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PRACTICUM: FORM AND POLICY

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The Impact on International Commerce of the Patriot Act, Sarbanes-Oxley and Other Recent U.S. Laws

[Editor's Note: There follows an edited transcript of the two program panels held jointly on 26 January 2005 at the New York Marriott Marquis of the International Law and Practice Section and the Corporate Counsel Section of the New York State Bar Association during the Annual Meeting of the NYSBA.]

I. Introductory Remarks

PAUL M. FRANK: Good morning, everybody. I am Paul Frank. I am the chair of the International Law and Practice Section, and it is our pleasure today to do a joint program with the Corporate Counsel Section.

It was Barbara Levi who originally came to me and suggested it. So, our thanks to Barbara.

I am going to turn the microphone over to Mitchell Borger on behalf of the Corporate Counsel Section. But I do want to thank our own Jack Zulack for having organized the program today. I think it is a very interesting one. The first panel is being put on by people from the International Law and Practice Section, who carried out similar programs for us up in Quebec City earlier this year and to the Bar of Quebec.

Later on we have a program from the law firms that were our hosts in Montreal when we were there. And I think the number of law firms from Canada that are represented in New York City by actual offices is impressive. As I suggested last evening at the Executive Committee meeting of the ILPS, I hope we will do more Canadian-American programs. We travel around the world with almost reckless abandon to various places for meetings, most recently in Santiago de Chile, and as successful as they are—and we will continue doing that, including in the next year in London, Shanghai and then Stockholm—we still have an obligation to our neighbors to the north and who are actually here in the city. And we'll hear from them later.

Mitchell, thank you very much for joining with us.

MITCHELL F. BORGER: Good morning, everyone. Some quick thanks and then a couple of notes on behalf of the Corporate Counsel Section. Thank you very much to the International Law and Practice Section for inviting the Corporate Counsel Section to join. I think this morning's presentation is going to be exciting for both sections. So thank you very much again on behalf of the Corporate Counsel Section.

JOHN F. ZULACK: Welcome, everyone. I'm Jack Zulack. I'm the program chair, and my duty is to introduce the moderator and sit down. We have a wonderful program, and we'd like the morning panel to come up, as Joyce Hansen will describe what our format is going to be.

II. The Impact of Anti-Terrorist Legislation on the Lawful Employment of Foreign Nationals in the United States and Related Concerns

JOYCE M. HANSEN: Thank you very much. We have a really excellent program this morning. The first section has three parts. We are going to be looking at developments in employment, immigration, and anti-corruption laws.

The first part of our panel is going to look at the impact of the anti-terrorist legislation on the lawful employment of foreign nationals in the U.S. We'll then turn to the emergence of multinational employment law, and looking in particular at the extraterritorial application of U.S. and foreign employment laws. And then end up with an excellent presentation on the U.N. Convention Against Corruption on U.S. business.

I'm going to introduce our first group of speakers, who will be addressing the immigration laws. And before each section I will introduce our next set of speakers.

We have three very experienced immigration lawyers for our first panel. Jan Brown has concentrated in the practice of immigration law since 1979. He is the chair of the Immigration and Nationality Committee of the New York State Bar Association's International Law and Practice Section. He has lectured numerous times for the New York State Bar Association and other bar associations and for PLI, and he has contributed to various periodicals and helped edit various periodicals on immigration law.

Allen Kaye is an attorney who has practiced United States immigration and naturalization, visa and consular law for the past thirty years. He is also a columnist on immigration matters, and a frequent lecturer on U.S. immigration, naturalization, visa and consular law.

Our third panelist is Ken Schultz. He represents clients in matters dealing with entry into the U.S. and the acquisition and loss of U.S. citizenship and lawful permitted residence. He is a partner at Satterlee, Stephens, Burke & Burke. His writings have been published in periodicals devoted to immigration law. He is a very experienced lawyer who has represented multinational corporations on the issues of immigration law.

So Ken is going to kick us off. Ken.

A. Immigration Laws

1. Situation

KENNETH A. SCHULTZ: The starting point of the business immigration component of today's program is the USA Patriot Act, which was enacted on 25 October 2001, just six weeks after September 11.

Does anyone happen to know what USA Patriot stands for? Well, it is an acronym for "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism."

Now, this doesn't sound like an act that would have very much to do with the world of business immigration law. And in fact, the Patriot Act didn't make any substantive changes in the law that governed eligibility for temporary working status or employment-based green cards. The Patriot Act did things like create a new crime of domestic terrorism, establish mandatory detention of suspected terrorists and authorize funds to triple the border patrol along the Canadian border. It set up a foreign student monitoring program. And it was designed to facilitate information sharing and cooperation among different government agencies, and then speed up the implementation of an integrated entry and exit data system, which was focused on biometric technology.

Now, data issues have been a concern of the Immigration Service for a long time. Back following the Iranian revolution, President Jimmy Carter wanted to identify all the Iranian students in the United States, and the INS just wasn't able to do it. So alarm bells went off, but they quickly faded away.

It wasn't until much later that legislation was enacted to establish a comprehensive entry and exit documentation system, and this was designed such that every non-citizen would have to have his or her entry and exit documented.

Now, the concept of exit controls was entirely new, and it presented a whole host of administrative problems for the Immigration Service. But really, the biggest problem was that Congress forgot that Canadians are not U.S. citizens. The prospect of documenting the entry and exits of every Canadian crossing the northern border created real panic. The business people in border states and the border state politicians knew that the INS didn't have the infrastructure or the manpower to pull this off. And experts were out there forecasting twelve to twenty-four hour waits to cross the border.

Now, politicians weren't interested in committing political suicide, so they quickly enacted another act, which put the implementation date of the exit and entry system off.

Then came the fateful date of September 11, and this of course was quickly followed by the Patriot Act. And today, what we are really confronted with and what Congress and the Administration are wrestling with is how to balance the appropriate security and economic considerations that come with international commerce.

Historically, the Immigration Service and the State Department have been very accommodating of the international business community and its need for a straightforward and predictable path for lawfully employing foreign nationals in the United States. While the tragic events of September 11 and the enactment of the Patriot Act have not resulted in the government's disregard for the interests of the international business community, the immigration regime has become more cumbersome and less predictable.

Colin Powell, in a recent cable sent to all of the U.S. consular posts on the subject of visa issuance, said: "Many of you have heard me describe secure borders, open doors as one of the most important goals of the Department of State and of this nation. This phrase describes a vision of an America with robust and effective measures to safeguard national security that is still able to open its door to the exchange of people, ideas and goods that have helped make this nation great." And here is the punch line: "It is no mistake that securing borders comes first. We can have no freedom without security." Now, I'm sure that we all agree with the Secretary's message in principle. But we also need to take a look at how this message and the Patriot Act are interpreted on the ground, where the attitudes of U.S. consuls and immigration inspectors and adjudicators make a big difference to the international business community.

In the world of immigration practitioners, we talk about the government's culture of "no." Not surprisingly, security considerations make it very easy for U.S. consuls, inspectors and adjudicators to say "no" when a foreign national seeks permission to work in the United States.

And then we throw in with the Patriot Act some additional ingredients that are receiving a good deal of press and upsetting a significant number of Americans. U.S. companies are downsizing. Aliens are displacing U.S. workers. Good jobs are being out-sourced abroad. The U.S. economy is experiencing a jobless recovery. We also have an increasingly sophisticated anti-immigration movement that has chosen to attack legal immigration as well as illegal immigration.

This might suggest that the environment is right for lawful immigration to come to a grinding halt. But immigration is an infinitely complex subject. The American people still value their heritage as a nation of immigrants, and the people recognize that the country has benefited greatly by attracting the world's best and brightest.

But immigration is an issue that is in a state of constant tension. The law changes one way and then another. And in reaction to economic security and political considerations, the attitudes of U.S. consuls, immigration inspectors and immigration adjudicators change as well.

My colleagues and I are going to address the current state of affairs regarding key temporary working classifications used by the immigration bar and by the international business community as well as new visa application and admission procedures resulting from the heightened security concerns.

With that I'm going to turn this over to Jan, who is going to tell us about one of the key working categories, known as the H-1B.

2. The H-1B Visa Program

JAN H. BROWN: The H-1B, which is a visa that allows professionals, people generally who have the equivalent of a U.S. university degree, to come to the United States and work on a temporary basis of up to six years. It also can lead to permanent residence.

From the perspective that Ken has talked about, it is a pretty good prism to see how this country is currently suffering from severe xenophobia. The H-1B program is disconnected from the business needs of our country right now.

Right now there is a cap of sixty-five thousand visas annually. The year starts on October 1st, and this year the cap was met on October 1st. So this is what we're up against. We'll probably be up against something similar next year.

Out of the sixty-five thousand, a huge amount, over ten percent, was carved out for Chile and Singapore under the Free Trade Agreement. And while this year I understand Chile only used about two hundred of these visas, so they were recaptured, they were nevertheless gobbled up immediately, because, really, the amount available is only about half what the United States society and economy demand.

Congress has done something to indicate that there is a reality of a constituency, namely our clients: People who need to get work done in the United States, need to bring foreign workers for very legitimate reasons other than just to undercut the pay scale of U.S. workers. And there is a great need to continue to bring very talented people from around the world to contribute to our dynamic society. There is a constant infusion of new blood.

So recently, about a month, month and a half ago, Congress passed an Omnibus Appropriations Act, and, as is Congress' habit, sowed some immigration legislation into this. One thing that was put in was the addition of twenty thousand more H-1B visas. They will be open to people who are graduates of U.S. universities and who have attained at least a master's degree or higher. This hasn't been implemented yet, but I assume that by the start of the next fiscal year, 1 October 2005, that they will be available.

They've also added new fees to make it much more expensive. Right now the base fee to file such an application is only $185. Congress has added a training fee, which is now in effect, of either $750 for corporations or businesses of twenty-five or fewer employees, and for those that are larger, the training fee is $1,500. They've also added another fee of $500, kicking in on 8 March of this year: It is basically an antifraud fee. Since there is a presumption that this, like many immigration programs, is rife with fraud and is just a vehicle to funnel foreigners into our country, this $500 is supposed to be used to try to keep the system clean and honest.

Again, to a certain extent it is a disconnect from the legitimate realities of this and many of the immigration programs we'll talk about today.

So we, basically, just have to keep our spirits up and make do as best we can under very difficult times right now. Our clients are often greatly inconvenienced at best, and at worst are forced perhaps to move their own businesses overseas, since they can't get the workers here that they need to service their industries.

Just one more part of this Omnibus Appropriations Act: it changed the way salaries are evaluated. Most salaries for H-1Bs, which were based essentially on Labor Department surveys, were such that the employer could come in with ninety-five percent of that. It gave employers a little leeway. That was changed and now the Labor Department survey has to be either met at one hundred percent or an alternate survey, which is at the employer's expense, can be presented to document that there is another viable survey. The only good news is that the Labor Department is used to having a two-tier system.

People who are entry level and people who are experienced: the situation was such that many employers found that the experienced level was way out of their budget, and there were a lot of complaints about that. So Congress has ameliorated this problem by making it a four-tier system now, with two intermediate steps.

So I'm ending my little section here on something that is a little positive. This is cutting employers a little slack in terms of being a little more realistic on pay scales.

I am now going to turn it back over to Ken, who is going to talk about another visa category, the L-1 category.

3. The L-1 Visa Program

MR. SCHULTZ: Since 1970, multi-national companies have been able to temporarily transfer key persons employed abroad to related entities in the United States. And the visa classification for these people is known as intracompany transferee, and is designated with the L-1 classification.

Executives and managers are designated L-1A, and they can work in the United States for up to seven years. Persons with specialized knowledge are designated L-1B, and they can work in the United States for up to five years.

These terms of "managerial capacity," "executive" and "specialized knowledge," are defined by regulation and historically have been interpreted rather liberally by the Immigration Service, particularly when the multinational group is a large, well-known corporation.

Despite the ups and downs of the economy since 1970, the L-1 category has been mostly non-controversial. There were times when immigration adjudicators seemed to be somewhat more restrictive than others. But for the most part the system worked very well, and multinational groups were able to easily move key people into the United States.

During the late 1980s, the Immigration Service went through an unusually restrictive phase in its interpretation of specialized knowledge. And at that time Congress had to step in and enact legislation in 1990 to loosen things up and right the ship, in accordance with its original intent to facilitate the admission of key staff. Congress was of the mind in 1970, as well as in 1990, that the L-1 category helped promote foreign investment. It created jobs. It promoted exports, and it improved the management of multinational groups.

The adjudication of L-1 petitions remained fairly constant, even after September 11th. But concerns started to grow as the economy suffered and reports of downsizing and outsourcing increased. Additionally, the anti-immigrant movement, which had been largely effective in combating legal immigration, changed its focus and started taking a very hard look at the temporary working visa classifications, including the L-1.

Then a major article appeared in *Business Week* on 10 March 2003, which told the story of a number of Siemens computer scientists, systems analysts, who were being laid off. And what was going on here is that Siemens was replacing these people with systems analysts who were coming in from India. And they were being brought in by an Indian group that was taking advantage of the specialized knowledge component of the L-1 category. So they were saying that these people had been working within the computer group abroad and then were being transferred into the United States to make use of the specialized knowledge that they had acquired working for the group abroad. The complaint by the U.S. workers was that these people didn't have any specialized knowledge. They were garden variety systems analysts that were being transferred to an India entity in the United States and then assigned to Siemens. So that the U.S. entity, part of the Indian group, was nothing more than a placement office.

Well, this created real issues, and everybody jumped on the bandwagon, and there was a flurry of activity in Congress. A great many hearings were held; reports were prepared, and proposed legislation started flying off the shelves. Bills were introduced to eliminate the specialized knowledge category. Other bills established quotas for the category, and there were bills that would radically change the criteria and frustrate the use of the L-1B category. Fortunately, cooler minds prevailed and the L1-Visa Reform Act ended up being enacted, which was part of the Omnibus Appropriations Act that Jan referred to. And what this reform act ultimately did was codify the policy that had been in place with respect to specialized knowledge: it provided that persons transferred in the L-1B category could not be assigned to other companies outside the group and operate under the control and direction of the other company. And by the way, that had been the policy all along. The real issue was whether the computer group was abusing the system.

The other aspect that Jan also mentioned was a fee that was implemented to attach to H-1B petitions as well as L-1 petitions of $500, which was designed to fund a fraud detection unit. It was for fraud prevention and detection. And it remains to be seen how these funds are going to be used and whether in fact the government is going to be able to root out this fraud.

But the important point, and my concluding point here, is that Congress ultimately acknowledged that the problem was fraud, not the L-1 program itself. And it subscribed to the well-settled principle that you don't throw the baby out with the bath water.

With that I am going to turn the program over to Allen, who is going to talk about some mechanical problems that we have with consular processing and new admission procedures.

4. Continuing Programs and Alienation Programs

ALLEN S. KAYE: Since September 11, there have been many changes in terms of legislation, regulation, and procedures, first starting with the USA Patriot Act of October 2001 that Ken mentioned. In May 2002 we had the Enhanced Border Security and Visa Entry Reform Act of 2002. And we have the Homeland Security Act.

Now, what we got from the Enhanced Border Security and Visa Reform Act was a requirement that not later than 26 October 2004 the Attorney General, what is now the Secretary of Homeland Security, and the Secretary of State were to issue to aliens only machine-readable tamper-resistant visas and tamper-resistant entry documents that use biometric identifiers. In order to fulfill this requirement of biometric identifiers, the State Department established a biometric visa program under which all applicants for immigrant and non-immigrant visas at American consulates enroll finger scans of their two index fingers and submit photographs with their visa application.

That program then keys into what happens when they get to the United States: when they get here, they run into another program, which is called U.S. Visit. On U.S. Visit, when they get to the inspection point, there appears up on the screen a copy of the photograph that they submitted with their application overseas, and the two fingers that were scanned in. And then they do it again. A photograph here, two fingers, and then the inspector at the airport matches up to see whether it's the same person. They've caught about four hundred seven people so far out of about six million. But then again, you might consider those four hundred seven people to be future terrorists, so maybe it does work.

Now, this is the U.S. Visit Program. It was very controversial when it started. They have got it really going fairly quickly now. You can go up on the DHS web site, which I suggest you all do, www.DHS.gov, and you even come across a video that you can see about how this process works.

Now what they are working on is another process, called U.S. Exit, which kind of ties into this seamless process that they are going to be doing. They are starting a pilot project at Newark Liberty Airport very shortly, which will be checkout procedures. So visitors on the way out will provide two index fingers, and a photograph, and they have to check out on the way out. So they are getting very, very good at this now. Because previously, no one ever got inspected leaving, and we still don't inspect people leaving.

Now the Immigration and Naturalization Service, as some of you know, no longer exists. It has been split into three agencies. One of the three agencies is called the Bureau of Customs and Border Protection (BCBP). No sooner did we get used to BCBP and they changed it to the United States Customs and Border Protection (USCBP). Those are the friendly folks that meet you at the airport when you come in. When you go down to the former Immigration and Naturalization Service you're going to run into people who are part of what used to be called the Bureau of Customs and Immigration Services. Those are the nice people who give you the benefits and occasionally deny things. They were called the Bureau of Customs and Immigration Service and are now called United States Customs and Immigration Services. We have a lot of acronyms here. The third component is called ICE, Immigration and Customs Enforcement, formerly called BICE—the Bureau of Immigration and Customs Enforcement. Now it is called USICE—the United States Immigration Customs Enforcement. And in the immigration field, we like to say ICE is not nice. Those are the investigators. And they have plenty of time to do a lot of investigating.

What they are going to be doing now is they are going to be getting some of this information in terms of people who overstayed and going after them, which rarely ever happened before. ICE also is in charge of control of students and exchange visitors as part of a new program called SEVIS, which is a computer program called the Student Exchange Visitor Inspection Program.

So students are now very tightly regulated and strictly controlled. Recall the situation that Ken described, when Jimmy Carter wanted to find out how many Iranian students were in the United States and the Immigration Service said, "We don't know": now, they know everything.

MS. HANSEN: Thank you. Does anyone have a question for our three immigration panelists before we move on to employment? We could at least take one or two.

MR. ZULACK: Is there a confusion with names, similar names in terms of identifying people? As you know, some terrorists and maybe two billion people have the same name.

MR. KAYE: It is a very good question. So if I have a client overseas who is applying for a visitor's visa and his name is Mohammed Hassan and they check and find two other bad Mohammed Hassans, who may not be my guy, they are going to take the fingerprints of my Mohammed Hassan, send it out to a bunch of government agencies. If one says hold up, we are still working on it, he's going to sit there for months or could be years. So, yes, there is a confusion of names, which could result in a considerable holdup.

I have had clients who filed for naturalization and had their interview two years ago, and they are still waiting to sort out security checks.

MR. BROWN: If I could also add, what is additionally frustrating is that Immigration takes the position it is out of their hands: "It is the FBI or another spy organization that's holding it up, and we don't know what they are doing, and we don't know when they are going to do it, and we'll get back to you." And as Allen indicated, getting back to you could be six months, it could be two years, it could be indefinite.

MR. KAYE: But at least that guy is here. The guy held up overseas waiting to come here, that could take a long time.

MALE SPEAKER: You correctly mentioned the needs of business. Recently we read—I'm sure you did too—that universities are concerned about a drop off of their foreign student population. I just would like to suggest that it is also a business question, not only for the income of the university. Foreign students themselves appear to be a huge business development. They go home, they will buy American goods and so on and so forth. So we should put that into the category of business.

MR. KAYE: You're totally right. And a cable went out from the State Department asking consular offices to try to facilitate students coming here. In fact, the rate of students has dropped by about fifty percent. The UK and New Zealand have recently liberalized their restrictions. They are very happy to take them. We are losing a lot of money, as you read in the papers.

