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Reporting Rules for U.S. and International Lawyers Under Sarbanes-Oxley: Exporting an Unfinished Product?

Lorella Nerini Dal Pezzo *

I. INTRODUCTION

By imposing on counsel “up-the-ladder”¹ reporting of corporate misconduct, the Sarbanes-Oxley Act of 2002 (SOX)² has undertaken to delineate the relationship of lawyers to their corporate clients as a function of corporate policing rather than as traditional counseling, advocating, or advising. In the private sector, even after the recent revisions, the American Bar Association (ABA) Model Rules of Professional Conduct (MRPC) R. 1.13(b) leaves to the corporate attorney the resolution of the ethical quandary regarding disclosure of known misconduct or violations of fiduciary duty up the corporate ladder: corporate counsel’s decision should be guided by the organization’s best interest and should be based on counsel’s reasonable belief.³ Section 307 of SOX and related Securities and Exchange Commission (SEC) rules, on the other hand, at least for public corporations, resolved the uncertainty: based on “credible evidence” of “material violations” of securities laws, when there is a breach of fiduciary duty or other

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¹ Senator Edwards’ vernacular, short for the expression “up the corporate ladder” which refers to the chain of responsibility and command in corporations and other business enterprises, commonly used in most cited sources discussing SOX.

² Sarbanes-Oxley Act, Pub. L. No. 107-204 (2002) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.A.).

³ Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, in ENRON CORPORATE FIASCOS AND THEIR IMPLICATIONS, 571, 583-84 (Foundation Press, 2004). After the 2003 revisions, ABA Rule 1.13 incorporates the SOX approach, albeit in permissive terms. See A.B.A. MODEL RULES OF PROF’L CONDUCT R. 1.13 (b) (2005) (“Unless the lawyer reasonably believes that it is not necessary ... the lawyer shall refer the matter to higher authority in the organization.”).

violation, the duty to report up within the organization is clear.⁴ Even though up-the-ladder reporting *per se* “does not break any new ground”⁵ and has been considered an appropriate response by corporate counsel, the SEC and the courts,⁶ and the MRPC before and after the 2003 revisions,⁷ the new rule, which makes up-the-ladder reporting a federal mandate for corporate internal and external counsel, creates an abundance of tensions and challenges going to the very core of the attorney-client relationship, some of which are reviewed in Section II.

SOX is a response to a United States (U.S.) problem of corporate governance and accountability, but its global implications did not escape domestic and international commentators and practitioners. Since 1,300 foreign corporations list securities on U.S. exchanges,⁸ a heated debate over the meaning of SOX provisions and the effect of their controversial, yet seemingly contemplated extraterritorial application ensued. After touching upon the extraterritorial reach of SOX, Section III examines the peculiar uncertainties and interpretive considerations involved in deciphering and complying with the federal reporting rules for the foreign lawyer. This Section next examines how the reporting provision may affect foreign lawyers in light of fundamental differences in general principles of law, specific foreign legislation, conflicting professional responsibility rules, corporate structure and governance, and the role of corporate lawyers within it. Lastly, this section reviews different approaches foreign countries have adopted to transition to systems of corporate governance directed at containing the

⁴ Cramton, *supra* note 3, at 585; 15 U.S.C. § 7245 (2002); 17 C.F.R. § 205.3(b) (2003) (stating that “the attorney shall report ... forthwith”); *Id.* § 205.2(e) (defining evidence of material violation to mean “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”); *Id.* § 202.2(d) (defining breach of fiduciary duty broadly as a breach arising under federal, state statute, or at common law).

⁵ Peter J. Henning, *White Collar Criminal Law in Comparative Perspective: The Sarbanes-Oxley Act of 2002: Sarbanes-Oxley Act 307 and Corporate Counsel: Who Better to Prevent Corporate Crime*, 8 BUFF. CRIM. L. REV. 323, 340 (2004).

⁶ See *S.E.C. v. Nat'l Student Marketing Corp.*, 457 F.Supp.682 (D.D.C. 1978) (denying the injunction and relying on the corporate bar to make sure that their conduct comports with the law, but stating that the attorney's silence was breach of his duty to speak and lent the appearance of legitimacy to the transaction); *In Re Carter and Johnson*, 22 S.E.C Docket 292, WL 384414 (1981) (finding that lawyers were used as a shield to protect against the pressures of the banks to get disclosure, which amounts to a perversion of the lawyer-client relationship, and that no lawyer may continue in such a situation to recommend disclosure when he knows the recommendations are not being heeded).

⁷ Before the 2003 revisions, A.B.A. MODEL RULES OF PROF'L CONDUCT R. 1.13 did not clearly establish an up-the-ladder reporting mandate as a way to deal with “known” misconduct by officers, employees or other people associated with the organization, stating only that the attorney “shall proceed as is reasonably necessary in the best interest of the organization.” A.B.A. MODEL RULES OF PROF'L CONDUCT R. 1.13 (b) (2001). The Rule then suggested that, in deciding how to proceed, the attorney consider the seriousness and consequences of the violation, the scope of representation, the responsibility and the motivation of the person, the policies of the organization, among other factors. *Id.*

⁸ Cramton, *supra* note 3, at 585.

underlying causes of the corporate scandals that have plagued most of the industrialized world, with a view to the role reserved to the corporate lawyer in the process.

Section IV, after exploring the propriety of charging the corporate lawyer—and even more so, the foreign corporate lawyer—with corporate policing duties, attempts to create a *vademecum* for the foreign corporate lawyer to steer clear of inadvertently trampling over SOX-created additional responsibilities with respect to reporting and vigilance of potential corporate wrongdoing.

In conclusion, although refining and clarifying lawyers' responsibilities and duties in corporate settings may be desirable and even necessary, it should not be regarded as a preventative remedy against future corporate fiascos. Deputizing corporate lawyers as watchdogs on behalf of a federal agency with prosecutorial authority may be appealing as a wake up call to the profession, particularly when a few of its formerly respected members fell asleep at the switch. On the other hand, lightly pondered federalization of the rules of professional conduct erodes not only client confidentiality and the foundation of the attorney–client relationship, but even more dramatically, shakes the foundation of the adversarial system by reconfiguring the balance of power between government and individual in favor of the government, a structural flaw not addressed by the SEC rules. A norm that creates multiple tensions and uncertainties for the domestic bar, while not demonstrably improving transparency of corporate governance or improving the opportunities to detect or prevent corporate misconduct, is not fit for export and should not be exported. At this point, short of creating exceptions for the foreign bar altogether, instead of retreating from the quagmire of SOX blanket applicability with SEC rules that still leave areas of confusion and uncertainty, it might be prudent to recast the federal professional responsibility rule in permissive terms, and consider it an aspirational norm—at least until tested with the domestic bar.

II. FEDERAL DEPUTIZATION: A DILEMMA FOR U.S. CORPORATE ATTORNEYS

SOX up-the-ladder reporting rules were ostensibly created to increase public accountability and transparency, and to improve corporate governance.⁹ They, however, impose on corporate counsel for corporations listed with the SEC an inquisitorial, if not prosecutorial, role they are likely not trained for and most definitively not placed on corporate payroll for, either

⁹ See Roger C. Cramton, George M. Cohen & Susan P. Koniak, Symposium, *Up the Ladder and Beyond: The New Professional Standards for Lawyers Under the Sarbanes-Oxley Act: Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 728 (2004).

as internal or external counsel.¹⁰ The SOX up-the-ladder reporting requirement (especially in its originally proposed form, including the “noisy withdrawal” later placed in abeyance), as part of the SOX’s concerted effort to restore investors’ confidence in the market, reflects the presumably widespread belief, to the extent that the expression of Congressional will can be taken as a reflection of the beliefs of the constituency, that lawyers were, to some extent, responsible for the recent spate of scandals.¹¹ Although the primary targets of the federal intervention to improve corporate governance were accountants and corporate officers, lawyers were included under the facially, not far-fetched assumption that the elaborate frauds that were perpetrated in the Enron, WorldCom, Tyco, Healthsouth, and other all too famous headline-grabbing financial disasters, could not have occurred without the lawyers’ active help or at least their acquiescence.¹²

In an ever more complex corporate world, lawyers have increasingly become an integral part of corporate decision-making and strategic planning in the business world, as opposed to serving only in the development of the purely legal aspects of individual transactions.¹³ Considering this trend, it is not surprising that Congress, while regulating executives and accountants, took an interest in defining the position, responsibility, and professional duties of a player whose importance in the corporate context is increasing and evolving. On the other hand, reacting to the unprecedented threat to the integrity of capital markets, the federal government intervened to a heretofore unthinkable extent in regulating attorneys’ professional responsibility in the business context, imposing on lawyers general watchdog duties not only regarding securities violations but also “other violations” or “breaches of fiduciary duty.”¹⁴

This Section highlights the traditional characteristics of the lawyer-client relationship as they apply to the client-corporation. The Section then examines the rules introduced by SOX that affect the practice of corporate lawyers, with particular attention to Section 307 and related SEC Rules. Further, this Section draws a comparison with MRPC, identifying conflicts between the overlapping application of SEC rules and the MRPC. Finally, the analysis identifies a sea-change in the role of the lawyer through the

¹⁰ Jason Thompson, *The Paradoxical Nature of the Sarbanes-Oxley Act as it Relates to the Practitioner Representing a Multinational Corporation*, 15 J. TRANSNAT’L L. & POL’Y 265, 269 (2006)(stating that the SEC enlisted domestic and foreign attorneys to resolve the practical difficulty of investigating whether companies are observing proper practices); see also Henning, *supra* note 5.

¹¹ Simon M. Lorne, *An Issue-Annotated Version of the SOX Rules for Lawyer Conduct*, 1464 PRAC. L. INST. 393, 402 (2005).

¹² *Id.*

¹³ See Henning, *supra* note 5, at 360 (noting that lawyers are a fact of life, especially in publicly traded corporations, that they become involved in most steps during business decisions providing advice in multiple areas of law).

¹⁴ 15 U.S.C. 7245(1) (2002).

federalization of professional responsibility standards. This change threatens the independence of the profession, and compromises the integrity of the adversarial system. At the same time, this sweeping change does little to correct the conditions that allowed corporate governance failures, while it produces several undesired and unintended consequences of its own.

A. Lawyers in the Corporate World

Lawyers work on behalf of their clients as employees, agents, or independent contractors. Like other professionals, lawyers bring to the relationship special expertise which leads clients to defer to their professional judgment and to follow their recommendations.¹⁵ However, unlike other professionals, lawyers have legal authority to make certain legal decisions, and the clout to pressure clients into accepting their advice, especially with respect to illegal or potentially illegal conduct.¹⁶ SOX has expanded the ability of lawyers, at least those “appearing and practicing” before the SEC, to persuade, force, or even override their clients by giving them power not only to withdraw, but to reveal confidential information—a more direct tool to persuade clients to act within the law or to correct illegal action, at least in public corporate settings.¹⁷

1. Confidentiality and Attorney-Client Privilege

Tensions between opposing values are not a new theme in the professional responsibility of corporate lawyers. The MRPC attempts to strike a balance between the competing values of protecting clients and protecting society. “A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted” under specific circumstances.¹⁸ At the outset, the rules of professional conduct recognize that confidentiality is at the basis of the attorney-client relationship, and endeavor to provide a framework for communication between lawyer and client based on trust and candor to allow the advocate to obtain accurate and complete information, and to enable him to provide competent assistance to resolve legal problems.¹⁹ Since the lawyer is duty-bound not to reveal information “relating to the representation” the client is “encouraged to seek legal assistance and to communicate with him fully and frankly even as to embarrassing or legally damaging subject mat-

¹⁵ Fred C. Zacharias, *Coercing Clients: Can Lawyer Gatekeeper Rules Work?* 47 B.C. L. REV. 455, 456 (2006).

¹⁶ *Id.*

¹⁷ *Id.* at 458.

¹⁸ A.B.A. MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2005).

¹⁹ *See id.*; *Id.* R. 1.6 cmt. 2; *Id.* R. 1.13; *Id.* R. 1.13; *Id.* R. 2.1; *Id.* R. 1.1; *Id.* R. 1.3.

ter.”²⁰ The lawyer needs this information to provide effective representation and to give legal advice, including advice to refrain from wrongful conduct when necessary.²¹ The client will not be able to express himself candidly if he is in fear that his advocate may turn against him.²² One scholar has compellingly, albeit critically, observed that confidentiality is treated by the bar as a constitutional norm alongside with loyalty.²³

There is, however, a tension between the client’s need for confidentiality and society’s need for transparency and accountability. Confidentiality is reinforced by the evidentiary tool of the attorney-client privilege recognized by the Supreme Court as a fundamental tenet of representation and promoting the “public interests in the observance of the law and the administration of justice.”²⁴ Society’s need for transparency and accountability is reflected in the exceptions to both the duty of confidentiality and the evidentiary protection of the attorney-client privilege which allow, or even mandate in specific circumstances, disclosure of otherwise confidential information.²⁵ As will be further discussed below, this tension has been addressed by the MRPC by means of a solution admittedly shrouded in ambiguity. However, this ambiguity is not exclusively due to the reluctance of the profession, but also is due to the recognition that a bright-line policing solution may irreparably compromise the partisan role of the advocate, while demanding of the lawyer the superhuman task of contemporaneously serving two masters with opposing interests in an adversarial system, and then offer one’s reputation to the easy attack of hindsight bias.²⁶

The importance of maintaining confidentiality, loyalty to the client, and the proper role of the lawyer in an adversarial system is not a legal profession concept that receives widespread appreciation by the uninitiated in general, much less in the corporate context; therefore, if SOX is to be taken, in a somewhat simplified view, as the expression of popular will, it is no surprise that its enactment may have given short shrift to these aspects of

²⁰ *Id.* R. 1.6 cmt. 2.

²¹ Kaveh Noorishad, *Current Development 2004-2005: The Sarbanes Oxley Act and In-House Legal Counsel: Suggestions for Viable Compliance*, 18 GEO. J. LEGAL ETHICS 1041, 1042 (Summer 2005).

²² See *Fisher v. U.S.*, 425 U.S. 391, 403 (1976) (stating that the purpose of the lawyer-client privilege is to encourage clients’ full disclosure to their lawyer, recognizing that “[a]s a practical matter, if the client knows that damaging information could more readily be obtained from the attorney following disclosure than from himself in the absence of disclosure, the client would be reluctant to confide in his lawyer and it would be difficult to obtain fully informed legal advice.”).

