, and will chill lawyer-client communications, reducing legal compliance.[126] Coffee points out that securities lawyers already perform a gatekeeping function; the differences between lawyers and auditors are less fundamental than their opponents maintain; imposing gatekeeping functions on lawyers is easier in some respects than on auditors; and such functions will neither chill lawyer-client privilege nor reduce a lawyer's influence over his or her client.[127] He argues that public policy must strike an appropriate balance between the obligation of client loyalty and the protection of the integrity of the market.[128]

Similar to Coffee, Fred Zacharias argues that lawyers have always played a gatekeeping function.[129] Similarly, Campbell and Gaetke argue that transactional lawyers, acting as gatekeepers, can discourage fraudulent conduct by managers, resulting in elevating the legal profession's own standards of behaviour and serving to reduce the level of corporate misconduct itself.[130] Campbell and Gaetke advocate

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[124] See Robert W. Gordon, "A New Role for Lawyers?: The Corporate Counselor After Enron" (2003) 35 Conn. L. Rev. 1185.
[125] John C. Coffee Jr., "The Attorney as Gatekeeper: An Agenda for the SEC," Columbia Law School, The Center for Law and Economic Studies, Working Paper No. 221 (April 2003).
[126] *Ibid.* at 2.
[127] *Ibid.* With regard to the last point, Coffee argues that client confidentiality is a means to an end, not an end in itself. The ultimate goal of the law is to achieve compliance, not to maximize uninhibited communications between the attorney and client (*ibid.* at 23).
[128] Coffee, "Gatekeeper Failure and Reform," *supra* note 10 at 63.
[129] Fred Zacharias, "Lawyers as Gatekeepers" (2004) 41 San Diego L. Rev. 1387.
[130] Rutherford B. Campbell Jr. & Eugene R. Gaetke, "The Ethical Obligations of Transactional Lawyers to Act as Gatekeepers." (2003) 56 Rutgers L. Rev. 9.

amendments to the Model Rules (discussed below) that impose a more rigorous gatekeeping function for transactional lawyers.

In Canada, Stanley Beck appears to have first advocated the gatekeeping role for lawyers who practice in the marketplace of securities transactions or regulated financial transactions.[131] Lawyers, Beck asserts, are likely to have more contact with senior management than auditors and to be involved in an ongoing way in significant transactions.[132] Beck asks, "If the Superintendent can require a waiver of confidentiality by the auditor and an agreement by the auditor to report, then why not a similar requirement of waiver with respect to the lawyer? On what basis could the institution object to such a waiver?"[133] For Beck, lawyers are well-positioned to prevent violations by refusing to participate in disputed transactions.[134] One of Beck's commentators responded by drawing attention to the already existent "keepers of the gate": the courts, securities commission and professional advisors.[135] Lawyers, he asserts, already act to some extent as gatekeepers, and he questions why a greater, regulated gatekeeping role should fall on members of the legal profession.[136]

Recently, Bonnie Fish has argued that lawyers make "lousy gatekeepers." For Fish, a gatekeeping function imposed on lawyers would infringe on the lawyer-client relationship: "Lawyers are well placed to extract confidential information from their clients because their clients trust them to advocate on their behalf and not to divulge information to regulators. The imposition of gatekeeper obligations on lawyers changes that dynamic; clients will come to regard 'gatekeeping' lawyers as agents of regulators and therefore less worthy of their trust. Adding liability to the equation creates a conflict of interest for lawyers every time their clients wish to challenge the regulators."[137]

Fish argues that lawyers play a different role than other professionals: they do not provide independent certification under securities laws. Accountants act independently; their role is to issue a certificate under

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at 15.

[131] Stanley M. Beck, "Gatekeepers and the commission: the role of professionals in the regulatory system" in *Securities Regulation: Issues and Perspectives*, Queen's Annual Business Law Symposium 1994 (Scarborough: Carswell, 1995) 239 [*Securities Regulation*].

[132] *Ibid.* at 260.

[133] *Ibid.*

[134] *Ibid.* at 262.

[135] Jonathan Lampe, "Comments on Gatekeepers and the Commission: Why Us?" in *Securities Regulation*, *supra* note 131 at 273.

[136] *Ibid.* at 273-274.

[137] Bonnie Fish, "Pointing the Finger at Professionals: The Responsibility of Lawyers and other Gatekeepers for Corporate Governance Failures" in Poonam Puri & Jeffrey Larson, eds., *Corporate Governance and Securities Regulation in the 21st Century* (Toronto: LexisNexis Butterworths) 97 at 114.

their name as to the accuracy, completeness, consistency and fairness of financial statements. Fish concludes that the duty to disclose material facts to third parties is inherently different for accountants and underwriters than it is for lawyers.[138] Others object to the policing or regulatory function that lawyers as gatekeepers would be obligated to undertake. One practitioner has commented, "Clients don't want me to *be* the regulator. They want help in *dealing with* the regulator. If I am the regulator, who is advising my client? Who should be advising me?"[139]

b) U.S. Reforms

Regulation under *Sarbanes-Oxley*

Under s. 307 of the act, the SEC has been required to promulgate rules of professional conduct for lawyers. The SEC's proposals included an "up-the-ladder" reporting rule, requiring lawyers to report evidence of a material violation by an issuer or any of its officers, directors or employees. Also included was a "noisy withdrawal" rule, which would have required a lawyer to withdraw her representation of an issuer and inform the SEC, if the lawyer did not receive a response reasonably demonstrating that there was no material violation, or that the issuer had adopted remedial measures to address the violation.[140] The SEC's final rules require "up-the-ladder" reporting by lawyers, but do not require that lawyers withdraw their representation.[141]

The "up-the-ladder" reporting rules apply to lawyers appearing and practicing before the SEC in the representation of an issuer, and require them to report "forthwith" to the issuer's chief legal officer (CLO), or CLO and CEO, evidence of a material violation of securities laws, breach of fiduciary duties or material violation of other laws by the issuer, or by any officer, director, employee or agent of the issuer. The lawyer must report the evidence of a material violation to the issuer's audit committee, independent board committee or the full board of directors, unless the lawyer believes that the CLO or CEO has

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[138] *Ibid.* at 118-119. While it is true that lawyers, unlike auditors, for example, do not provide independent certification under securities laws, it is also the case that every public offering depends on one or more legal opinions. This may include a tax opinion, a "legal for life" opinion, or a 10b5 opinion. In addition, the name of the law firm at the heart of the offering is usually found on the front page of the prospectus – adding credibility to the offered securities.

[139] James E.A. Turner, "Comments on 'Gatekeepers and the Commission: The Role of Professionals in the Regulatory System'" in *Securities Regulation*, *supra* note 131 at 270. Emphasis in original.