FEMALE SPEAKER: As part of H-1B visa you say in October of last year there were sixty-five thousand visas available and they finished on the same day. Were there people that applied that day, people that applied months ago, and the sixty-five thousand were the first sixty-five thousand to apply, let's say in February of 2004. How do they begin choosing those visas?

MR. BROWN: That's a good question. The question is, what are the mechanics of applying for the H-1B? Did everybody apply on 1 October, and first come first serve, was it chaos?

Well, actually the answer is no. The rules of the game are that people can apply up to six months in advance. So for example, this year the key day is 1 April 2005, when I expect many, many people will apply. So Immigration will work on the cases starting on 1 April and start approving them with startup dates of 1 October 2005. So they were actually approving cases before 1 October 2004, but just at that date they said okay, no more. We've either approved all we are going to approve or the ones we still have in the pipeline are such that we've reached our sixty-five thousand.

MR. KAYE: To show you what a problem that was, he's saying people started applying 1 April for the sixty-five thousand visas, which were going to be available 1 October, and when 1 October came, they were all gone already for the whole year from 1 October to next 1 October. That's part of the problem.

MS. HANSEN: Thank you very much.

B. The Emergence of Multi-National Employment Law—The Extraterritorial Application of U.S. and Foreign Employment Laws

MS. HANSEN: We are going to turn now to the extraterritorial application of U.S. and foreign employment law.

Helping us with that topic we have two employment lawyers. One is Phil Berkowitz, partner at Nixon Peabody. He has extensive labor and employment experience. He has dealt with issues in particular having to do with discrimination, harassment, wrongful dismissal, denial of benefits, ERISA violations and breach of contract and restrictive covenants.

He's also been involved in litigation, so he has a wealth of knowledge and experience about this topic.

Joining him will be Donald Dowling from Proskauer Rose. He represents multinational employers in connection with all cross-border human resources issues they face as they manage their worldwide work forces.

He has also advised on global diversity programs, and he has also worked as an adjunct law professor teaching International Employment Law.

So I will turn it over to our next group of panelists. Thank you.

1. Changing Legal Framework Regarding Whistleblower

PHILIP M. BERKOWITZ: Thank you, Joyce. I'm Philip Berkowitz. I'm a labor and employment partner with Nixon Peabody. I head our International Labor Law practice team. I'm here with my good friend, Don Dowling, from Proskauer. We are going to talk about how new laws, Sarbanes-Oxley and the Patriot Act, and the new emphasis on corporate ethics brought about after the Enron scandal, have affected the labor operations of U.S. multinationals. And we are talking about how those laws affect foreign companies doing business in the U.S.

Why should we be concerned? These are essentially laws that prohibit retaliation against employees who assert their rights under the law or even in some cases public policy. An employer is forbidden from retaliating against an employee who brings to his or her attention, or to the attention of authorities, some wrongful conduct in which the employer or its agents have allegedly engaged. If the employer violates the law, this may give rise to a cause of action under various federal and state statutes under the common law.

Historically, these kinds of retaliation claims frequently arise in discrimination and harassment cases. An employee makes a complaint of discrimination or harassment, and then he or she says that his or her situation in the company has changed: He or she is treated differently by the boss or other colleagues. He or she is ostracized and ultimately forced perhaps to resign in disgrace.

Of course, it seems fine in principle to prohibit retaliation against an employee who asserts a right under the law. Sounds quite reasonable. The problem is that the employer can be held liable even if it didn't engage in the underlying wrongful conduct. So even if the employer didn't discriminate or harass or deny the employee any rights, a retaliation claim can nevertheless exist. The employee doesn't have to prove a violation of the law or of his or her rights. He or she only has to prove that he or she reasonably believed that there was a violation of his or her rights, and that he or she was retaliated against for complaining about the violation.

The courts have made these cases very easy for the plaintiff to prove, if there is what's called a "temporal proximity": if the bad act occurs shortly after the complaint of allegedly wrongful conduct, then the burden is on the employer to prove that it would have taken the same action even in the absence of the complaint.

And who likes being accused of being a racist or a sexual harasser or violating the law? Well, nobody does. And it may be inevitable that an employer's or supervisor's conduct changes when they are the subject of this kind of accusation.

For our Canadian friends who are here today, a little bit of background on U.S. labor and employment law. It may not be news to you that in the U.S. employment, termination of employees, terms and conditions of employment, and their wages are highly regulated areas. The U.S. is known as an employment-at-will-jurisdiction. But in fact federal and state laws prohibit employment discrimination, sexual harassment, age discrimination, disability discrimination and so forth.

These claims are heard by juries. Juries have the ability to award significant damages, maybe in the millions of dollars, including back wages, attorneys' fees, damages for emotional distress, embarrassment, punitive damages and so forth.

Discrimination laws, as I've mentioned, have their own whistleblower provisions. It is illegal both to retaliate against an employee who claims he or she has been discriminated against and who brings a claim or even participates in a claim brought by someone else. Apart from these specific prohibitions, there has really been no consistency in the U.S. in regard to whistleblower laws. Until recently this has been a hodgepodge. There are some federal laws that pertain to a discrete statute: for example, violations of the Environmental Protection Act. But mostly this has been an issue governed by state law, and very few states actually have a comprehensive remedy for whistleblowing.

Setting aside again the prohibitions against retaliation for asserting discrimination or harassment claims that exist under federal law and most state laws, very few states have any prohibitions against retaliation against whistleblowers. New York, for example, does not provide a remedy for whistleblowers. For example, an employee who is fired after accusing his or her boss of, say, accounting improprieties: New York State Law doesn't prohibit that.

There are a couple of narrow exceptions under New York law that I don't have time to go into. But in fact, in most states there is no law that prohibits retaliation against whistleblowers.

An exception, and you may not be surprised, is California, which does prohibit retaliation against employees who complain about any conduct that he or she reasonably believes constitutes a violation of any law.

Federal law in recent years, though, has greatly expanded remedies for U.S. employees. This gets me to Sarbanes-Oxley. Sarbanes-Oxley, of course, is an extraordinarily comprehensive statute. It was enacted in response to the Enron, Worldcom, and other scandals involving misstated earnings, accounting irregularities, and off-balance sheet transactions. Sarbanes-Oxley encompasses broad-based regulations of corporate governance. The law applies to all public companies, or more precisely, all companies who issue securities registered under Federal Securities Laws: it applies to U.S. and foreign companies, their subsidiaries and related companies. Sarbanes-Oxley was intended to address fraud and the lack of oversight by self-interested corporate management.

An important part of the law is designed to protect employees who expose, who blow the whistle on fraudulent conduct, on conduct that they reasonably believe constitutes fraud against shareholders. That sounds fine, but it opens up a new basis of liability against U.S. corporations whose conduct, as I've already mentioned, vis-a-vis their employees is already highly regulated.

The cases are starting to come in, and as I'll discuss in a minute or so, or five minutes actually to be precise, that the results don't look good.

Don.

2. The Employer Response

DONALD C. DOWLING: Good morning. I'm going to focus more on how multinational companies are responding to this new legal situation in their human resources operations. Given that there are these legal hurdles out there, I am going to discuss how companies are ensuring that they are complying with Sarbanes-Oxley and with increased focus on ethics after Enron, et cetera.

My practice is exclusively international labor and employment working for multinationals, mostly in the U.S., on their global employment operations. In the last few years, since Enron and Sarbanes-Oxley, we have seen a huge shift in emphasis from what there used to be toward globalizing your corporate human resources policies and globalizing your approach to ensure that you're in compliance with local employment laws, et cetera. And companies are still focused on that.

But what leap-frogged to the top in terms of importance in that area is ensuring in your worldwide operations that you're complying with Sarbanes-Oxley. Specifically, if you're publicly traded in the U.S. or if you're simply caught up in this post-Enron atmosphere, the importance of increased emphasis on ethics to assure that your company is behaving ethically and legally worldwide has become paramount.

So what we are seeing is our clients coming to us and asking about rolling out global codes of conduct. And the phrase "code of conduct" is being used in many different contexts. You hear it a lot in a manufacturing operation that sources from abroad, such as Nike or clothes retailing. Thus codes of conduct are talked about as far as ensuring against sweat shops and people making shoes in Bangladesh, et cetera. But other companies, which aren't as focused on sourcing that kind of low-priced product from abroad, when they talk about a code of conduct they are talking about (and again we are assuming a U.S.-based multinational that's traded on a U.S. stock exchange, so it is governed by Sarbanes-Oxley) a handbook form of code of conduct that tells their employees worldwide what's expected of them as far as ethical and legal behavior is concerned.

Remember, your employees in France, Brazil and Thailand aren't steeped in Enron and Sarbanes-Oxley. A lot of them might not even know what we mean when we are talking about Enron and Sarbanes-Oxley. So they are faced with this human resource communications challenge of ensuring people understand what is going on and how a U.S. company is now operating in this U.S. post-Sarbanes-Oxley, post-Enron environment.

Now the policies that are what you might call these global codes of conduct differ a lot, depending on the industry. In the financial services industry you see one set of policies, while companies with heavy government contracting have other concerns. Thus there is no cookie-cutter global policy. But what you do see is that the policies tend to break down into two sections. One would be the "in compliance with U.S. laws," and the other would be "in compliance with local laws or company policies."

There are three big U.S. laws with which U.S.-based multinationals are looking to be in compliance. One is the Foreign Corrupt Practices Act: we have been talking about that in conferences for decades. But, in light of the OECD treaty and another U.N. treaty, companies are paying all the more attention to bribing government officials abroad.

The companies who have governments as customers or who need a lot of government permits are the ones most focused on this issue. But it is important, obviously, for all companies. But the relative importance does change if you're a defense contractor versus a company selling diapers and soap.

We are talking about three big U.S. laws we are concerned about complying with abroad in a code of conduct. Second is Sarbanes-Oxley, which Phil mentioned, and we'll talk about that later. In our second part we are going to mention specifically compliance with Sarbanes-Oxley abroad.

Third is the extraterritorial application of U.S. employment laws. The U.S. discrimination laws that Phil mentioned all apply abroad, since they are U.S.-controlled companies, but only as to U.S. citizens overseas, i.e., expatriates who are locally hired. So in other words, of the tens of thousands of people who work for Ford Motor Company overseas at the Ford plants in Brazil and England, et cetera, none is protected by U.S. discrimination laws other than American expatriates who happen to be posted abroad.

But still, you find that the tail wags the dog in this area. If you look at multinational codes of conduct, they tend to have pages and pages on compliance with nondiscrimination or non-harassment standards, since American companies are committed to eradicating harassment and discrimination from the work force. So they say, "Thou shalt not discriminate. Thou shalt not harass." They tend to impose a very strong rule on the work force worldwide. That is a business decision they make. It is probably a good one. I'm not making a value judgment. I'm just pointing out that it is a business decision.

It is very analogous in the U.S., where many corporations in their code of conduct will list protected groups on which they won't tolerate discrimination or harassment, including age, sex, race, religion. But they throw in sexual orientation, even though in most states—not New York—there is no law against sexual orientation discrimination. It is perfectly legal to discriminate on the ground of someone's sexual orientation in many states today. But companies are saying, "We are not going to tolerate that."

In the international context they essentially impose non-harassment and nondiscrimination policies on work forces abroad. It could lead to legal issues that a company needs to go into with its eyes open.

The one point that jumps out in the acid test is age, because in most every country abroad it is not illegal to discriminate on age. And in fact, the governments want companies to have mandatory retirement so that they can keep their unemployment statistics lower and essentially get people out of the work force when they hit retirement age. That's slowly changing in Europe. But speaking today in England, it is still legal and in Europe it is still legal to have mandatory retirement. Many U.S. companies will have in their nondiscrimination and non-harassment policy a statement that they don't discriminate on the basis of . . . and then give the laundry list and put age in there. So I'll say to the client: "Therefore, you're telling me that nowhere in the world do you have any mandatory retirement policy in your operations, nor do you ever place help wanted ads to fill a certain job and give a certain age range, which are very common in many countries?" Very often the client says: "Well, we haven't thought about that part." What they are essentially doing is giving their employees a contractual right they don't have under the law, and it gets them in trouble.

I know of a place in China where some employees working for a Chinese subsidiary of a U.S. company hit mandatory retirement age, and they were kicked out. They found on the web site a nondiscrimination policy under age, and they sued in court. Then their citation was "It's not illegal under Chinese law, but we had a contractual right."

Employment-at-will disclaimers are essentially unique to the U.S. So any published policy essentially has the force of contract. So you have to be very careful with these policies, and they end up being a little more difficult than taking the U.S. rules in the U.S. and saying, "Let's apply them abroad."

3. Whistleblower Provision under Sarbanes-Oxley

MR. BERKOWITZ: Getting back to Sarbanes-Oxley, or SOX, I'm going to talk about an overview of the SOX whistleblower provision. The official title of SOX is the Corporate and Criminal Fraud Accountability Act. One section provides a whistleblower cause of action, a cause of action that exists for employees retaliated against for disclosing to their supervisor or to any employee who has responsibility for investigating wrongful conduct. If an employee discloses to their supervisor and any employee responsible for investigating wrongful conduct, any information of the order conduct that they believe constitutes "fraud against shareholders," and if they are retaliated against for having complained about that, that is a SOX whistleblower violation.

What is "fraud against shareholders?" It is open to your imagination. It is an undefined term.

The way the statute works, the employee makes the allegation of retribution: the employee must establish what's called a prima facie case. The employee does that by showing temporal proximity, at which point the burden shifts to the defendant to prove by clear and convincing evidence that it would have done the same thing even if the employee had not complained.

By the way, these cases are brought before the Department of Labor's Occupational Safety and Health Administration. I would add parenthetically that that entity has very little experience dealing with employees' claims of this nature. So at that point, if OSHA does not dismiss, OSHA can provide interim relief. It can order the employer to reinstate the employee prior to a hearing. Then the matter goes to a hearing. On the papers OSHA can order reinstatement.

As I mentioned there have been very few substantive opinions. Some are troubling. One case had a nightmare scenario, a case called *Welch v. Cardinal Bankshares,* where we had a nightmare CFO who ran amok: he started alleging fraudulent accounting practices. He insisted on tape recording board meetings, tape recording conversations with his boss. He insisted on having his lawyer present during conversations he was having with his boss, with the board. He said he was being retaliated against for asserting these claims.

The company said enough is enough. We have looked into your allegation. They tried to resolve things. They tried to speak reasonably with him. They fired him. He brought a claim, and the OSHA Administrative Law Judge ordered him reinstated and held that because the company didn't have in writing anywhere a policy that said that you can't tape record meetings and because the company didn't have in writing a policy that said you can't have a lawyer present in meetings of this nature, this was pretextual. And the employee had shown that the reason in fact he was fired was because of his complaints. That decision paid scant attention to the body of law in the U.S. that recognizes that employers have certain prerogatives in dealing with their employees and running their workplace. And that decision is on appeal.

I don't have time to talk about some of the other cases I really wanted to talk about. But I do want to mention that the news is not all bad. The courts have said that, if you can show that you have a policy in place, which provides a remedy that tells employees that if they think that they are a victim or they think there is something wrong going on, they must bring these complaints to the company and the company will investigate. If the employee unreasonably fails to take advantage of the remedy, the employer may in certain circumstances avoid liability. And the courts are exporting that body of law into this body of law.

So as Don said, employers must implement effective compliance policies. You should be reviewing your clients' policies. They must have policies that prohibit retaliation against employees who complain about unethical conduct. They must have policies that require employees to bring to the company's attention allegations of improper conduct. They should be providing training.

You should be looking at your client's release agreements to make sure that employees who get severance are, in addition to waiving claims under discrimination laws, also waiving claims under SOX whistleblowing. There is plenty to do, and it is very clear we can't sit still.

4. The Extraterritorial Reach of the Sarbanes-Oxley Whistleblowing Provision

MR. DOWLING: Now a final word on the extraterritorial reach of the whistleblower provisions in Sarbanes that Phil was just talking about.

The issue is that you're traded on a U.S. stock exchange. You're a publicly traded company, but not necessarily U.S. based. There are hundreds of other foreign companies traded on the U.S. stock exchange, so you're regulated by SOX.

Phil explained the whistleblower rules for a whistleblower in the U.S. What about somebody in operations overseas? The good news is that the current state of the law is that there is not a lot of law. But what law there is makes crystal clear that SOX whistleblower protections do not apply overseas. The two main citations we can point to are both from just last August. One is an OSHA dismissal in a case against Swatch, the Swiss-based watchmaker. Someone in their European or Asian operations blew the whistle, got fired, then sued in the U.S. And it went to OSHA, which is, as Phil said, the administrative agency. OSHA dismissed it.

Another case was against Boston Scientific and came from Argentina. OSHA dismissed that one. The theory, by the way, is that there are lots of U.S. Supreme Court law that says a U.S. statute does not apply abroad unless it is crystal clear, explicit in the text of the statute itself, that Congress meant for it to apply abroad. Otherwise, all our laws would apply abroad. It would be crazy. Our traffic laws would apply abroad. It would not make sense. So the presumption is that our laws don't apply abroad unless the law says it does. Nothing in the SOX whistleblower provision says that it does.

So this District Court of Massachusetts, also in August, came out and upheld an OSHA dismissal of a SOX whistleblower case coming out of Argentina. So, where does that leave U.S. employers? Law can change. Congress can amend SOX, but right now the whistleblower provision doesn't apply abroad. Yet the SOX accounting provisions do, to the extent that if you have a company that is grossly inflating its profits in its overseas operation and putting those on a financial statement that it files with the SEC, obviously that is a Sarbanes violation. So you still have interesting policing of accounting irregularities abroad. And you're seeing companies wanting to propagate those policies that Phil was just talking about in their overseas operations, even though the brand new case law from August says you don't technically have to do that.

So where that leaves a company is that at least the company has a little more leeway. Because in fashioning an overseas SOX whistleblower provision, you might want to root out whistleblowers and you might want to encourage whistleblowing to find out what's going on. And you might not want your local management abroad to fire people for whistleblowing. Yet you may not want to make it as straight as you have to.

But you will have to communicate better with foreign workers than U.S. workers on this point, because the foreign workers may not understand whistleblowing.

You find a lot of whistleblowing policies that say, "If you witness an irregularity a co-worker is doing, you have to report it or you're fired." That's very important in these policies. You say that in Europe, and you're going to get a huge push back.

I worked with a company in France. They said this is like the Vichy government. To a European, to have a mandatory ruling that you have to rat out our neighbor is very, very offensive, and yet American companies do it all the time. My anecdote is just one. U.S. companies run into human resources problems when they come in with a heavy hand and say, "You have to rat out your co-workers in Europe and other countries."

I've had Australian counsel tell me that, if you had a rule that said you have to rat out a co-worker if you see any violations, it wouldn't be upheld. In Australia, you can fire the guy, but he might get reinstated. He would win his wrongful termination claim because an Australian court won't even recognize that rule, even though it is written under Australian law.

Also you have Australia's mandatory subject of bargaining. Unions and work councils are much more common abroad. Even companies that think of themselves as non-union in the U.S., you try to roll out a rule saying you're obligated to rat out your co-workers, you can't unilaterally impose that. You have to sit down and negotiate that. It is a big issue in rolling out a SOX-like policy abroad. Luckily, the law doesn't force you to do it yet. But you do have business reasons why you want to find out about improprieties of your overseas operation. It is a delicate area and a fascinating one in international HR law now.

C. UN Efforts Regarding Bribery Convention

MS. HANSEN: Thank you. I think we'll move right along to our final speaker, and hopefully at the end we'll have time for questions for any of our panelists.

Our final speaker is Professor Charles Biblowit. He's a Professor of Law at St. John's University. He's Co-Chair of the Committee on Public International and Comparative Law for our Section. He has also experience as a trial attorney, and he was part of the Executive Office of the President's Council on Environmental Quality.

Don mentioned that one of the statutes that U.S. companies have to be concerned about is the Foreign Corrupt Practices Act. Professor Biblowit is going to talk to us about the new U.N. treaty on anticorruption and its impact on U.S. business.

