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Comment on S.M. Beck "Gatekeepers and the Commission: The Role of Professionals in the Regulatory System"

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FOREWORD

The release of this publication highlights the successful inauguration of the *Queen's Annual Business Law Symposium*. This event held in the fall of 1994 marked the beginning of an annual business law symposium to be organized by the Symposium's Executive, the Queen's Corporate Law and Investment Club and the Queen's University Faculty of Law. This symposium demonstrates the Faculty of Law's strong commitment to teaching and research in the broad area of business and corporate law.

The quality of the inaugural symposium and the papers contained in this book augurs well for the future of the *Queen's Annual Business Law Symposium*. I was delighted that so many distinguished speakers lent their presence to this event and submitted papers for publication. The annual symposium should provide a valuable opportunity for both practitioners and academics to work toward solutions to some of the more pressing problems facing the business and corporate law community.

The Queen's Faculty of Law is particularly grateful to all those who assisted in organizing the inaugural symposium. The Advisory Board provided invaluable advice all through the planning stages. We are most grateful to those firms and organizations that provided financial support to make this event possible. Particular mention must also be made of the many hours that the members of the Symposium's Planning Committee spent on this project. Their commitment to this project has been unwavering and to them must go the greatest credit for the success of the inaugural symposium.

Don Carter
Dean, Queen's University Faculty of Law

COMMENTS ON "GATEKEEPERS AND THE COMMISSION: THE ROLE OF PROFESSIONALS IN THE REGULATORY SYSTEM"

Mary G. Condon

The theme of Beck's paper is that there is a need to re-examine the issue of the accountability of professionals, particularly lawyers, who act for clients in securities-related transactions. The role of law and lawyers in securities regulation has in the past been considered from the standpoint of the influence of legal professionals and legal ideas (such as those of fairness and equity) on the content of regulation and the practices of regulators.[1] Beck's paper, however, considers the position of lawyers, not as the creators and shapers of regulation, but as objects of it.

As I read the paper, it deals with at least three aspects of the issue of lawyers' accountability: (1) the rationale for enhanced accountability of lawyers (the "why" question); (2) the appropriate parameters of such responsibility (the "for what" question); and (3) the mechanisms for accomplishing it (the "how" question). To a non-specialist in this field, the paper is a comprehensive and provocative presentation of the relevant issues. My own sense is that the most contentious aspect of it is likely to be the proposition itself, as opposed to its implementation, so it is in this area that I will concentrate my remarks.

Why?

Beck's paper advances at least two reasons for reconsidering the question of exacting more accountability from legal advisors. The first of these concerns the role of lawyers as "facilitators" of financial transactions, in the context of their on-going relationships with clients. As gatekeepers of complex

1 *See* Condon, M., *Ideas and Regulatory Practice: The Ontario Securities Commission 1945-1978*, SJD Thesis, Faculty of Law, University of Toronto, 1991 and MacIntosh, J. "The Canadian Securities Administrators' Takeover Proposals: Old Wine in Old Bottles?" (1993) 22(2) *Canadian Business Law Journal* 231.

regulatory obligations and financial opportunities, their involvement and expertise makes transactions possible.

Beck's argument here may, I think, be supported by drawing a parallel between the position of legal advisors in securities transactions and that of underwriters in a distribution of securities by prospectus. Civil liability for misrepresentation in a prospectus is currently imposed on underwriters by s.130(b) of the *Ontario Securities Act*. The accepted rationale is that investor protection objectives require the discipline of potential liability to be imposed on an independent professional involved in the prospectus process. Can a similar argument be mobilised about the situation of lawyers advising clients on mandatory disclosure requirements? Sceptics will argue that the legislature has not to date supported the proposition that legal counsel acting for issuers or underwriters in the prospectus process should be rendered liable, except in specified situations. Nevertheless, acknowledgement of the importance of the principle that independent professionals should be encouraged to take their role seriously is a separate point from the question of the form that this encouragement should take.