[140] Philip Anisman, "Regulation of Lawyers by Securities Commissions: Sarbanes-Oxley in Canada," Capital Markets Institute Policy Comment (March 2003), online: <http://www.rotman.utoronto.ca/cmi/news/LSUCpaper.pdf> at 1.

[141] SEC, "Final Rule: Implementation of Standards of Professional Conduct for Attorneys" (5 August 2003), online: <http://www.sec.gov/rules/final/33-8185.htm>.

provided an appropriate response within a reasonable amount of time. The lawyer may report directly to the audit committee or board if she believes it would be futile to report evidence of a material violation to the CLO or CEO. "Evidence of a material violation" means "…credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[142] Once a lawyer reports evidence of a material violation to the CLO, the CLO must investigate or refer the report to a Qualified Legal Compliance Committee (QLCC). The rules allow an issuer to establish a QLCC as an alternative procedure for reporting evidence of a material violation; once a lawyer reports to a QLCC, he or she satisfies the reporting obligation and no longer must assess the issuer's response to the reported violation.[143]

Lawyers who violate the rules are subject to all remedies and sanctions available to the SEC for violation of federal securities laws. These remedies and sanctions are in addition to the possibility of discipline for the same conduct by the lawyer's state Bar Association. An administrative disciplinary proceeding initiated by the SEC for violation of the rules may result in a lawyer being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the SEC. The rules do not create a private right of action against a lawyer or law firm for violations of the rules.

Authors such as Jill Fisch and Kenneth Rosen have been critical of the "up the ladder" reporting requirements adopted by the SEC, arguing they reflect a "second-best" approach to corporate governance reform by assigning to the lawyer the role of corporate gatekeeper and information intermediary. They assert that the provisions threaten to undermine the flow of information between lawyers and corporate actors, and are likely to reduce the quality of legal services provided to the corporation.[144]

American Bar Association: Model Rules

The American Bar Association's (ABA) *Model Rules of Professional Conduct* (Model Rules) were adopted by the ABA House of Delegates in 1983. They serve as models for the ethics rules of most state Bar Associations. The ABA Model Rules identify instances where lawyers are obligated to play a

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[142] See *ibid.* for the definition of "evidence of material violation." The summary of the SEC rules in this paragraph is adapted from "Final SEC Rules Concerning Standards of Professional Conduct for Attorneys," Orrick corporate law update, online: <http://www.orrick.com/fileupload/188.pdf> at 2.
[143] *Ibid.* at 3.
[144] Jill E. Fisch & Kenneth M. Rosen, "Is There a Role for Lawyers in Preventing Future Enrons?" (2003) 48 Vill. L. Rev. 1097.

gatekeeping function:

- Model Rule 1.13(b) obligates a lawyer for a corporation to "proceed as is reasonably necessary in the best interest of the organization" if the lawyer knows that corporate managers are engaged in actions that amount to a "violation of a legal obligation" to the corporation, or that are unlawful and likely to result in substantial injury to the corporation;
- Model Rule 1.2(d) forbids a lawyer from lending assistance to corporate managers, to any action by managers that the lawyer knows is criminal or fraudulent.[145]

The ABA expressed strong opposition to the noisy withdrawal provisions recommended by the SEC, on the basis that such provisions would divide loyalties and drive a wedge in the lawyer-client relationship.[146] The association's task force on corporate responsibility advocated an approach that would facilitate communication between lawyer and client in relation to legal compliance matters: "…by encouraging early and regular attention to and communication about potential problems of legal compliance will significantly diminish the occurrence of material violations of law."[147]

It is important to note that it is up to each state Bar Association to develop their own Rules of Professional Conduct and there is some variation from the ABA Model Rules. An issue has arisen in some states where the state Bar Association's Rules of Professional Conduct place limits on disclosure that are potentially in conflict with the rules. The SEC has indicated that should a lawyer in a state like Delaware, whose rules may not permit disclosure to the same extent as the ABA rules, disclose information as allowed under the ABA rules, the lawyer may not be prosecuted for violation of the state rule.[148] Violation of the Rules of Professional Conduct subjects lawyers to a range of sanctions including disbarment, suspension, probation, reprimand, restitution and costs of proceedings. The ABA provides *Model Rules for Lawyers' Disciplinary Enforcement* and *Standards for Imposing Lawyer Sanctions*, but it is up to each state Bar Association to develop its own rules and standards.

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[145] American Bar Association, Model Rules of Professional Conduct, Rule 1.13(b), online: <http://www.abanet.org/cpr/mrpc/new_rule1_13.pdf>; Rule 1.2(d), online: <http://www.abanet.org/cpr/mrpc/rule_1_2.html>.
[146] American Bar Association, "Report of the American Bar Association Task Force on Corporate Responsibility" (31 March 2003) at 53, n. 94.
[147] *Ibid.* at 34.
[148] Michael D. Goldman & Melony R. Anderson, "Professionalism and Ethics: An Overview of Standards Applicable to Delaware Lawyers" (2004), online: <http://library.findlaw.com/2004/Jun/11/133463.html#ftn>. Rule 6 (d), Part 205, Standards of Professional Conduct for Attorneys, online: <http://www.law.uc.edu/CCL/p205/205.6.html>.

c) U.K. Reforms

With regard to the regulation of solicitors, the U.K. Law Society's *The Guide to the Professional Conduct of Solicitors* points out exceptional circumstances where the duty of confidentiality does not apply, such as information acquired by a solicitor where he or she is being used by a client to facilitate the commission of a crime or fraud.[149] The Law Society is currently bringing in a new Code of Conduct which will replace *The Guide to the Professional Conduct of Solicitors*. The new code is expected to come into force in 2006. The draft code's section on confidentiality and disclosure does not address reporting requirements in the corporate context as do the U.S. Model Rules.[150]

Section 413 of the FSMA 2000 creates a limitation on the powers of the FSA to require the production of documents identified by the Act as "protected items."[151] The section protects communications between a professional legal adviser, his client or any person representing his client and any other person, from disclosure. In order to qualify for the protection, the communication or items must be made in connection with the giving of legal advice to the client; or in connection with, or in contemplation of, legal proceedings and for the purposes of those proceedings.[152] Communications or items are not deemed protected items if they are held with the intention of furthering a criminal purpose.[153]

In two recent cases, the scope of legal advice privilege has been discussed by the British courts. In *Three Rivers District Council v. Governor and Company of the Bank of England (No. 6),* investors sought disclosure of communications passed between the Bank of England and its lawyers about an inquiry into the collapse of the Bank of Credit and Commercial International.[154] The case raised questions about what constitutes legal advice and what documents are protected by legal advice privilege. The House of Lords decision confirmed that all communications between a solicitor and client, relating to the transaction for which the client sought legal advice, will be privileged even if these communications are not strictly

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[149] The Law Society (U.K.), Chapter 16.02, "Circumstances Which Override Confidentiality," *The Guide to the Professional Conduct of Solicitors*, online: <http://www.lawsociety.org.uk/professional/conduct/guideonline/view=page.law?POLICYID=390&PARENT=387>.