CHARLES X. BIBLOWIT: The U.N. Convention is a little different from the other new developments that my colleagues discussed, because it is not yet law. It has not yet entered into force. It has not yet been enacted into U.S. law. It was open for signature just thirteen months ago, and today has at least signatories and thirteen ratifications. All indications are that the United States will become a party. The U.S. has expressed strong support, and that support appears to be more than rhetorical.

Just a few weeks ago we donated half a million dollars to the U.N. Office on Drugs and Crime to support its ratification efforts.

The Convention is very long. Many of its provisions will have only a very indirect impact on American business. So I'm just going to refer to a few aspects of the treaty that have raised concerns, justified or not, among some members of the business and legal communities. Also, I am going to assume that any American company doing transnational business is already familiar with the Foreign Corrupt Practices Act and already has a compliance program. So I'll try to point out a few aspects of the convention that may have an impact on existing compliance programs.

It is somewhat surprising that the Convention has raised qualms in the U.S. business community, because, in a very real sense, it represents the culmination of a long effort by American business to internationalize the Foreign Corrupt Practices Act.

When the FCPA was adopted in 1977, it faced strong business opposition. For a long time American businesses sought its repeal or dilution. But when it became clear that the law was here to stay, the U.S. business community shifted course, seeking international agreements that would impose on their foreign competitors the same kinds of strictures that American companies face under the FCPA.

In the last few years that effort has attained considerable success with the adoption of the OECD Antibribery Convention and regional agreements like the OES and now the U.N. Convention.

With that background, I'll address three areas of the Convention that may affect international commerce: First of all, a few provisions of the Convention that differ from the Foreign Corrupt Practices Act; second, litigation risks; and third, the consequences of the internationalization of the prohibition on foreign bribery.

So first of all, a few of the differences—and there are a lot—are more significant than others. If you look at the text of the Convention, you will see that the nature of the obligations that it imposes on parties varies considerably from one provision to another. At one end some provisions are mandatory: "Each state party shall adopt." At the other end some provisions are little more than hortatory: "Each state party shall consider." There is a wide range in between. Other variations are: "Each state party shall endeavor" or "Each state party shall take appropriate measures within its means," and so forth.

So not surprisingly, commentators have expressed conflicting views on whether the Convention will or will not require changes in the Foreign Corrupt Practices Act.

Let me just highlight a few specific provisions. First, the FCPA, and I'm pretty sure Canadian law as well, contains a famous or perhaps infamous exception for facilitation or grease payments to secure or expedite routine governmental actions, like phone service or garbage pick-up or the issuance of visas and licensing. The U.N. Convention has no such exception. The OECD Convention, whose language is quite similar to the U.N. Convention, does not have such an exception in its text either, although it has been construed as not prohibiting these kinds of payments where they are *de minimis* in amount. On the other hand, the FCPA doesn't look at the amount. It looks only at the purpose.

Second, the FCPA contains two affirmative defenses: one for payments that are lawful under the written laws of the other country; and the other for reasonable and bona fide expenses, like travel and lodging, related to the promotion of the product or service. Again, I think Canadian law has a similar provision. And again, the Convention has no such provision.

The U.S. takes the view—I think justifiably—that these kinds of payments are just not violations, regardless of whether there is anything in the text expressly designating them as defenses.

Third, the Convention applies to private sector bribery. The FCPA applies only to public sector, governmental corruption. There is no general federal law prohibiting commercial bribery. The U.S. does sometimes invoke federal wire or mail fraud statutes in cases of commercial bribery. But for the most part, this is a subject that we leave to state regulation. And I don't think that's going to change. The United States is not going to adopt a general federal prohibition on commercial bribery. However, the Convention obligation here is simply to consider such a ban, so no change in federal law would be required.

With the possible exception of the facilitating payments provision, I don't think any of these or other discrepancies between U.S. law and the Convention require significant changes in compliance programs.

Some other discrepancies can best be viewed from the standpoint of litigation risk. The Convention provides for a civil remedy for persons who have suffered damage as a result of an act of corruption against those responsible for that damage. It also provides for a private right of action for state parties to recover assets stolen by their own officials. The FCPA provides no private right of action. Nevertheless, violations of the FCPA have often been used as a basis for civil remedies under other laws. FCPA violations can be predicate acts under RICO. They have been invoked in federal and state antitrust cases, tortious interference claims, and many others.

The Philippine government spent a generation trying to recover assets looted by the Marcos family. They encountered all sorts of practical and legal difficulties, but the lack of a viable legal theory was not the problem they faced. So I think we could probably take the view that the absence of a private remedy under FCPA does not put us in violation of the Convention. We have other legal remedies that provide similar relief that satisfies the requirements.

One of the main focuses of the Convention is the recovery of assets stolen by government officials. At the G8 Summit last summer, the G8 Governments expressly reiterated their very strong support for asset recovery provisions of the Convention. The Convention provides not only for a private right by state parties, but also for public enforcement in the form of government confiscation and return of the assets.

The USA Patriot Act now makes foreign government corruption a specified unlawful activity under U.S. money laundering laws. So we do have a very wide range of civil and criminal forfeiture remedies available in the U.S. courts.

No doubt all these provisions entail some litigation risk. I'm not sure, however, that the Convention adds much to existing risks beyond a level of political and moral encouragement. Moreover, I would be surprised if much of this kind of litigation takes place in the United States. Maybe I am naive here, but the U.S. has had relatively strong money laundering laws in force for a relatively long time. So I suspect it is probably not a very attractive place for foreign kleptocrats to stash their loot. It just happened: Just ask General Pinochet and Riggs Bank. But I suspect it is not going to happen a lot.

The final aspect of the Convention I wanted to mention is the conflict of laws problem that arises from the globalization of the provisions on foreign bribery. Just a few years ago American companies had only one such law to deal with. A few years from now, every country will have its own FCPA, and while the purposes will be similar, there are going to be a lot of differences from one country's law to another's. You're going to have to comply with U.S. law, with the domestic bribery laws of the host country, and with the home country laws of your foreign subsidiaries, affiliates and joint venture partners.

Suppose, for example, that U.S. law permits grease payments, but your foreign subsidiary does not, and obviously the host's country law does not. What do you do? Well, one obvious answer is to say: "As a matter of corporate policy we'll follow the highest possible applicable standard." That's a pretty common approach. Of course, that may mean that there is no telephone service in the host country, but who needs a telephone.

This kind of conflict of laws problem is not easy, but it is hardly unfamiliar. Phil and Don just discussed it in the employment law context. And it arises in many other contexts as well. Now you're going to see it in the anti-corruption context.

I'll stop there, and we'll take whatever time is left for questions.

AUDIENCE MEMBER: Do the SOX whistleblower provisions apply to non-reporting public companies?

MR. DOWLING: I'm not sure what you mean by non-reporting public companies.

AUDIENCE MEMBER: Those are companies traded like on pink sheets that have fewer shareholders that don't file 10-Ks.

MALE SPEAKER: It does not apply.

MR. DOWLING: Okay, I hear the answer is no.

AUDIENCE MEMBER: A similar question, does it apply to not-for-profits?

MR. DOWLING: Well, they are not publicly traded.

AUDIENCE MEMBER: Does the U.N. treaty apply?

PROFESSOR BIBLOWIT: The U.N. treaty does apply to financial organizations.

MS. HANSEN: But having been involved in a number of non-profits on their boards, if they have one of the big four firms as an auditing firm, those firms are encouraging the non-profits to adopt many of the SOX-type provisions for their own internal operations.

MR. BERKOWITZ: And I actually think that every company should be adopting policies that encourage employees to come forward with complaints. Regardless of whether they are technically governed by SOX, they should be adopting policies that encourage and indeed require employees to come forward with complaints of wrongful conduct. There is no reason why you don't want to know about that.

And I think it is also good business to prohibit retaliation against employees who in good faith make that kind of a complaint. It is conceivable that even if it doesn't give rise to a cause of action under Sarbanes-Oxley, retaliation against an employee in those circumstances could give rise to a breach of public policy, which could violate state law.

MS. HANSEN: Final questions?

AUDIENCE MEMBER: Same question. My question pertains to territorial application, meaning a U.S. company has a U.S. national working abroad, such as a U.S. national abroad in China, you know.

MR. BERKOWITZ: The Sarbanes-Oxley provisions have not been specifically held to have extraterritorial effect. But the U.S. discrimination laws that Don was talking about, the laws for discrimination and harassment, do apply to conduct overseas against a U.S. citizen who works for a U.S.-owned or -controlled company.

AUDIENCE MEMBER: But the nationality of the employee. . .

MR. BERKOWITZ: That's the key.

MR. DOWLING: Nationality is the key under the discrimination laws, but not under Sarbanes. Because under Sarbanes, regardless of nationality, if you're working abroad and your place of employment is abroad, it doesn't apply.

Now the decisions are very skimpy, and they don't raise that point, but their language doesn't make a distinction. It just says it doesn't apply abroad. Just the way, again, an American citizen with a U.S. passport can go "x" miles an hour in France, and he might violate French traffic law, but he doesn't violate U.S. traffic law. So it is possible some court could come up with a theory along those lines, but currently, if your place of employment is abroad, you're not covered by the Sarbanes whistleblower protections.

If you're a U.S. citizen working for a company in the U.S., you are covered.

III. The View from Canada

MR. FRANK: I would like to thank once again the members of the Canadian law firms. The four who are here today on the panel also have offices here in New York and provide us with Canadian lawyers and legal consultants who are active in our Section. They were very gracious in hosting us when we held an Executive Committee retreat in Montreal earlier this year.

MR. ZULACK: A very short introduction. We talked this morning about the movement of people, labor and bribes. Now, during the second program, we are going to talk about the movement of goods, data, securities and funds. So we are covering the whole global universe of international commerce. Lorraine.

LORRAINE P. THARP: Thank you so much, Jack and Paul.

I think when Jack asked me to moderate he didn't realize there was a connection. I grew up on the Canadian border in a small town in northern New York called Messina, and our biggest nearby city was Montreal. That's where we went for all of our cultural events, medical care, shopping, restaurants, et cetera.

I had a lot of wonderful memories of Canada: skiing in the Laurentians and all that. But my favorite memory was the fact that my younger sister and I, a teenager at the time, both went to Montreal and Toronto to see the Beatles, and that has stayed with me forever. I'll never forget that.

So why are we doing this? Why are we examining Canadian law, other than bringing back wonderful memories for Lorraine? I think you will see that we have four wonderful panels that will examine different aspects of this flow that Jack talked about. There are more than $1.9 billion in goods and more than 300,000 people who traverse the border between Canada and the U.S. daily. And that alone is enough of a reason for us to examine these issues.

So without further ado, we will have approximately twenty-five minutes for each two-person panel. I will just briefly introduce them. And then we will have all of the panelists participate in a Q and A.

Our first panel is "Border Security: The New Normal." Our first two panelists are Dunniela Kaufman and Dalton Albrecht, both from the Fraser Milner firm in Toronto. And Dunniela is going to go first.

A. Border Security: The New Normal and Its Impact on North American Business Flows

DUNNIELA KAUFMAN: Good morning. As evident from this morning's discussion, the new millennium has been defined by new events, all of which have challenged and altered the legal discourse. While there have been corporate scandals, epitomized by Enron, no event has served to define this century more than that which occurred on 11 September 2001.

From that date forward, government policy has been guided by a concerted focus on a nation's security needs. This can be contrasted with the end of the previous century, when there seemed to be a naive belief that international warfare could be subsumed by the benefits of free trade. As security needs must necessarily have a point entry, borders, as their main focus, there is the potential for security concerns to trump trade facilitation. But as the actions of both the Canadian and U.S. governments have proven in confronting security concerns while simultaneously making trade facilitation a priority, two sovereign economies can continue to integrate under the favorable conditions of a free trade agreement.

For Canada, an export-focused nation by necessity, the thought that the border through which eighty-two percent of its exports flowed could be closed was unfathomable. The Canadian government thus set out to partner with the United States and ensure that the comfort level was there to maintain open and accessible borders. On 12 December 2001, Canada and the United States signed a Smart Border Declaration, which was accompanied by an Action Plan. Another result, one not so easily identified, was a restructuring of the Canadian Executive as it related to both trade and security, leading to harmonization with the structure found in the United States in an effort to create both comfort and compatibility.

Since my colleague Dalton will be addressing the finer points of the Action Plan, I've proposed to begin by briefly explaining the framework changes that have occurred and then just provide a bridge to the next portion of the panel by providing the context within which the specific measures related to creating a more efficient border have been undertaken.

As some of you may be aware, while the political party that governs Canada has not changed, leadership of that party has. And in December of 2003, a new Prime Minister was sworn in, and with that a new Cabinet was also sworn in. At that time certain structural changes in the Executive of the Government were announced, and two new Ministries were formed.

I want to mention a point here. That is, while the changes I am about to describe were implemented in 2003, as we sit here discussing them the legislation to actually create them has not yet received Royal Assent. Thus while these departments and agencies exist and function, they are not yet legally mandated to do so.

So the Canadian government created an entirely new department called the Department of Public Safety and Emergency Preparedness. This department mirrors the creation of the Department of Homeland Security in the United States. The Department was created as a center to coordinate all matters related to safety and security. The new Department combined the core activities of the Office of the Solicitor General, the Office of Critical Infrastructure and the National Crime Prevention Centre. What is even more telling about this Ministry, though, is the agencies that it subsumed.

When we look at these agencies, we can see that the bulk of them are vestiges of the Office of the Solicitor General. But in terms of our topic and from the perspective of the trade lawyer, what is most interesting is the transfer of Customs responsibilities from the Revenue Agency to the Security Department.

No longer is Customs about revenue generation, tax collection and protectionism. It is now about providing integrated border services that support national security and public safety priorities, while simultaneously facilitating the free flow of persons and goods.

The other structural change that was put into effect in December of 2003 was the creation of a Department of Trade, separate and apart from the Department of Foreign Affairs. While Canada has always had a trade department, this department was previously subservient to the Department of Foreign Affairs. In addition, many trade-related functions were under the purview of another department, Industry Canada. This newly liberated Department of Trade was created by transferring all trade-related functions from Foreign Affairs and Industry Canada to the Department of Trade.

By creating a department to deal with all trade-related matters, Canada has acknowledged that trade relations have become too important and complex, and thus they must be dealt with in a context that does not necessarily import the complexities of international affairs generally. Even in the announcement regarding the tabling of legislation to create this department, which occurred in December of 2004, the Minister of Trade acknowledged that Canada was doing what many countries before it had done, and in effect now Canada's Trade Department would become more akin to the office of the United States Trade Representative. Canada's Department of Trade will now be a standalone department that has the authority to deal with all matters related to trade, including negotiation, promotion and investment.

These two new departments will have to coordinate their efforts to ensure that trade flows can continue unabated while the borders of a successful trading relationship realign.

To paraphrase the recent joint statement by the President and the Prime Minister, as a result of the emergence of security concerns as a number one priority, a new partnership in North America must be created, a partnership that acknowledges the primary precepts of common security and prosperity concerns. In this statement the leaders of Canada and the United States set out to reinforce their commitment to pursuing initiatives that provide for the secure movement of goods and people, while ensuring that the border remains open for business.

Canada's structural changes, which have led to compatibility with the United States, complement the foundations laid in the aftermath of 9/11.

As stated earlier, immediately following September 11th, Canada and the United States executed a declaration that set up four pillars upon which they would proceed to ensure that the two countries could commonly address potential security concerns while simultaneously ensuring that the border remained open for business.

Rather than a mere laudatory document, this declaration went further and had a detailed Action Plan attached to it. The Action Plan set out specific programs, goals and commitments under these four pillars, each of which identifies the required area of focus for a secure yet efficient border control.

In addition, to ensure that momentum for implementation was not lost, the plan provided for yearly progress updates, the most recent of which was 17 December 2004. If you would like further details, there is a Canada Border and Services Agency web site.

So while Canada and the United States have much in common, nothing binds us more than the border we share. While the current security-conscious atmosphere within which we all function does threaten the economic integration that has occurred, concerted efforts have been made, the result of which is more efficient and expedient border processes, which commercial interests have to take advantage of.

And now my colleague Dalton Albrecht will provide you with some specifics. Thank you.

DALTON ALBRECHT: As Dunniela mentioned, she summarized the structural and bureaucratic changes in Canada in response to what we call the "new normal." I'm not sure I'm going to live up entirely to Dunniela in terms of all the specifics, but my talk is going to focus more on why these systemic changes are so important, more from a practical focus, and really the impact on your business or, since I would guess that most lawyers here are in private practice, on your client's business. I'd also like to share what I think is some important information with you in terms of goods crossing the border, something you should be aware of. At least you can sort of talk the lingo if it comes up. There are a lot of acronyms here, so I'll warn you in advance.

Why is it so important? It is so important for both countries, as Lorraine mentioned, because of NAFTA. Cross border trade is astounding. NAFTA, with its preferential duty rates for Canada, has basically resulted in 45 percent of Canadian GDP being represented by exports to the U.S. and actually 45 percent imports by the U.S. NAFTA is the world's largest trading block, a GDP of 3 trillion. Canadian goods alone account for 835 billion. I don't think most people realize, but the count in U.S. trade in goods is $600 billion. It is phenomenal.

I've left a paper at the back of the room and also on the chart I've handed out; there is a copy of the web site, my e-mail. I'm happy to e-mail the paper, but essentially I summarize NAFTA and what it means in Canadian laws and to the import of goods, export of goods, taxes, cross border, duty considerations. I'm obviously not going into that kind of detail here.

Suffice it to say, NAFTA is unique. It is unprecedented. It has been a huge success. But as a result of 9/11, border enforcement is moving more towards security concerns rather than revenue, again as revenue collection, as Dunniela mentioned. So businesses are—or if they are not they should be—very much concerned with what these measures mean in terms of cross border flow of goods, in other words, shutting it down.

If we had another WMD event, that is, a weapon of mass destruction event, as it seems to be called, the border would be closed. When you think about it, 600 billion in trade in goods would be a major problem. A lot of people would be out of work. A lot of businesses would shut down, and frankly it would be hard to get normal goods to be relied on, because the economies are so integrated.

As I say, it is an incredible problem because of the integration of the economies. Canada is the United States' best customer and vice versa. Eighty percent of Canadian exports went to the U.S. As I say, that represents a significant portion of our GDP. What a lot of people don't realize is that twenty-seven percent of U.S.

exports go to Canada. Canada imports more from the United States than the entire European Union combined, and three times as much as Japan. In fact, here is one simple example: Michigan-Ontario trade is bigger than U.S.-Japan trade. So it is quite significant when you think about it.

Now, most of this trade or a lot of this trade, sixty percent of this trade, is inter-company. So the companies are very intertwined, and it is something that's very important when you think about the border impact of security. You really have to expect the unexpected. This is the new normal.

So what have Canada and the United States done in response to the security issues of 9/11, and how does it impact on trade? If you look back at 2001, you'll see Canada had something called Partners in Protection or PIP, pre 9/11. Now, you probably haven't heard of PIP, but you've heard of CTPAT, Customs Trade Partnership against Terrorism which is the U.S. equivalent of PIP. In fact, it is an exact copy of PIP, which Canada has actually had since 1999. So that was very significant.

One of the first things is that the U.S. basically adopted our PIP, and I'll talk about that a little bit later. Right after or around 9/11, October 2, 2001, Canada adopted the United States regulation against terrorism. More significantly, on October 15th, Canada introduced the Anti-Terrorism Act, which has its counterpart in the famous or infamous Patriot Act. On 12 December there was the 30 Point Plan. Right after that, we talked about expanding our financial security transactions to prevent the funding of terrorism.

As I say, I'm not going through all of these in detail, but if you consider 28 March 2002, we formed our Canadian Air Transport Security Authority, and coordinated visas: Canada and the United States actually share visa information. In fact, we have the same policies involving 175 countries. There are only a few countries where the U.S. and Canada actually don't have a common visa policy. This is visas across borders.