²³ Susan P. Koniak, *When the Hurlyburly’s Done: The Bar’s Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1244 (2003) (criticizing the fact that confidentiality shapes the interpretation of other norms of lawyer’s conduct and noting that state law requires that ethics rules be subordinate to state law, not the other way around).

²⁴ *Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981).

²⁵ A.B.A. MODEL RULES OF PROF’L CONDUCT R. 1.6(b) (2005).

²⁶ Cramton, *supra* note 3, at 587.

the profession, especially when some voices from its very ranks were airing the same concerns.²⁷ As will be further discussed below, client confidentiality is re-defined in the context of listed companies by up-the-ladder reporting rules, and by the whistleblower provision.

2. Confidentiality and the Corporation

It is important to define who the client is in the corporate context, since in a situation of confidentiality, the attorney-client privilege belongs to the client. Is it the Board of Directors, management, the shareholders, or the corporation? In *Upjohn v. United States*, the Supreme Court noted this dilemma, rejected the control group test, which would afford protection only to information flowing between top executives and corporate attorneys, and indicated that the applicability of the attorney-client privilege should be decided on a case-by-case basis.²⁸ The Court held that the privilege could apply to communication by both middle and lower level employees, arguably extending the protection of the privilege with respect to lawyer-client communication in corporations, since the corporation is an artificial creature of the law.²⁹ The MRPC takes a similar approach by clearly identifying the organization as the client, and stating that communication with employees or other “constituents” in their organizational capacity is confidential.³⁰

Similarly, § 205.3(a) specifies that attorneys representing issuers owe their duty to the issuer, meaning the organization, not to the officers or employees that the attorney normally works or interacts with.³¹ However, based on the SEC Rules, confidentiality is apparently redefined by implication to apply only to the information which lies outside of the mandatory up-the-ladder reporting.³² A paradoxical situation is thus created: the issuer, through its management, determines the scope of representation; all lawyer-client interactions are perforce with the individual executives, managers or employees, as the representatives of the corporation. In this setting at least,

²⁷ Lorne, *supra* note 11, at 403. The proposal for Federal regulation of lawyers was instigated by law professors. *Id.*; see, e.g. Koniak, *supra* note 23 (describing her contribution to the proposal by Senator Edwards and charging that the bar legal vision of what the law is “functions in the day to day life of a substantial segment of the bar to nullify state law.”).

²⁸ *Upjohn*, 449 U.S. at 389-90.

²⁹ *Id.* However, *Upjohn* is not consistently followed in state courts. See Alexander C. Black, Annotation, *What Corporate Communications are Entitled to Attorney-Client Privilege-Modern Cases*, 27 A.L.R. 5th 76 (1995).

³⁰ See A.B.A. MODEL RULES OF PROF'L CONDUCT R. 1.13 (a) (2005); *Id.* R. 1.13 cmt. 2 (specifying that the constituents of the organization are not *ipso facto* the lawyer's clients, and that the lawyer may not disclose to them information relating to the representation of the organization except as expressly or impliedly authorized to carry out the representation or otherwise permitted by the rules).

³¹ 17 C.F.R. § 205.3(a) (2003).

³² See *id.* §205.3(b)(1) (clarifying that the act of up the ladder reporting does not constitute revealing clients confidences or secrets or otherwise protected information).

the sacrosanct confidentiality norm is reduced to little more than an empty shell. While the line of demarcation between the corporation and senior management may seem clear, in practice it blurs.³³ Indeed, it blurs even as it relates to in-house counsel and senior management, against whom the attorney is expected to turn in, carrying out his duty to report up-the-ladder the very group or individual who most likely hired him, to whom he may report daily, and from whom he receives his compensation check.³⁴ The question, therefore, is how many attorneys are willing to risk their jobs or lose face with the Board based on the belief, even though founded on credible evidence and satisfying a reasonable likelihood standard (as further explored below), that a violation has been committed, or even less concretely, may be about to be committed?³⁵ In practice, the first time the in-house attorney or the outside attorney report up the corporate ladder is likely to be the last.³⁶ Conversely, in the context of the corporation, up-the-ladder reporting is considered to be completely consistent with client confidentiality in that it appraises the decision-makers of the need to take internal corrective action.³⁷

3. Corporate Lawyer-Counselor

The corporate lawyer is not merely a transaction engineer,³⁸ but retains his role of advisor as expressed in MRPC R. 2.1.³⁹ The lawyer “shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law, but to other considerations such as moral, economic, social and political factors that may be relevant to the client’s situation.”⁴⁰ The attorney is therefore urged to provide the client more than the narrow legal terms,⁴¹ to offer perspective on the implication of a course of conduct, to help the client clarify his objectives by weighing the short term advantages against the long term costs of a proposed course of action.⁴² In his role as advisor, the lawyer is expected to offer straightforward legal advice even when it goes against what the client

³³ Noorishad, *supra* note 21, at 1045.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at 1051.

³⁷ Timothy P. Glynn, Symposium, *Federal Privileges in the 21st Century: One Privilege to Rule them All? Some Post Sarbanes-Oxley and Other Reflections on a Federally Codified Attorney-Client Privilege*, 38 LOY. L.A. L. REV. 597, 611-12 (2004) (opining that even noisy withdrawal would not discourage candor promoted by attorney-client privilege and would not significantly expand existing withdrawal obligations).

³⁸ Thomas G. Bost, *Corporate Lawyers After the Big Quake: The Conceptual Fault Line in the Professional Duty of Confidentiality*, 19 GEO. J. LEGAL ETHICS 1089, 1137 (2006).

³⁹ A.B.A. MODEL RULES OF PROF’L CONDUCT R. 2.1 (2005).

⁴⁰ *Id.*

⁴¹ *See id.* R. 2.1 cmt. 2.

⁴² Bost, *supra* note 38.

wants to hear.⁴³ Giving legal advice *perforce* engages a moral discourse, since ethical and moral considerations are always involved in discussing rights, duties, and the consequences of one's conduct vis-à-vis third parties.⁴⁴ In a somewhat idealized and slightly anachronistic picture of the attorney-client relationship, they each depend and rely on one another for honesty and candor to develop, in conjunction, the right solution, not only in terms of being prudent and wise in the specific situation, but also in the sense of being morally and ethically correct.⁴⁵ Even in less than ideal situations, in exercising the function of counselor, the lawyer most likely will and should engage in moral discourse, which presumes a system of values and beliefs, to a large extent shared by lawyer and client, that the lawyer can draw upon to steer the client in the morally correct direction.

Many agree that, whether the lawyers were victims, bystanders or knowing agents, at the center of the corporate scandals that spurred the federal professional responsibility intervention, there was a general failure of moral compass.⁴⁶ The question is whether it is even plausible to posit that the Federal rules can succeed by fiat, where the existing rules have arguably not measured up, in the mission of ultimately changing the behavior of corporations to conform to the federal ideal of corporate morality using lawyers as their roving investigation and enforcement tools.

4. SOX for Lawyers: Up-the-Ladder Reporting

Several provisions of SOX may affect lawyers in corporate settings. For example, Section 303 makes it unlawful "for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently . . . mislead any independent public or certified accountant . . . for the purpose of rendering such financial statements materially misleading."⁴⁷ Another provision of SOX affecting lawyers is Section 806, which provides whistle-blower protection for fraud-related communi-

⁴³ A.B.A. MODEL RULES OF PROF'L CONDUCT R. 2.1 cmt. 1 (2005) (specifying that the attorney "should not be deterred from giving candid advice by the prospect that . . . [it] will be unpalatable to the client.").

⁴⁴ *Id.* R. 2.1 cmt. 2 ("It is proper for a lawyer to refer to moral and ethical considerations in giving advice.").

⁴⁵ Bost, *supra* note 38, at 1138. For a skeptical perspective on the relationship between lawyer and client in practice, see Cramton, Cohen & Koniak, *supra* note 9, at 815 (noting that the notions of trust and candor in the lawyer-client relationship is surrounded by a great deal of romanticism while studies reveal mistrust and suspicion where clients are unwilling to reveal sensitive and embarrassing facts).

⁴⁶ Bost, *supra* note 38 at 1139.

⁴⁷ Pub. L. No. 107-204, 116 Stat. 745, §303 (2002).

cation by an employee of a public corporation, which presumably applies also to those employees who are lawyers.⁴⁸

However, Section 307, the provision specifically directed at the corporate bar, has generated the biggest reaction by the profession. Section 307 directs the SEC to set minimum standards of professional conduct for attorneys representing issuers before it.⁴⁹ It requires attorneys to report evidence of material violations of securities law, breaches of fiduciary duty, and similar violations to the Chief Legal Officer (CLO) or to the Chief Executive Officer (CEO) of the issuer, and to report to the audit committee if the CLO or the CEO fails to respond.⁵⁰ Section 307 and SEC Rule 205 place attorneys “appearing and practicing” in front of the SEC “in representation of an issuer” within the purview of the SEC’s own rules of professional conduct.⁵¹ An attorney is considered to be “appearing and practicing” before the SEC when he transacts any business with the SEC; represents an issuer in an administrative proceeding or in connection with any SEC investigation, inquiry, information request, or subpoena; or gives advice on securities laws or Commission rules on any document, information or statement he knows will be filed with the SEC.⁵²

Attorneys who engage in the conducts indicated outside the context of providing legal services to an issuer with whom they have an attorney-client relationship, and “non-appearing” foreign attorneys are exempted.⁵³ Commentators have concluded that the provision has a broad reach covering inside and outside counsel, both domestic and foreign.⁵⁴ Attorneys serving in legal departments (even those working in a non-public subsidiary of a

⁴⁸ Pub. L. No. 107-204, 116 Stat. 745, §806 (2002) (stating that “no public company . . . may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee (1) to provide information, cause information to be provided, or otherwise assist in the investigation which the employee reasonably believes constitutes a violation of . . . any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by (A) a Federal, regulatory or law enforcement agency; (B) any member of Congress or any Committee of Congress; or (C) a person with supervisory authority over the employee or such other person working for the employer who has the authority to investigate, discover or terminate misconduct; or (2) to file, cause to be filed, testify, participate in , or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation . . .”).

⁴⁹ 15 U.S.C. § 7245 (2002).

⁵⁰ *Id.*

⁵¹ See 17 C.F.R. § 205.1 (2003) (indicating that the standards supplement existing applicable standards of professional conduct where the attorney practices, and do not limit the ability of any jurisdiction to impose additional obligations—albeit in conformity with the rules—but specifying that “[w]here the standards of a state or other United States jurisdiction . . . conflict with this part, this part shall govern.”).

⁵² See *id.* § 205.2(a)(1).

⁵³ *Id.* § 205.2(a)(2)(i) and (ii) (2002); *Id.* § 205.2(j) (defining foreign attorneys).

⁵⁴ J. Curtis Greene, Note, *New Regulations for Lawyers: The SEC Final Rule for Professional Conduct in the Wake of Sarbanes Oxley: Challenges for Foreign Attorneys*, 14 IND. INT’L & COMP. L. REV. 807, 829 (2004).

public company) of an issuer or providing legal services in the context of an attorney-client relationship are included in the purview of the rules, but attorneys employed by a public company in a non-legal capacity are not.⁵⁵ It is noteworthy that an attorney-client relationship can be found even though there is no retainer or agreement for the provision of legal services.⁵⁶ However, employees of an issuer who, even though they may be licensed attorneys, are not engaged as such but employed in different capacities, such as compliance officer, business development executive, or employee benefit administrator, are not subject to the rules.⁵⁷

The attorney who becomes aware of credible evidence of a material violation,⁵⁸ defined as a violation of “applicable United States Federal or state securities law, a material breach of fiduciary duty arising under United States Federal or state law or a similar violation of United States Federal or state law” committed by an officer, director or employee of the issuer, is required to report such evidence to the issuer CLO or CEO.⁵⁹ A violation of foreign law does not constitute a material violation under the Act.⁶⁰ Evidence includes only 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.”⁶¹ The determination of whether there is sufficient evidence to support a finding that a material violation has occurred or is about to occur is fact sensitive, involving the attorney’s skills, background, previous contacts and experience with the particular client, the time limitations under which he is working, and the availability of additional counsel for consultation.⁶² Therefore, mandatory reporting up the corporate ladder, as indicated by the expression “reasonably likely,” is triggered only when the attorney, in weighing the evidence available to him, concludes that it is more likely than not that a violation has occurred, is occurring, or is about to occur.⁶³ The trigger to instigate reporting within the ranks of the client corporation, and to encourage consideration of the conduct thus identified within the organization is relatively low.⁶⁴ The rules indicate that, in performing “up-the-ladder reporting,” the attorney “does not reveal client confidences or secrets or privileged or otherwise protected

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ Stanley Keller, *SEC’s Attorney Professional Conduct Rules*, THE PRACTITIONER’S GUIDE TO THE SARBANES-OXLEY ACT, Vol. 2, Section III 1, 3 (2004).

⁵⁸ 15 U.S.C. § 7245 (2002).

⁵⁹ 17 C.F.R. § 205.3(b)(1) (2003); *Id.* § 205.2(i).

⁶⁰ Keller, *supra* note 57, at 5.

⁶¹ 17 C.F.R. § 205.2(e) (2003); Keller, *supra* note 57, at 5.

⁶² Greene, *supra* note 54, at 836.

⁶³ *Id.*

⁶⁴ Keller, *supra* note 57, at 5.

information related to the attorney's representation of an issuer."⁶⁵ Once subject to the rules, it is not necessary that the information be obtained in connection to the representation or that the information relates to the representation, for the duty to report to be triggered, but time-wise, the duty to report is likely to be considered at an end when the representation ends.⁶⁶

Reporting to the CLO, in turn, triggers an obligation on her part to make a reasonable inquiry into the evidence to determine whether a violation is occurring, has occurred, or is about to occur.⁶⁷ The CLO must then report back to the attorney if she concludes in the negative, or cause the issuer to take all reasonable steps to adopt an "appropriate response," including remedial measures or sanctions to stop or prevent the violation, if she concludes in the positive.⁶⁸ Last, the CLO must advise the reporting attorney of the issuer's response.⁶⁹ If the CLO fails to provide an appropriate response to the reported violation within a reasonable time, the attorney is required to report up-the-ladder to the issuer audit committee or other committee of independent directors or to the full Board of Directors (BOD).⁷⁰ The attorney could also bypass the CLO and go directly above her if he believes that it would be futile to report below.⁷¹

Once he receives an appropriate and timely response to his report, the attorney is in compliance with the reporting requirements of the rule.⁷² If he is not satisfied with the response received from the CLO, the attorney must explain his reasons.⁷³ The debate is open as to the meaning of appropriate response, even though the rules provide some guidance.⁷⁴ The debate is likewise open regarding what constitutes reasonable time for the response to be provided,⁷⁵ as well as what exactly is the obligation of the attorney

⁶⁵ 17 C.F.R. § 205.3(b)(1) (2003).