[150] The Law Society (U.K.), "The Law Society's Code of Conduct & The Recognised Bodes Regulations" (draft, no date), online: <http://www.lawsociety.org.uk/secure/file/150700/e:/teamsite-deployed/documents//templatedata/Internet%20Documents/Consultation%20on%20the%20rules/Documents/Code%20of%20conduct/draftRule04.pdf>.

[151] FSMA 2000, *supra* note 109, s. 413.

[152] *Ibid*., s. 413(3).

[153] *Ibid*., s. 413(4).

[154] [2004] UKHL 48.

related to matters of law; the communications must relate to the legal advisor's performance of his professional duty as legal advisor of his or her client.[155] Only if a lawyer is using his or her legal skills will privilege apply, which may have an impact for in-house lawyers who adopt a number of roles in their daily work.[156] The protection is limited to lawyer-client communications: it does not protect communications between a lawyer and other advisors or consultants, and problems concerning the definition of "client" remain.[157] In a second case, fears that the *Proceeds of Crime Act 2002* obliged solicitors to abandon client confidentiality and report any suspected illegality were laid to rest by a Court of Appeal decision which has ruled that solicitors will no longer face prosecution if they fail to report clients, even on minor financial irregularities.[158]

The *Public Interest Disclosure Act 1998* (PIDA) is designed to protect workers who make certain public interest disclosures. The information must be a qualifying disclosure, and must be disclosed in a way that attracts statutory protection.[159] A "qualifying disclosure" under the act means any disclosure of information which, in the reasonable belief of the worker making the disclosure, tends to show, *inter alia*, that a criminal offence has been committed, is being committed or is likely to be committed; or that that a person has failed, is failing or is likely to fail to comply with any legal obligation to which he is subject.[160] The act excludes from this definition "a disclosure of information in respect of which a claim to legal professional privilege… could be maintained in legal proceedings is not a qualifying disclosure if it is made by a person to whom the information had been disclosed in the course of obtaining legal advice."[161] That is, a person cannot be protected under PIDA if that person made a disclosure for which a claim to legal professional privilege can be maintained, if that disclosure was made in the course of obtaining legal advice. To protect lawyers who raise concerns regarding corporate wrongdoing, the public whistle-blowing watchdog, Public Concern at Work, has suggested that this section be amended to clarify that disclosures of information subject to privilege are protected by PIDA, where that disclosure does not breach legal professional privilege.[162]

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155 Mills & Reeve, "Privilege and Three Rivers (No 6)" (11 November 2004), online: <http://www.mills-reeve.com/dispimg.asp?id=1587>.
156 Guy Pendell & Amanda Wadey, "Three Rivers—Storm in a Teacup? (2)" (2005) J.B.L.R. 238 at 239.
157 Mills & Reeve, *supra* note 155.
158 Francis Gibb, "Solicitors win right of confidentiality" *Times Online* (9 March 2005).
159 1998 (U.K.), c. 23. See also Public Concern at Work, "'In the Public Interest' Legal Professional Privilege" (n.d.), online: <http://www.pcaw.co.uk/policy_pub/legal_professional_privilege.html>.
160 1998 Chapter 23, s. 43B(1)(a) and (b).
161 *Ibid.*, s. 43B(4).
162 Public Concern at Work, *supra* note 159.

d) Recommendations

<u>Recommendation #7</u>: Joint task forces should be struck in each of the provinces with members from the securities commission and the law society, to consider the law societies' rules of professional conduct that address lawyers' corporate gatekeeping function.

Unlike the U.S. model and more akin to the U.K. model, the Canadian model for gatekeeper liability for lawyers clearly assigns the key regulatory function to the provincial law societies. The benefit of this model is that the problem of conflicting standards that exist in the U.S. between the Rules of Professional Conduct, set by each state Bar Association and the SEC rules, does not arise. It is also the case that the law societies are keenly aware of the competing tensions between lawyers' gatekeeping function and the confidentiality requirements that are inherent to the lawyers' functioning. However, there is variation among the law societies with respect to the extent to which they have created specific rules to address lawyers' gatekeeping function. Ontario appears to have created the model, most similar to the U.S. model, which best strikes a balance between lawyers' roles as gatekeepers and advocates.

In order to improve the competitiveness of Canadian capital markets, it is recommended that each law society give consideration to adopting a similar set of rules, with the input of each provincial securities commission. A more uniform and comprehensive set of rules of professional conduct will simplify the existing system and at the same time ease investors' concerns with the role that lawyers are playing in Canadian capital markets. Following a provincial consultation process, it may be helpful to strike a national working group to develop a uniform set of rules of professional conduct. It is not recommended that securities legislation be amended to regulate lawyers' gatekeeping function beyond the current legislation. It is clear that such amendments do not fit the current Canadian understanding of the respective regulatory functions of the provincial law societies and securities regulators.

v. Directors

Directors can act as gatekeepers to capital markets because they are in a position to scrutinize and question corporate activities and management proposals. Ultimately, directors are responsible for managing or supervising the management of the business and affairs of the corporation. As well, the federal and provincial corporate law statutes vest in directors an integral role in making fundamental changes to the corporation. Directors also have the ability to act as gatekeepers due to their role in appointing and evaluating the executives of the corporation. Essentially, subject to the constraints imposed by law, directors have complete discretion to exercise their powers, as they deem appropriate.[163]

In many of these functions, some consider independent or outside directors more able to perform a gatekeeping role because of their more arms-length relationship with management. A major role of independent directors is to serve on audit committees, which must usually be composed of independent directors, or at least have a majority of independent directors.[164]

a) Summary of Literature

Much debate exists as to whether directors are in fact corporate gatekeepers and if so, if they should be exposed to liability. Many argue that legal sanctions should not be imposed on directors because other forces, such their reputations or the market, sufficiently ensure that directors will comply with their fiduciary obligations.[165] Major corporate scandals such as Enron, however, demonstrate that reputational sanctions were not enough to curb director misconduct.[166] The Report of the Staff to the Senate Committee on Governmental Affairs identified two private sector gatekeepers - boards of directors and auditors - in its discussion of the financial oversight of Enron, asserting that these gatekeepers “were the first lines of defence” against corporate fraud.[167] Directors, according to the report, are charged with protecting shareholders’ interests by “setting the direction for the corporation and by watching over management,” and as such the board’s role is to provide leadership and oversight with the goal of maximizing shareholder value.[168] The report notes that despite their responsibilities, in reality, directors have little personal accountability or oversight.[169]

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[163] Osler, Hoskin & Harcourt, “Corporate Governance in Canada: A Guide to the Responsibilities of Corporate Directors in Canada,” online: < http://www.osler.com/resources.aspx?id=8115>. See also: Stephanie Ben-Ishai “A Team Production Theory of Canadian Corporate Law” (2006) 44 Alta. L. Rev. 2 [forthcoming in 2006].