The biggest event I'm going to talk about is December of 2002: It's for fast, free and secure trade. And that was a very important one in terms of flow of goods. I'll explain a little more about that later.

Perimeter residency cards. On 12 December 2003, Canada introduced a new perimeter resident card basically in response to U.S. demands. And it really improved security. The National Risk Assessment Center in 2004 again was a harmonized U.S.-Canada initiative, as most of these things are, such as the Nexus Air Project, PAXIS, which is a name record program for air. Basically Canada and the U.S. again share passenger name registration, and advance this passenger information. That was done in July of 2003. Right down to January 2005, as recently as last week as a matter of fact, discussions on the Presidential-PM Summit announcement in November and how we are going to advance this joint initiative in terms of security. So there is a lot of stuff in here that really has harmonized the border relationship across the border.

Essentially, the question is, "Why has Canada done that?" Mainly because we had the crap scared out of us with 9/11. Because if the border were to be closed, the Canadian economy would be shut down. The U.S. economy would be certainly impacted, because obviously, you need that trade. Certainly automotive production would stop for a long time. But the U.S. is a much larger economy. While twenty-seven percent of their U.S. exports go to Canada, as I mentioned, eighty percent of our exports go to the U.S. So Canada was really forced to react: either show initiative, as it did with PIP, or react to U.S. provisions to ensure that that border remained open. And it included things such as advance commercial information—I'm not sure if you're aware of it—where marine shipments have to provide a one-day notification.

The U.S. highway and rail are going to be coming under this regime in November of 2005: advance commercial information again. This is really to force the companies effectively into a partnership with the two governments, and that's where you get these partners and protection, CTPAT, which also has a partnership.

Essentially, the governments are forcing the businesses to pay for new border security. I guess one question is: Should the companies pay for that? And that's certainly been controversial. Some companies are resisting it, because it is a very large cost, both in time as well as money. A lot of companies resisted it, and some still do. But there is both the carrot and the stick here. If you get into what I call a clubbing, which is getting into Partners in Protection, Customs Self Assessment, the U.S. equivalent is ISA; if you get into the program, then you're in the club, really guaranteed border access and crossing even if there is another WMD event. Certainly, you get fast access, you get less paperwork, your goods flow across with minimum data elements, and all of these things.

Now, there is a stick if you don't get into it. And as I say, if there is another event, your goods simply won't cross the border. So, the question is: Is it worth it for you? Essentially, the governments want a partnership. That's what PIP is and what CTPAT is in a nutshell.

Basically, you have to sign a memorandum of understanding, provide complete security of your entire supply chain of customers and suppliers, all the way back. You basically have to give the government a tour of your premises. You have to put up fences and various things. And essentially, you open up not only your books but your entire operation, and you get certified. If you do, you're a partner, and, therefore, you have less scrutiny. As I say, your goods cross the border. You go beyond that, you can go to the CSA or ISA, which is a Self Assessment Program, which means you open up all of your back end books, et cetera, and essentially you open up completely to the government, and you provide them with direct information on automated information sharing. Then what happens: you end up with less paperwork. In fact, you don't have transactions at the border.

Normally, Customs is transaction by transaction. If you get into these programs, you essentially are into an income tax-like program. Once a month you file a return; you share automated information, and you don't really do the normal border things. So there are some real advantages.

The biggest rank is FAST, which stands for Free and Secure Trade, but it really means fast. Essentially, there are dedicated lanes at border crossings for trucks, less border examination. In fact, oftentimes the trucks don't even have to stop. The advance commercial information is provided, and they roll through.

The drivers have to be certified as well, which is the biggest problem, frankly. Apparently, a lot of truck drivers seem to have criminal records, which causes problems in getting certified. But assuming the driver is cleared, the importer is cleared and the carrier is cleared under FAST, there is simply no transaction at the border. The trucks literally roll through, and you only have to provide minimum data ahead of time.

Under normal customs and security you have to provide a lot of advance information, advance commercial information: provide the manifest ahead of time, a certain number of hours and so forth. If you're on FAST, there are basically only three data elements: Who you are; when you're coming; and what you're bringing. Because the government trusts you; they can always do an audit on you whenever they want. And you're going to provide them with the information later, so you don't have to provide the ten and twelve data elements and all the details. All of this is really for risk assessment. The idea is if you're in the club, you've already had your risk assessed; therefore, we don't need to involve you in regular risk assessment, like the other importers. Now you actually can get to the bridge; it really does mean fast.

The problem is that there are not very many people in the program in Canada. I think there are about a thousand U.S. people on FAST importing in the U.S. Canada has only twelve to fifteen. The reason is that Canada also requires something called CSA, Customs Self Assessment. And that is something way beyond the PIP and CTPAT. Essentially I'll talk about it a little bit: a complete sharing of information at the back end approach, and you have once-a-month reporting. That's extremely difficult to do. Even if you want to do it, it is very expensive to do. It takes service providers; it takes years basically. You also have to get a Chief Executive Officer or a Chief Financial Officer to sign a memorandum of understanding saying the books are correct, which, as we all know from Sarbanes-Oxley, people don't really like doing.

Now, the problem is that Canada requires this CSA before Canada will let you into FAST in regard to importing into the U.S. And that means there is really only the Big Three automotive, the aeronautics and so forth that are into this. It's causing a real problem.

One suggestion, if you're interested, if you have clients interested in this: lobby the Canadian government. The Canadian government at this point is looking into whether they should harmonize with the U.S. The U.S. requires only CTPAT, not ISA. But if you're interested, I think really the point would be to lobby the Canadian government. It is something they are looking at right now: get everybody onto FAST.

Essentially, as I say, if we get another WMD event, borders will be closed except for FAST participants.

This system is great for large multinationals. The problem is that small- and medium-size enterprises, which are the backbone of many economies (including those of Canada and the U.S.), find it hard to get into the club. I won't go into detail, but obviously with CSA they can't get into that. The cost of getting Partners in Protection or CTPAT is extremely high. We need to let some of these other companies get into the club so they can get across the border on a fast basis as well.

MS. THARP: Yes, sir.

AUDIENCE MEMBER: I've got a practical question for Dalton. In Canada, how involved are the attorneys in the process of walking the importers and exporters through these various security programs?

MR. ALBRECHT: The question was: In Canada how much are attorneys involved, or are they involved in helping these various security programs such as CSA, PIP and FAST?

I think the answer is not as much as we should be. The accounting firms are very aggressive in marketing it, and some of this is more suited to them in terms of certifying their books and records.

I'm involved with companies. I explain it to companies. I provide a more general overview. I explain the details of the program. I also explain some of the concerns about CSA, for example. I'm not a big proponent of CSA unless you're a certain type of company, such as

GM, which is one of the drivers behind this. But I think the short answer is that we should be more involved. We should be more protective with our clients. That would be one plea I would make: the advertisement both for our clients and our own business. We should be getting a little more involved in this and lobbying the governments to get more of these. And also lobby our government to let SME companies import into Canada on FAST without CSA, because CSA is a real bottleneck. I think that's coming, as a matter of fact.

MS. THARP: Remind us again what an SME is.

MR. ALBRECHT: Small to Medium Enterprises. It depends on what you mean by SME. These are very important companies to the economy, and the problem is that they really have trouble coping with these programs. These programs are just too complex and too expensive, and they are too time consuming. So I think that's where we could try perhaps to get the regulations a little more streamlined. That would be helpful.

MS. THARP: I'm assuming that the larger multinational companies aren't having as much trouble, just from the basis of resources and cost. Would you comment?

MR. ALBRECHT: Yes, that's true. Part of the reason for PIP or CTPAT, either of those programs, crossing the border, essentially, is that it requires you to have a lot of control over your supply chain, a lot of influence, pull. I've acted for many clients: I get the questionnaires and explain them to the clients. Someone comes and says, "I just got this from GM; do I have to do this?" I reply, "No, you don't have to fill in the questionnaire, but if you don't you're not going to be shipping goods to GM. It is your choice."

So if you're a small- to medium-size enterprise whether you have that degree of influence is part of the problem. I think that leads to the concerns. Even the large companies (there are only twelve Canadian companies on CSA, meaning twelve on FAST) are taking years to try to coordinate this, because it is very, very difficult. The government is very demanding on how your books look. Because, essentially, you're not going to fill in the normal customs documentation. They are going to take the documentation right from your books. So how your books look, how your security clearances are: it is not even easy for large multinationals.

B. Current Issues in Outsourcing Transactions: Canadian Privacy Laws, the Patriot Act and Other Considerations

MS. THARP: I think now we'll move on to our second panel. And this is on Canadian privacy laws, the Patriot Act, and other considerations.

We are very pleased to have two partners from the Blake, Blake, Cassels & Graydon firm in Toronto, Richard Corley, who will present first, and Elizabeth McNaughton.

I'd also point out to you, those of you who are members of the ABA, that there was an article in the recent issue of the *Business Law Journal*, "Privacy North of the Border, Ten Things You Should Know About Canadian Personal Information Laws."

And with that, when Richard is ready to go.

1. Geography

RICHARD F.D. CORLEY: Well, thank you very much. I appreciate the opportunity to speak on what has become one of the most controversial areas. I'm actually the warm-up act. My partner, Elizabeth McNaughton, will be dealing with privacy issues.

As has been apparent from the other speeches earlier this morning, there is a tremendous volume of trade between Canada and the U.S., and much of this involves matters relating to outsourcing. There is a traditional outsourcing of goods, such as automotive parts, which I think has really predated the description of the transaction as outsourcing. And more recently there has been a real focus on the movement of data and the movement of information, data processing, call centers and other similar types of services, across the border. Something that we have been increasingly involved in is the movement of call centers and other types of operations from the U.S. to Canada. There are a number of drivers for that, one of them being simply lower costs, the other drivers being very attractive telecom capabilities and rates in Canada.

The other major advantages that Canada has as a destination, which may make it more likely that you in the near future will become involved in transactions into Canada, are obviously the proximity of Canada to the U.S. (in many respects the Canadian centers, such as Toronto and Montreal are closer to the U.S. than many other destinations in the U.S.), the highly compatible business cultures and project management standards, and also the very similar legal structures.

In any event, one of the areas that I would like to focus on today is the close compatibility between the legal regimes, which has been a major factor in leading U.S. companies to choose Canada as an outsourcing destination, and it is encouraging U.S. companies to trade generally with Canada. Areas such as the compatibility of intellectual property laws and the safeguards in areas such as privacy and securities laws, which the subsequent speakers will be talking about, are among those areas where there is a very close similarity between the two systems.

What we're seeing in outsourcing transactions are a number of different trends. And the complexity of these deals, the complexity of the legal requirements, the multinational focus of the deals and other factors are making them very challenging for counsel and for the consultants that are working on these deals. There has been an expansion in the number of multinational near-shore, offshore and multivendor arrangements, where a company is actually dealing with multiple vendors at once.

There is now, as has developed in the past few years, an increasing array of regulatory restraints. Those include things as SOX but also privacy laws, greater focus on governance and the implications of governance requirements for outsourcing. And also, in addition to all these things, there has been a great heightening of social sensitivity. You know, five years ago one wouldn't have thought outsourcing was a terribly politically loaded subject, but now it has taken on a real life as a topic.

So what I would like to talk about now are some of the legal and business issues that arise when doing outsourcing deals across the U.S.-Canadian border. The first of these is privacy and data protection rules, and that is a topic about which my partner, Elizabeth McNaughton, is going to speak. The additional and alternative regulatory regimes are a second topic that I'll talk about. In addition, we have choice of law, choice of forum issues, currency and exchange rate topics. Remedies and the termination provisions which may arise in these deals are the issues.

Looking at the legal due diligence requirements, specific areas are worth mentioning: The Canadian right to privacy laws; Sarbanes-Oxley; and the specific Canadian requirements under Canadian securities law. We also have the Office of the Superintendent of Financial Institutions, which has published outsourcing guidelines. And in larger transactions you'll often find the Competition Law, the Investment Canada Act, Income and Commodity Tax Laws and employment and labor law issues will arise. There are also some significant differences between Canadian and U.S. intellectual property laws, employment and labor law issues and issues that arise under third party contracts. Effectively, that's a short checklist of things that the U.S. lawyer looking at an outsourcing deal in Canada will want to consider when assessing what impact the Canadian legal regime has for this proposed transaction.

Among the more challenging areas has been the growth in the oversight by securities regulators in Canada. Many companies are subject to Sarbanes-Oxley, and I know that's the subject that a later speaker is going to address. We also have Canadian counterparts of those laws. I'm going to skip over those in favor of the later speakers.

Additional laws that we have are the Competition Act. And in large outsourcing transactions, those involving the acquisition of business enterprises, you may find there are requirements for pre-merger filings. In a number of cases that we have been involved in there has been quite significant competition law review. The reason for that is that the Canadian economy tends to be a more concentrated economy, and transactions which in the U.S. would not give rise to potential issues are more likely to do so in the context of the Canadian economy.

Another area is the Investment Canada Act. The Investment Canada Act generally becomes more of an obligation with respect to a filing, in some cases involving very large transactions. The transaction may be a reviewable transaction, and that may have some time implications for the transaction.

As I'm almost out of time, I'll touch briefly on income and commodity tax issues, and they do need to be looked at, especially in IT deals where there is licensing across the border. Thus, there are withholding tax issues, and in some cases maybe non-recoverable commodity tax. We found a number of deals where these tax considerations weren't considered at the outset, and when they arose later in the transaction, they were fairly disruptive to the development of the transaction.

Employment and labor law issues: Canada is not an employment-at-will jurisdiction. It is more of a security and tenure jurisdiction. So there can be significant employment, pension, severance costs associated with outsourcing. And this is something that can necessitate some fairly extensive investigation and due diligence and should be done early in the process.

At this point I'm going to turn the microphone over to my partner, Elizabeth McNaughton, and she will speak about the privacy laws.

2. Privacy Legislation

ELIZABETH L. NAUGHTON: I'm going to try to talk very briefly about some specific issues in Canada relating to our privacy legislation.

Lorraine has referred to an article which dealt with ten differences between Canada and U.S. privacy laws. I've boiled them down to five, just because we haven't got very much time this morning. But then I'm going to try to explain to you how the issue, particularly of the Patriot Act, has become headline news in Canada and has caused some of our governments to pass new legislation.

I think it is important to understand that the privacy laws in Canada are fundamentally quite different. They are new. They are quite different than the laws in the United States. And I think if you want to sum one thing up that you take away from my talk this morning, think California. I think the Canadian laws are more similar to the new laws in California than they are to other kinds of legislation that you're perhaps familiar with in the United States.

So what are the five key differences? First there is the scope of the legislation: it's comprehensive federal legislation, but also we have got some provincial legislation, just to keep things interesting. Second, personal information is not just non-public information: It is all information, with very limited exemptions for publicly available information. Third, it's a consent regime, not a notice regime: The fundamental difference is that you have got to get consent, not just tell people what you're going to do. That is not restricted to the online world: Therefore, it is offline just as much as online. And further, there is a whole bunch of specific requirements in the legislation, like appointing a Chief Privacy Officer. You don't have to call him or her a chief privacy person, but you have got to have a point person or persons.

So, just to go into these five differences very, very briefly.

The legislation, with an unpronounceable acronym of PIPEDA or Personal Information Protection and Electronic Documents Act, choose your poison, is comprehensive. It is federal legislation. The only place where it doesn't apply is if you're not a commercial entity or you're not engaged in a commercial activity. You may not even be a commercial entity, but if you're engaged in a commercial activity, you're caught. And it does not apply to employee information, except for a limited class of what we call federal workers, which are companies like banks and airlines and telecom companies.

We also have provincial legislation, just to keep the lawyers well employed in our country. Quebec has had legislation since 1994. Alberta and British Columbia have more business-friendly legislation now. Ontario, just as of 1 November 2004, has enacted personal health information. So we have a lovely patchwork. As I say, lots of work for Canadian lawyers.

The second big difference is that personal information is not just non-public information. I've looked at so many U.S. privacy policies which talk about non-public information. It just doesn't make any difference in Canada. The exemptions for publicly available information are very, very limited.

Consent versus notice. The individuals have got to consent to the use of their personal information. Now, the consent can take all different forms. It doesn't have to be express consent. It may even in some instances be implied consent. But watch Quebec. Quebec's legislation requires manifest consent, and it doesn't really even have the concept of implied consent.

Online versus offline. There is no distinction in any of the Canadian legislation between the online and offline world. We don't have legislation similar to your Children's Online Privacy Protection Act, COPPA. The legislation applies any time you're collecting, using or disclosing personal information in the course of a commercial activity. So, of course, any kind of outsourcing typically will involve personal information. So one of the items on your checklist, when you're considering outsourcing with a Canadian company, either to or from a Canadian company, is whether it could be done under Canadian privacy laws. Of course, the answer is always that it can be. You just have to figure out how.

The provincial legislation is even more broadly worded. It doesn't require a commercial activity. So in Quebec, Alberta and British Columbia your activity will be caught even if it is noncommercial.

Some of the specific requirements of our Canadian legislation that I find U.S. attorneys are particularly surprised about include the rights of individuals to have access to their information. There are some limits, but they are defined. Being open about your privacy policies is an obligation. You must appoint a chief privacy officer or some other person who takes accountability and responsibility within your organization. And the bugbear for commercial lawyers, and certainly an issue in outsourcing, is that, under the federal legislation, there is no exemption for business transactions. So share sale, asset sale, outsourcing, you've got to figure out how you're going to deal with privacy.

Now, Alberta and British Columbia have seen the light. And they have a specific regime for business transactions. In part I think the developing trend is to regard those as best practices and follow those practices and hope to heck that the federal legislation gets amended.

So what is the impact of this in Canada? I doubt that there are headlines in U.S. papers about the Canadian privacy law, and outrage over it. These are just some recent headlines in the Canadian press. The first one relates to one of the Canadian banks that disclosed to its Visa cardholders that the processing of their Visa payments was in part done in the United States. Headline: "U.S. Law Could Open Millions of Canadian Visa Records."

The second headline I've just drawn attention to relates to an article about a study that's been done by a number of federal government lawyers concerning the issue of Canadian military secrets or other top-secret information—we have virtually no military, so one sort of wonders how we could get so upset about this. But in any event, this information, because of various U.S. organizations that are performing services for the Canadian government, is subject to U.S. law, particularly the Patriot Act.

And the third one—the specific example that I'm going to deal with—is a situation in British Columbia where, because of the Patriot Act, they actually changed the public sector privacy legislation. So let me just talk about that for a minute.

The B.C. Saga. This is what really brought this to a head. British Columbia has Public Sector Privacy Legislation, like all the provinces do, and has for many, many years. The B.C. Public Sector Privacy Legislation is quite broad. It covers universities and hospitals; organizations that you might not expect to be covered by public sector legislation.

There was a proposal to outsource some of the provincial medical services to a subsidiary of a U.S. company. Now, we have a different healthcare system, as you know, and the result is that the governments have a lot of medical and health information about individuals in Canada. It wasn't actually the individuals whose personal health information was being dealt with that brought this to the fore. But there was a union in Canada, and a bunch of people were going to lose their jobs, or at least they were concerned they were going to lose their jobs. So they raised the issue and actually brought a court proceeding to try to stop this outsourcing to the U.S. company.

The concerns are twofold. First of all, there was the concern about the consequences if data were to be stored in the United States—which could well happen if you're dealing with a subsidiary of a U.S. company, since many companies find it more convenient to consolidate where they store data. The second concern was about what would be the consequences, even if the data were stored in Canada, but the party storing it was a subsidiary of a U.S. company, since U.S. law is usually able to reach beyond borders to cause a parent to cause its subsidiary to do something.