⁶⁶ Keller, *supra* note 57, at 5.

⁶⁷ 17 C.F.R. § 205.3(b)(2) (2003).

⁶⁸ *Id.*

⁶⁹ *Id.* (the rule makes the CLO responsible to adopt all appropriate steps to cause the issuer to undertake an appropriate response).

⁷⁰ *Id.* § 205.3(b)(4).

⁷¹ *Id.* (bypassing reporting under §205(b)(1), the report to the CLO and CFO, and mandating reporting by the attorney directly to the BOD audit committee, or if the issuer does not have an audit committee, directly to the BOD).

⁷² *Id.* § 205.3(b)(8) (the attorney who receives an appropriate and timely response "need do nothing more . . . with respect to his or her report").

⁷³ *Id.* § 205.3(b)(9) (the attorney who is not satisfied with the response must explain his reasons for dissatisfaction to the CLO, CEO or Board of Directors).

⁷⁴ See *id.* § 205.2(b); See Keller, *supra* note 57, at 7 (stating that appropriate response, one of the most difficult concepts, should cause the attorney to form the reasonable belief that (i) no material violation has occurred, is ongoing or about to occur; (ii) the issuer has taken appropriate remedial measure, or (iii) the issuer has directed an attorney to review the evidence and has substantially implemented recommendations made, or has advised the attorney that a colorable defense can be asserted. The attorney's determination as to whether the response was in fact appropriate has to be reasonable in light of the circumstances.).

⁷⁵ See 17 C.F.R. § 205.3(b)(3) (2003).

who is not satisfied after he has reached the end of the ladder for internal reporting, besides the mere explanation of his reasons indicated by the rules.⁷⁶ In practical terms, after reporting, the lawyer may not face this thorny dilemma, as he is likely to have been eliminated from the issuer's payroll or any retainer agreement may come to an abrupt end.

In addition, as under MRPC, the attorney is allowed to reveal without the consent of the client corporation confidential information relating to the representation, to the extent that he believes it is necessary, in three instances:

- 1) in connection with an investigation or with litigation where the attorney's compliance with the rules is at issue (referred to as the "self defense" disclosure); or
- 2) to the SEC, where the attorney reasonably believes disclosure would prevent the client from committing a material violation likely to cause substantial injury to the financial interests or property of the issuer or investors or an illegal act; or
- 3) to rectify the consequences of a material violation to further which the attorney's services were used.⁷⁷

5. ABA Rules and State Rules

The ABA MRPC that the states use as guidance for their own rules of professional conduct, even after the recent changes, adopts a fundamentally different approach to the issue of client confidentiality and the attorney's duty regarding client confidences. As noted above,⁷⁸ a fundamental principle in the attorney-client relationship is that the lawyer must not reveal information relating to the representation unless the client gives informed consent.⁷⁹ Even when the MRPC recognizes situations where confidentiality may have to be breached, most of the time the choice is left to the lawyer.

Most provisions, such as the crime-fraud exception, center on permissiveness. "A lawyer may reveal information relating to the representation to the extent the lawyer reasonably believes necessary . . . to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another" ⁸⁰ In addition, pursuant to MRPC R. 1.2,

⁷⁶ After the originally proposed "noisy withdrawal" was not adopted, and reporting to the SEC or others is worded permissively. *See id.* § 205.3(b)(9) and (10) (whistleblower protection provision).

⁷⁷ *Id.* § 205.3(d)(1)-(2).

⁷⁸ *See Keller supra* note 57 at Section II. A.1.

⁷⁹ A.B.A. MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 2 (2005).

⁸⁰ *Id.* R. 1.6 (b)(2).

“[a] lawyer shall not counsel a client to engage, or assist a client in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with the client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.”⁸¹

However, a lawyer does not become party to a criminal or fraudulent course of action solely based on the fact that a client may use his advice to further her criminal purposes. The MRPC recognizes the critical difference between providing legal analysis of a proposed conduct and providing the means by which it can be committed with impunity.⁸²

On the other hand, the rules provide more definitive guidance for the lawyer when he discovers the client is engaged in ongoing fraudulent or criminal activity. The lawyer “shall withdraw” if “representation will result in violation of the rules of professional conduct or other law.”⁸³ However, the lawyer “may withdraw” for good cause, some examples of which include situations where the client persists in a course of conduct “involving the lawyer’s services that the lawyer reasonably believes is criminal or fraudulent;”⁸⁴ or where “the client has used the lawyer’s services that the lawyer reasonably believes is criminal or fraudulent.”⁸⁵ Notably, the lawyer’s mandatory withdrawal duty is only triggered in extreme cases, for example, if the client demands that the attorney engage in illegal or unethical conduct,⁸⁶ a situation that, although possible, is likely to rarely present itself so blatantly. The permissiveness standard of MRPC R. 1.16(b) provides that the option to withdraw is only available if it can be accomplished without “material adverse effect” to the client.⁸⁷

Also applicable is MRPC R. 1.13 which, in the context of the organizational client relationship, establishes that, if the lawyer knows that an officer or employee is engaged in illegal action, he shall proceed in the best interest of the organization.⁸⁸ The rule was modified after SOX to harmonize with federal requirements, or to restate the federal requirement in terms conforming to the general regulatory framework of the MRPC. Here, the obligation of up-the-ladder reporting, although established in positive seemingly mandatory terms, leaves it up to the lawyer to determine whether it is necessary to do so, and whether it is in the best interest of the organiza-

⁸¹ *Id.* R. 1.2 (d).

⁸² *Id.* R. 1.2 cmt. 9.

⁸³ *Id.* R. 1.16 (a)(1).

⁸⁴ *Id.* R. 1.16 (b)(2).

⁸⁵ A.B.A. MODEL RULES OF PROF’L CONDUCT R. 1.16 (b)(3).

⁸⁶ *Id.* R. 1.16 cmt. 2.

⁸⁷ *Id.* R. 1.16 cmt. 7.

⁸⁸ *Id.* R. 1.13 (b) (the lawyer “shall report” unless he reasonably believes it not necessary).

tion.⁸⁹ Likewise, the choice of whether the lawyer should report out information relating to the representation, when the highest authority in the organization insists upon a course of action that is clearly in violation of the law and reasonably certain to cause substantial injury to the organization, is left with the attorney if and to the extent that he believes it necessary.⁹⁰

The ABA rules in this area have been criticized as lacking substance and not being adequately enforced.⁹¹ Conversely, after the 2003 revisions, they have also been criticized for eroding the foundation of attorney-client confidentiality by expanding the exceptions to its protective advocacy cocoon, and by forcing the lawyer to take into account with heightened awareness the financial interests of third parties in deciding whether to report client confidences.⁹²

The MRPC is adopted by each state only to the extent that the rules are found persuasive. Even after SOX and the 2003 MRPC revisions, to date there is substantial diversity among the rules adopted by the states on the importance of confidentiality, reflecting different judgments as to the proper balance to be maintained between the trust-inducing confidentiality rules, and the obligations of lawyers to third parties reflected in an almost even split between jurisdictions that mandate or permit disclosure, and jurisdictions that prohibit it.⁹³

6. Uneasy Coexistence of Federal and State Professional Conduct Rules

When SOX was enacted, the domestic bar was outraged by the federal intervention in a traditionally state regulated subject matter.⁹⁴ There was concern about the creation of additional conflicting standards governing lawyers inherent in the intervention of a different regulatory body. There was the sentiment that, with respect to regulating lawyers, SOX opened a Pandora's box. There was preoccupation with overlapping norms emanating from federal and state levels. There were misgivings over inviting trespassers into the traditional domain of the ABA.⁹⁵ Indeed, Section 307 and related SEC rules delineate norms of conduct piece-meal, with little regard to how the rules integrate with a body of law, that has been evolving and refining for decades, tending towards a basis of national uniformity, while allowing the states to experiment and express their judgment regarding how

⁸⁹ See *id.* R. 1.13 (b).

⁹⁰ *Id.* R. 1.13 (c) (1)-(2).

⁹¹ Greene, *supra* note 54, at 820-22.

⁹² Bost, *supra* note 38, at 1140-42.

⁹³ *Id.* at 1125-26.

⁹⁴ See Henning, *supra* note 5, at 345.

⁹⁵ Chi Soo Kim & Elisabeth Lafitte, *The Potential Effects of SEC Regulation of Attorney Conduct Under the Sarbanes-Oxley Act*, 16 GEO. J. LEGAL ETHICS 707, 708-09 (2003).

the local bar should conduct itself vis-à-vis their clients, and in general, as professionals in the law.

However, with the SEC final rules, some of the outrage subsided because the rules—at least on their face, pending authoritative interpretation by the Division of Enforcement—have mediated some of the most troublesome issues raised by the federal intervention. First, by defining a new category, the “attorney appearing and practicing” before the SEC, the rules have arguably limited their reach to those members of the bar who satisfy those requirements, and subjected only that subset of attorneys to their purview.⁹⁶ Some commentators have gone so far as characterizing the rules, after the “fall” of the “noisy withdrawal” or “dirty withdrawal” as “substantially inoffensive.”⁹⁷ Second, the lamented inconsistencies between state rules and federal rules, although most certainly not eliminated, especially in light of the inter-jurisdictional variations mentioned above,⁹⁸ have been lessened by conflict resolution provisions that, at least with regards to discipline and sanctions or other liability under state rules of professional conduct, exempt the “appearing and practicing” lawyer from the impossible task of following conflicting mandates between the SEC and his state bar.⁹⁹ Third, the same conflict as it pertains to foreign attorneys has been resolved in the opposite manner, i.e. by exempting foreign attorneys from following SEC rules when prohibited by applicable foreign law.¹⁰⁰

However, on the negative side, unlike state bar rules of professional responsibility, mainly because the SEC rules are federal and their enforcement is not likely to mirror their state counterparts, some commentators have predicted that they are likely to have their principal effect, not by influencing the behavior of lawyers, but by creating the principles under which the appearing and practicing lawyers will be subjected to SEC sanctions.¹⁰¹ In other words, the main thrust of the federal rules would be negative rather than positive and constructive, and premised, not on the facts as understood or anticipated by the lawyer, but as they later unravel,¹⁰² inevitably giving in to hindsight bias. In addition, according to some, the SEC

⁹⁶ 17 C.F.R. § 205.1 and 205.2 (2003).

⁹⁷ Lorne, *supra* note 11. However, the fall of the noisy withdrawal rule could be a premature conclusion, since reportedly the SEC is taking a wait and see approach on its introduction. *Id.*; see Sue Reisinger, *Securities Law: At the Revolution*, CORPORATE COUNSEL Vol. 6 Issue 03 (March 2006) available at <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1140689110891> (last visited Mar. 25, 2008).

⁹⁸ See *supra* Section II.A.5.

⁹⁹ See 17 C.F.R. § 205.6(c) (2003) (compliance in good faith to the SEC rules shall not subject the attorney to discipline under inconsistent rules of the state bar where he is admitted to practice).

¹⁰⁰ *Id.* § 205.6(d).

¹⁰¹ Lorne, *supra* note 11.

¹⁰² *Id.*

rules in their definitional precision would exceed the scope permitted by SOX.¹⁰³

Furthermore, areas of direct conflict between MRPC and SEC rules still persist, and not on minor points. For example, while MRPC R. 1.6 states that the attorney shall not reveal any information pertaining to client representation without prior client permission, derogating only in the case of the crime fraud exception,¹⁰⁴ the SOX up-the-ladder reporting rules require just the opposite, establishing that up-the-ladder reporting does not constitute violation of clients' confidences.¹⁰⁵ Of course, the SEC rules give a way out to the "appearing and practicing" attorneys and support compliance with SOX by establishing that compliance can be used as a defense in case the attorney is reported to the disciplinary board of the state where he practices.¹⁰⁶ The reporting attorney, therefore, most likely violates the rules of ethics he vowed to uphold as the price to pay for not violating the SEC rules where the penalties are extremely severe.¹⁰⁷

Indeed, the non-complying "appearing and practicing" attorney is subject to civil penalties as well as SEC remedies available under securities laws, including civil injunction, monetary penalties, and cease and desist orders.¹⁰⁸ Attorneys are also subject to discipline and potential suspension under the SEC rules of practice, but not to criminal liability for the violation of the duty to report.¹⁰⁹ The professional responsibility rules subject the individual attorney to liability, but should not subject his firm to liability; however, the SEC could sanction the law firm or the company that employs the lawyer on other bases.¹¹⁰ In fact, a willful violation of SOX, or any rules enacted under it, is punishable with maximum prison sentences of twenty years and maximum fines of \$5 million for a natural person, and up to \$25 million for a business.¹¹¹

B. Is Mandatory Up-the-Ladder Reporting the Solution?

Many experts, after a critical analysis of the Enron debacle, believe that it would be fallacious to expect that that a set of rules would be sufficient to correct the underlying causes of financial disasters resting on an

¹⁰³ *Id.* at 399.

¹⁰⁴ Thompson, *supra* note 10, at 268; MRPC R. 1.6 limits the disclosure "to the extent that the lawyer reasonably believes it is necessary to prevent a client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm." A.B.A MODEL RULES OF PROF'L CONDUCT R. 1.6 (2005).

¹⁰⁵ 17 C.F.R. § 205.3(b)(1) (2003).

¹⁰⁶ Thompson, *supra* note 10; 17 C.F.R. § 205.6(c) (2003).

¹⁰⁷ Thompson, *supra* note 10, at 268-69.

¹⁰⁸ Keller, *supra* note 57, at 11.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ Thompson, *supra* note 10; 15 U.S.C. § 78j-o, 7210 (2002).

entrenched culture of cavalier practices and corporate incentives that encourage or permit deception and fraud.¹¹² Commentators have posited that it is likely the new rules will not have a meaningful impact on the behavior of corporate lawyers.¹¹³ For example, Jeffrey Garten, Dean of the Yale School of Management, has warned against the creation of an audit mentality based on the illusion that enough rules, and literal compliance with them, will make up for structural deficiencies in corporate governance.¹¹⁴ Many have suggested that, instead of federal rules, a starting point to reassess the role of the lawyer in corporate governance should be to do away with conditions endemic to the corporate world, such as personal competitiveness or the premium placed on expediency and flexibility that, although not unethical per se, may compromise the basis for independent professional judgment of counsel.¹¹⁵ But the interventions needed to bring about these types of shifts may be daunting, expensive, operate on the long term, and are not as immediately visible as a set of federal rules.