[164] National Instrument 52-110, “Audit Committees.” Available online at <http://www.sfsc.gov.sk.ca/ssc/files/nat-inst/52-110mi.pdf>.

[165] Lisa M. Fairfax, “Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability” (2005) 42 Houston L. Rev. 393 at 428.

[166] *Ibid.* at 432.

[167] Report of the Staff to the Senate Committee on Governmental Affairs, “Financial Oversight of Enron: The SEC and Private-Sector Watchdogs” (8 October 2002), online: FindLaw < http://files.findlaw.com/news.findlaw.com/hdocs/docs/enron/100802enronsec.pdf> at 26,

[168] *Ibid.* at 16.

[169] *Ibid.* at 17.

b) U.S. Reforms

In the U.S. context, while *Sarbanes-Oxley* imposes increased responsibilities on directors, it does not impose any direct legal penalties on directors who breach these responsibilities.[170] Section 301 requires that companies have an audit committee comprised solely of independent directors; this committee is responsible for appointing and compensating auditors, as well as overseeing their work.[171] Through the provisions of section 301, the act imposes an oversight function on audit committee members similar to directors' more general monitoring duty under state fiduciary law.[172] Under section 302, a company's CEO and CFO are required to certify in each annual or quarterly report that they are responsible for establishing and maintaining internal controls - designed to ensure that material information is known to them - and that they have evaluated the effectiveness of these controls.[173] These officers must also disclose to the board's audit committee any significant deficiencies in the design or operation of internal controls that could adversely affect the company's ability to record and report financial data.[174] Lisa Fairfax argues that these provisions, taken together, impose fiduciary-like duties on directors and add teeth to directors' duty to oversee the financial affairs of the corporation by creating greater specificity to this duty.[175] The Act, however, contains no liability provisions for directors who do not comply with their responsibilities under the Act,[176] although under s. 1105 of *Sarbanes-Oxley*, the commission has the authority to prohibit persons from serving as officers and directors.[177]

In addition, the NYSE has adopted corporate governance rules that apply to directors, codified in s. 303A of the Listed Company Manual; companies listed on the Exchange must comply with these corporate governance standards, although certain provisions apply to some listed companies but not to others.[178] Under the rules, for example, listed companies must have a majority of independent directors.[179] The rules also stipulate that to empower non-management directors to serve as a more effective check on

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[170] Fairfax, *supra* note 165.
[171] *Ibid.* at 401.
[172] *Ibid.*
[173] *Ibid.* at 402.
[174] *Ibid.*
[175] *Ibid.* at 404-405.
[176] *Ibid*. at 406.
[177] *Supra* note 35, § 1105.
[178] "Final NYSE Corporate Governance Rules," online: <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>.
[179] *Ibid.* at 4. An independent director is defined as a director who has no material relationship with the listed company, as determined by the board. The rules specify other indicators of independence, such as the following: a director who receives, or whose immediate family member receives, more than $100 000 in direct compensation from the company is not independent until three years after he or she ceases to receive this compensation (*ibid*. at 4-6).

management, the non-management directors of a company must meet at regularly scheduled executive sessions without the attendance of management; that listed companies must have a nominating/corporate governance committee and compensation committee composed entirely of independent directors; and that listed companies must have an audit committee that satisfies the requirements under securities legislation (discussed above).[180] Listed companies must also adopt and disclose a code of business conduct and ethics for directors, officers and employees, and disclose any waivers of the code for directors or executive officers.[181]

c) U.K. Reforms

Recent amendments to U.K. company law have relaxed the provisions protecting directors and other company officers from liability.[182] The Act forms part of the U.K. government's strategy to help restore investor confidence in companies and financial markets following major corporate failures, amending provisions of the Companies Acts 1985 and 1989.[183] Under ss. 19-20 of the Act, directors may have liabilities to third parties.[184] In addition, under s. 9 of the Act, directors' reports are required to contain a statement that a director has provided an auditor with all "relevant audit information."[185] Where the required statement in a director's report is false, every director of the company who knew that the statement was false - or was reckless as to whether it was false - and failed to take reasonable steps to prevent the report from being approved, is guilty of an offence and liable to imprisonment and/or a fine.[186] Under the *Companies Act*, directors are required to prepare financial statements that provide a "true and fair" view and for those financial statements to be independently audited. Breach of this duty may give rise to liability on the part of directors.

In the U.K. context, James Kirkbride and Steve Letza use Kraakman's model to explore imposing gatekeeper liability on non-executive directors in their monitoring of executive directors, in particular the

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[180] *Ibid.* at 7-9.
[181] *Ibid.* at 15.
[182] C(AICE) Act 2004, *supra* note 60, ss. 19-20.
[183] "Explanatory Notes to Companies (Audit, Investigations and Community Enterprise) Act 2004" (2004), online: <http://www.opsi.gov.uk/acts/en2004/2004en27.htm>.
[184] C(AICE) Act 2004, *supra* note 60, ss. 19-20.
[185] *Ibid.*, s. 9, which amends pt. 7 of the *Companies Act 1985*. "Relevant audit information" means information needed by the company's auditors in connection with preparing their report.
[186] *Ibid.*

CEO.[187] Non-executive directors might serve as internal monitors of CEO behaviour because they have access to privileged information about firm operations, which is inaccessible to public enforcement officials.[188] They outline some of the problems associated with imposing gatekeeper liability, including the cost element: if gatekeepers cannot shift their liability risks, they will charge higher premiums.[189] In addition, they note the concern that the non-executive director as gatekeeper may result in a more interventionist approach in the operation of board matters and corporate affairs, which in turn may not enhance efficiency. Finally, they point out that imposing gatekeeper liability may make it difficult to persuade individuals to operate as non-executive directors.[190]

In the context of non-executive directors, Kirkbride and Letza suggest that the greatest difficulties lie in the design of gatekeepers' duties: should they be required to monitor and report to the board the potential commission of crimes or failure to comply with statutory requirements?[191] Or, should a broad concept of failure to disclose key information affecting the management and performance of a company be preferred? Furthermore, how will the courts define and measure the gatekeeping duty? The authors point out that for non-executive directors to adopt these duties, they would require access to information and skills possessed only by lawyers and accountants.[192]

d) Recommendations

<u>Recommendation #8:</u> The current regime for gatekeeper liability for directors should be reviewed following a period of at least one year of experience with the new Ontario secondary market civil liability regime.