So what happened? Well, bottom line is, fortunately or unfortunately depending on your point of view, the outsourcing in that particular case went ahead. But it went ahead because the legislation that was introduced to amend the B.C. public sector legislation was not applied retroactively. The particular contract in question was in effect grandfathered. But now under the B.C. legislation it is an offense to disclose personal information, unless you're permitted to disclose it, specifically permitted. There is no ability to disclose personal information by a company regulated under the B.C. public sector legislation in response to a court order from outside Canada. The personal information must be stored in Canada. That's obviously inconvenient if your data storage is in Virginia or some other foreign place.

As you know, one of the issues under the Patriot Act is that you're not allowed to disclose that there has been a request made by the government agency for access to see the information that's been requested. Well, B.C. has come along and enacted legislation that, if any organization requests access to data, you must immediately notify the relevant minister. So you've now got a circumstance where the company is going to be between a rock and a hard place. It is either going to get into trouble with the FBI under the Patriot Act, or it is going to get in trouble with British Columbia authorities under the British Columbia legislation. It is, however, not retroactive. But certainly going forward, it applies. You may be thinking, "Well, so what, this is public sector legislation." But it also applies to service providers providing services to those public sector organizations. And remember, they are fairly broad. And service providers could be, goodness knows, financial institutions, data service providers, outsourcers of various kinds. So if you have anything to do with British Columbia, think public sector legislation.

MS. THARP: Thank you very much, Elizabeth. Do you anticipate any more similar legislation in the other provinces?

MS. MCNAUGHTON: Well, there is no indication as of yet that anyone else is going to legislate. But it's certainly still a topic and a concern. So it is hard to say.

MS. THARP: Any immediate questions right now?

AUDIENCE MEMBER: As we collect more and more data, we get more and more articles in the paper and in updates about the vulnerabilities of our database systems. And it seems to me that, even though there are those who are focused on assaulting a system and getting into a system, creating a virus, changing data, stealing data—it happens both in-house and out-of-house—the government is not protecting us by collecting the data. And I just want to ask you what your feelings are about that?

MS. MCNAUGHTON: So you're talking about data that's collected by governments?

AUDIENCE MEMBER: Right, right.

MS. MCNAUGHTON: Well, that's a good question. I think you're raising the essential issue that we've all been struggling with, which is the concern for security. And Canadians, just like Americans, are very concerned post 9/11 about security. And on that level there is probably a willingness to provide information to governments. But yet we have seen that any system is hackable. I mean governments have been hacked. Microsoft has been hacked. It is somewhat of a fragile technology in that way. I guess that's where we are struggling to find the common ground.

I noticed just this week that the European Union has ruled that the Canadian collection of passenger data for airline travel complies with the European legislation. That had been controversial in Canada, and of course, was in no small part in reaction to requirements of the U.S. government. So I think everybody, every organization, is struggling with it: Europe is struggling with it; Canada is struggling with it. I don't have any specific answers.

MS. THARP: Thank you.

MR. KAUFMAN: I want to add to what Elizabeth said. That issue is being debated in Canada now over whether we should have a national identity card, and all the advocates are weighing in. I can tell you the Department of Justice wants to implement that, and I think it is because of some discussions with their counterparts in the U.S. But this debate is not going away in Canada or the U.S., and the issue is going to be what kind of safeguard measures or security controls can we put in to protect adequately the information. If you look at your own security rules under HIPAA, you'll realize how complex that is. I think you're going to see that it is going to be the debate in the next five years.

AUDIENCE MEMBER: What I'm saying basically is that if we have national IDs and anything else, anyone who is a terrorist, who is hell bent on infiltrating the system can steal ID cards or do anything else to be able to do it. So are we gaining security, or are we losing more and more liberties? I don't think it is helping our security. I think that all of you who are involved in privacy have an obligation to our society to tell people that.

MS. THARP: One of the things that I had learned in preparing for this program and in speaking with these fine attorneys from up north was the difference in the view of individual rights in Canada and in the United States. And I do believe I have this correct: that individual rights are much more constrained in Canada. That the idea in Canada is that we are more of a community, and the communal needs come first, and the individual rights come second. So keep that in mind as we're talking about these issues. These are very interesting issues. But even though Elizabeth has a rebuttal on that, we'll move right along.

C. Getting No Sleep in the Continental Bed: American Securities Enforcement Initiatives Reverberate in Canada

MS. THARP: Our third panel is "Getting No Sleep in the Continental Bed: American Securities Enforcement." And we have a substitute person who has very graciously jumped in at the last minute. Jeff Clark from the Fasken Martineau DuMoulin law firm in Toronto, and Jeffrey Kaufman. I'm not sure who is going first, so take it away.

JEFFREY A. KAUFMAN: First of all, I would like to start by adding one point to Elizabeth's excellent presentation on the intersection of the Patriot Act and outsourcing in Canada, because it affects, in my view, potentially every multinational who operates in Canada: every one of my multinational clients stores their data in the United States. And although you might hear that B.C. is a great place to ski, they are trying to create this issue to reverberate across all jurisdictions in Canada. Right now, luckily, they haven't been successful. But I can tell you that I spoke to the Commissioner last week, and he is quietly trying to make strides here and in the EU. So it is an issue to watch out for. It is not just going to be a public sector issue.

But that's not my topic today. In terms of the issues of securities, security regulation and litigation in Canada, I can say, whether you like it or not, we don't have an Eliot Spitzer.

MS. THARP: He's getting an award as we speak.

MR. KAUFMAN: I don't know whether you like him or hate him—it is either one or the other, but we traditionally in Canada have weaker enforcement and less legislation, although Jeff Clark will tell you the strides we are making to catch up. And we don't have the desire of the Commission to spend the resources, as you do here. As a result, in Canada we have to fill that gap. As you may have seen in today's *USA Today*, the picture of Bernie Ebbers, and as you can see, he's a Canadian. So you don't have the exclusive domain on what happens in the corporate world regarding misrepresentations, accounting fraud, et cetera. So in order to deal with the Bernie Ebbers types of Canada, we deal with those matters as creative litigation counsel.

I would like to give you some examples of how we do it, because we have remedies in Canada that your very creative litigation bar does not have in the United States. In other respects, we are catching up very quickly. Some might say it's post-Enron. I think it is really an evolving view of the courts to the effect that, "You know what? Not everyone is telling the truth in my courtroom!"

So in terms of dealing with those issues, we for many years have had a statutory remedy that has broadly dealt with these issues. It is called an oppression remedy. You do not have a statutory oppression remedy. I found this out about fifteen years ago when I was dealing with Skadden, when one of my clients invested in a little company in California. They had invested $5 million, and they were shocked to hear that the President was a Jehovah's Witness and decided to donate all the money one weekend from all the investors coming in and lock the doors, and by Monday there was no money left. I thought: "Classic oppression case. Easy case." Skadden says, "Only remedy you have is to put it in receivership. Not a good idea if you want to go tell your investors what's happening." In the end we were able to bring the case back to Canada and use oppression.

Oppression is a most powerful remedy. As one judge said recently, "It is not a scalpel; it is a battle axe." And what it does is that, if there is any conduct where the affairs of the company are being operated in an unfairly prejudicial manner, it gives the court the right to intervene, to find the appropriate remedy. That remedy could be a full accounting, disgorgement of profits, or appointment of an inspector. I mean anything you can think of to right the wrong of the breaches of duty that you see.

It's most similar probably to some Delaware laws, where you do have fraud in the market concepts or fraud in the minority concepts. But it's much more expansive. It doesn't end there.

Recently, as well, we have started in the last ten years to have class action legislation. We are far behind the U.S. in that respect but trying to catch up quickly. Part of the problem is that we are not used to the very large awards. We don't have juries, and we are fairly conservative in that respect. But very recently—last year—there was the first major securities class action case. Prior to that we were bogged down with issues such as reliance: Did everyone hear the same representation? Did they deal with the same broker? So the courts threw out all the cases. But in a case involving a retail company called Danye Leather, the Court took the case to trial, deciding to make a seminal case on the issue. And although Jeff Clark and I disagree on whether it is going to the Court of Appeal, and whether they'll succeed or not, it was simply a case of a forecast that went wrong, because a lot of people didn't want to buy leather jackets in an unseasonably warm May period. In two months their forecasts exceeded actually what they did, and by the end of the year there was really no loss because they made 95 percent of their forecast. In any event, the court found that the misrepresentation happened at the time that they failed to disclose the revised forecast and issued $15 million in damage awards, including interest and cost. That's not big by your standards, but we usually multiply everything by ten, because we are about a tenth of the size. So it is like a $150 million award in Canada.

The Bernie Ebberses also won't do well in Canada, because our fiduciary duty principles are matched with our oppression principles to disgorge any gain where somebody unfairly benefits themselves over and above the shareholders who don't have a say in the company.

There was a well-known case in Canada, where a very inventive and creative American entrepreneur decided not only to restructure the company, but to pay himself an exorbitant severance that far outstripped any profit any shareholder could ever see. Again, the court used a battle axe in that case to set an example, to show that you always have to act in the best interest of the company. And there, even though Mr. Berg in that case said, "Well, I had the blessing of the board and no one cared," the courts now don't consider, as you know with Sarbanes-Oxley, the fact that a board rubber stamp approval means anything anymore. The boards have to exercise proper governance, get proper expert reports, and independent advice in every case right now.

Well, we haven't stopped there. We've also decided that, in light of the fact that misrepresentations are too hard to prove for class actions, counsel needed to become a little more inventive last year, and they decided to use broader principles that can apply to everyone. One such principle is the principle of constructive trust. And in a case last year, the court approved this principle for a class action. Again, it's going to the Court of Appeal. You're going to hear that a lot from me. Because a lot of these things are relatively novel, stretching traditional lines. So I think in the next few years these issues are going to be resolved at our Court of Appeal. But in the constructive trust area, what our courts are doing is taking principles out of the UK decisions. You'll see in Canada we take a lot of principles out of the UK on common law concepts, just as we are looking at some of the principles in the U.S. where we really just haven't caught up yet. And in those cases they can look at broader principles of disgorgement of profits and restitution, so you don't have to prove individual damage. In that regard, the courts have said that these claims can be certified as a class action.

To add to that, we also are using a waiver of tort principle now. Maybe it is like your unjust enrichment principles in the states. But in those principles, you don't have to prove your own loss. You just disgorge the other's gain. So that's now becoming much more in vogue.

I would like to just end by summarizing what the difference is between Canada and the U.S. The difference in Canada is, as you'll hear, we don't have strong securities enforcement by regulation, although we're trying to get there. In the meantime, you can't get away with anything more in the U.S. than in Canada, because there are so many wide-ranging equitable litigation remedies that good counsel of companies are there in the front end to try to forewarn people like the Bernie Ebberses, like the Conrad Blacks, that you're not going to be able—for too long—to get away with it in what is a post-Enron environment in Canada.

MS. THARP: Thank you very much. Jeff?

JEFFREY CLARK: My name is Jeff Clark, and I'm replacing David Hausman, who wasn't able to be here today. One thing that's important to know in order to look at how U.S. securities matters reverberate in Canada is that you first must recognize some of the differences between the way the U.S. securities regulatory infrastructure is set up versus the infrastructure in Canada.

Now, in the United States, as you know, there is one principal securities regulator, namely, the SEC, functioning under the Federal Securities Act. In Canada there are thirteen separate securities commissions and thirteen separate securities acts. So when Jeff mentioned earlier that there is less legislation in Canada, well, yes, perhaps, but not when you look at the numbers as far as the number of jurisdictions you have to deal with. So we do not have a Federal Securities Act in Canada. Interestingly, we have a Federal Corporations Act, which the United States doesn't have. But we do not have federal securities laws.

Now, there is an unofficial umbrella group, called the Canadian Securities Administrators, that tries to coordinate and harmonize securities laws in Canada. Sometimes they are successful at that, but they don't have the statutory power actually to implement anything that they recommend. So, for example, one thing that they were trying to do in Canada was to harmonize the securities laws right across the country. And they came up with this idea for the Uniform Securities Act. They were going to publish this document with the hope that all of the different jurisdictions would pass that as their securities act and therefore have uniform legislation across Canada. So that was going along very well. Then this past year British Columbia decided they didn't like that idea anymore: they maintain that in regard to securities laws in Canada, and in the United States as well, there are just too many rules and that the axe is getting too thick, too many regulations, now too many policies and other obligations to comply with. So they came up with the idea, "Well, we're going to have a new securities act in B.C." So the harmonization was completely tossed out the window. British Columbia had what's called a principles-based approach, where they said, "We have loved small issuers in British Columbia, and it is too cumbersome for them to deal with all these rules, so we'll have these just broad policies to guide people's behavior, and this will be how securities law will happen in B.C. And you know, it doesn't matter about harmonization, because we are trying to do what's best for our jurisdiction."

A great debate occurred after that, and this initiative never has been put in place, but you can see some of the challenges that exist when trying to have a uniform securities regime in Canada. And also, when looking at how American securities matters reverberate in Canada, it's not necessarily just a Canadian response, because there could be different responses from different jurisdictions within Canada.

So sometimes when matters arise in the securities world where regulators perceive there is a need for response, for example, in the United States when there was the enabling of Regulation FD, Fair Disclosure, in Canada, we looked at that issue and we looked at the way the securities laws were in Canada. And at that time there was a decision that, "Well, in this particular case, there needs to be no action taken in Canada, given the way the different securities acts are written." So there was no response to Regulation FD in Canada.

At other times there is a perceived need that, since our capital markets are so closely related, there had better be some code of response, so we are at least seen to be doing something as well. A very good example is what happened after the Enron, Worldcom, et cetera scandals happened in the United States and the U.S. Congress passed the Sarbanes-Oxley Act of 2002. George Bush characterized that legislation as the most far-reaching reform of American business practice since the time of Franklin Delano Roosevelt, which was in reference to the U.S. Securities Act of 1933, following the stock market crash of 1929. Canadians said, "Well, if there is an investor confidence problem in the United States, then there is also one here. And we want to also be perceived as vigilant by not only Canadians but the rest of the world where people can have confidence in our markets." So led by the Canadian Securities Administrators, that umbrella group, they came up with new securities rules for corporate governing, new rules for what they call the Investor Confidence Rules, which is a series of three of them: One related to auditor oversight, very similar to the mandate in the Sarbanes-Oxley Act; one for CEO/CFO certification, again very similar to what was in Sarbanes-Oxley; and another investor confidence rule regarding the composition and responsibilities of audit committees. So there is an example of where American matters have led to a direct Canadian response in a very similar way.

However, again, there was a Canadianization of these in that, for example, with the Audit Committee Rule, the Americans required there to be a financial expert on the audit committee. That requirement is not in the legislation in Canada; there is just simply a requirement that there be members that are financially literate. And again, that's trying to reflect the differences between the Canadian capital markets and the American capital markets, in that there are so many smaller issuers in Canada, so that there are not necessarily the human resources that you have a financial expert on every single audit committee.

One of the other responses that is important to note in how American matters can reverberate in Canada is when you look at liability for secondary market disclosure. Primary market disclosure is the registration statement and the prospectus: there is a statutory regime in both Canada and the United States where investors can sue for misrepresentations in this type of document. Now, when there is a misrepresentation that occurs in the secondary market in the United States, usually investors will be suing or relying on Rule 10b-5, where they must show that there was a misrepresentation, that it was done with intent, that the investors relied on it, and that misrepresentation caused part of the damages.

There was a U.S. case, *Basic v. Levinston*, which brought forward the doctrine of Fraud on the Market, where you no longer needed to show an investor relied on a specific misrepresentation. That theory was that if there was publicly available information and if there was a misrepresentation, then it was considered to be built into the stock market price. And if you relied on the price, therefore you relied on the misrepresentation.

So in Canada there was a case which was a massive stock market fraud. This company alleged to have found the largest gold deposit ever, I guess with the philosophy that the bigger the lie the more likely people are to believe it. Investors in Ontario sued in a class action, and they found that, when they tried to advance the same U.S. doctrine of fraud on the market, it was not effective: the Ontario courts found that this type of U.S. principle cannot be used in Canada.

So as further part of this package that's come out recently there is a new statutory regime for secondary liability for secondary market disclosure in Ontario. And this can be seen as a response to improved investor confidence in Canada to try to make it an appealing capital market to the world, including American investors, as well.

MS. THARP: Thank you, Jeff.

Any questions on the securities side of things?

Do you gentlemen feel that the enactment of Sarbanes-Oxley has improved investor confidence? Or is it too soon to tell?

MR. KAUFMAN: Not yet. But I think we are going to see what is happening in the U.S. Our companies, as you have heard from Jeff, aren't there yet. But I think in the next three years we'll know if it is going to work or not. And if we are going to get an Eliot Spitzer.

D. Cross Border Anti-Money Laundering and Anti-Terrorist Financing

MS. THARP: The last panel has to do with anti-money laundering and anti-terrorist financing issues.

We are very pleased to have two attorneys from the Stikeman Elliott law firm, one from the Montreal office and one from the New York City office. First up will be Alix d'Anglejan-Chatillon from Montreal, and then we have Kenneth Ottenbreit from the New York City office.

I just quickly will tell you that a couple of years ago I was asked to speak on money laundering issues, and the session was being held in Paris, which was really why I accepted the engagement. I had to cross the border into Canada, because we were flying out of Montreal. Of course, I had prepared my outline and everything, and as we are crossing the border the guard came over and chose our group to really grill on these various issues. And I was so excited: every time he asked a question, I said, "Great, that's in my outline." I think he was starting to wonder about me at a certain point in time. So I've lived through it.

Alix.

ALIX D'ANGLEJAN-CHATILLON: Well, we agree with you: These are very exciting issues, and we are very happy to talk to you about them today. Ken and I are essentially going to shift back and forth. We thought we'd start our discussion with a few fairly graphic images taken from a recent public awareness campaign put out by the U.S. Department of Treasury and the Office of Foreign Assets Control: We see the Canadian dollar actually prominently featured right next to public enemy number one. And the point of this campaign and the point of showing them to you today is really to say that money laundering and terrorist financing operations are not just some back room activity of shabby storefront banks or activities on far-away sunny islands. Money laundering and terrorist financing is big business. The estimates are that billions of dollars are laundered annually through the U.S. economy. The numbers are in the trillion dollar range worldwide. So the odds are that somewhere at some point, at some level, even the most prestigious global financial services enterprises will be caught inadvertently laundering money through their operations.

Also, I just wanted to say at the outset that, in light of what has been going on in the United States over recent years, and beginning really with 9/11, and in light of some of the most recent enforcement action the stakes have risen dramatically for Canadian financial institutions and other foreign financial institutions with ties to the U.S. financial system. The events of 9/11, the U.S. government's commitment to spearheading the global war on terror, and certain special features of the USA Patriot Act have put the spotlight on what U.S. financial institutions are doing with foreign banks and what foreign banks are doing in the United States.

KENNETH G. OTTENBREIT: As Alix mentioned, we are going to go back and forth in our panel discussion. We are going to try to cover just five topics quite quickly and just try to stress the importance of anti-money laundering and counter-terrorist financing issues.

To put it in context, we are going to talk first about the global anti-money laundering regulatory landscape. The international financial system has undergone profound changes in the last several years, particularly relating to international anti-money laundering and counter-terrorist financing issues, both internationally and domestically. We will talk about that.

Both Canada and the United States have been at the forefront of these regulatory developments, and it is important to look at it from a cross-border perspective, at how these developments impact people doing business internationally, and how people try to comply. We will ask the question: Is there a new global compliance standard? And we are going to talk about whether there is clearly an international convergence on the principles and broad outlines of how this should be regulated. You'll see that there are some clearly divergent tracks in the domestic legislation which cause enormous problems for firms that are trying to comply on both the North American and country-by-country basis. So we'll look at that, and we will also talk about some of the enforcement issues, particularly in the United States. There has been a whole series of regulatory enforcement actions that are becoming very serious as companies now face both regulatory and reputational risks that can go to the core of whether that organization is going to stay in business. So it is becoming very serious big business. And then we will conclude with just some general remarks as to what we are advising our clients.