Noting that lawyers normally try to stay away from fraud, alternative explanations of the corporate debacles have been proposed that take the focus away from the lawyer's professional practice, allegedly at the service of schemes to defraud investors, positing that some members of the bar may be as susceptible as sophisticated investors, analysts, and other employees to be fooled by skilled perpetrators.¹¹⁶ "Perpetrators of large scale fraud succeed because they are good at it."¹¹⁷ Inevitably, when the fraud is uncovered, investigation will reveal signals that, in hindsight, may appear so clear that they should have been identified earlier on,¹¹⁸ especially, so the reasoning goes, by the lawyer who is charged with knowledge of the difference between legal and illegal conduct.

Others have welcomed the coherent set of coordinated reforms heralded by SOX and followed by Sentencing Guidelines and by amendments to the MRPC. All share a similar approach, that of relying on lawyers as the eyes and ears of government to monitor corporate malfeasance and to create

¹¹² *Contra*, William H. Simon, *Wrongs of Ignorance and Ambiguity: Lawyer Responsibility for Collective Misconduct*, 22 YALE J. ON REG. 1, 35 (2005) (concluding that the rules "undercut the attractiveness of deliberate ignorance and calculated ambiguity" and continue the trend of increasing legal pressures towards "duties of inquiry and articulation" exemplified by the federal courts imposition of criminal liability in situations of "conscious avoidance").

¹¹³ Lorne, *supra* note 11, at 400.

¹¹⁴ Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics, and Enron*, in ENRON CORPORATE FIASCOS AND THEIR IMPLICATIONS, 625, 641 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

¹¹⁵ *Id.*; see, e.g., Mark A. Sargent, *Lawyers in the Moral Maze*, 49 VILL. L. REV. 867, 867-68 (2004) (positing that "the problem of lawyer complicity, active or passive, in managerial wrongdoing may be rooted in a socially determined moral obtuseness shared by too many corporate managers and corporate lawyers" so deeply embedded in the social context that rules may affect it only marginally).

¹¹⁶ Lorne, *supra* note 11, at 401.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

a more transparent, ethical corporate environment to restore the confidence of the investing marketplace.¹¹⁹ Some consider promising the fact that the reforms enlist the insiders of the organization, who are the repositories of information, and use stiff penalties to help them overcome the gut wrenching moral and social challenges involved in turning in friends. At the same time, these reforms elevate corporate wrongdoing to the top of prosecutorial agendas, sensitizing the public and potentially, in the long run, bringing about a change in norms of behavior in the business world.¹²⁰

Other commentators have characterized the provisions addressed specifically to the lawyers as largely aspirational.¹²¹ Even though the quest to enlist the support of corporate attorneys to help the cause of preventing corporate crime may have been admirable in its purpose, it was viewed as ill-conceived in its means, and generated a vituperative response from the bar,¹²² as opposed to the hoped for compliance and the ultimate change in behavior of lawyers and clients. These critics maintain it was a mistake to introduce the idea of the lawyer as gatekeeper and attempt to impose a harsh rule that compounded “noise” with “withdrawal” impinging so deeply on confidentiality, the basic tenet of client representation, to then fall short of even imposing withdrawal in case of failure of the client corporation to take appropriate action.¹²³ Mandatory withdrawal, it is argued, could have been a potent tool in preventing misconduct, and in sending a signal to the corporation and other lawyers that the entity stands on shaky ground.¹²⁴ In fact, every time a corporation would have to secure a new attorney after the withdrawal of the predecessor, the causes of such a drastic act would be disclosed and investigated, potentially providing new counsel leverage for the client to accede to his compliance demands.¹²⁵ While lawyers may have played a part in corporate scandals, it is not certain whether many of them were at the center of the problem or could have averted it.¹²⁶ In either case, according to these voices, a better conceived rule would be one that simply withholds the tools for the commission of wrongdoing when all else fails, while falling short of reporting out.¹²⁷

¹¹⁹ See Pamela H. Bucy, Symposium, *White Collar Criminal Law in Comparative Perspective: The Sarbanes-Oxley Act of 2002: “Carrots and Sticks”: Post Enron Regulatory Initiatives*, 8 BUFF. CRIM. L. REV. 277, 306 (2004).

¹²⁰ *Id.* at 314-15.

¹²¹ Henning, *supra* note 5, at 324.

¹²² *Id.* at 325.

¹²³ *Id.* at 325-26.

¹²⁴ *Id.* at 326.

¹²⁵ *Id.* at 326-27.

¹²⁶ Henning, *supra* note 5, at 328. However, examples where the attorney was the linchpin of scandals include Parmalat S.p.A., where Gian Paolo Zini, the company’s long-term outside counsel, was one of the architects of the fictitious transactions that led to its precipitous bankruptcy and to ruinous losses to its investors. *Id.*

¹²⁷ *Id.* at 328-29.

Other commentators have emphasized that when it comes to gate-keeping rules, allowing jurisdictional experimentation may be a better solution than imposing the same standard across multiple jurisdictions either condoning or outright condemning experimentation and its learning opportunities.¹²⁸ The tradeoff is between promoting unimpeded flow of information to the gatekeepers through confidentiality rules which may discourage adequate response to risk, and promoting adequate response to risk through mandatory reporting up, withdrawal, or reporting out, which may cut off the flow of information necessary for risk evaluation.¹²⁹ Better solutions would probably emerge from experimentation in each jurisdiction, which allows for faster and more focused reaction to outcomes as well as jurisdictional competition, regarded as a central component of institutional design.¹³⁰ Considering the initial thrust of the proposed rules (including “noisy withdrawal” and a broad jurisdictional reach) and the subsequent retreat, it is unlikely that the SEC would aggressively pursue observance by foreign attorneys.¹³¹

Still other voices noted that the SEC has been relatively lenient with lawyers as compared to accountants and executives, and attributed the marked difference in treatment to the recognition that lawyers must still fulfill their obligation of zealous advocacy in favor of their client.¹³² Lawyers, therefore maintain a position quite apart from accountants whose role entails third party scrutiny of their client financial records.¹³³ Also, the difference in treatment can be attributed to the fact that, traditionally, attorneys have long-established, strong self-governing bodies committed to creating, refining, and enforcing ethical standards with what many regard as a good measure of success.¹³⁴ This commitment is evidenced by the enactment of professional standards since the 19th Century, followed by the ABA Canons of Professional Ethics, and eventually by the MRPC, which provides the basis of each state disciplinary code and rules of professional responsibility.¹³⁵ Further, State Bar Associations issue ethical opinions regarding the interpretation of the rules and according to which attorneys are expected to

¹²⁸ Richard W. Painter, *Evaluation and Response to Risk by Lawyers and Accountants in the U.S. and E.U.: Convergence and Competition in Rules Governing Lawyers and Auditors*, 29 IOWA J. CORP. L. 399, 400 (2003).

¹²⁹ *Id.* at 415, 420.

¹³⁰ *Id.* at 421, 422 (pointing out that the New Institutional Economics perspective looks less at the effectiveness of rules in isolation and more at the effectiveness of institutions, a combination of formal and informal rules and sanctions; less to the static, equilibrium viewpoint, and more to the evolutionary processes bringing about institutional arrangements that emerge to solve problems).

¹³¹ *Id.* at 421.

¹³² Robert J. Anello, *Sarbanes-Oxley Wake Up Call to Attorneys*, 22 PENN ST. INT’L L. REV. 545, 547 (2004).

¹³³ *Id.*

¹³⁴ *Id.* at 557.

¹³⁵ *Id.* at 557-58.

model their professional behavior; and, lastly, states have grievance systems run through the state courts.¹³⁶

1. Unintended Consequences

Many commentators have concluded that mandatory reporting rules disturb the traditional nature of the attorney-client relationship in the corporate environment and, instead of furthering the purposes of SOX by improving corporate governance, reducing misconduct, giving clarity and guidance to securities lawyers in reference to their ethical obligations, and ultimately protecting the investing public, can instead promote results that run counter to SOX's objectives.¹³⁷ For example, one criticism is that the rules take a static view of the attorney-client relationship and do not consider the effect that a change in the power of one party to the relationship produces on the other party, suggesting that corporate dynamics will neutralize the intended function of the lawyer as gatekeeper.¹³⁸ This perspective focuses on the likely adaptive behaviors produced by reporting, such as selective information sharing with internal counsel, cabining information different lawyers receive, using of outside counsel to control the flow of information more easily and because outside counsel can be easily dismissed, and non-lawyers as much as possible.¹³⁹ With available firms, large and small, as outside counsel competing for business and negotiating at different levels with the company and internal counsel, corporations are likely to negotiate the right mix of lawyers' services to minimize their combined influence via reporting.¹⁴⁰ The reporting rules, in this view, end up producing perverse effects, indeed reducing the opportunities for lawyers to prevent potentially unlawful conduct by their remonstrance and persuasion or to identify unlawful conduct and exert their influence to eliminate it.¹⁴¹

Also, corporate counsel, eager to avoid liability, will tend to err on the side of caution, and potentially waste a lot of time and resources within the organization by over-reporting.¹⁴² The same fear may tend to produce the

¹³⁶ *Id.* at 558-59.

¹³⁷ Lauren Harper, Comment, *United States Regulation of Canadian Securities Attorneys under Sarbanes-Oxley: Exploring Costs and Finding an Optimal Allocation of Authority*, 36 U. MIAMI INTER-AM. L. REV. 139, 140-141 (2004); see also Lorne, *supra* note 11, at 404 (noting that the rules are likely to exacerbate current trends in corporate practice promoting internalization, the tendency of in house counsel to keep more of the legal work for himself to control the reporting, while outside firms, which may not be anxious to file reports either may also encourage internalization of legal work; corporate counsel may also want to reduce the number of matters in the hand of the SEC counsel- the one "appearing and practicing" and therefore subject to the SEC rules- encouraging balkanization).

¹³⁸ Zacharias, *supra* note 15.

¹³⁹ *Id.* at 481-82.

¹⁴⁰ *Id.* at 488.

¹⁴¹ See Anello, *supra* note 132, at 559.

¹⁴² Greene, *supra* note 54, at 848-849.

additional counterproductive, adaptive behavior of information avoidance on the part of the lawyer: since the rules do not include a “should have known” standard, one way of avoiding the trigger of reporting duties with its unsavory repercussions and potential liability for counsel is to actually “know” less.¹⁴³ Sadly, the less informed corporate attorney is also less effective at delivering professional services to the client.¹⁴⁴ Also, the less informed, less effective attorney costs additional money to the organization that depends on the lawyer for advice. Arguably, for the lawyer to be able to identify potential pitfalls, and to educate the client as to the appropriate course of action under current law, whose meaning is less than clear cut, this likely result is the exact opposite of what the federalization of professional responsibility rules was intended to achieve.

2. Lawyers’ Role Redefined?

Most dramatically, the rules intending lawyers as gatekeepers of good corporate governance challenge the traditional role of the lawyer in an adversarial system. The attorney in an adversarial system is viewed by many as the most unlikely candidate for a watchdog position.¹⁴⁵ Placing the attorney in that role is antithetic, not only to the information exchange in an atmosphere of trust that is central to effective client representation,¹⁴⁶ but to the lawyer’s ability to assume and maintain a partisan posture, central to preserving the integrity of the system and to the corollary of the lawyer’s duty of zealous advocacy on behalf of the client vis-à-vis the counterpart and, even more importantly, vis-à-vis the government.¹⁴⁷

In this light, the federal rules of professional conduct challenge the foundations of the adversarial system, threaten the independence of the bar, and redefine the meaning of lawyering, at least in this area of legal practice. Indeed, many attorneys rely on their duty of confidentiality to lay the foundation for a relationship of trust, encouraging the client to reveal as much detail as possible to facilitate rendering the best legal advice and to minimize surprises later on.¹⁴⁸ Mandatory reporting makes lawyers accountable to third parties while at the service of the client, placing the lawyer in the unenviable position of serving two masters, and reducing the client’s (or its agents’) expectation of confidentiality which hinders trust, central to a suc-

¹⁴³ *Id.* at 849.

¹⁴⁴ *Id.*

¹⁴⁵ *See, e.g.,* Zacharias, *supra* note 15, at 501-02.

¹⁴⁶ *Id.* at 494.

¹⁴⁷ *See* A.B.A MODEL RULES OF PROF’L CONDUCT R. 3.1 cmt. 1 (2005) (explaining the duty of the advocate to use legal procedure to the fullest advantage of his client in light of the fact that the law, while establishing limits of conduct, is ambiguous and dynamic).

¹⁴⁸ Bost, *supra* note 38, at 1140.

cessful attorney-client relationship.¹⁴⁹ Although up-the-ladder reporting has the ostensible purpose of serving the client, by allowing information of potential wrongdoing to reach the head of the legal department or the BOD for correction, the process is likely to produce the undesired effect of depriving lawyers of the information they need to properly advise their client.¹⁵⁰ This likely will not succeed in changing the perspective and behavior of the corporate lawyer to focus on preventing, discouraging, or intercepting and correcting corporate misconduct at the outset, presumably the ultimate purpose of the rules.

For example, Professor Baimbridge notes that SEC rules do little to combat the natural tendency of lawyers not to antagonize their employers.¹⁵¹ In his opinion, corporate attorneys inescapably fall into the cognitive bias of skewing their analysis of their clients' conduct in positive terms, and "turn a blind eye" to their client's misconduct.¹⁵² Also, even assuming that corporate attorneys were not victims of this occupational hazard, arguably, as we have seen, without mandatory withdrawal or "noisy withdrawal," the SEC rules have no bite to the extent that they fail to provide leverage to the corporate attorney in influencing client's behavior.¹⁵³ In this light, the structural attack to the bar's professional independence and time honored, if not perfect, self-regulation is therefore even less justified.