The current Canadian gatekeeper liability regime for directors is in line with the U.S. model, but has not

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[187] James Kirkbride & Steve Letza, "Can the Non-executive Director be an Effective Gatekeeper? The Possible Development of a Legal Framework of Accountability" (2005) 13:4 Corp. Gov. 542 ["Non-executive Director"]; James Kirkbride & Steve Letza, "Corporate Governance and Gatekeeper Liability: the lessons from public authorities" (2003) 11:3 Corp. Gov. 262. The non-executive director, in the U.K. legal context, is director who is not an employee of the company and who only dictates part of his available time to the company is known as a non-executive director. Usually a person with particular experience or skills who holds a seat on the board to exercise a steadying influence on board decisions. His legal obligations to the company and creditors of skill and honesty are the same as those of an executive director (definition obtained from http://www.clickdocs.co.uk/glossary/non-executive-director.htm).
[188] Kirkbride & Letza, "Non-executive Director," *ibid.* at 544.
[189] *Ibid.*
[190] *Ibid.*
[191] *Ibid.* at 545.
[192] *Ibid.*

gone the U.K. route of attaching additional liability to the additional responsibilities now placed upon directors, and in particular independent directors, as gatekeepers. The academic literature suggests that the exact nature of the gatekeeping role that directors, including independent directors, should play remains unclear. The literature suggests that imposing increased liability on directors or only on independent directors, as gatekeepers, does not necessarily contribute to a more effective gatekeeper liability regime. The recent introduction of the secondary market civil liability scheme in Ontario presents an opportunity to evaluate the impact of increased gatekeeper liability for directors and at the same time the judiciary's role in applying such a regime. Further amendments are not recommended until this experience has been fully evaluated in the Canadian context. Following an evaluation of the current regime, further consideration should be given to attaching increased liability to the increased responsibilities placed on directors, and in particular, independent directors.

vi. Retail Investment Advisors

Retail investment advisors provide investment advice to clients and execute trades on their behalf in securities and other investment products. They stand in an agency relationship with their clients, who are often less knowledgeable and do not have the same access to information. As such, there is some degree of trust and reliance by the client on the investment advisor and the investment advisor is thereby able to act as a gatekeeper in this position.[193]

The Canadian Securities Administrators report that investment advisors top the list of complaints received by securities regulators across Canada with suitability, customer service and registration documented as common complaints.[194] Beyond these issues, investment advisors appear to be exposed to limited liability in their specific role as gatekeepers to capital markets.

a) Summary of Literature

Little academic writing was located specifically with regard to the gatekeeping role of retail investment advisors.

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[193] Gowlings Lafleur Henderson LLP, "Investment Advisors' Liability" (30 May 2001), online: <http://www.gowlings.com/resources/publicationpdfs/InvestmentAdvisorsLiability.pdf>.

[194] OSC, News Release, "Investment Adviser Practices Trigger Most Complaints to Securities Regulators" (21 January 2003), online: <http://www.osc.gov.on.ca/About/NewsReleases/2003/nr_20030121_csa-complaints.jsp>.

b) U.S. Reforms

The SEC regulates investment advisors, primarily under the *Investment Advisors Act of 1940* and the rules adopted under this statute. A person or firm that meets the definition of an "investment advisor" under the act must register with the Commission.[195] Section 202(a)(11) of the *Advisors Act* defines an investment advisor as any person or firm that for compensation, is engaged in the business of providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications.[196] Brokers or dealers whose advisory services are incidental to their conduct as brokers or dealers, and who do not receive compensation for their advisory services, are excluded from regulation under the *Advisors Act*.[197] Under s. 206 of the Act, investment advisors have an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to their clients, as well as a duty to avoid misleading them.[198]

The *Securities Exchange Act of 1934* [*Exchange Act*] governs the operation of American securities markets, brokers and dealers. Retail investment advisors fall under the definition of brokers. Most investment advisors must register with the SEC and join an SRO.[199] The National Association of Securities Dealers (NASD)[200] and the national securities exchanges qualify as SROs that investment advisors may join. An SEC-registered investment advisor must deliver to each prospective client a disclosure statement (regarding business practices, educational and business background), disclose all potential conflicts of interest between advisors and their clients, and disclose all material information

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[195] SEC, "General Information on the Regulation of Investment Advisors," online: <http://www.sec.goc/divisions/investment/iaregulation/memoia/htm> ["General Information"]. Note that smaller advisors register under state law under state securities authorities. Excluded under the operation of the Act are: domestic banks and bank holding companies; lawyers, accountants, engineers and teachers if their performance of advisory services is incidental to their professions; brokers and dealers if their performance of advisory services is solely incidental to the conduct of their business as brokers and dealers, and they do not receive any special compensation for their advisory services; publishers of bona fide newspapers, news magazines and business or financial publications of general and regular circulation; and persons and firms whose advice, analyses, or reports are related only to securities that are direct obligations of, or obligations guaranteed by, the U.S., or by certain U.S. government-sponsored corporations designated by the Secretary of the Treasury (*ibid.*).
[196] 15 U.S.C. 80b-1.
[197] *Ibid.,* s. 202(a)(11).
[198] SEC, "General Information," *supra* note 195.
[199] Section 3(a)(4)(A) of the act broadly defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others." A dealer, defined in s. 3(a)(5)(A) of the act, is "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." See SEC, "Guide to Broker-Dealer Registration" (December 2005), online: <http://www.sec.gov/divisions/marketreg/bdguide.htm>. Note that a broker-dealer who conducts all of his or her business in one state does not have to register with the SEC.
[200] The NASD oversees the activities of securities firms, registered securities professionals and the markets operated by NASDAQ.

regarding compensation.[201] Investment advisors must ensure that the statements made with respect to a security have an adequate foundation. The SEC has the power to revoke the registration of investment advisors under its control if they violate the *Exchange Act*.[202]

Investment advisors must conduct their activities in accordance with the anti-fraud provisions of the *Exchange Act*, which prohibit mis-statements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.[203] Rules and regulations guide the interpretation of the Act.[204] One of the fundamental duties of investment advisors is that of fair dealing: they must represent to their customers that they will deal fairly with them, consistent with the standards of the profession, including the duties to execute orders promptly; disclose certain material information; charge prices reasonably related to the prevailing market; and fully disclose any conflict of interest.[205]

Investment advisors also fall under the SEC's Regulation AC, discussed above, which requires that brokers, dealers and persons associated with brokers or dealers that publish, distribute or circulate research reports include in those reports a certification that the views expressed in the reports reflect those of the analyst; they must disclose whether the analyst received compensation for the views expressed in the report; and if the analyst received compensation, they must disclose the amount, source and purpose.[206] NASD members must also comply with the Rules of Fair Practice.[207]

A full-service investment advisor is obligated to recommend to a customer only those securities that match the customer's financial needs and goals (the "suitability obligation"). In the U.S., breach of the suitability obligation has grown into the most commonly alleged basis of investor recovery against investment advisors.[208] The suitability obligation forms part of the investment advisor's fiduciary duty. NASD imposes the suitability obligation on its members through the Rules of Fair Practice (Conduct Rule 2310); failure to observe suitability obligations results in a violation of investment advisor's statutory

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201 *Ibid.*

202 Susan Heinemann, "Reviewing the Current State of Government Regulation of Investment Advisors" (2004) 42 Duq. L. Rev. 113 at 119-120.