We have a very active cross-border banking investment dealer, financial services practice, and people ask us all the time: How do we deal with this? Do we just comply with the U.S. rule, or the Canadian rule? Is that sufficient? How do we get to the standard that both protects our institution but also complies with both international and domestic law?

Our first topic is the global anti-money laundering regulatory landscape. The initial body that looked at this was the Financial Action Task Force on Money Laundering, FATF. FATF, an inter-governmental body that was initially established by the G7, includes more than thirty-three countries plus the European Union. And FATF in 2003 revised its forty recommendations, which were the original anti-money laundering guidelines. In 2003 they adopted some additional counter-terrorist guidelines that organizations were expected to follow. FATF also exerted pressure on some of the less compliant countries, and you ended up with the Non-Cooperative Countries and Territories Initiative.

So when FATF first started listing some of these NCTI countries, there were many more on the list. In the last number of years some countries got themselves off the black list by improving their own local compliance standards. The Egmont Group is a collection of companies that collect data and share information on unusual and suspicious financial activity. The Financial Crimes Enforcement Network, a division of the U.S. Department of the Treasury, and in Canada the Financial Transactions Reports Analysis Centre, FINTRAC, are the bodies in the U.S. and Canada that participate in that initiative. There are some other global initiatives as well in specific sectors. The Basel Committee on Banking Supervision has established best practice standards for customer identification, know your client.

Furthermore, the European Union Second Money Laundering Directive and a pending third directive also establish standards in the European Union, and there have also been some private initiatives. These are just a few of the highlights.

On the private side, the Wolfsberg Group is comprised of twelve global banks getting together to establish certain best practices and standards that they will try to follow in meeting their international and domestic obligations.

MS. D'ANGLEJAN-CHATILLON: Just as Enron has been a turning point in the area of corporate governance, the turning point in the area of AML and CTF regulation was of course 9/11. And what we saw in Canada and in the United States was essentially the proper transformation of the recommendations into the domestic legislation, but with really very different approaches. So we saw the U.S. Congress enact in record time an omnibus package of amendments to the U.S. Bank Secrecy Act, the Money Laundering Control Act. And the USA Patriot Act is an enormous piece of legislation covering a very broad range of topics, including national security issues, surveillance issues, the protection of the very sensitive northern border with Canada, the DNA testing of suspected terrorists, and most notably, part three, which deals with financial institutions.

What's unique about the USA Patriot Act is how it attempts to cover the very broad array of financial intermediaries in the United States, ranging from very sophisticated global financial services groups to local credit unions to credit card operators to casinos, to used car sales companies, et cetera. Again, this reflects the specific complexities and particular risk exposures of the U.S. economy.

By contrast, the Canadian legislation, where we have unfortunately yet another mouthful of acronyms, is found in the Crime Money Laundering Terrorist Financing Act and the Anti-Terrorist Act Amendments to the Criminal Code and certain other pieces of legislation and supporting regulations. It's all pretty straightforward when you compare it with the USA Patriot Act. But both sets of legislation are generally convergent in terms of the big picture, and yet very different in terms of their detailed application. Ken is going to say a few words about that.

MR. OTTENBREIT: Just from a big picture perspective, the good news when you first talk to the clients about the Canadian standard and then the U.S. standard is that they are very similar. They call for internal controls, independent testing, designation of a compliance officer, and providing training for all of your employees and staff. And they have all the rules with respect to suspicious and unusual activity reporting, large cash transactions, customer identification and due diligence. Sounds fine. It all comes from a lot of these international initiatives. But when you look at the legislation of all the different countries, including Canada and the U.S., there is a high divergence in connection with the details. That is particularly problematic when you have a lot of major financial institutions, operating not just in U.S. or Canada, trying to comply.

A couple of differences between the Canadian and U.S. systems in the detail: when you look at the reporting or suspicious transactions in both Canada and the U.S., in the U.S. you have to file a suspicious transaction report when there is a known or suspected violation, while in Canada the standard is when you have reasonable grounds for suspicion of money laundering offense. Thus there are slightly different standards.

And in the U.S. you have to file reports when the transaction involves more than $5,000 ($2,000 in some money center situations), while in Canada there is no preliminary limit in terms of reporting a suspicious transaction.

In the U.S. you must file your reports generally within thirty days or sixty days if there are some identification problems. In Canada you would expect to file your reports within thirty days or immediately if there are known violations.

Finally, if you're a filer of one of the suspicious transaction reports in the U.S., you get certain fairly limited safe harbor protections for filing of reports. In Canada, you generally receive immunity from both criminal and civil prosecution. So if you're looking at trying to establish an international compliance standard, the real challenge is how do you get there when you've got these particular standards and the diverging details, and how do you comply with the rules of both Canada and the U.S. It is a real challenge facing some major financial institutions and many other smaller institutions, and that's something that everybody should be aware of, because we are certainly seeing this impacting a number of our clients.

MS. D'ANGLEJAN-CHATILLON: And so most of these clients and these global financial services groups: How are they reacting? Well, they are adopting common enterprise-wide standards based on the highest standards in effect around the world. And what are the highest standards in effect around the world? Everything points to the standards dictated by the provisions of the USA Patriot Act. And nowhere are these standards more compelling than in the area of correspondent banking. Correspondent bank accounts are essentially bank accounts opened by U.S. banks to receive deposits from their foreign bank customers and to facilitate payments by foreign bank customers et cetera.

So what Part 3 of the Patriot Act mandates is enhanced due diligence of the beneficial owners of foreign bank accounts or correspondent accounts. And last year ABN AMRO Bank unfortunately found itself in the news as the largest non-compliant foreign financial institution operating in the United States, as a result of the fact that it had not been as thorough and diligent as the U.S. enforcement agencies thought it should have been in screening its correspondent accounts. And it turned out that it had a number of accounts on its books that were used for laundering money for Russian organized crime, among others. So there is the critical importance of correspondent bank accounts, which were described by the U.S. Senate Permanent Subcommittee on Investigations as the back door for funneling dirty money into the U.S. financial system. So that's really where the spotlight is.

In terms of other provisions of the USA Patriot Act that are creating a compelling incentive for foreign financial institutions to comply with the U.S. rules, we have Section 311 of the Patriot Act, which gives the U.S. Treasury the authority to prohibit jurisdictions and foreign financial institutions found to be of primary anti-money laundering concern from doing business with U.S. financial institutions. And we saw this designation of power exercised last year on several occasions when the U.S. Treasury issued these designation orders against Commercial Bank of Syria, Infa Bank of Belarus and the First Merchant Bank of the Turkish Republic of Northern Cypress. In making these announcements, the U.S. Treasury official cautioned the international financial community that the designations alert the global financial community to the threat posed by these entities. It also serves notice to others that there will be significant consequences for institutions that launder tainted money or engage in similar corruptions: "We will cut you off from the U.S. financial system."

So, again, the stakes are extremely high for Canadian financial institutions with correspondent accounts, let alone operations in the United States. And the same goes for any other foreign financial institutions.

Another built-in incentive to compliance is Section 314 of the Patriot Act, which mandates information-sharing both vertically between financial institutions and law enforcement agencies and horizontally between and among financial institutions through a safe harbor arrangement. And here I get back to what Elizabeth was talking about earlier: this vast pool of information-sharing, combined with the recent announcement of the U.S. Treasury that it has this great new software called BSA Direct, which allows for the electronic filing of Suspicious Activity Reports. The idea is that there will be sort of a central clearinghouse of all sorts of information, including personal financial information, potentially of Canadian customers and of Canadian financial institutions, which have correspondent banking relationships with U.S. banks.

Section 317 of the USA Patriot Act also grants long-arm jurisdiction to U.S. courts over any foreign person who commits an offense that takes place in whole or in part in the United States or which maintains a bank account in the United States.

And Section 319 gives the U.S. Treasury or the Attorney General the authority to issue a summons or subpoena to obtain documents or information relating to a correspondent bank account.

So, with this move toward the USA Patriot Act as the common standard comes a series of very high-profile enforcement actions, particularly over the last year. Thus 2004 was really the year of the headline-grabbing enforcement actions. The landmark case, of course, was the Riggs Bank case. Riggs Bank is a bank based in Washington, D.C., which has a significant private banking and embassy account business. And it entered into a consent agreement, a $25 million consent agreement, for various systemic AML compliance failures that led to the failure to file Suspicious Activity Reports. As it turned out, a number of very unfortunate accounts were found on its books, including accounts used by former Chilean President August Pinochet and also a number of accounts for several hundred million dollars of proceeds of foreign corruption stemming from the oil reserves of equatorial Guinea. So these unfortunate accounts and others created a public relations and reputational nightmare for Riggs Bank. We understand that just today or yesterday Riggs has finally settled these issues, paving the way for its takeover by PNC Financial Services Corporation. That transaction itself is an illustration of how extreme caution has to be applied in connection with any acquisition of a financial services business to ensure that you're not inadvertently taking over a huge AML compliance ledger in the process.

AmSouth Bank is another big ticket enforcement case of the last year. It resulted in a series of very significant monetary penalties for AmSouth. And bottom line, the U.S. enforcement agencies are looking to the board of directors to ensure front line supervisory authority over AML compliance within the group's operation.

So all of these point to a brave new world again for financial services groups and foreign financial institutions operating in or with ties to the U.S. financial system. What we need to come away with on this issue is really the critical importance of ensuring that a financial services group has robust AML/CTF compliance procedures. A top-down culture of compliance, in which the board is very much informed of what is happening down the chain, is necessary. And there might be adequate employee training and a culture in which compliance is absolutely critical.

I think that's all we have to say today.

Getting No Sleep in the Continental Bed: American Securities Enforcement Initiatives Reverberate in Canada

By David A. Hausman and Jeffrey A. Kaufman

> "Living next to you is in some ways like sleeping with an elephant: No matter how friendly and even-tempered the beast, one is affected by every twitch and grunt."
>
> —Pierre Elliot Trudeau

I. Introduction

Pierre Trudeau's famous analogy at the Press Club in Washington, D.C., in 1969, regarding the challenges of sharing the continental bed with the most powerful nation on earth, is particularly compelling in the context of securities regulation. In capital market terms, there is no doubt that Canada is a very small mammal when compared to the creature lying next to it on the North American mattress.

Together, the Toronto Stock Exchange (TSX) and the TSX Venture Exchange (the two principal Canadian exchanges) had a market capitalization of $121.5 billion at the end of 2003, representing ninety-eight percent of Canada's GDP. By comparison, the three principal U.S. exchanges—the New York Stock Exchange ("NYSE"), the NASDAQ and the American Stock Exchange ("AMEX") had, at that time, a market capitalization of $1.4266 trillion, representing approximately one hundred thirty percent of U.S. GDP. Canadian issuers constitute the single largest cohort of foreign firms listed on the NYSE, NASDAQ and AMEX, with one hundred eighty inter-listed firms at year-end 2003. About fifteen percent of TSX listed companies are also listed on one of these U.S. exchanges and trading in the United States accounts for forty to fifty percent of the trading in their listed securities, on average.[1]

The Canadian capital market is not only thinly capitalized compared with its U.S. counterpart, but there is also a credibility gap in terms of regulation. The Canadian securities regulatory environment is widely considered by U.S. market observers to be weak and cumbersome. This is due, in large part, to the fact that the regulation of Canada's capital markets is fragmented into thirteen separate regulatory regimes,[2] with only relatively informal mechanisms in place to coordinate their activities.[3] In fact, the recently created Territory of Nunavut with a population of twenty-two thousand has its own securities regulator.

In 2003, the Federal Minister of Finance established the Wise Persons' Committee to provide an independent assessment of what securities regulatory structure will best serve Canada's interests. In its final report dated 17 December 2003,[4] the Wise Persons' Committee determined that the current regime is an "outlier" in global terms and that Canada needs a single federal securities regulatory regime. Significantly, for present purposes, the conclusions of the Wise Persons' Committee were informed, in part, by the U.S. National Securities Markets Improvement Act of 1996, which resulted in increased national regulation of the U.S. capital markets by empowering the Securities and Exchange Commission (SEC) to regulate exclusively in areas that had also been subject to state regulation.

It had often been assumed that there were Canadian constitutional impediments to the establishment of a national securities commission, because securities regulation was thought to be a matter of exclusive provincial jurisdiction under section 92(13) of the *Constitution Act of 1867* (regulation of property and civil rights in the province). However, the Wise Persons' Committee received legal opinions that a proposed federal securities act would also fall within the Canadian Parliament's legislative power to regulate trade and commerce.[5] Notwithstanding these legal opinions, it is safe to conclude that the Wise Persons' Committee's clarion call for a single regulator will be muffled by inter-governmental jurisdictional bickering, a favorite Canadian pastime.

The reputation of Canada's capital markets has also been compromised among American observers for a different reason. As much as we Canadians are famous for our niceness among our southern neighbors in other contexts, we have also earned a reputation for being a disproportionately large source of boiler room pump-and-dump schemes (perpetrated at home and abroad), as well as other scams and market abuses.[6] Part of this perception may be a throwback to the bad old days of the Vancouver and Alberta stock exchanges, but it is also informed by more recent internationally publicized scandals such as Bre-X Minerals, Livent, and YBM Magnex,[7] to name a few. There is also a wide perception among Americans that part of this problem is attributable to lackluster enforcement on the part of Canadian securities regulators. In this regard, the Wise Persons' Committee made the following observation:

> The adequacy of Canada's enforcement has been seriously questioned for some

time. The criticism intensified following the wave of corporate scandals in the United States involving companies such as Enron, WorldCom and Tyco. In Canada a number of high-profile corporate scandals have also occurred, including Bre-X and the massive fraud it represented. There is a perception both in Canada and abroad that serious misconduct in Canada too often goes unpunished.[8]

These comments did not go unnoticed by Canadian regulators. David A. Brown, Q.C., the Chair of the Ontario Securities Commission (Canada's premier securities regulator) recently made the following observation:

> It is not surprising that many people are asking: Are Canadian authorities being aggressive enough in prosecuting abuses in the securities markets?
>
> When the Wise Persons' Committee examined the structure of securities regulation in Canada, the point they heard most consistently was the need for better enforcement in Canada. Indeed, some people who said that they were quite opposed to a single-securities regulator said they would change their views if the Wise Persons' Committee could assure them it would lead to better enforcement.
>
> The concern about enforcement in Canada is not confined to our own shores. The Wise Persons' Committee visited the U.S., the U.K., the European common market and Australia. They heard consistently that, looking at Canada as a whole, tougher enforcement of our securities laws is needed.
>
> What do these opinions stem from? Probably some of the high profile cases that we've been dealing with—Bre-X, YBM, and Livent—all subject to criminal law enforcement investigations—and the realization that no one involved has yet gone to jail.
>
> Concerns about the effectiveness of Canada's enforcement record may not be entirely without foundation. A recent academic study ranked Canada near the bottom of all the major countries in the world as exhibiting insider-trading problems. There have been some disturbing reports in international media that Canada may be becoming a jurisdiction of choice for scam-artists who are operating globally.[9]

There is no doubt that this perception has had an effect on capital formation. A recent study found that Canadian-listed companies trade at a discount to U.S.-listed companies, and the authors of the study postulate that this discount can be reduced when Canadian companies become inter-listed on a U.S. exchange and thereby come under the regulatory oversight of American securities regulators. The authors conclude:

> Our results show that Canadian-listed firms are priced at a discount to their U.S.-listed peers, after controlling for firm-specific and market-specific factors that may affect valuation. This discount is linked to differences in corporate governance between Canada and the United States and the home bias of U.S. investors. We document that cross listed Canadian firms receive a premium valuation relative to exclusively Canadian-listed firms, but are priced at a discount to other U.S. listings. These results suggest that cross listed Canadian firms that are subject to SEC supervision and the tougher enforcement of insider trading laws in the United States are valued more highly than Canadian firms listed exclusively in Canada. At the same time, the act of cross listing does not mitigate U.S. investor home bias, as cross listed Canadian firms still trade at a discount to other U.S.-listed firms. Our results concerning cross listed Canadian firms are sensitive to the relative share of trading in the firm's shares between Canada and the United States. Specifically, the cross listed Canadian firms that are predominantly traded in the United States receive the same valuation as other U.S. firms, and trade at a premium to other Canadian firms. At the same time, cross listed Canadian firms that are traded predominantly in Canada are valued similarly to exclusively Canadian-listed firms and are valued at a discount relative to U.S.-listed firms. These results suggest that the benefit of cross listing in terms of valuation depends on the ability to effectively bond the firm to the U.S.[10]

II. Corporate Governance Reform in Canada

It is not an exaggeration to conclude that the recent corporate scandals in the United States have shaken confidence in Canada's already fragile capital markets to their core. As David Brown recently observed:

> We Canadians pride ourselves on our cultural and societal differences from Americans, but when it comes to capital markets, we live and work in the same borderless world. For the most part, this is an advantageous position for us to be in. We can enjoy what we regard as a better life style yet still be players in that larger arena. But such easy access cuts both ways. When criminal charges are laid in the U.S., when executives plea bargain and household names are found guilty, all of those activities have a toxic impact on how Canadian investors feel about their own money and their own money managers as the bad news spills north.[11]

For many years, Canadian securities regulators have been concerned about the state of the corporate governance practices of Canadian public issuers. In 1994, the TSX published a report recommending that the TSX company manual be amended to provide corporate governance guidelines for directors of TSX-listed companies and to require those TSX issuers who did not comply with these guidelines to disclose this fact publicly (essentially a voluntary "comply or explain" regime).[12] In 1999, the TSX published a follow-up study that found that in only one quarter of listed companies had the board reviewed and formally approved control and management systems. In about forty percent of the companies surveyed, the board had reviewed systems but had not approved them formally. About one-quarter of the listed companies contacted reported that the board had little involvement in internal control and management information systems. In about forty percent of the listed companies, the board had no formal role in the formation or implementation of risk management policies.[13]

As the United States came to grips with corporate malfeasance in the public company context through, among other things, the enactment of the Sarbanes-Oxley Act and the promulgation of new rules by the NYSE and NASDAQ, most Canadian securities administrators felt that they had no choice but to take more pro-active measures to address corporate governance issues as they pertain to Canadian reporting issuers.

That being said, it was also recognized that, given market realities in Canada (which is primarily still a small- to mid-cap marketplace), a "made in Canada" approach to improved corporate governance had to be adopted that, generally speaking, would necessitate the promulgation of less stringent rules than those adopted in the United States. As discussed below, there is a significant issue in Canada as to how many new rules can be imposed on independent directors before it becomes impossible to recruit individuals with the appropriate background and experience to serve on the board of directors of public issuers (particularly venture issuers).

Recent corporate governance reform in Canada has resulted in four initiatives:

- National Instrument 58-101 and National Policy 58-201 (currently in the comment phase) respecting corporate governance standards.
- National Instrument 52-108 respecting auditor oversight.
- Multilateral Instrument 52-110 respecting audit committees.
- Multilateral Instrument 52-109 respecting certification of disclosure in issuers' annual and interim filings.