However, the most poignant and harshest challenge to the federal professional responsibility rules, determinative in their final assessment of propriety domestically and internationally, is the one that turns on the very structure and philosophy underlying our legal system. This challenge retains its legitimacy even though refinement of the implementation rules and prosecutorial discretion by the SEC, as it relates to the "appearing and practicing" bar, may moderate the sweeping effect of the federal professional responsibility rules compared to what was originally anticipated. It is indeed very poor policy to have a prosecutor, and the SEC is primarily a prosecutor, in charge of regulating the bar that practices before it.¹⁵⁴ It is like having the U.S. Attorney's Office regulating the behavior and professional ethics of the criminal defense bar.¹⁵⁵ Indeed, the most troublesome aspect is that the up-the-ladder reporting provisions apply not only to situations related to the preparation of disclosure documents, which would be less pro-

¹⁴⁹ *Id.* at 1141-44.

¹⁵⁰ M. Peter Moser & Stanley Keller, *Sarbanes-Oxley 307: Trusted Counselors or Informers?* 49 VILL. L. REV. 833, 837 (2004).

¹⁵¹ Noorishad, *supra* note 21, at 1051.

¹⁵² *Id.*

¹⁵³ *See supra* Section II.B.

¹⁵⁴ Richard W. Painter, Roberta S. Karmel & Stewart Kaswell, Symposium, *The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002: Panel 2 The Evolution of Corporate Governance*, 52 AM. U. L. REV. 613, 620 (2003) (hereinafter *Evolving*).

¹⁵⁵ *Id.*

foundly troublesome and logically justifiable as part of the overall federal intervention on corporate governance, but also to attorneys who are instead working on enforcement actions on behalf of their clients.¹⁵⁶ Even though the SEC may state that it does not intend to impede zealous advocacy, the rules turn attorneys into policemen working in part for their clients and in part for the SEC.¹⁵⁷

Yet another challenge is that the reporting rules go beyond mere violations of securities laws to encompass breaches of fiduciary duty under state law and other violations in general,¹⁵⁸ effectively, at least facially, giving this newly instituted police core “general jurisdiction.” The imprecise, potentially sweeping phraseology of Section 307 extends reporting to a potentially undetermined array of possible violations.¹⁵⁹

The last, but not least bit of irony, is that not only has the economic burden of this investigative, fact-gathering, and prosecutorial function been placed on the very people and organizations the SEC is after, but also the budget for that function has been increased. In this light, SOX professional responsibility rules are a swift move, especially considering that the provision regarding attorneys was tacked on without much debate,¹⁶⁰ to reconfigure corporate internal and external counsel as the privately funded security force of the modern corporate governance scheme, a wholly unacceptable federal deputization.

Of course, one of the propelling forces behind the regulations affecting lawyers, besides the fact that attorneys do not enjoy widespread esteem as a category, is that they were to blame for the recent corporate failures. The provisions regulating the bar were intended to punish lawyers for their role during the securities bubble, when, as a group, they were perceived as making inordinate profits, while turning a blind eye to potential fraudulent schemes.¹⁶¹ However, if the purpose was to punish lawyers as a category,¹⁶² the profession comes out winning financially and occupationally, at least to the extent that the solution incorporated in SOX translates into the need for yet more lawyers¹⁶³ to wade through a regulatory and business environment

¹⁵⁶ *Id.* at 624.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 621.

¹⁵⁹ Commentators have defined this imprecision as one of the many “vagaries” of SOX. *See, e.g.,* ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW, 488 (LexisNexis 2d ed. 2004).

¹⁶⁰ *Evolving*, *supra* note 154, at 621.

¹⁶¹ *Id.* at 624.

¹⁶² *Contra* Koniak, *supra* note 23 (casting a dark light on the entire legal profession; implying that for every one of the lawyers that may have been found at the center of a fraudulent activities perpetrated by their client, there are scores who are never examined; noting that even the lawyers investigated were dealt a light hand by the investigators; and maintaining that lawyers had to be at the very center of the corporate scandals storm).

¹⁶³ *Evolving*, *supra* note 154, at 624.

of ever increasing complexity, even though confidentiality, loyalty, and zealous advocacy, time honored earmarks of the profession, may have been dealt a deadly blow.

III. EXPORTING THE SOLUTION

To get or to maintain access to the U.S. market, now foreign companies must do much more than simply “divulge the cold numbers behind their operations.”¹⁶⁴ The environment in which the SEC operates has dramatically changed, and foreign issuers have increased exponentially, comprising approximately one-third of the capitalization of the New York Stock Exchange (NYSE) in 2002 with \$4.3 trillion and 17% of the listings from a humble beginning of 33 in 1975.¹⁶⁵ The increase of foreign issuers in U.S. markets has been matched by a decrease of U.S. listings in recent years.¹⁶⁶ These days, given the preeminence of foreign issuers in U.S. markets and the interdependence of capital markets the world over, the SEC cannot promulgate securities regulations without taking into account their impact on foreign companies.¹⁶⁷ In the past, the SEC granted accommodations and exemptions to foreign issuers, to account for differences in corporate governance environments foreign issuers function within.¹⁶⁸ Because of the political pressures at the time of enactment, SOX largely ignored these differences; at least on its face, SOX seems to reach beyond U.S. borders into areas that would generally be the subject of domestic regulation in other countries.¹⁶⁹

In general, foreign issuers have to adapt their corporate structure and their business practices to the U.S. business model, and particularly to the “model of corporate governance crafted by the U.S. Congress.”¹⁷⁰ This presents several problems: (1) it offends traditional rules of comity, which respecting other nations’ sovereignty, would favor a deferential approach to the laws of other states; (2) it potentially clashes with corporate governance models that reflect different value systems and different social systems; and (3) it presents unique interpretation challenges because foreign attorneys are ill prepared to maneuver through a maze of American-grown legal concepts in figuring out whether they fall within or beyond the purview of the rules.

¹⁶⁴ Cramton, *supra* note 3, at 525.

¹⁶⁵ Greene, *supra* note 54, at 824.

¹⁶⁶ *Id.* at 820.

¹⁶⁷ *Id.* at 824.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 826.

¹⁷⁰ Cramton, *supra* note 3, at 525.

A. Extraterritoriality of SOX

SOX has been considered another aspect of American economic imperialism.¹⁷¹ SOX imposes standards on foreign issuers who are already obliged to follow their own country's corporate governance rules.¹⁷² The extension of the SEC jurisdiction across international borders is considered completely inappropriate, particularly as it pertains to Section 307, because it infringes on a purely domestic matter, the rules of professional conduct of the legal profession in the respective countries, based on the fact that, occasionally, the attorney may represent a corporate client which, by virtue of being listed with the SEC, is subject to the jurisdiction of the SEC.¹⁷³

Indeed, at the enactment of Section 307 with its original corollaries of possible mandates of "noisy withdrawal" and before the adoption of the final rules by the SEC, which toned down and made some accommodations for international legal practitioners caught in the web of multiple uncertain and conflicting professional obligations, the international legal community was outraged.¹⁷⁴ The International Bar Association requested complete exemption for attorneys not admitted to practice in the United States from the up-the-ladder reporting requirements.¹⁷⁵ The refinements of the final rules, requiring the attorney "appearing and practicing" to satisfy specific criteria,¹⁷⁶ and excluding foreign attorneys from some of the obligations imposed on domestic counsel, have the effect of exempting many, although not all, foreign lawyers from the purview of the Rules.

1. General Principles

a) Bases for Extraterritorial Jurisdiction. At the outset, the general principle of international law is that a nation's assertion of prescriptive jurisdiction, the reach of its laws, does not extend beyond its national territory.¹⁷⁷ Similarly, under traditional canons of statutory construction, there is a presumption against extraterritoriality.¹⁷⁸ Therefore, the legislation of Con-

¹⁷¹ Corinne A. Falencki, Comment, *Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality*, 36 GEO. WASH. INT'L L. REV. 1211, 1224 (2004).

¹⁷² Greene, *supra* note 54, at 825.

¹⁷³ Harper, *supra* note 137, at 141.

¹⁷⁴ Exch. Act Release 47241 (Jan. 24, 2003), available at <http://www.sec.gov/rules/final/33-8180.htm> (last visited Feb. 6, 2007).

¹⁷⁵ *Id.*

¹⁷⁶ See *infra* Section III.B.1

¹⁷⁷ *American Banana Co. v. United Fruit Co.*, 213 U.S. 347, 357 (1909) (holding that acts of a domestic corporation outside the U.S. in a conspiracy to drive a competitor out of business cannot be the basis for a action in treble damages in the U.S., as the Court refused to sit in judgment on the legality of a Costa Rican seizure in application of the principle whereby courts of one country will not sit in judgment of the acts of the government of another done within its territory).

¹⁷⁸ *EEOC v. Arabian American Oil Co.*, 499 U.S. 244, 248 (1991).

gress, unless a contrary intent is shown, does not apply outside of the U.S.¹⁷⁹ This, in turn, is founded on the basic principle of unnecessary conflict avoidance with foreign sovereigns, which is at the basis of Congressional legislation and finds its origin and counterpart in customary international law.¹⁸⁰ But the question of whether a U.S. law applies to citizens of other countries is a question of construction, rather than of sovereign power, generally resolved by the courts.¹⁸¹ A brief overview of several traditional approaches developed by U.S. courts to decide whether asserting jurisdiction was proper in specific cases, mostly in the context of antitrust and securities, and the position of the Restatement of Foreign Relations and prevalent doctrine follows.

(i) **The Territorial Approach.** Almost a century ago, in 1909, Justice Holmes in *American Banana Co. v. United Fruit Co.*, held that when a statute is silent it should be construed to apply only within the territory of the United States.¹⁸² Justice Holmes referred to the almost universal principle whereby the character of an act, lawful or unlawful, should be determined with reference to the territory over which the legitimate power of the legislator extends.¹⁸³

(ii) **The Effects Test.** The Second Circuit first announced the “effects test” in 1968 in *Schoenbaum v. Firstbrook*, where the court held that it had subject matter jurisdiction where fraudulent extraterritorial conduct had a substantial impact on the investors’ market in the U.S. This case dealt with a shareholder of a Canadian corporation trading in the Toronto and the U.S. stock exchanges that alleged fraud against the shareholders and directors.¹⁸⁴ The test, with its vague contours, seems to cast a wide net; however, courts have applied it sparingly.¹⁸⁵

(iii) **The Conduct Test.** Under this test, if significant conduct involving a security fraud violation occurred in the U.S., the jurisdiction of the federal court is established regardless of the nationality of the victim.¹⁸⁶

¹⁷⁹ *Id.*

¹⁸⁰ Falencki, *supra* note 171, at 1219; RESTATEMENT (SECOND) OF FOREIGN RELATIONS, § 40 (1965).

¹⁸¹ *Blackmer v. U.S.*, 284 U.S. 421 (1932) (holding that a statute providing for service by consul on witnesses abroad who are U.S. citizens and for ensuing contempt proceedings whereby property of the witness may be seized following notice, service and failure to appear does not deny due process and is therefore valid).

¹⁸² *American Banana*, 213 U.S. at 357.

¹⁸³ *Id.* at 356.

¹⁸⁴ *Schoenbaum v. Firstbrook*, 405 F.2d 200, 204-08 (2d Cir. 1968) (en banc) (holding § 10(b) applicable even when the fraudulent acts were committed outside of the U.S. and the securities belonged to a foreign company doing business in the U.S. where the transaction involves listed securities and are detrimental to the interests of American investors).

¹⁸⁵ Jonathan Shirley, Note, *International Law and the Ramifications of the Sarbanes-Oxley Act of 2002*, 27 B.C. INT’L & COMP. L. REV. 501, 519 (2004).

¹⁸⁶ *Id.* at 520.

Different circuits approach the application of this test more or less rigidly. For example, the Second Circuit uses the test most rigidly, while the Third, Eighth and Ninth Circuits take a less rigid view whereby any significant activity taking place in the U.S. in furtherance of a fraudulent scheme can provide the basis for jurisdiction.¹⁸⁷

(iv) **The Balancing Approach.** By the time Judge Choy wrote his opinion in *Timberlane Lumber Co. v. Bank of America* in 1976, *American Banana* had been limited to its facts and there was no doubt that at least American antitrust laws would apply to conduct taking place in other nations.¹⁸⁸ It was clearly understood that extraterritorial assertion of jurisdiction was a concern for foreign nations, and they might resent “broad assertions of authority by American courts.”¹⁸⁹ Judge Choy opted for the application of a “jurisdictional rule of reason,”¹⁹⁰ weighing a number of factors to decide whether the “links to the United States . . . are sufficiently strong, vis-à-vis those of other nations, to justify an assertion of extraterritorial authority.”¹⁹¹ He considered conflicts with foreign law or policy; nationality; allegiance of parties; and locations or principal places of business, and the extent to which enforcement by either state can be expected to achieve compliance. He further considered the relative significance of effects on the U.S. as opposed to elsewhere, the existence of an explicit purpose to harm American commerce, the foreseeability of such an effect, and the relative importance to the violations charged that they be conducted within the United States as opposed to abroad.¹⁹² In determining whether U.S. contacts and interests are sufficient to support extraterritorial jurisdiction, in respect of comity and fairness principles, the court is not required to evaluate foreign law or policy, but the legitimacy of the interests of each nation, and the court needs to evaluate only the concern of each state with the suit at hand.¹⁹³

(v) **The Restatement (Third) of Foreign Relations.** Even though not binding on courts, it includes the broadest statement of extraterritorial reach of U.S. securities regulations, stating that courts have jurisdiction over conduct predominantly occurring in the U.S. related to a securities transaction, even if the transaction itself takes place outside of the U.S., including investment advice or solicitation of proxies or of consents with respect to securities.¹⁹⁴ The U.S. exercise of jurisdiction to prescribe de-

¹⁸⁷ *Id.*

¹⁸⁸ *Timberlane Lumber Co. v. Bank of America*, 549 F.2d 597, 608-09 (9th Cir. 1976).

¹⁸⁹ *Id.* at 609.

¹⁹⁰ *Id.* at 613.

¹⁹¹ *Id.*

¹⁹² *Id.* at 614.

¹⁹³ *Id.* at 614-15.