Second, to buttress the proposition concerning the gatekeeper role of legal advisors, Beck cites the high cost to taxpayers of past and potential regulatory failures, where professionals may be uniquely positioned to alert other parties to potential or actual wrongdoing, or indeed to prevent it taking place. The plausibility of this argument would be augmented by empirical demonstration that incidents of lack of professional responsibility have increased so as to warrant greater accountability mechanisms. Does such evidence exist? Are the regulatory failure problems perhaps limited to the financial institution area, because of factors unique to that sector (for example, a lesser role for commercial risk-taking).[2] Alternatively, is there evidence that the practice of securities law is stratified such that specific types of clients or types of transaction are especially problematic from a regulatory point of view?

More consequentially, is there any evidence that financial failure problems could be solved by increasing advisor accountability? Sceptics might again argue that, given that the ultimate objective is better-quality disclosure of information (to the market and/or regulators), a thorough analysis of the problem would require consideration of alternative strategies, for example increasing the adverse consequences for *clients* of engaging in dubious, loss-occasioning, transactions without adequate disclosure. In this respect, the current debate about civil liability for issuers misrepresenting information in non-prospectus or similar materials may be significant.

2 In this connection, the paper, at pp. 259-260, describes the additional reporting requirements imposed on professionals dealing clients regulated by the Ontario *Loan and Trust Corporations*, 1987.

It is possible to propose some reasons, additional to those identified in the paper, for revisiting the issue of legal advisor accountability. First, it should not be forgotten that the goal of maintaining and furthering investor confidence in the capital markets is now expressly within the mandate of the OSC.[3] Would the ability of the regulator to sanction legal advisors in appropriate cases produce such confidence to a greater degree than at present? This is again an empirical question, but it is at least arguable that if the case can be made about underwriters, it can equally be made about lawyers.

Relatedly, and somewhat more provocatively, there is the question of the benefits obtained by professionals from the regulatory system as it currently operates. Phillips and Zecher, in their book entitled *The SEC and the Public Interest*,[4] conducted a study of the effects of the mandatory disclosure system in the U.S. They concluded that:

> These [disclosure] programs are characterized by wealth transfers from investors and corporations for whom the cost is not great on a per capita basis to a relatively small group of processors, which includes securities lawyers, accountants, security analysts, and of course the SEC's employees. There is insufficient economic incentive by the members of the taxed groups to organize in opposition to this type of regulation.

Assuming that an empirical study would yield similar results in Canada, it could be argued that increased accountability is the regulatory price to be paid for the redistribution of wealth to professionals that is occasioned by the mandatory disclosure system.

Finally, an argument might be mounted that the ability to sanction securities lawyers is necessary to maintain institutional integrity itself. This is a more specific version of the proposition concerning the role of lawyers as facilitators of transactions. Given the task of "order maintenance" allocated to various regulatory agencies, including the OSC, their position may be analogous to that of criminal courts, where judges have the power to sanction defence lawyers in the interests of maintaining the integrity of court proceedings. This idea is discussed by Beck (at p. 255), though he seems ultimately to reject it. For one thing, to have any bite in the securities setting, the argument would have to be extended to include the integrity of the regulatory process generally, rather than being confined to the various situations in which the OSC may hold hearings pursuant to its statutory powers.

In resisting the prospect of sanctions for their role in client wrongdoing, lawyers frequently cite the importance of solicitor/client privilege. That is, to defend themselves against the possibility of sanctions, lawyers would have to reveal to regulators confidential information from the client's file. Beck

3 *Securities Amendment Act*, 1994, s. 2.

4 Phillips, S.M and J.R. Zecher, *The SEC and the Public Interest* (Cambridge, Mass.: MIT Press 1981) at 118.

disposes of this argument by pointing out that a variety of accountability mechanisms could be envisaged which would not necessarily harm the client in this regard. I would simply add that Beck's account of the action taken by the Office of Thrift Supervision in the U.S. against the law firm of Kaye, Scholer for their part in the failure of the Lincoln Savings and Loan Association suggests that professionals are willing to alert other professionals to difficulties caused by the client's activities. Thus (at 27), "Kaye, Scholer had been told by a senior partner at Arthur Anderson of the serious concerns that Anderson had with respect to Lincoln's operations and that they were "high risk clients" for a number of reasons relating to their operating strategies". It may be rebutted that accountants do not have the same privileged relationship with clients that lawyers do, but this argument is unlikely to appease the "outside" investor who has suffered financial loss as a result of only selective dissemination of information about the client.

For What?