It is interesting to note that British Columbia has elected not to adopt the new rules respecting audit committees and CEO and CFO certification. This highlights the problem with the Canadian regulatory environment: different regulators pull in different directions. At the same time as most Canadian regulators have sought to impose new requirements to address deficiencies in corporate governance, the British Columbia Securities Commission has taken the view that the promulgation of additional rules will not promote ethical behavior among corporate officials. This is viewed in the rest of Canada as a radical approach to regulation. The following is a recent quotation from the Chair of the British Columbia Securities Commission:

> One of our challenges in making regulation effective is that the complexity of our rules has, itself, become an impediment to compliance. Securities regulators in Canada and abroad have succumbed too easily to the temptation to adopt a new rule to respond to every new problem that comes along. The result is a rulebook of mind-numbing detail and complexity.
>
> This might be justifiable if it contributed to better protection of investors and market integrity, but it doesn't. We mandate mountains of disclosure that is irrelevant to investors' decisions. In

> some cases, our excessively detailed and prescriptive requirements actually undermine our goals, as market participants follow the letter but not the spirit of the rules.
>
> Obviously, we can't move completely away from prescriptive rules and detailed guidance. The Ten Commandments provide a good guide to ethical behavior but we have found some elaboration is helpful for interpretation. In some places, bright line tests, like stop signs, do help things move more smoothly. But the balance in Canadian securities regulation has shifted much too far toward prescriptive rules. We have too easily decided that a rule is the answer to every problem in the market. Sometimes we have made few rules because people weren't complying with the old rules, as if they would take the new ones more seriously.
>
> In British Columbia, we are reversing the tide.[14]

MI 52-109 is similar to the certification requirements provided for in the Sarbanes-Oxley Act. It requires that the Chief Financial Officers and Chief Executive Officers of most reporting issuers in Canada (the principal exception being investment funds), to certify the accuracy of their company's annual and interim filings. They must also certify (by 2006) that their issuers have designed disclosure controls and procedures as well as internal controls over financial reporting. The CEO and CFO must also certify that they have evaluated the effectiveness of the issuer's disclosure controls and procedures and have caused the issuer to disclose in the annual MD&A their conclusions about the effectiveness of the disclosure controls and procedures based on such evaluation. For present purposes, it is significant to note that there are many obligations on public companies, their officials and advisers provided for in the Sarbanes-Oxley Act that are not included in Ml 52-109 (presumably on the basis that they would be overly burdensome to smaller issuers). Of particular interest in this regard, there is currently no equivalent to the requirement in section 404 of the Sarbanes-Oxley Act that management and external auditors certify the effectiveness of the issuer's financial controls (although there has been a suggestion made that this may be a requirement for larger Canadian issuers in the future).

Multilateral Instrument 52-110 provides that every issuer must establish an audit committee comprised of at least three independent members. Given the limited pool of available directors in Canada, unlike the case under the new U.S. rules, there is no requirement that the issuer appoint "an audit committee financial expert" to the audit committee. MI 52-110 provides instead that each member of the audit committee be "financially literate." The financial literacy test is satisfied if the member of the audit committee has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements. Venture issuers (essentially issuers of securities listed on junior Canadian or U.S. exchanges) are exempt from the requirements respecting audit committee composition. This is another nod to the differences between the nature of the Canadian and U.S. capital markets.

Under MI 52-110, the responsibilities of the audit committee are set out as follows:

> (1) An audit committee must have a written charter that sets out its mandate and responsibilities.
>
> (2) An audit committee must recommend to the board of directors:
>
> (a) the external auditor to be nominated for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer; and
>
> (b) the compensation of the external auditor.
>
> (3) An audit committee must be directly responsible for overseeing the work of the external auditor engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer, including the resolution of disagreements between management and the external auditor regarding financial reporting.
>
> (4) An audit committee must pre-approve all non-audit services to be provided to the issuer or its subsidiary entities by the issuer's external auditor.
>
> (5) An audit committee must review the issuer's financial statements, MD&A and annual and interim earnings press releases before the issuer publicly discloses this information.

> (6) An audit committee must be satisfied that adequate procedures are in place for the review of the issuer's public disclosure of financial information extracted or derived from the issuer's financial statements, other than the public disclosure referred to in subsection (5), and must periodically assess the adequacy of those procedures.
>
> (7) An audit committee must establish procedures for:
>
> (a) the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and
>
> (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.
>
> (8) An audit committee must review and approve the issuer's hiring policies regarding partners, employees and former partners and employees of the present and former external auditor of the issuer.

For many years, regulators (particularly enforcement staff charged with the responsibility of addressing market abuses in the micro-capital markets) have been concerned about the quality of financial statements prepared by certain Canadian public issuers. NI 52-108 requires that auditors of public companies in Canada be members of the recently created Canadian Public Accountancy Board ("CPAC"). CPAC was created in April 2003 by federal and provincial financial and securities regulators, as well as Canada's chartered accountants to contribute to public confidence in the integrity of financial reporting of reporting issuers by promoting high quality, independent auditing. It is responsible for developing and implementing an oversight program that includes regular and rigorous inspections of the auditors of Canada's public companies.

Finally, National Instrument 58-101 essentially adopts "comply or explain" corporate governance rules akin to those previously imposed in the TSX Company Manual. NI 58-101 applies to all issuers apart from investment funds, issuers of asset-backed securities, certain foreign issuers and subsidiaries of issuers who are subject to the instrument or the corporate governance requirements of U.S. marketplaces if they do not have equity securities that trade on a marketplace. There is a less stringent form of disclosure required for Venture Issuers. The companion policy (NP 58-201) provides guidance to reporting issuers respecting best practices.

III. The Ontario Securities Commission Casts an Eye on Corporate Governance

Concomitant with the promulgation of the new rules set out above, the focus of enforcement action by Canadian securities commissions has shifted away from consumer protection toward what might generally be described as a market integrity issue.[15] More particularly, there has been an emphasis upon enforcement proceedings that address alleged failures in corporate governance. One Canadian regulator, the Ontario Securities Commission, has sought to move the goal posts considerably in terms of the legal standards respecting the scope of the duties owed by officers and directors in Canada.

The recent decision of the Ontario Securities Commission *In the Matter of Jack Banks a.k.a Jacques Benquesus*[16] represents the high water mark in Canadian authority respecting the duties owed by officers and directors. For reasons that follow, it is also very likely that the case was wrongly decided, since the conclusions reached respecting the duties owed by the respondent as a corporate director are at odds with long-established Anglo-Canadian authority.

The only conduct in issue in *Banks* was the respondent's role as a director and chief executive officer of a TSX-listed issuer, Laser Friendly Inc. ("LSI"), in connection with its participation in a transaction (known as a "Roll Program") that had the effect of allowing third parties to pledge share certificates fraudulently obtained from an LSI escrow account to financial institutions as security for loans. *Banks* is unique insofar as the facts in issue did not relate directly to the distribution or sale of LSI shares or any disclosure issue, but rather only to the possibly unwitting participation by LSI in a fraud perpetrated by third parties. Even though Banks was not personally involved in the transactions giving rise to the release of the share certificates from escrow, and was unaware of them, the Commission found that he should have recognized the risk of that happening when he recommended the underlying transaction to LSI's board of directors. As the Commission held:

> His duty. . . required him to understand the potential for fraud that signed share certificates presented when they purported to be for shares that had been issued as fully paid and non-assessable. He had a duty to ensure that adequate safeguards were in place so that the share certificates could not be used for an improper purpose.

The Commission also held that Banks' duties as the Chief Executive Officer of LSI (in contrast, presumably, to his duties as a director) were not discharged by the delegation of responsibility for the so-called Roll Program to other officers of the Company. As the Commission held:

> The exercise of care and diligence required of him was not a onetime event. Banks was required to be proactive, to monitor LFI's participation in the Roll Program and to obtain regular reports from his subordinates as to how LFI's participation in the Roll program was unfolding. He had a duty to supervise the other officers and ensure that the Roll program was being executed in an appropriate manner.

In its reasons for decision, the Commission acknowledged that there was no allegation of fraudulent conduct on Banks' part and appeared to accept that he was unaware of many of the problems that arose in the context of the Roll Program. In fact, the Commission found Bank's lack of knowledge to be indicia of unacceptable conduct on his part. In this regard, the Commission found:

> If in fact, Banks did not know all the events described above, then his lack of knowledge was all the more egregious. The standard of conduct expected of Banks required a sound understanding of the legitimacy of the Roll Program as a whole, and ongoing engagement by him. If he was unaware of all the problems that emerged, then he performed his duties with reckless abandon.

As stated, the Commission's decision in *Banks* is inconsistent with Anglo-Canadian authority respecting the duties of directors as originally laid down by House of Lords in *Re City Equitable Fire Insurance Co. Ltd.*[17] In that case, Lord Justice Romer held:

> A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed.

Although there is subsequent Canadian authority that makes it clear that the *Re City Equitable Fire Insurance Co. Ltd.* standard does not permit a director to remain passive and deliberately ignorant of the corporation's affairs,[18] *Banks* seems to suggest that directors are required to be omniscient and omnipresent.

IV. Global Securities—the Door Remains Open to the SEC

In May 2004, *Time* magazine reported that Canada's former Finance Minister, John Manley, made the following comment respecting the establishment of a national securities regulator in Canada.

> Canada has a national securities regulator. It's called the United States Securities and Exchange Commission.

At times, it almost appears that Canadian securities commissions function as branch offices of the SEC. As a more well-funded and aggressive regulator than its thirteen Canadian counterparts, the SEC often takes the lead on cross-border investigations. Of particular concern recently to the SEC is the propensity of certain Canadian market participants to engage in Regulation S-8 violations[19] respecting shares of issuers quoted on the OTC Bulletin Board and the pink sheets.

In 1988, the securities commissions of Quebec, Ontario and British Columbia entered into a Memorandum of Understanding ("MOU") with the SEC. Each signatory agreed to provide the "fullest mutual assistance" to each other, including "obtaining documents" and "taking evidence" from persons when requested by another signatory. That same year, pursuant to the MOU, the securities legislation of the signatory provinces was amended to permit the Ontario, British Columbia and Quebec Commissions to order any person or company to produce records and attend to give evidence under oath "to assist in the administration of the securities laws of another jurisdiction."

Until recently, there had been doubts about the constitutionality of these provisions of provincial securities law, based on a 1966 decision of the Manitoba Court of Appeal in *R. v. W. McKenzie Securities Ltd.*,[20] in which it was held that any provision of provincial securities legislation that sought to regulate conduct beyond its borders was beyond the legislative competence of the provinces:

> The Securities Act of Manitoba is not designed to reach out beyond provincial borders and to restrain conduct carried on in other parts of Canada or elsewhere. Its operation is effective within Manitoba and nowhere else. For a person to become subject to its restraint he must trade in securities in Manitoba
>
> Thus examined, the Act cannot be considered as designed in any way for the regulation of interprovincial trading. It does not invade the domain of trade and commerce reserved to the Domin-

ion by the provisions of s. 91(2) of the B.N.A. Act.

The Supreme Court of Canada recently revisited this issue in *British Columbia Securities Commission v. Global Securities Corporation*.[21] In *Global Securities*, the British Columbia Securities Commission sought to compel a British Columbia-based dealer to produce trading records in aid of an SEC investigation. The dealer refused to comply and commenced a petition in the British Columbia Supreme Court seeking an order that the provisions of the British Columbia Securities Act under which the information was sought were *ultra vires* the Province as a matter of federalism. The British Columbia Supreme Court dismissed the petition. An appeal to the British Columbia Court of Appeal was allowed (with a strong dissenting opinion of one member of the three-judge panel) on the basis that the provisions did not fall within provincial legislative powers to regulate property and civil rights in the Province.

A further appeal to the Supreme Court of Canada was allowed. In its decision, the Supreme Court of Canada had particular regard to the principles of mutual cooperation. In this regard, the Court found the evidence of Paul Leder, the SEC's director of international affairs, to be determinative. In his evidence on the original petition, Mr. Leder made it clear that the British Columbia Securities Commission had to provide information to the SEC if it was to be assured of such assistance in return. In fact, he gave evidence that the SEC is statutorily required to consider whether the requesting authority has agreed to provide reciprocal assistance to the SEC in securities matters, as well as whether granting the request would prejudice the public interest of the U.S. Exchange Act § 21(a)(2). Since one of the dominant purposes of the impugned legislation was obtaining reciprocal cooperation from other securities regulators, thus enabling the Commission to carry out its domestic mandate effectively, the Supreme Court of Canada concluded that the provision fit squarely within the legislative competence of the province.

Canadian companies that have securities listed on the NASDAQ, the NYSE or another U.S. stock exchange, and any other Canadian companies that are subject to U.S. periodic reporting requirements because they have previously made registered offerings of debt or equity securities in the United States, are subject to Sarbanes-Oxley and other SEC requirements. Moreover, the financial controls of Canadian subsidiaries of American public companies are subject to the certification requirements section 404 of the Sarbanes-Oxley Act. Accordingly, it is likely that in the upcoming years Canadian residents will be subject to investigation in Canada by representatives of the SEC respecting alleged breaches of the Sarbanes-Oxley Act.

V. The Investment Dealers Association and the USA Patriot Act

The USA Patriot Act has also reverberated in the Canadian capital markets. For years, many Canadian investment dealers had on their books offshore accounts opened with documentation that made it difficult, if not impossible, for regulators to determine beneficial ownership of the accounts. This caused a great deal of frustration in the prosecution of manipulation cases where it appeared that certain accounts of Canadian dealers were engaged in wash trades in support of boiler-room promotions perpetrated by Canadian-related entities based in Europe and elsewhere. There had never been any suggestion or intelligence to the writer's knowledge that such accounts were being used to launder money in aid of terrorist activities.

The coming into force of the USA Patriot Act in 2001 and new regulations promulgated under the Canadian equivalent, the Proceeds of Crime (Money Laundering) and Terrorist Financing Act 2001, brought home to the Investment Dealers Association (the "IDA") (a recognized self-regulatory organization and Canadian equivalent of the National Association of Securities Dealers) that a review of its account-opening "Know Your Client" procedures was necessary.

In October 2002, the IDA published a guide for Investment Dealers as to steps that salespeople, branch managers and compliance staff could take to deter money laundering through IDA member accounts.[22] In terms of offshore trusts, the IDA made the following recommendation:

> Firms should identify the principal ownership of a trust established in a foreign jurisdiction. A firm should consider conducting additional due diligence for trusts established in jurisdictions that lack regulatory oversight over trust formation. Although the documentation may vary, a firm should strive to obtain sufficient documentation regarding the principal ownership of the account. Additional due diligence may also be warranted depending on a number of factors, including the location of the offshore entity and the location of the principal owner(s).[23]

Similar recommendations were made respecting offshore corporations (the preferred vehicle for carrying on anonymous trading in Canada). The guide provided:

> A firm should identify the principal beneficial owner(s) of all corporate accounts, domestic or offshore, where such accounts are personal investment

> corporations or personal holding companies. Although the documentation may vary, a firm should strive to obtain sufficient documentation regarding the principal beneficial owner(s) of the account. Additional due diligence may also be warranted depending on a number of factors, including the location of the entity and the location of the principal beneficial owner(s). For example, while the PCMLTF Regulations require verification of identity only for those having authority over an account, firms should consider verifying the identity of the principal beneficial owner(s) using the methods permitted under the PCMLTF Regulations.[24]

More recently, the IDA put into place new account supervision rules (Regulation 13.1) that require every dealer to identify the beneficial ownership of all accounts (including offshore corporations and offshore trusts). Regulation 13.1 will likely not result in Canada or the United States becoming any safer from terrorists, but it will greatly assist securities regulators in identifying individuals engaged in market manipulation and other abuses.

VI. "Made In Canada" Mutual Fund Scandal

Canadian securities regulators have exhibited an increasing tendency to engage in copycat investigations respecting issues that have given rise to regulatory action in the United States. Very recently, the Ontario Securities Commission announced that settlement agreements had been entered into with four mutual fund managers that had permitted hedge funds to engage in market timing abuses.[25] On the same day, the IDA announced that it had entered into settlement agreements with three dealers that had permitted clients to engage in this form of trading.[26]

It is essential to note the differences between the conduct complained of in the recent Canadian proceedings and the activities of the mutual fund managers that came under the relatively recent scrutiny of the New York Attorney General's office. In the first place, there was no allegation that the mutual fund companies received any improper payments, "sticky money" or other inducements for permitting the trades in issue. The mutual companies also did not permit late trading in their funds. The conduct consisted entirely of market timing. In its oral reasons for decision respecting the settlement agreements, the Commission acknowledged that market timing was not in and of itself contrary to Ontario securities law, but that the mutual fund managers had contravened their fiduciary duties to their long-term unit holders (as set out in section 116 of the Securities Act (Ontario)). The basis of the complaint was that the mutual fund managers failed to exercise their discretion to charge a short-term trading fee to the accounts that engaged in the market timing trades. The mutual fund dealers, in aggregate, were ordered to pay $156.5 million in restitution to longer term unit holders harmed by the market timing conduct.

The case brought by the IDA against the dealers is even more interesting insofar as these dealers did not owe fiduciary duties to unit holders who had been harmed by their clients' market timing activities. These dealers simply executed unsolicited trades by clients and, in some cases, assisted in arrangements with mutual fund companies to ensure that no fees were charged. There is no statement in the settlement agreement as to the policy basis upon which the penalties were based. It would appear that the settlement agreements implicitly support an argument that, in their role as gatekeepers of the capital markets, investment dealers must have regard to the harm that their clients can cause to other investors who do not have a relationship with the member firm (even if that harm does not result from any criminal activity or specific breach of securities law or IDA Regulation).

VII. Conclusion—Finding a Solution that Is Right for Canada

It is very difficult to maintain balance when caught up in a vortex. That said, there are characteristics of the Canadian capital markets that make it difficult for market participants to comply with the onerous requirements of Sarbanes-Oxley and other U.S. initiatives. Leaving aside the fifty or so largest Canadian enterprises (the vast majority of which are listed on U.S. exchanges and subject to the Sarbanes-Oxley Act as foreign private issuers) the Canadian capital markets consist for the most part of a cohort of public companies that would be regarded as small or, at most, mid-cap companies in the United States. The majority of the members of the board of directors of each of these issuers ought to be independent. Yet, it is becoming readily apparent to the best and brightest corporate minds in Canada that the potential costs associated with serving as an independent member of a board of directors is not worth the meager benefits. Whatever rules and policies are recommended or imposed upon issuers by regulators the best defense against poor corporate governance will always be the recruitment of wise and qualified individuals to serve on boards of directors.

From the perspective of issuers as well, at some point, the costs of compliance (particularly for smaller issuers) will outweigh the benefit of access to the capital markets. That does not serve the interests of capital formation.

Whether we will ever be able to strike the appropriate balance between fostering fair and efficient capital markets on the one hand, and promoting capital formation in Canada on the other, remains to be seen. It is certain, however, that we cannot simply assume that the adoption of all the rules in place to govern the largest and most dynamic economy in the world will accomplish this objective.

Endnotes

1. Hendry and King, *The Efficiency of Canadian Capital Markets: Some Bank of Canada Research*, BANK OF CANADA REVIEW at 9-10 Summer 2004.
2. Each of Canada's ten provinces and three territories has enacted securities legislation. The four principal securities regulators in Canada are: the Ontario Securities Commission; L'Autorité des Marches Financiers du Quebec; the British Columbia Securities Commission; and the Alberta Securities Commission.
3. The Canadian Securities Administrators (CSA) is a forum for the thirteen securities regulators of Canada's Provinces and Territories to coordinate and harmonize regulation of the Canadian capital markets.
4. www.wise-averties.ca/reports/
5. Section 91(2) of the *Constitution Act*, 1867. Parliament can, under that section, regulate trade and commerce provided that the pith and substance of the enactment is to regulate trade generally and not a specific calling or trade.
6. A notable recent example was the "Bermuda Short" joint criminal investigation of the FBI and Royal Canadian Mounted Police into stock manipulation and money laundering. This investigation resulted in the arrest of a Canadian broker, Mark Valentine, and resulted in the collapse of Thomson Kernaghan & Co., a well-established Canadian investment dealer.
7. YBM involved a Pennsylvania-based manufacturer of industrial magnets. The FBI investigated certain founding shareholders of the company on the suspicion of ties to Russian organized crime. Disclosure issues respecting the FBI investigation became the subject matter of the longest hearing before the Ontario Securities Commission.
8. Wise Persons' Committee Final Report at 25-26 (hereinafter "Report").
9. Speaking notes for David A. Brown, Q.C., Chair, Ontario Securities Commission, on "The 3 Cs for Improving Securities Law Enforcement: Coordination, Cooperation and Communication," Financial Services & Public Policy Conference at Schulich School of Business, York University, 23 April 2004.
10. King and Segal, *Corporate Governance, International Cross Listing and Home Bias*, 16 CANADIAN INVESTMENT REVIEW 18-19.
11. Remarks by David A. Brown, Q.C., Chair, Ontario Securities Commission, "Enforcement in the Capital Markets," at the IFIC Investor Education Month Event, Toronto, Ontario, 5 April 2004.
12. Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada, *Where Were the Directors? Guidelines for Improved Corporate Governance in Canada*, December 1994.
13. Report of Corporate Governance 1999, "Five Years to the Day," December 1999.
14. Doug Hyndman, Chair, "A New Approach to Securities Regulation: More Effective - Less Costly," BCSC Capital Ideas Conference, 15 September 2004.
15. This includes insider trading issues, which is a very serious problem in most Canadian jurisdictions.
16. (2003), 26 OSCB 3377.
17. [1925] Ch. 407.
18. *Soper v. Canada,* [1998] 1 F.C. 124 (C.A.).
19. Issuance of shares for consulting services.
20. (1966), D.L.R. (2d) 56 (C.A.).
21. [2000] 1 S.C.R. 494.
22. Deterring Money Laundering Activity: A Guide for Investment Dealers, October 2002.
23. See section 3.8 of the Report, note 8 *supra.*
24. See section 3.7 of the Report, note 8 *supra.*
25. The mutual fund management companies involved are: CT Mutual Funds Inc.; AGF Funds Inc.; I.G. Investment Management, Ltd.; and AIC Limited. The settlement agreements are available on the Ontario Securities Commission website www.osc.gov.on.ca.
26. The dealers involved were: TD Waterhouse Canada Inc.; RBC Dominion Securities Inc.; and Nesbitt Burns Inc. The settlement agreements are located on the IDA's website www.ida.ca.