¹⁹⁴ RESTATEMENT (THIRD) OF FOREIGN RELATIONS § 416 (1987) (Jurisdiction to Regulate Activities Related to Securities).

depends on (a) whether the exercise of jurisdiction is reasonable in light of the conduct's expected substantial effect on the U.S. securities markets; (b) whether representations or negotiations are conducted in the U.S.; (c) whether the party to be subjected to jurisdiction is an American or a foreigner; or (d) whether the party to be protected is a U.S. national or resident.¹⁹⁵

(vi) **Evidence of direct conflict with laws regulating the same issue.**

This test, adopted by some scholars, and also reflected in the Restatement (Second) of Foreign Relations Law § 40, looks at the interests of the competing countries in regulating the conduct, and if there is a conflict, then principles of comity apply.¹⁹⁶ Each state in a situation of conflict is required by international law to moderate the exercise of its enforcement jurisdiction.¹⁹⁷

b) Extraterritoriality of Securities Law: Regulation S. SOX is directed at issuers. Any foreign company that wants to list its securities in the NYSE, American Stock Exchange or Nasdaq must register with the SEC and, therefore, comes under the purview of SOX. However, SOX does not add to the extraterritorial applicability of U.S. securities laws; consequently, its extraterritorial reach is determined by reference to other securities laws.¹⁹⁸ In the ambit of the extraterritorial reach of U.S. securities laws, a duality exists. On one side, Regulation S, adopted by the SEC in 1990, specifies when securities transactions fall outside of the reach of U.S. securities laws, codifying the territorial reach of Section 5 of the Securities Act of 1933, which was previously left to the interpretation of the courts.¹⁹⁹ It sets forth two conditions for issuing and reselling unregistered securities:

1. The offer or sale must be made in an "offshore transaction"; and
2. No "directed selling efforts" can be made in the United States.²⁰⁰

An offshore transaction occurs when the offer was not made to someone in the United States and either the buyer is outside of the U.S., or the transaction is executed on a foreign exchange.²⁰¹ "Directed selling" means any activity in preparation for the sale of those securities, such as road shows or advertising efforts taking place in the United States.²⁰² Regulation S clari-

¹⁹⁵ *Id.*

¹⁹⁶ Falencki, *supra* note 171, at 1222; RESTATEMENT (SECOND) OF FOREIGN RELATIONS, § 40 (1965) (stating that "where two states have jurisdiction to prescribe and enforce rules of law" requiring inconsistent conduct by the person, "each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction").

¹⁹⁷ RESTATEMENT (SECOND) OF FOREIGN RELATIONS, § 40 (1965).

¹⁹⁸ Shirley, *supra* note 185, at 501.

¹⁹⁹ *Id.* at 517.

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² *Id.*

fied the reach of U.S. securities registration requirements, preventing application of those requirements from interfering with the sovereignty of other countries.²⁰³

c) *Enforcement of the Anti-Fraud Provisions.* On the other hand, since the anti-fraud provisions of the U.S. securities laws are seen as a cornerstone in promoting stability of the U.S. capital markets, and in protecting investors, their territorial application is considered broader.²⁰⁴ For example, when Rule 10b-5 was promulgated, since the bulk of securities transactions were predominantly in the domestic market, there was scant attention to the rule's far-reaching language, while the U.S. Congress and the SEC remained silent on its territorial reach. Therefore, the courts were left to define this area, and, as noted above,²⁰⁵ they continue to be divided on the factors establishing jurisdiction.²⁰⁶ Consequently, investors and issuers in international transactions face uncertainties regarding the applicability of the antifraud provisions.²⁰⁷

d) *Extraterritoriality of U.S. Ethics Rules for Lawyers.* Recognizing the increasing prevalence of cross-border practice,²⁰⁸ the MRPC has also undertaken to state its extraterritorial reach in the 2003 revisions, specifying how lawyers' ethics rules are to be understood and applied to U.S. lawyers practicing abroad. MRPC R. 8.5 states that a lawyer admitted to practice in one jurisdiction is subject to the rules of that jurisdiction as well as of those where the conduct occurred, and can be subject to discipline in both.²⁰⁹ Choice of law is determined in favor of the jurisdiction where the tribunal sits "for conduct in connection with a matter pending before a tribunal,"²¹⁰ and for any other conduct, either where it occurred, or where the predominant effect of the conduct occurred.²¹¹ On the other hand, the lawyer will not be subject to discipline if his conduct conforms to the ethics rules of the jurisdiction where he reasonably believed the predominant effect would occur.²¹² These provisions apply to lawyers in transnational practice "unless international law, treaties or other agreements between competent regulatory authorities . . . provide otherwise."²¹³

²⁰³ *Id.* at 518.

²⁰⁴ Shirley, *supra* note 185, at 518.

²⁰⁵ See *supra* Section III.A.1.a.

²⁰⁶ Shirley, *supra* note 185, at 518-19.

²⁰⁷ *Id.* at 522-23.

²⁰⁸ Natalie E. Norfus, Note, *Assessing the Recent Revisions to Model Rule 8.5: How do the Changes Affect U.S. Attorneys Practicing Abroad, Specifically those Practicing in Japan?*, 36 GEO. WASH. INT'L L. REV. 623, 628, 633 (2004).

²⁰⁹ A.B.A. MODEL RULES OF PROF'L CONDUCT R. 8.5(a) (2005).

²¹⁰ *Id.* R. 8.5(b)(1).

²¹¹ *Id.* R. 8.5(b)(2).

²¹² *Id.*

²¹³ *Id.* R. 8.5 cmt. 7.

By giving priority to the rules of the tribunal where the matter is pending, MRPC R. 8.5 encourages respect of the rules of conduct of the foreign country of transnational practice.²¹⁴ The disposition is worded with a view to international application and has a broad reach, as demonstrated by the use of the word “tribunal,” which encompasses a wider range of judicial bodies, as opposed to the narrower term “court”.²¹⁵ Although the lawyer is given some leeway with respect to which discipline norm to follow, it is a choice based on reasonable belief, not a choice to ignore U.S. rules in case of doubt.²¹⁶

2. How Much Extraterritoriality?

Although the legislative history of SOX shows no specific intent regarding its applicability abroad,²¹⁷ by its plain language, it is directed at issuers and their employees and consultants wherever located. Applicability of SOX is subordinate to being an issuer, and therefore, it is conditioned on the issuer being subject to registration.²¹⁸ In this context, the extraterritoriality of SOX is limited under Regulation S, and therefore, there is no risk that SOX will ensnare a foreign transaction that would not have fallen under U.S. jurisdiction prior to the passage of SOX.²¹⁹ Based on these observations, it would seem that SOX would raise little concern abroad; however, the opposite has been true.²²⁰

Indeed SOX has restricted access to the U.S. capital markets by foreign issuers because, in addition to complying with registration provisions and providing disclosure of numbers behind their operations, now the foreign issuer is forced to conform to the model of corporate governance envisioned by the U.S. Congress.²²¹ SOX has been another example, probably the most relevant to date, where the U.S. is asserting its role of international corporate regulator, based on its own perception of the needs brought about by the globalization of markets, with little respect for either sovereignty of other nations or principles of comity. Thus, the U.S. is promulgating rules that appear in conflict with principles of public international law regarding the basis for the exercise of jurisdiction.²²² In addition, there is an anticompetitive aspect to SOX in that compliance costs are much higher for foreign as opposed to domestic issuers. Foreign issuers face a higher risk of error

²¹⁴ Norfus, *supra* note 208, at 641.

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ Falencki, *supra* note 171, at 1222-23.

²¹⁸ Shirley, *supra* note 185, at 523.

²¹⁹ *Id.*

²²⁰ *Id.* at 524.

²²¹ *Id.* at 525.

²²² Falencki, *supra* note 171, at 1218.

and, consequently, of criminal liability, and exemptions favor U.S. issuers.²²³ Of course the defense to these contentions is that foreign companies chose to subject themselves to the rules, and they can likewise chose to delist.²²⁴ But this argument does little to justify a policy stance that discourages foreign access to the U.S. capital markets when free access to the U.S. markets ultimately benefits the U.S. economy as well.²²⁵

Indeed, the high price of SOX compliance for foreign companies causes American stock exchanges to suffer diminished appeal with foreign issuers.²²⁶ Several powerful companies, such as Japanese Daiwa, German Porsche, and UK Benfield Insurance have delayed listing on the NYSE due to SOX, even after the SEC exemptions were introduced.²²⁷ On the other hand, competitive foreign exchanges, such as the London Stock Exchange (LSE) and Euronext are emerging as a welcoming alternative for foreign issuers spooked by the excessive requirements of SOX.²²⁸

a) *The U.S. Should Exercise Restraint Based on Principles of International Law and Comity.* Foreign commentators have noted, on one hand, that SOX is tailor-made to respond to American problems and violates principles expressed in multilateral agreements, such as NAFTA, Bilateral Agreements (BITs), and the World Trade Organization (WTO).²²⁹ A better approach to promoting compliance with acceptable reporting standards may have been, not to pass new legislation through Congress, but to negotiate Mutual Recognition Agreements to achieve the same objectives, thereby avoiding potential interference with foreign sovereignty.²³⁰

Along the same reasoning, others advocate for the SEC to adopt a pragmatic approach to SOX extraterritorial reach, realizing that multiple provisions are in direct conflict with foreign law. Under principles of comity, such a situation suggests enforcement restraint, and the author recommends that the SEC grant relief to foreign issuers through a situation-specific no action process.²³¹ This approach is favored because it would

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ Ian L. Shaffer, *An International Train Wreck Caused in Part by a Defective Whistle: When the Extraterritorial Application of SOX Conflicts with Foreign Law*, 75 *FORDHAM L. REV.* 1829, 1845 (2006).

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ Maria Pia Belloni, *Il Sarbanes-Oxley Act il Business-Lawyer e la Multidisciplinary Practice (MDP). I Commenti della Dottrina Statunitense e la Reazione Europea. Qualcosa di Nuovo Nella Sfera di Cristallo?* [U.S Doctrinal Comments and The European Reaction. Anything New in the Crystal Ball?] *Riv. Ital. Dir. Pubbl. Comunitario* 417, 430 (2005) (reflecting on the consequences of the American discipline of foreign issuers with particular reference to the European Union, and positing that SOX may be too high of a barrier against financial scandals).

²³⁰ *Id.* at 431.

²³¹ Shaffer, *supra* note 226, at 1873-74.

create an atmosphere of regulatory cooperation, as opposed to regulatory alienation with foreign governments and companies, which will ultimately benefit U.S. investors. This would promote the retention of foreign issuers, while maintaining the cooperation threads that are essential in enforcing securities regulations abroad in the global market.²³² This approach would also be a viable alternative to both strict enforcement, which may prove contentious, if not impossible, and to the likewise counterproductive approach of a blanket exceptive relief, which would subvert the purposes of the Act.²³³

b) The U.S. Should Exercise Restraint Based on Structural Differences Between Domestic and Foreign Corporate Governance. Unmitigated extra-territorial reach, besides breaking with traditional international law principles and canons of construction, produces additional challenges. Due to differences in the bases of corporate structure and governance in foreign countries, conflicts with related laws that SOX is, of course, not anticipating or taking into account may affect the operation of subsidiaries of multinationals listed with the SEC as well as foreign issuers in general. At the risk of stating the obvious, the philosophical and ideological differences underlying foreign legal and economic systems make many domestic constructs and concepts inapplicable or not susceptible of comprehension abroad, even after thoughtful translation and even though they may be perfect for the place of origin. Uncertainties and misapprehensions follow. It is indeed overly simplistic to think that mere transplantation of rules from a different legal environment may successfully curb incentives to engage in misconduct in a different system. The idea of using stopgaps—such as the lawyers as gatekeeper—as an effective tool to investigate and prevent corporate malfeasance the world over is an example of this one-size-fits-all mentality.

Corporate structure and governance, just like the legal and social orders, tend to reflect the culture they originate into, a nation's values. For example, the principles of individual accountability and independence in corporate governance, which are presumed for the applicability of SOX and for it to achieve its purposes, directly clash with corporate governance norms in Germany or in Japan. These countries boast a significant numerical presence of SEC-listed organizations, and are founded on collective decision making and pervasive employee participation in management.²³⁴ Consequently, Section 301 of SOX, geared at protecting the independence of the audit committee, contrasts with civil law regulatory systems based on a dual-board system composed of a management board, which does not

²³² *Id.* at 1876-77.

²³³ *Id.* at 1877.

²³⁴ Shirley, *supra* note 185, at 511-12.

have independent directors, and a supervisory board, which includes employees and union representatives.²³⁵

Another illustration of the difficulty in making rules that cross jurisdiction, and of the inherent challenges in extending domestic norms to foreign settings, is the meaning of specific terms, such as fiduciary duty. The concept of fiduciary duty does not quite translate to identify the same notion in many civil law countries.²³⁶ In common law countries, the duty of care refers to the prudence that managers are expected to exercise in carrying out supervision and decision-making. It has been refined by U.S. courts for the protection of investors in multiple corporate situations.²³⁷ By contrast, the concept of fiduciary duty is not as refined in civil law countries where different methods of police management are in place, such as state interest in major corporations, with ensuing government controls not implicating the courts.²³⁸

c) *SOX may Exert More Influence Internationally by its Persuasiveness.* The U.S. could attain the goal of influencing legislation internationally by the sheer persuasiveness of many SOX rules and the purposes underlying them, since many countries are looking for guidance in devising and implementing their own corporate reforms. Indeed, many countries around the world have experienced problems of corporate governance and have been struggling with reforming their own corporate governance rules for quite some time.²³⁹ It stands to reason that most countries would look to U.S. legislation, fairly well developed in this area, for guidance.

In the U.S., SOX represented a departure from the traditional approach of securities regulations, bringing under the federal umbrella areas of law heretofore left to non-federal fora.²⁴⁰ Indeed, federal law was historically aimed at protecting capital markets via registration, financial disclosure requirements and anti-fraud provisions embodied in the Securities Act of 1933 and the Security and Exchange Act of 1934, while corporate entities were traditionally organized under state law, and the accounting and legal professions were under self-regulation.²⁴¹ The dynamics of the corporate scandals of large proportions, which ultimately precipitated swift legislative

²³⁵ Belloni, *supra* note 229, at 423.

²³⁶ Shirley, *supra* note 185, at 514.

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ For example, in the last few years, Italy underwent a comprehensive legislative reform that replaced an entire section of its Civil Code and modified several provisions of its Civil Procedure Code modernizing corporate and business organizations law. *Cfr.* Decree-Law No. 5 and No. 6, January 17, 2003, Gazz. Uff., 22 Gennaio 2003, n. 8/L. Italy experienced its share of corporate scandals resulting in enormous losses to investors with the fall of companies such as Parmalat and Cirio. *See Painter, supra* note 128.

²⁴⁰ Shirley, *supra* note 185, at 524.