203 See ss. 9(a), 10(b), and 15(c)(1) and (2).

204 These include Rules 10b-1 through 10b-18, 15c1-1 through 15c1-9, 15c2-1 through 15c2-11, and Regulation M.

205 SEC, "Guide to Broker-Dealer Registration," *supra* note 199.

206 *Ibid.*

207 Analyst conduct is also governed by NASD Rule 2711 and Rule 472.

208 Frederick Mark Gedicks, "Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability" 37 Ariz. St. L.J. 535 at 543.

obligations to deal justly and equitably with their clients.[209] No private right of action exists for violation of NASD or exchange rules.[210]

c) U.K. Reforms

In the U.K., the FSA oversees retail investment activities.[211] Retail investment advisors fall under the market abuse provisions of the FSMA 2000 and MAD regime, discussed above in relation to analysts. Section 118 of the FSMA 2000 refers to behaviour which (1) occurs in relation to qualifying investments traded or admitted to trading on a prescribed market, and (2) falls within one or more categories of behaviour.[212] The FSMA 2000 (Regulated Activities) Order 2001 (FSMA Order 2001) prescribes specific kinds of activities and investments for the purposes of the FSMA 2000.[213] When an activity of a specified kind is carried on by way of business in relation to an investment of a specified kind, it is a "regulated activity" for the purposes of the Act. The FSMA 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 makes provision as to the circumstances in which a person is, or is not, to be regarded as carrying on a regulated activity by way of business.[214] Section 19 of the Act prohibits persons who are not authorized or exempt from carrying on any regulated activity in the U.K.. Contravention of that prohibition is a criminal offence.

Under s. 14 of the FSMA Order 2001, buying, selling, subscribing for or underwriting securities or contractually based investments as a principal or agent is a specified kind of activity.[215] Furthermore, making arrangements for another person (whether as principal or agent) to buy, sell, subscribe for or underwrite a particular investment that is a security, a contractually based investment, or an investment specified by the Act also constitutes a specified kind of activity.[216] As such, retail investment advisors would be subject to the market abuse scheme imposed by the FSMA 2000, including administrative and criminal liability for contravention of the Act.

In a 2001 review of institutional investment in the U.K., the report concluded that an incentive existed for fund managers to direct business to investment advisors to obtain additional services, rather than the most

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[209] *Ibid.* at 559.
[210] *Ibid.* at 562.
[211] Retail investment activities are: (a) advising on investments, (b) arranging deals in investments; or (c) making arrangements with a view to transactions in investments. FSA, Newsletter Police Statement 04/9 (March 2004), online: <http://www.fsa.gov.uk/pubs/policy/ps04_09_newsletter.pdf>.
[212] FSMA 2000, *supra* note 109, s. 118.
[213] FSMA 2000 (Regulated Activities Order) 2001, (S.I. 2001/544) [FSMA Order 2001].
[214] FSMA 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (S.I. 2001/1177).
[215] FSMA Order 2001, *supra* note 213, s. 14, s. 21. Note that s. 15 outlines exclusions.
[216] *Ibid.*, s. 25(1).

favourable trade execution for their customers.[217] The FSA concluded that the commission paid by fund managers to investment advisors for the execution of deals on behalf of their customers resulted in a significant cost of investment fund management.[218] In July 2005, the FSA issued final rules to confront the lack of transparency and conflicts of interest between investment managers and their relationships with investment advisors.[219]

EU Regulation

One of the main objectives of the EU-led "Markets in Financial Instruments Directive" (MiFID) is the protection of investors and the integrity of the market through a new regulatory framework governing investor transactions on exchanges, and by investment firms, and the harmonization of national supervisory rules.[220] The MiFID will provide rules on conflicts of interest and imposes transparency obligations on investment firms. Consultations to finalize the directive are currently being undertaken. The FSA reports that the MiFID is likely to apply from November 1, 2007, and its implementation will significantly alter financial services regulation in the U.K..[221] The MiFID will cover investment banks; portfolio managers; stockbrokers and broker-dealers (including investment advisors); corporate finance firms; many futures and options firms; and some commodities firms.[222] The MiFID requirements will be more extensive than existing requirements, and the FSA Handbook will be amended to reflect the new regulations. The MiFID's reach will include:

- requirements governing information about the firm and its services that must be provided to a client;
- "know your customer" suitability requirements to apply when a firm provides investment advice and portfolio management;
- changes to rules pertaining to products provided on an execution-only basis;
- changes to "best-execution" rules (an investment firm will be required to take all reasonable steps to obtain the best possible result for clients, taking into account considerations such as cost, price, speed and the likelihood of execution and settlement);

[217] FSA, "Bundled Brokerage and Soft Commission Arrangements," Consultation Paper 176 (April 2003), at 3.
[218] *Ibid.*
[219] See FSA, Bundled Brokerage and Soft Commission Arrangements: Feedback on CP05/9 and Final Rules" (July 2005), online: <http://www.fsa.gov.uk/pubs/policy/ps05_09.pdf>.
[220] Avgouleas, *supra* note 110 at 296.
[221] FSA, "Planning for MiFID" (November 2005), online: <http://www.fsa.gov.uk/pubs/international/planning_mifid.pdf> at 3.
[222] *Ibid.* at 4.

- reporting requirements to ensure that clients are promptly advised of the essential details of a transaction; and
- pre- and post-trade transparency regimes.[223]

Article 18 of the directive pertains to conflicts of interest, requiring all firms to identify conflicts of interest between themselves and their clients, or between different clients that can arise during the provision of investment services.[224] Where the management of conflicts cannot prevent the risk of damage to clients' interests, a firm must disclose the conflict before commencing business.[225] The directive also outlines general conduct of business obligations: firms must act honestly, fairly, professionally and in accordance with the best interests of their clients.[226] They must act in a way that is not misleading, providing clients with appropriate information about the firm, its services and the associated costs.[227]

d) Recommendations

<u>Recommendation #9:</u> Following consultation with industry and non-industry groups, the IDA should develop a policy similar to IDA Policy No. 11 ["Research Restrictions and Disclosure Requirements"] imposing restrictions and disclosure requirements for investment advisors with liability attached.