I can deal only briefly with the arguments made in the paper concerning the appropriate *nature* of legal advisor accountability. The author looks to the work of Wilkins[5] to argue that we need to move to a more "context-sensitive" notion of accountability, and that the standards of conduct we expect should reflect the occupational tasks of securities lawyers, and the actual opportunities for wrongdoing. In his work, Wilkins suggests that the context-specific standards for thrift lawyers in the U.S. should be those of (1) independent counselling, that is, counselling with respect to the spirit as well as the technicalities of rules, and advice about the likely regulatory attitude to a transaction; (2) cooperation with regulators in collecting information, along with a prohibition on assisting clients to impede the regulator; and (3) disclosure of disputes with the client about adherence to a particular regulation, both to the client's board and to the regulator. Each of these standards reflects a different level of obligation and Wilkins'implication is that breaches of all of them could potentially attract sanctions.

In applying this analysis to securities lawyers, Beck's paper seems to favour a scenario involving the application of standards somewhere between #1 and #2 on Wilkin's scale. The proposal (at pp. 241, 262) is that liability should accrue for failure to withhold cooperation from a client who wishes to breach the terms of the Act or the regulations. What is envisaged therefore is more than an obligation on lawyers to "independently" counsel the client, but less than active professional cooperation with regulators. One effect of adopting these standards is that the regulatory obligations on lawyers, if cooperation was appropriately withheld, could be maintained within the privacy of the

5 Wilkins, D.B. "Making Context Count: Regulating Lawyers after Kaye, Scholer", [1993] 66 *Southern California Law Review* 1145.

solicitor/client relationship, without a requirement for active disclosure to regulators and the public. However, at least two unanswered questions remain as a result of pitching responsibility at this level.

(1) If investor protection and confidence are the ultimate goals, is it sufficiently likely that this level of obligation on lawyers will achieve them? The proposal is based on an assumption that the withholding of cooperation by legal counsel would have the effect of making clients change their behaviour, if investor protection results are to be achieved. Can regulators be sufficiently confident that the deterrent effect of these sanctions on lawyers will outweigh pressures in the market for legal services, such that the client will not simply find another lawyer to facilitate the transaction?

(2) Securities lawyers will need some guidelines from regulators to enable them to decide when withholding cooperation is required. Presumably the desired end result of behavioural reform by the client will not be achieved if an "independent counselling" obligation is not absorbed in the requirement to withhold cooperation. Otherwise clients would not know when and how their actions could be in breach of securities law. Will it always be clear to lawyers when further advice is fruitless and the time has come to resign from the file? Infamous Securities Commission cases like *Canadian Tire*[6] illustrate the difficulties involved in relying on ex post facto decisions to communicate understanding about regulatory objectives, if lawyers are to have responsibility for counselling clients concerning them.

How?

If the notion of context-specific standards for securities lawyers is accepted in the manner advocated by Beck, then a question arises concerning the appropriate body to be responsible for enforcing them. The primary contenders appear to be the OSC and the Law Society. At least two points can be made about this matter. One has to do with the issue of relative institutional competence. Is the Law Society likely to have adequate knowledge of the context in which securities lawyers work and their "gatekeeping" role, in order to be an effective enforcer? Would the market regulator not be better placed to engage in this task? Indeed, it is easy to see that the regulatory interests of the OSC and the Law Society might differ with respect to this matter. The Law Society would be primarily concerned with disciplining lawyers so as to prevent loss of reputation by the profession, while the OSC would regulate securities lawyers as an aspect of their role in regulating the investment process generally. On the other hand, of course, the argument can be made that self-regulation has been generally accepted as an organising principle of the Ontario securities markets. However, the statute recognises the OSC's ability to oversee the regulatory activities of recognised self-regulatory organisations. Is it too far-fetched to envisage a similar oversight function with respect to the Law Society?

6 (1987), 10 O.S.C.B 857.

Second, if battle is joined over who is to have power to discipline, it may be assumed that securities lawyers would prefer to have control residing in the Law Society. However, the current market for legal services may be such that it could be in lawyers' interests for standards to be imposed by an external regulator. In other words, externally-defined and enforced standards might create more of a "level playing field" for professionals competing for clients in the same way that information disclosure is supposed to provide a "level playing field" for investors. In any event, there is much food for thought in Mr. Beck's challenging paper, and further developments will be awaited with interest.