²⁴¹ *Id.*

reaction, brought into sharp focus the fact that the corporate attorneys and accountants involved failed to identify and report corporate misconduct, and led Congress to conclude that basic principles and practices of corporate governance for public companies had to be put in place at the federal level.²⁴² It was a matter of national economic security.

While the U.S. was struggling with its own corporate debacles, many countries in the industrialized world were faced with the sudden fall of corporate giants under the weight of elaborate frauds, ultimately affecting the investing public. Many foreign countries have undergone and are undergoing sweeping reforms. For example, in Italy, the entire legislative structure underlying business organizations has been reformulated and modernized during a legislative process that started in 2001 and entered into effect in 2004.²⁴³ Likewise, Spain's corporate environment, traditionally accused of being dominated by a "clubby atmosphere," has been changing dramatically in recent years.²⁴⁴ A corporate reform, started in the 1990s, finally was passed into law in 2003.²⁴⁵ Even though the legal reform may not find instantaneous application, while questions remain open about its enforceability, Spain is said to have embraced the post-Enron era by undertaking a transformation under the guiding principle of transparency.²⁴⁶ The engine that drives transformation of corporate law and corporate governance rules and practices throughout Europe is not the regulators, but globalization and the demands of the global marketplace.²⁴⁷

At this juncture, while legal and economic commentators criticized the bold moves of the U.S. federal government in its pretenses vis-à-vis the global marketplace, SOX quickly became the object of just as much analysis geared at understanding its structure, purposes, efficiencies, and at identifying those concepts, methods, and rules that could indeed be reproduced or used as a model for foreign legal and regulatory schemes.²⁴⁸ SOX became, in fact, one of the most studied pieces of U.S. federal legislation in recent years, and presently seems to provide, for better or for worse, the

²⁴² *Id.* at 525.

²⁴³ *Id.* at 524.

²⁴⁴ David Hechler, *Market Report Spain: The Spanish Revolution*, CORPORATE COUNSEL, Vol. 05, Issue 9 (2005).

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ *Id.*

²⁴⁸ Luca Condosta, *Adeguamento al Sarbanes Oxley Act: Metodologia, Problematiche e Opportunità*, [Compliance with SOX: Methodology, Problems and Opportunities] 19 AMMINISTRAZIONE & FINANZA 13 (2006) (examining the compliance challenges for foreign corporations listed in the NYSE imposed by Section 404 of SOX within the deadline of 2006 while not omitting an indication of the principal opportunities: increased transparency, the opportunity to conduct an internal evaluation of the business methodologies and processes, and the opportunity to improve accounting methodologies).

lexicon of corporate governance models globally.²⁴⁹ In this somewhat forced U.S. federal law mania, the SOX regulations affecting lawyers have taken lesser relief as compared to rules affecting the accounting profession and the role of corporate executives in the evolution of corporate law worldwide because a comparatively smaller number of SOX provisions relate to attorneys, and the SEC final rules have somewhat lessened the original potential bite of the reporting dispositions.

B. SOX and the Foreign Bar- Problems of Interpretation of U.S. Rules Abroad

Foreign attorneys are ill-equipped to evaluate the meaning of U.S. law to make an educated decision regarding whether they personally fall within the purview of the rule, and whether the conduct they are faced with falls within the reporting rules. They are required to navigate a “legal mine-field,”²⁵⁰ an interconnected multiplicity of legal issues, legal definitions, and processes they are performance not familiar with.

1. The Non-Appearing Foreign Attorney

The first subject area where the foreign attorney is likely to get confused is the safe harbor provision of the SEC rules.²⁵¹ Who is the non-appearing foreign attorney, and how does the foreign lawyer make a determination as to whether the SEC professional conduct rules apply to him or his firm? A non-appearing foreign attorney is an attorney:

(1) who is admitted to practice law in a jurisdiction outside of the United States; (2) who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States Federal securities or other law . . . ; and (3) who: (i) conducts activities that would constitute appearing and practicing before the Commission only incidentally to . . . the practice of law in a jurisdiction outside the United States²⁵²

The last qualification in the rules, the safe harbor for the foreign attorney appearing “only incidentally,” was introduced in response to feedback during the comment phase of the rulemaking process.²⁵³ Likewise, a further qualification that limits applicability of the rules to the foreign attorney who

²⁴⁹ See, e.g., Francesco Denozza, *Le Regole della Globalizzazione tra (Pretesa) Efficienza e (Finti) Mercati*, [The Rules of Globalization between (Feigned) Efficiency and (Fake) Markets] 33.2 GIURISPRUDENZA COMMERCIALE 167, 174 (2006) (recognizing that there is a tendency towards a unified model of corporate governance across different legal systems).

²⁵⁰ Greene, *supra* note 54, at 837.

²⁵¹ See 17 C.F.R. § 205.2(j)(1)-(3) (2003).

²⁵² *Id.*

²⁵³ Greene, *supra* note 54, at 831.

appears before the SEC in consultation with an attorney licensed to practice in the U.S. was introduced during rulemaking.²⁵⁴ Also, a foreign attorney does not have to comply if compliance is prohibited by applicable foreign law.²⁵⁵ It bears noting that the originally proposed rule did not distinguish between the obligations of domestic and foreign attorneys, and the SEC specifically requested comments from attorneys in foreign jurisdictions and attorneys subject to foreign law because it realized that the rules could subject foreign lawyers to conflicting standards and obligations.²⁵⁶

Even though the rule seems rather straightforward, the only simple determination is the first, namely, whether the attorney is admitted to practice in a foreign country. After that, the rule is structured in terms that hold meaning only by reference to American legal theories, even though specifically directed at regulating safe harbors for the foreign legal practitioner. Indeed, it is unlikely that a foreign attorney would be able to evaluate the meaning of the phrase “holding themselves out” as practicing in the U.S., while the rule provides no guidance on the subject.²⁵⁷ Likewise, the rule does not give guidance as to the circumstances that would qualify the practice in front of the SEC as incidental or how much cooperation with a U.S. lawyer would either include or exempt the foreign lawyer from the rule.²⁵⁸

Many foreign firms that sent in comment letters to the SEC during the comment phase expressed concern, and requested that non-U.S. attorneys be exempted altogether, while others asked that the SEC consider the potential for conflict and exempt foreign attorneys in the interim.²⁵⁹ In the end, the SEC rejected all notions of exempting foreign attorneys altogether, recommending that those concerned about whether they fall within the purview of the rules should simply seek the advice of U.S. counsel. The SEC took the position that the rule is clear regarding what is outside of the definition of “appearing and practicing.” Based on § 205.2(a), the simple preparation of a document that may be included as an exhibit into an SEC filing does not constitute “appearing and practicing” before the Commission unless “the attorney has notice that the document will be filed with or submitted to the SEC, and he or she provided advice on [U.S.] securities law in preparing the document.”²⁶⁰

²⁵⁴ 17 C.F.R. § 205.2(j)(3) (i)-(ii) (2003).

²⁵⁵ *Id.* § 205.6(d).

²⁵⁶ Greene, *supra* note 54, at 831.

²⁵⁷ Harper, *supra* 137, at 141.

²⁵⁸ *Id.*

²⁵⁹ Greene, *supra* note 54, at 831.

²⁶⁰ *Id.* at 832; 17 C.F.R. § 205.2(a)(1)(iii) (2003) (specifying that to be considered appearing and practicing in front of the SEC, mere preparation of a document does not suffice unless the attorney has notice that it will be filed, submitted or incorporated in other document to be filed or submitted to the SEC).

2. When is Reporting Required?

Another aspect where confusion is likely, regarding the applicability of the rules to foreign attorneys, is in determining under what circumstances the reporting requirement is triggered. As noted earlier, up-the-ladder reporting is required when there is credible evidence of a material violation by the issuer of U.S. federal or state securities law, or a material breach of fiduciary duty or other similar violation; the standard is whether a prudent and competent attorney is reasonably likely to become aware of the material violation.²⁶¹ Foreign attorneys are likely to lack the professional expertise to determine under what circumstances the conditions of compliance with the rule are met.²⁶²

It is clear that the rule does not apply to violations of foreign law; rather, it is triggered by the violation of U.S. federal or state law.²⁶³ But clarity ends there. For example, the SEC purposely left the definition of the word “material” open, to be defined by reference to established federal law, unlikely to be at the fingertips of any foreign attorney, which defines material violation as “conduct or information about which a reasonable investor would want to be informed before making an investment decision.”²⁶⁴ The definition is not necessarily free from ambiguities for the domestic practitioner either.

Another issue of confusion, which ties in with the safe harbor provisions, as opposed to those instances when reporting up-the-ladder may be required, is exclusion from the rule if compliance would expose the foreign lawyer to sanction or other prohibition by foreign law.²⁶⁵ Here, SEC compliance requirements would seem to extend as far as allowed by foreign law.²⁶⁶

The next issue relates to the concept of sufficient evidence. Section 307 and rule 205 require the attorney to report evidence of material violation. As noted above, the standard is reasonable likelihood, a conclusion of preponderance of the evidence based on a factual analysis that may be problematic for a U.S. attorney, and that is likely to be even more problematic for the foreign attorney not accustomed to the American legal standards of preponderance of the evidence, clear and convincing, and beyond a reasonable doubt.

In addition, unpredictability in the enforcement of Section 307 and rule 205 can unduly raise the fear of liability and produce an environment

²⁶¹ Harper, *supra* note 137, at 148.

²⁶² *Id.*

²⁶³ Greene, *supra* note 54, at 834.

²⁶⁴ *Id.* at 835.

²⁶⁵ See 17 C.F.R. § 205.6(d) (2003) (exempting the foreign attorney from compliance “to the extent that . . . [it] is prohibited by applicable foreign law”).

²⁶⁶ *Id.*

where shareholders and the public receive even less protection in the international arena.²⁶⁷ The uncertain reach and enforcement of the rules can cause the international corporate client to seek out the services of an American lawyer with whom candid and ongoing communication is likely to be dampened by language and cultural barriers. On the other hand, a lawyer faced with perceived strict rules may over-report, thus chilling the flow of information necessary to his function as a lawyer and his newly appointed duty of roving investigator.²⁶⁸ In sum, as applicable to the foreign bar, due to overlapping norms, uncertainty of application, and misapprehension of the law, the reporting rules can have an even higher counter-productive effect than with the domestic bar.

3. Supervising Attorneys

The rules related to the responsibility of supervising attorneys are also relevant for the attorney of foreign issuers. A supervising attorney is one who supervises or directs another attorney appearing and practicing before the SEC in representation of an issuer.²⁶⁹ Based on MRPC R. 5.1(b) and (c)(1) and SEC rules §§ 205.4 and 205.5, when the subordinate attorney reports evidence of a material violation to the supervisory attorney, the latter becomes responsible to comply with the reporting requirements of § 205.3.²⁷⁰ If the supervising attorney provides direction to the subordinate, albeit only in matters related to the subordinate attorney's appearance before the SEC, he would qualify as a supervising attorney.²⁷¹ The potential implications for foreign issuers are significant since any foreign attorney of an issuer is in fact supervising a U.S. attorney "appearing and practicing" before the SEC, and therefore shares responsibility, at least to a certain extent, regarding reporting compliance.²⁷²

4. Discipline and Sanctions

The discipline and sanction provisions of the rules start by saying that attorneys who violate § 205 are subject to the civil penalties and remedies applicable for violation of U.S. federal securities laws in an action brought by the SEC.²⁷³ The right of action under the rules belongs to the SEC only, as no private right of action is admitted against attorneys or issuers based

²⁶⁷ Harper, *supra* note 137, at 163; Greene, *supra* note 54, at 847 (stating that turning lawyers into watchdogs may end up causing the issuer to become more secretive and break even more laws by ignorance than they ever did intentionally).

²⁶⁸ See *id.* at 848.

²⁶⁹ 17 C.F.R. § 205.4(a) (2003).

²⁷⁰ Greene, *supra* note 54, at 841-42.

²⁷¹ *Id.* at 842.

²⁷² *Id.*

²⁷³ 17 C.F.R. § 205.6(a) (2003).

on the further clarifications provided in § 205.7, which resolved the debate previously left open by the rules. However, § 205.6(b) specifies that an attorney appearing and practicing before the SEC is subject to the disciplinary authority of the SEC even though he may simultaneously be subject to discipline for the same conduct where the attorney is admitted to practice.²⁷⁴

A foreign attorney could be subject to discipline by the SEC and the disciplinary authority of his home country imposing contrasting duties and requiring him to choose which to violate (or to comply with) if it were not for the later introduced § 205(d), which provides that “an attorney practicing outside of the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.”²⁷⁵ Still, the foreign attorney is required to comply with the SEC rules to the maximum extent permitted by the foreign law applicable to him.²⁷⁶

The foreign bar is still concerned about the applicability of SOX rules of professional responsibility, especially in relation to the trend for lawyers to be invested with increasingly essential functions in business operations, including strategic planning, solving business problems, and advising on risk management.²⁷⁷ Overall, the most lamented negative repercussion so far is more time spent on studying regulations, more time spent on fulfilling reporting requirements, and in general more paperwork, with enormous expenditure of resources for the issuer in attorneys’ time and executive investigative time.²⁷⁸

C. Foreign Responses to Corporate Scandals

Different nations have adopted a variety of approaches to the challenges of transparency and accountability of corporations to their constituents, and there have been a variety of reactions to the recent financial debacles, large and small. The idea of enlisting corporate lawyers for the unenviable task of policing their clients has occurred in other contexts, although not to the extent envisioned by SOX, which seems to be peculiar to the U.S. approach.

1. A Lighter Hand: the European Union (E.U.) Legislation

While the U.S. decided to federalize corporate governance rules, the E.U., facing similar challenges to investors’ confidence after corporate scandals of similar resonance, such as Parmalat and Cirio, considered that

²⁷⁴ *Id.* § 205.6(b).

²⁷⁵ *Id.* § 205.6(d); Greene, *supra* note 54, at 849.

²⁷⁶ *Id.*

²⁷⁷ *Id.* at 846.