Recent reform efforts with respect to the liability of investment advisors in Canada have not focused on their role as corporate gatekeepers. Rather, the focus has been on putting into place consumer protection mechanisms to address power imbalances in investment advisors' relationships with customers. The evidence suggests that consumer protection issues are the most pressing concern in the Canadian context. In certain instances, there is an overlap between liability introduced for more general consumer protection purposes and liability for failure to perform a corporate gatekeeping function. However, recent U.S. and U.K. reform efforts demonstrate that similar issues arise with respect to the role of analysts and investment advisors as corporate gatekeepers and accordingly, similar gatekeeper liability regimes

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223 *Ibid.* at 8-16.
224 HM Treasury, "U.K. Implementation of the EU Markets in Financial Instruments Directive (Directive 2004/39/EC)" (December 2005), online: <http://www.hm-treasury.gov.uk/media/2EO/ukimplementationmarkets151205.pdf> at 12.
225 *Ibid.*
226 *Ibid.* at 13.
227 *Ibid.*

(specific to the role of each gatekeeper) are justified and should be put into place. To a certain extent, the corporate gatekeeping role of investment advisors in Canada has been underestimated. The IDA, as a national SRO, is ideally suited to develop and implement a parallel policy to Policy No. 11, which is specific to the role of investment advisors. In particular, like Policy No. 11, the policy for investment advisors should build on the existing requirements in securities legislation for disclosure of possible conflicts resulting from the firm's relationships to issuers and clients. The new policy should respond to issues created by relationships in the firm, in the same way as Policy No. 11 seeks to respond to relationships between analysts and investment bankers.

vii. Underwriters

An "underwriter" acts as an intermediary between the issuer and investors in the distribution of securities to the public, and is defined in s. 1(1) of the *Ontario Securities Act* (and similarly in other provincial securities statutes) as, "a person or company who, as principal, agrees to purchase securities with a view to distribution or who, as agent, offers for sale or sells securities in connection with a distribution and includes a person or company who has a direct or indirect participation in any such distribution."[228] When purchasing shares for their own account as principals, and not merely as agents for their clients, underwriters act as dealers. On the other hand, when purchasing and selling shares as intermediaries or agents for others, underwriters act as brokers. Further, underwriters provide advice to issuers about how to structure financings and how to design and price securities to be issued. As such, both issuers and investors rely on underwriters for their integrity and expertise.[229] The unique position of the underwriter as an intermediary enables it to detect misconduct of the issuing company; in particular, this position allows them to discover and compel disclosure of essential facts about the offering being made to the public.

a) Summary of Literature

In the American context, little scholarship has examined the gatekeeping function performed by underwriters. Gilson and Kraakman, in "The Mechanisms of Market Efficiency", suggest that investment banks implicitly rent their reputations as underwriters of securities, and as such underwriters are

[228] *Securities Act*, R.S.O. 1990, c. S.5, s. 1(1).
[229] Jeffrey G. MacIntosh & Christopher C. Nicholls, *Securities Law* (Toronto: Irwin Law, 2002), c. 4(B) (QL).

implicitly gatekeepers.[230] Choi singles out underwriters as one example of potential certification intermediaries: part of what underwriters sell is their ability to deliver investors willing to purchase securities from the offering, and investors, in turn, rely on the reputation of underwriters who determine how much to discount the issuer's disclosures for the risk of fraud.[231] Underwriters face strong incentives to act as certifiers; if they can provide credible assurances that an issuer's disclosures are truthful, investors will be willing to pay more for the issuer's securities.[232] The issuer will then pay more for the underwriters' certification service. Choi questions whether gatekeeper liability is warranted, suggesting that lawmakers consider aiding the underwriter certification market by bolstering the market-based incentives of intermediaries to act as certifiers (as opposed to the imposition of gatekeeper liability).[233]

In a recent article that looks at the efficacy of the "qualified independent underwriter,"[234] Royce de R. Barondes points out that investment banks acting as underwriters are not required to be independent.[235] Investment banks have both issuers and investors as clients, and therefore have conflicts of interest. The author analyzes empirical data to show that investment banks' conflicts of interest produce different kinds of IPO pricing. The results of his study demonstrate that qualified independent underwriters are not effective in eliminating pricing differences, bringing into question the NASD's proposed requirement that in each IPO, the reasonableness of the pricing be passed on by an independent broker-dealer.[236] Barondes argues that current NASD rules are not adequate to assess the extent of conflicts of interest: "Insofar as these NASD rules are considered as seeking to employ investment banks as 'gatekeepers' to make IPO pricing invariant to the existence of these conflicts of interest, they do not succeed."[237]

b) U.S. Reforms

Recent reforms in the U.S. have not focused on imposing or modifying the liability that underwriters are subject to as gatekeepers. For example, in October of 2004, the SEC proposed amendments to Regulation

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[230] Ronald J. Gilson & Reinier H. Kraakman, "The Mechanisms of Market Efficiency" 91984) 70 Va. L. Rev. 549, 620.
[231] Choi, *supra* note 8 at 962.
[232] *Ibid.*
[233] *Ibid.* at 963-964. Choi, for example, suggests information intervention by lawmakers: that is, the government could support information production in the market on underwriters' track records, or force underwriters to disclose their monitoring procedures to the SEC to ameliorate any defects arising from investors' inability to distinguish the quality of underwriters' services (*ibid.* at 964).
[234] Royce de R. Barondes, "NASD Regulation of IPO Conflicts of Interest—Does Gatekeeping Work?" (2005) 79 Tul. L. Rev. 859.
[235] *Ibid.* at 862.
[236] *Ibid.* at 898.
[237] *Ibid.* at 900-901.

M that would “prohibit certain market activities that undermine the integrity and fairness of the offering process, particularly with respect to the allocation of [IPOs].”[238] The proposed amendments would lengthen the restricted period for IPOs (the time period during which distribution participants must refrain from activity that could stimulate the market for the security in distribution); require syndicate covering bids (indicating that an underwriter is buying shares to cover its short position) to be publicly disclosed to the market; prohibit the use of penalty bids; and prohibit IPO abuses such as “tying” an allocation of shares on an agreement by the customer to buy shares in another less desirable offering, or paying excessive trading commissions on unrelated securities transactions.[239]

IPOs are also governed by the NASD: the rules seek to protect investors from overpriced IPOs when participating banks have conflicts of interest, by requiring the securities be sold at a price no higher than recommended by a qualified underwriter.[240] On September 15, 2003, the NASD filed proposed rules with the SEC to prohibit certain abuses in the allocation and distribution of shares in IPOs. The proposed rules do not focus on imposing gatekeeper liability on underwriters. Rather, they address the following recommendations made by the NYSE and NASD IPO Advisory Committee: require the lead managing underwriter to disclose indications of interest and final allocations to the issuer’s pricing committee; prohibit the acceptance of market orders to purchase shares in the aftermarket for one trading day following an IPO; and impose procedures designed to ensure that reneged IPO allocations are not used to benefit favoured clients of the underwriter. The NASD’s request for comments to the proposed rules suggested other regulatory steps to promote transparency in IPO pricing, including requiring underwriters to obtain an independent broker-dealer opinion as to the reasonableness of the pricing (and disclose this opinion in the prospectus); or including a “valuation disclosure” section in the prospectus containing information as to how the managing underwriter and issuer arrived at the initial IPO price range and final price.[241] The SEC published the comments to the NASD’s proposed rules in 2005.[242]

[238] SEC, “SEC Proposes IPO Allocation Reforms” (13 October 2004), online: <http://www.sec.gov/news/press/2004-145.htm>.
[239] *Ibid.*
[240] Rule 2720(c)(3)(a); 871.
[241] NASD, Notice to Members, “Proposed Rule Governing Allocations and Distributions of Shares in Initial Public Offerings (IPOs)” (November 2003), online: <http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_001118>.
[242] SEC, “Comments on NYSE and NASD Rulemaking,” online: <http://www.sec.gov/rules/sro/nyse200412.shtml>.

c) U.K. Reforms

The activities of underwriters fall under the FMSA 2000. Under s. 14 of the FSMA Order 2001, buying, selling, subscribing for or underwriting securities or contractually based investments as a principal or agent is a specified kind of activity.[243] As such, retail investment advisors are subject to the market abuse scheme imposed by the FSMA 2000, including administrative and criminal liability for contravention of the Act.

As part of the broader EU initiatives to harmonize market regulation, the Public Offers and Admissions Prospective Directive (2003) have created a disclosure regime for all issuers of securities in the EU. The Directive's definition of "offer(s) of securities to the public" extends to the placement of securities through financial intermediaries.[244] The prospectus must contain all the information necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profits and losses, prospects of the issuer, and of any guarantor of the rights attaching to the securities.[245] Member states are required to ensure that their laws and regulations on civil liability apply to those responsible for the information given in the prospectus.[246] On July 1, 2005, the Prospective Directive and new listing rules came into effect in the U.K.. According to consultation documents issued by the FSA, the changes planned for the U.K.'s public offers and listing regime include amending Part 6 of the FSMA 2000 to extend the relevant sections to include public offers and the admission of securities to trading on a regulated market, and to offer a new definition of "public offer" to incorporate that of the Directive.[247]

d) Recommendations

<u>Recommendation #10:</u> The academic literature and approaches to reform in the U.S. and the U.K. suggest that no reforms to the gatekeeper liability that underwriters are subject to in Canada are warranted at this time.

<u>Recommendation #11:</u> A study that reviews the disclosure that is provided under National Instrument 33-105 and evaluates the impact of the level of independence disclosed on IPO pricing should be undertaken.

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243 FSMA Order 2001, *supra* note 213, s. 14.
244 Avgouleas, *supra* note 110 at 302.
245 *Ibid.* at 303.
246 *Ibid.* "Persons responsible for drawing up the prospectus" and for auditing the financial statements are defined as directors, senior management, advisors and auditors.
247 Avgouleas, *supra* note 110 at 397-98.

The reforms introduced by National Instrument 33-105 are consistent with the recent and proposed reforms in the U.S. and the U.K. to improve the effectiveness of underwriters' role as gatekeepers. The current regime does subject underwriters to civil, administrative and criminal liability for failure to perform their gatekeeping role. However, the focus is on disclosure of conflicts, rather than enlarging the instances and possibility for gatekeeper liability. In this way, the current regime is consistent with the model that Choi advocates where underwriters are incentivized to become more independent and arguably better gatekeepers, by the market for independent certifiers. There is insufficient evidence to suggest that increasing or modifying the gatekeeper liability regime that underwriters are currently subject to will contribute to more competitive Canadian capital markets. At the same time, the time constraint issues related to fast track offerings and the implications for the ability of underwriters to conduct adequate due diligence should continue to be monitored.

A study that reviews the disclosure that is provided under National Instrument 33-105 and evaluates the impact of the level of independence disclosed on IPO pricing, in a similar manner to the Barondes study described above, would provide empirical evidence of the impact of independence on underwriters' gatekeeping role in Canada. With this evidence the question of whether increasing gatekeeper liability and/or market incentives prompted by increased disclosure requirements are the best measures for improving the effectiveness of underwriters as corporate gatekeepers may be further investigated.

5. Conclusion

This paper analyzed the effectiveness of the corporate gatekeeper liability regime in Canada. In particular, seven gatekeeper were considered, namely:

i. Auditors;
ii. Credit Rating Agencies;
iii. Financial Analysts;
iv. Lawyers;
v. Directors;
vi. Retail Investment Advisors; and
vii. Underwriters.

The objective of this paper was to provide recommendations for modernizing securities legislation and improving the competitiveness of Canadian capital markets. The analysis of the academic literature and the comparative context suggested that developing a streamlined approach to amending the gatekeeper liability scheme in Canada, which comes closer to the U.S. and the U.K. models, is not desirable. Overall, the polycentric legal environment for gatekeeper liability in Canada appears to be developing in a manner that provides gatekeepers with guidance and incentives to perform their gatekeeping function, and at the same time facilitates the competitiveness of Canadian capital markets. This paper identified areas where reforms to existing regulation may enhance these developments with respect to the particular gatekeepers under consideration.

For auditors and financial analysts, who have recently been subject to significant regulatory reforms, the recommendations seek to tweak and improve these reforms. For directors and lawyers, there does not appear to be sufficient evidence from the literature or comparative analysis to merit intervention without a period of experience with the new secondary market civil liability regime (in the case of directors), and consultation with representatives from law societies and securities commissions in the case of lawyers. In the case of credit rating agencies and retail investment advisors, which represent the least-analyzed set of corporate gatekeepers under consideration, more substantial recommendations for modernizing securities legislation are made. These recommendations, which seek to clarify and give specificity to the nature of their role and liability as gatekeepers, are made to increase the public's confidence in their role as gatekeepers and in turn to improve the competitiveness of Canadian capital markets. Finally, with respect to underwriters, the current Canadian regime, which mixes information intervention by lawmakers with some measure of gatekeeper liability, is consistent with the insights on the effectiveness of underwriters as gatekeepers found in the academic literature and with recent comparative developments in the U.S. and the U.K.. Accordingly, no modifications to the gatekeeper liability regime for underwriters are recommended at this time.

In making recommendations that fit within the existing Canadian model, where the boundaries between law and professional practice are somewhat blurred and subsystems of liability that apply to various. gatekeepers differ both from gatekeeper to gatekeeper and geographically, it became apparent that participants in the market and other members of the public may not be aware of the extent of the existing corporate gatekeeper liability regime in Canada. Awareness of the liability scheme plays a key role in developing confidence in Canadian capital markets. Accordingly, a final recommendation is made with regards to the widespread dissemination and availability of this paper and others that seek to map out the existing gatekeeper liability regime in Canada and situate it in the context of recent academic literature and reforms in comparable jurisdictions.

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