²⁷⁸ *Id.*

codification at the European level was going to have very little impact, since there is great variance among the member states securities and corporate laws, which are still expected to take many years and much work to harmonize.²⁷⁹ Europeans take a different view of the potential effectiveness of a single code to regulate the activities of individuals inside corporations.²⁸⁰ In 2001, a group of appointed experts recommended not to attempt a single code, but to endeavor to promote harmonization of member legislation by promulgating general, non-binding principles and rules to allow Member States to learn from each other by passing a directive which makes it mandatory for companies to disclose their governance policies, but leaves to each Member State the task of specifying the content of such disclosures.²⁸¹ In 2003, the European Commission presented an Action Plan for "Modernising Company Law and Enhancing Corporate Governance in the E.U.," a set of proposals to better coordinate Member State initiatives, establishing a broad E.U. framework but allowing a degree of Member State flexibility in three phases stretching through 2009.²⁸² In response, many of the E.U. Member States have since been active in promulgating reforms to their corporate and societal systems in recent years, tending to bring the individual country's legal framework up to par with the global marketplace.²⁸³

2. Conflicts in Germany

German issuers concerned with the increased costs imposed by SOX on foreign issuers, and with the fact that many of its provisions are incompatible with German corporate governance mechanisms, postponed listing with the NYSE.²⁸⁴ For example, following SOX, Porsche postponed its NYSE listing and questioned whether it was necessary or advisable for it to entertain this step, and 24 German companies met to discuss the effects of U.S. law and how it directly conflicts with German law.²⁸⁵

The corporate structure in Germany is two-tiered: it is composed of a management board, which has duties similar to the American BOD, and a supervisory board. However, unlike in the U.S., there is no CEO to whom the others report, and it would not make sense to hold any one individual

²⁷⁹ Elias Mossos, *Sarbanes-Oxley Goes to Europe: A Comparative Analysis of United States and European Union Corporate Reforms After Enron*, 13 CURRENTS INT'L TRADE L.J. 9, 10 (2004).

²⁸⁰ *Id.*

²⁸¹ *Id.*

²⁸² Maria Camilla Cardilli, *Regulation Without Borders: The Impact of Sarbanes Oxley on European Companies*, 27 FORDHAM INT'L L. J. 785, 821 (2004).

²⁸³ See *supra* Section III.A.2.c.

²⁸⁴ Anapama J. Naidu, *Was its Bite Worse than its Bark? The Costs Sarbanes Oxley Imposes on German Issuers may translate into Costs to the United States*, 18 EMORY INT'L L.REV. 271, 273-74 (2004).

²⁸⁵ Falencki, *supra* note 171, at 1228.

member of the management board responsible in lieu of the group.²⁸⁶ This difference makes compliance with SOX particularly challenging and costly.

3. Corporate Governance Regime in the United Kingdom (U.K.)

Bankers and lawyers in the U.K. believe that SOX does not fit their corporate governance reality, and that the model of corporate governance which prevails in the U.K. overlaps with SOX. In fact, many corporate provisions similar to the ones of SOX have already been enacted and are systematically implemented, well-defined and complied with, as they have been evolving for over a decade.²⁸⁷ There is in effect a Code of Corporate Governance which lists principles and practices for the companies listed on the London Stock Exchange (LSE); as a supplement, the Smith Rules assist companies in implementing audit committees, making SOX unnecessarily duplicative.²⁸⁸

Further, under the Companies Act of 1985, directors of U.K. companies have a statutory duty to compile accounts that give a true and fair view of the state of affairs of the corporation and its profits and losses, and they are criminally liable for failure to comply.²⁸⁹ According to the view of British solicitors, the system is inspired to a “comply or explain” approach and provides a high level of corporate governance regulation and compliance with no need to superimpose the largely duplicative, “Draconian and ill thought-out” U.S. law.²⁹⁰

4. The Hong Kong Negotiated Solution

Having suffered through a wave of corporate scandals, Hong Kong, just like the U.S., has examined the role of lawyers and introduced measures to enlist them in policing corporate governance.²⁹¹ Hong Kong actually started to address the issue back in 1996, several years prior to the U.S., when the Hong Kong Law Society and the Hong Kong Stock Exchange negotiated a Memorandum of Understanding (MOU), which defines the expectations of the Exchange as it pertains to the conduct of solicitors representing listed companies.²⁹² Then, the Hong Kong Standing Committee on Company Law Reform (SCCLR) released Phase I of its report and proposed regulations in 2001, and, in the wake of recent scandals, in 2004,

²⁸⁶ *Id.* at 1227.

²⁸⁷ *Id.* at 1225.

²⁸⁸ *Id.* at 1226.

²⁸⁹ *Id.*

²⁹⁰ Falencki, *supra* note 171, at 1227.

²⁹¹ Susan E. Carroll, *Caught Between a Rock and a Soft Place: Regulating Legal Ethics to Police Corporate Governance in the United States and Hong Kong*, 14 PAC. RIM L. & POL'Y 35, 37 (2005).

²⁹² *Id.* at 38.

the SCCLR issued Phase II of its report on reforms needed.²⁹³ Both countries are experiencing the unintended consequences of their attempts to ameliorate and monitor corporate governance, albeit with different approaches, by regulating lawyer's conduct and relying on lawyers as agents of control.²⁹⁴

In Hong Kong, solicitors are self-regulated through the Law Society, roughly similar to the state bar associations in the U.S., which maintains rules, the Guide to Professional Conduct, similar to the domestic state rules of professional conduct.²⁹⁵ Unlike the U.S., in Hong Kong, the Law Society and the Exchange had the foresight to anticipate that lawyers would have a role to play in corporate securities law violations and to cooperate to produce the MOU.²⁹⁶ There are three instances where the conduct of the solicitor would subject him to discipline by the Exchange, as opposed to the Law Society:

1. Making an untrue representation to the Exchange (knowingly or recklessly) either per the instruction of the client or directly by the solicitor without reasonable inquiry as to the truthfulness of the same;
2. Knowingly or recklessly facilitating or participating in a breach of the listing rules;
3. Knowingly or unreasonably failing to advise the clients in relation to the requirements of the listing rules.²⁹⁷

Even though it represents an example of cooperation and foresight, the MOU has not been effective in preventing corporate fraud, stopping solicitors from aiding corporations in defrauding minority shareholders or looting company resources; and it has never been used in a disciplinary proceeding.²⁹⁸

Hong Kong negotiated an enforcement agreement between entities, while in the U.S., the SEC attempts to strong-arm the attorneys into compliance with disclosure rules. Unfortunately, it seems that both approaches, while possibly in line with their respective cultures, fail to accomplish the ultimate goal.

5. Impact on Canadian Lawyers

Since Canada is the largest foreign issuer in the U.S. exchanges, the impact of the reporting rule on Canadian lawyers becomes particularly rele-

²⁹³ *Id.* at 52.

²⁹⁴ *Id.*

²⁹⁵ *Id.* at 53.

²⁹⁶ Carroll, *supra* note 291, at 53.

²⁹⁷ *Id.* at 53-54.

²⁹⁸ *Id.* at 56.

vant.²⁹⁹ Canadian lawyers are subject to the rules of professional conduct of the various provinces and territories where they practice, and only the Law Society of Ontario, which recently modified its rules to harmonize with the U.S., imposes mandatory up-the-ladder reporting on corporate attorneys, while all the other codes have permissive rules on the subject.³⁰⁰ Canadian lawyers, therefore, may be subject to liability, both under the jurisdiction of the SEC and under their codes of professional conduct.³⁰¹

Canadian codes of professional conduct emphasizing integrity, which is said to be a unique tradition of Canadian lawyers' ethics, are characterized by an exhortatory tone and look beyond partisanship to encourage the bar to act in the best interest of the community.³⁰² On this backdrop, Canadian lawyers subject to the SEC may over-report, causing managers and officers of the issuers to be guarded about how much information they share with their counsel.³⁰³ If U.S. lawyers are chosen instead, managers and officers of the issuers may refrain from divulging information that may lead to uncovering misconduct to a lawyer who is less knowledgeable on Canadian custom.³⁰⁴ Clearly, either option is likely to produce less protection for the investor.³⁰⁵ Alternatively, both Canadian and U.S attorneys may be on the job.³⁰⁶ In this situation, the Canadian attorney benefits from the safe harbor, and only the U.S attorney faces liability for misconduct.³⁰⁷ The Canadian attorney may not.³⁰⁸ Yet another alternative is for issuers to avail themselves of the help of legal experts who are outside the purview of the rules.³⁰⁹ In all alternatives, the up-the-ladder reporting rules impose high transaction costs without yielding the hoped-for result of guaranteeing investor protection.³¹⁰

IV. WHAT SHOULD FOREIGN LAWYERS DO?

The suggestions for proper compliance for foreign attorneys are relatively simple, yet not easy to implement right away, and definitively not without cost. Lawyers of foreign issuers should become familiar with U.S. securities laws and with SOX professional responsibilities rules. Otherwise, unless they meet the definition of non-appearing, the only way they could

²⁹⁹ Harper, *supra* note 137, at 142.

³⁰⁰ *Id.* at 153.

³⁰¹ *Id.*

³⁰² *Id.* at 158.

³⁰³ *Id.* at 163.

³⁰⁴ Harper, *supra* note 137, at 163-64.

³⁰⁵ *Id.* at 163.

³⁰⁶ *Id.* at 164.

³⁰⁷ *Id.*

³⁰⁸ *Id.*

³⁰⁹ *Id.*

³¹⁰ *Id.*

effectively avoid liability is to decline to give advice on U.S. securities or to seek the support of U.S. counsel any time they get involved in legal analysis which could constitute appearing and practicing in front of the Commission.³¹¹ The conclusion is supported by the fact that SOX does not define the meaning of material in regards to material violation, relying, as noted earlier, on its well-established meaning under federal law. The only way the foreign attorney can be comfortable in appreciating whether he may be in fact faced with such a situation³¹² is to become conversant in securities laws, SOX provisions, and U.S. federal law in general.

Another solution implicit in the rules is, of course, to retain a U.S. law firm. Although it may not fully protect from supervisory liability, it definitively places the U.S. legal expertise at the service of the foreign company listed in the exchange, avoiding misapprehension of the law, and to a large extent, confusion.

Also, foreign issuers should make sure that their legal department has a structure characterized by a clear hierarchy and clear definition of responsibilities, so that only “supervising” attorneys are charged with the duty of up-the-ladder reporting, thereby minimizing the exposure of subordinates and reducing reporting time and effort.³¹³

Another suggestion is for general counsel to establish regular meetings with officers and executives on the subject of potential breaches of law and duty, promoting understanding and fostering compliance, rather than a mentality whereby these meetings only happen in times of crisis³¹⁴ where emotions likely run high and everyone is functioning in a reactive mode. This should actually be part of a process of education for corporate executives regarding the relevant dispositions to equip them to be more vigilant with respect to potential evidence of material violations, which should percolate through the organization via information and procedures for handling receipt of reports and investigation of possible material violations of U.S. securities laws.³¹⁵ These suggestions, of course, generate a significant increase in transaction costs, which many foreign issuers take into account when deciding whether the cost of listing is matched by the rewards of access to the U.S. capital markets.

V. CONCLUSION

SOX reaches across borders to impose on foreign attorneys duties to their client-corporations by virtue of the fact that the foreign issuers have

³¹¹ Greene, *supra* note 54, at 852.

³¹² *Id.* at 853.

³¹³ *Id.* at 851.

³¹⁴ *Id.* at 852.

³¹⁵ *Id.*

registered with the SEC for the privilege of access to the U.S. capital markets. The U.S. federal government is thus attempting to export a novel and, as yet, experimental regulatory system, which breaks with an established tradition of state regulation and self-regulation. SOX professional conduct norms are understandably resisted by the domestic bar where the remonstrations center around the fact that Section 307 compromises the independence of the profession, deals a fatal blow to the duty of confidentiality, the pillar of the attorney-client relationship, and even compromises the foundation of the adversarial system, intending to deputize the corporate lawyer for the benefit of the SEC's investigative needs, and asking him to prioritize the interests of third parties, as opposed to the interests of his employer, to loyal and expert legal advice.

SOX rules may have been a well-intentioned part of the grand scheme of imposing a more responsible behavior on corporate entities vis-à-vis the investment base and the public in general. However, while imposing on the bar the superhuman task of serving two masters, the rules do not hold promise to enhance transparency and accountability, or to bring about behavioral changes inspired to higher ethical and moral standards in the corporate arena. Instead, SOX compliance has been causing an increase in transaction costs throughout listed companies, an increase in the lawyer's work, a likely chill in the flow of information to corporate counsel, and has possibly made counsel less effective in providing legal advice, spotting potential problems, or persuading the clients to follow legally acceptable courses of conduct.

These problems are only exacerbated as it pertains to the foreign bar. Besides the unresolved question regarding the general propriety of extending the SEC's jurisdiction to the foreign bar, even if only by way of voluntary choice of the foreign issuer to be listed, the U.S. federal rules of conduct for lawyers, already at odds with domestic state rules, are likely to be even more distant, and therefore in dissonance with foreign rules of professional conduct. The result is to impose contrasting mandates upon foreign attorneys regarding the same representation, while remaining at odds with corporate governance schemes in other nations that do not subscribe to corporate structures based on individual responsibility, but embrace collegial schemes with shared corporate responsibility.

To determine whether he qualifies based on one of the exemptions or whether he falls squarely under the provision of the rules, the foreign attorney has to wade through a maze of legal definitions peculiar to American law and with which the foreign practitioner is not likely to be familiar. The same is true with regard to the determination of which particular conduct triggers the applicability of up-the-ladder reporting. The logical course of action is to rely on the support of the American bar, which increases transaction costs for the issuer while not necessarily exempting the foreign lawyer from responsibility under SOX in all cases.

Unfortunately, uncertainty of application in overlapping regulatory frameworks has only been increased by SOX under the guise of promoting transparency and certainty. The SEC may have recognized that new, controversial, and resisted norms of uncertain effectiveness and untested application are particularly unfit to be exported wholesale. Appropriately, the refinement of applicability provided by the SEC final rules tones down the extent of federal imposition on the domestic bar regarding its accountability as “corporate watchdog.” Even more appropriately, in respect of the territoriality principle and of general rules of unnecessary conflict avoidance and comity, the SEC final rules have also introduced safe harbor provisions specifically to exempt the foreign bar to a large extent. However, possible areas of applicability of the up-the-ladder reporting duties and its draconian consequences cannot be underestimated by foreign attorneys who become involved in representing foreign issuers registered with the SEC. The foreign bar is well advised to be cautious.

Likewise, in applying these controversial rules to the foreign bar, the SEC should take a restrained approach. The SEC should allow the rules’ persuasive force to bring about responses and solutions from foreign countries and the foreign bar, adapted to their own corporate regulatory systems. This way, the rules might achieve the common goal of cooperation in preventing and curbing gross corporate malfeasance which compromises the stability of the global market.