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How Regulatory and Enforcement Developments in the United States Are Raising the Compliance Bar in Canada and Worldwide

By Kenneth G. Ottenbreit and Alix d'Anglejan-Chatillon

I. Overview

Recent regulatory developments and enforcement actions in the area of anti-money laundering (AML) and counter-terrorist financing (CTF) in the United States have dramatically raised the compliance bar for Canadian and other foreign financial institutions with ties to the U.S. financial system.

As described in Part II of these comments, a series of multilateral initiatives have established a common framework for collective efforts to combat money laundering and terrorist financing.

As described in Part III, these initiatives have given rise to broadly convergent AML and CTF compliance legislations in Canada, the United States and elsewhere, but also to divergences in the detailed requirements of domestic legislation which have become a key compliance challenge for financial services groups operating in multiple jurisdictions worldwide.

The 9/11 terrorist attacks, the U.S. government's initiative in spearheading the "global war on terror" and the unique features of the USA Patriot Act (hereinafter "Patriot Act") have increasingly shifted the compliance spotlight onto financial institutions with connections to, or activities in, the United States. These developments, combined with the recent spate of high-profile enforcement actions by U.S. federal and state regulators culminating with the Riggs Bank case (described in Part IV), have signaled the substantial legal and reputational risks associated with a lax AML and CTF compliance culture.

As with Sarbanes-Oxley, the new regulatory and enforcement pressures heralded by the Patriot Act are of critical importance to Canadian and other financial institutions with operations connected to the U.S. financial system.

II. The Global AML Regulatory Landscape

A. Various Key Initiatives

In recent years, the international financial system has undergone profound changes in its legal and regulatory environment, including a series of domestic and international AML initiatives aimed at combating narcotics trafficking, organized crime, and terrorism. The key initiatives have included the following:

1. FATF

The Financial Action Task Force on Money Laundering (FATF) is an inter-governmental body which establishes the standards, and develops and promotes policies, to combat money laundering and terrorist financing. The FATF was established by the G-7 Summit that was held in Paris in 1989 in response to mounting concern over money laundering. It currently has thirty-three members, with thirty-one countries (including Canada and the United States), two international organizations (the European Commission and Gulf Co-operation Council), and over twenty observers, including five FATF-Style Regional Bodies (FSRBs) and some fifteen other international organizations and bodies.

In 2003, FATF revised its Forty Recommendations to combat money laundering to include counter-terrorist financing recommendations. These Recommendations, along with the complementary Eight Special Recommendations on Terrorist Financing adopted in 2001, define a common framework for countries to establish comprehensive domestic legislation to combat money laundering and terrorist financing.

FATF also exerts pressure on less compliance-oriented countries through its Non-Cooperative Countries and Territories (NCCT) initiative, which provides for the blacklisting of countries that have critical deficiencies in their anti-money laundering systems or a demonstrated unwillingness to cooperate in anti-money laundering efforts. As a result of this initiative, the original list of fifteen NCCTs has been driven down to the current list of three (Myanmar, Nauru, and Nigeria).[1]

2. FIUs

The Egmont Group of Financial Intelligence Units (FIUs) is an international network of ninety-four countries that have implemented national agencies to collect information on unusual and suspicious financial transactions, to analyze data, and to share information with other FIUs and national law enforcement agencies to assist in national AML and CTF programs. The Financial Crimes Enforcement Network (FinCEN) of the United States Treasury and the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) have been key participants in this initiative.

3. Basel Committee

The Basel Committee on Banking Supervision (the Basel Committee) has established best practice standards for customer identification, know your client (KYC), and related corporate governance matters for banks (*e.g.,* Basel Committee publication No. 85 "Customer Due Diligence for Banks," October 2001, supplemented by the "General Guide to Account Opening and Customer Identification," February 2003, and "Consolidated KYC Risk Management," October 2004).

4. EU

The EU's Second Money Laundering Directive (with its pending Third Directive) has established common anti-money laundering compliance standards among European financial institutions.

5. IMF and World Bank

The International Monetary Fund and the World Bank have incorporated AML compliance in country risk assessments and increased technical assistance efforts to enhance AML compliance efforts in their member countries.

6. Independent Initiatives

Independent initiatives within the global financial services industry such as the Wolfsberg Group, an association of twelve global banks, has developed a series of financial services industry standards for KYC, AML and CTF policies.[2]

B. Generally

The greatest catalyst for detailed AML and CTF compliance measures has perhaps come from the events of 11 September 2001, the U.S. government's ensuing "war on terror," and the resulting far-reaching changes introduced to domestic legislation in the United States by the Patriot Act of 2001. (The term "USA Patriot" is an acronym for "United in Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism.") The Patriot Act is predicated on the central tenet that:

> Money launderers subvert legitimate financial mechanisms and banking relationships by using them as protective covering for the movement of criminal proceeds and the financing of crime and terrorism, and by so doing, can threaten the safety of United States citizens and undermine the integrity of United States financial institutions and of the global financial and trading systems upon which prosperity and growth depend.[3]

III. The Canadian And U.S. Regulatory Frameworks: A Brief Roadmap

A. Overview

The need for latitude and specificity in the domestic implementation of the Forty Recommendations was expressly acknowledged by the FATF in adopting the Forty Recommendations:

> The FAFT recognizes that countries have diverse legal and financial systems and so all cannot take identical measures to achieve common objectives, especially over matters of detail. The Recommendations therefore set minimum standards for action for countries to implement the detail according to their particular circumstances and constitutional frameworks. The Recommendations cover all measures that national systems should have in place within their criminal justice and regulatory systems; the preventive measures to be taken by financial institutions and certain other businesses and professions; and international corporation.[4]

This flexibility in the customization of global AML and CTF compliance standards is very well illustrated in the relatively different legislative frameworks and enforcement mechanisms developed to implement these standards in Canada and in the United States.

The Canadian legislative and enforcement mechanisms in many ways reflect a relatively concentrated financial system with a small number of medium- to large-sized financial institutions. These features meant that Canada was able to move relatively quickly following the events of 9/11 to overhaul its AML legislation with the introduction over the course of 2001 to 2003 of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act (Canada)*, the *Proceeds of Crime (Money Laundering) and Terrorist Financing Suspicious Transaction Reporting Regulations*,[5] the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations*,[6] the *Cross-Border Currency and Monetary Instruments Reporting Regulations*,[7] as well as various amendments to the *Criminal Code* and the *United Nations Act*[8] and associated U.N. Regulations.

The authority for AML oversight and enforcement in Canada is exercised by a relatively small number of agencies, including the Federal Finance and Justice Departments, FINTRAC, the Office of the Superintendent of Financial Institutions (OSFI), the Investment Dealers' Association of Canada (IDA), the provincial securities regulators, the Canadian Security Intelligence

Service (CSIS) and the Royal Canadian Mounted Police (RCMP).

The basic AML compliance obligations of U.S. financial institutions are set out in the Bank Secrecy Act (BSA) of 1970, the Money Laundering Control Act of 1986, and the Patriot Act, which amended both prior laws. With some one thousand sixteen sections adopted in record time by the United States Congress, the Patriot Act is an omnibus package of amendments to U.S. domestic legislation regulating a broad array of matters ranging from national security, the interception of communications, the protection of the northern border and DNA testing of suspected terrorists. The breadth of the legislation reflects the specific complexities and risk exposures of the U.S. financial system, and the need to extend the regulatory ambit to a wide-range of financial sectors covering some of the largest concentrations of financial institutions worldwide, as well as local credit unions, credit card systems operators, casinos, pawn shops, jewelers, etc., each with its own configuration, market practices and compliance risks.

Detailed implementing regulations have been devised and are enforced on an industry-by-industry basis by a plethora of regulatory and law enforcement agencies, including the United States Treasury Department and its agencies, such as FinCEN, the Office of Foreign Assets Control (OFAC),[9] the Office of Terrorism and Financial Intelligence, and the Executive Office of Terrorist Financing and Financial Crimes; the Department of Justice; the Department of Homeland Security; the "seven federal functional regulators" (including the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration); as well as the Internal Revenue Service.

B. Convergence in the Big Picture; Divergence in the Detail

Both Canadian and U.S. legislation require the implementation of AML compliance programs that, at a minimum, (i) provide for a system of internal controls to ensure ongoing compliance; (ii) provide for independent testing for compliance by internal or external auditors; (iii) designate one or more individuals responsible for coordinating and monitoring ongoing compliance; and (iv) provide training for appropriate personnel. Both sets of legislation provide for suspicious activity reporting, large cash transaction reporting, customer identification, and due diligence standards.

As might be expected, however, the detailed requirements differ in many significant respects. For example, there are a number of key differences between the Suspicious Activity Reporting (SAR) obligations under United States rules and the Suspicious Transaction Reporting (STR) requirements applicable in Canada. First, the requirement to file an SAR applies where there is a "known or suspected violation" of U.S. law. The requirement to file an STR in Canada applies only where there are "reasonable grounds for suspicion" that a transaction is related to the commission of a money laundering or terrorist financing offense. Where a transaction is "known" to be so related, a Terrorist Property Report must be filed. Second, the SAR requirements are triggered in the United States for transactions involving at least $5,000 in funds or other assets ($2,000 in the case of money services businesses), while there is no minimum reporting threshold for Suspicious Transaction Reporting in Canada. Third, a SAR must be filed in the United States within thirty days after the date of initial detection, or sixty days if the suspect is not identified immediately. By contrast, an STR must be filed in Canada within thirty days of initial detection in all cases, and "known" violations must be "immediately" reported using a Terrorist Property Report. Fourth, filers of SARs receive safe harbor protections, whereas filers of STRs enjoy immunity from civil and criminal proceedings for reports filed in good faith.

While they are the expected by-products of different legal and financial systems, differences in these detailed requirements from one jurisdiction to the next have become a significant challenge for the AML compliance divisions of global financial services groups. The October 2004 Report of the Basel Committee on "Consolidated KYC Risk Management" is one of the first published sources of guidance for reconciling diverse standards across multiple jurisdictions and calling for enterprise-wide consolidated compliance systems (at pages 4 and 5):

> Consolidated KYC Risk Management means an established centralized process for coordinating and promulgating policies and procedures on a groupwide basis, as well as robust arrangements for the sharing of information within the group. Policies and procedures should be designed not merely to comply with all relevant laws and regulations, but more broadly to identify, monitor and mitigate reputational, operational, legal and concentration risks. Similar to the approach to consolidated credit, market and operational risk, effective control of consolidated KYC risk requires banks to coordinate their risk management activities on a groupwide basis across the

> head office and branches and subsidiaries.
>
> […]
>
> Every effort should be made to ensure that the group's ability to obtain and review financial information in accordance with its global KYC standards is not impaired as a result of modifications to local policies and procedures necessitated by local government requirements. In this regard, banks should have robust information sharing between the head office and the branches and subsidiaries. Where the minimum KYC requirements of the home and host countries differ, offices in the host jurisdictions should apply the higher standard of the two…

C. Toward a New Global Compliance Standard?

With this movement toward a consolidated enterprise-wide approach to compliance, based on the highest standards in effect, comes a recognition that perhaps no other set of rules creates a more compelling case for compliance than do the provisions of the Patriot Act.

Section 311 of the Patriot Act, for example, gives the U.S. Treasury the authority to prohibit jurisdictions and foreign financial institutions found to be of "primary anti-money laundering concern" from doing business with U.S. financial institutions. The U.S. Treasury used this designation power in May 2004 against the Commercial Bank of Syria and Infobank of Belarus and in August 2004 against the First Merchant Bank of the "Turkish Republic of Northern Cyprus," with the result that U.S. financial institutions have had to sever all correspondent relations with these institutions.

A statement issued by a U.S. Treasury official following the most recent designations cautioned that:

> Today's designations alert the global financial community to the threat posed by these entities. It also serves notice to others that there will be significant consequences for institutions that launder tainted money or engage in similar corruption. We will cut you off from the US financial system.[10]

Section 311 vividly illustrates the kind of leverage that is built into the U.S. regulatory and financial system and the pressures which the United States (unlike any other single country) can bring to bear on the rest of the international community to implement robust AML and CTF regulations and standards.

Other similar built-in incentives to compliance by financial institutions worldwide include the following:

- Section 314 of the Patriot Act, which mandates the implementation of procedures for the sharing of information both "vertically" (between financial institutions and law enforcement agencies) and "horizontally" (through a safe harbor which allows information sharing among industry members).
- Section 317 of the Patriot Act, which grants special "long-arm jurisdiction" to U.S. courts over any "foreign person, including any financial institution" which commits an offense involving a financial transaction that occurs in whole or in part in the United States, or any financial institution that maintains a bank account at a financial institution in the United States.
- Section 319 of the Patriot Act, which gives the U.S. Treasury or the Attorney General the authority to issue a summons or a subpoena to any foreign bank that maintains a correspondent account in the United States and to request records relating to the correspondent account, including records maintained outside the United States relating to funds deposited with the foreign bank.

IV. Enforcement Milestones: The New Lines in the Sand

The adoption of the Patriot Act amendments to the Bank Secrecy Act and related legislation in the United States has been followed by an unprecedented number of enforcement actions in the United States. Each of these actions has offered up a variety of textbook illustrations of compliance systems breakdown and prosecutorial action on a scale never before seen in the AML enforcement world. The most recent round of cases comes on the heels of an earlier generation of cases, including the Bank of New York case (1999-2000), the Broadway National Bank case (2002), the Hartsfield Capital case (2003), and the Banco Popular de Puerto Rico case (2003).

Collectively, these cases illustrate just how serious U.S. regulators have become about AML compliance and enforcement.

A. RIGGS BANK, N.A. (May 2004)

By far the biggest action in the AML compliance world today, the Riggs Bank matter, warrants special attention as a story of the failure of both AML compliance and AML enforcement.

Riggs Bank, N.A., is the principal subsidiary of Riggs National Corporation, a publicly traded bank holding company based in Washington, D.C., with a longstanding private client and "embassy" banking business. In May 2004, Riggs Bank consented to the assessment by FinCEN of a civil monetary penalty of $25 million for a variety of systemic AML violations. In particular, FinCEN found that widespread deficiencies in the four basic components of its required AML compliance program had resulted in willful violations of the suspicious activity and currency transaction reporting requirements of the BSA and related regulations. The findings of the FinCEN are particularly instructive in outlining what kinds of deficiencies were present within the Riggs operation:[11]

> 1. Internal Controls
>
> Riggs' system of internal controls was inadequate to ensure ongoing compliance with the BSA across all business lines. Riggs' internal controls were not designed to take into account the exposure posed by the customers, products, services, and accounts from high-risk—geographic locations that are commonly viewed as high-risk for money laundering. Indeed, Riggs' internal controls proved insufficient to detect and monitor risk, or to alert the bank to the need to take preventive or corrective action when the risk materialized.
>
> Riggs did not implement an effective system to identify and assess the BSA/AML risk present throughout the institution. The risk matrices used in some of Riggs' divisions all contained similar criteria, rather than being tailored to the particular lines of business on a risk-graded basis, which weakened their effectiveness. As a result, management was unable to define and analyze concentrations of risk in the accounts, customers, locations, and products of Riggs.
>
> Riggs' customer due diligence program was weak and was not implemented in an effective or consistent manner. Certain areas of Riggs failed to acquire or to use the bank's account opening and customer activity information collection procedures. Further, customer due diligence information required by Riggs' policies and procedures was frequently missing. As a result, Riggs failed to identify a large number of accounts associated with the governments of two foreign countries. Moreover, Riggs' enhanced due diligence policies and procedures governing high-risk areas were weak or, in some cases, nonexistent. High-risk areas include high-risk transactions such as transactions payable upon proper identification ("PUPID"), high-risk customers such as check cashers and money remitters, and accounts involving high-risk—geographic locations, including private banking, embassy banking, politically exposed persons, and non-resident aliens. On two occasions, although Riggs' management said that the institution had discontinued PUPID transactions, Riggs allowed the transactions to continue.
>
> Riggs also failed to implement adequate internal controls to ensure the identification of suspicious transactions and the timely filing of complete suspicious activity reports ("SARs") on reportable transactions. Riggs did not effectively use procedures and automated technology already in place to identify and review suspicious cash, monetary instruments, or wire activity. Riggs did not have procedures or internal controls to ensure that subpoenas and other government requests regarding accountholders were referred to the division responsible for investigating potential suspicious activity.
>
> Finally, internal controls were lacking in Riggs' management of its largest banking relationship, which involved the accounts of a foreign government, its politically exposed persons, and the companies owned by such persons […]. There was insufficient staff and procedures to monitor the accounts and a lack of oversight over the account relationship manager and his staff. These problems continued even after numerous warning signs indicated that Riggs needed to take corrective action.
>
> 2. Independent Testing
>
> Riggs did not implement an adequate system for independent testing of BSA compliance. The independent testing for compliance with the BSA was neither timely nor effective for the level of risk within Riggs. The internal audit could not verify that management's corrective action for identified deficien-

cies were effective or timely. In addition, the scope of the audit failed to include an evaluation of the areas of money laundering vulnerabilities, BSA compliance, or the suspicious activity reporting process.

> 3. Designation of Individual(s) to Coordinate and Monitor Compliance
>
> Riggs also lacked effective monitoring for compliance by the BSA officer. Day-to-day oversight and monitoring of high-risk transactions, high-risk customers, and high-risk geographies were minimal. Strategies and alternative measures to ensure ongoing BSA/AML monitoring for suspicious transactions were not adequately developed and applied. In addition, the person(s) responsible for BSA compliance at Riggs failed to adequately monitor, identify, investigate, analyze, and report suspicious activity.
>
> 4. Training Appropriate Personnel
>
> Training on monitoring and detecting suspicious activity was particularly weak at Riggs. For example, bank officer visits to customer business locations did not include assessments of BSA/AML risk factors. In addition, branch personnel most familiar with accounts held by money services businesses ("MSBs") were unaware of the factors that typically are associated with suspicious activity and the new BSA registration requirements for MSBs.

Moreover, these deficiencies put Riggs at the center of a crippling reputational quagmire, as a result of findings that (i) Riggs had opened accounts and issued certificates of deposit (CDs) for deposed Chilean President Augusto Pinochet in respect of funds which may have been used in connection with Operation Condor, the wide-ranging conspiracy of Latin American dictatorships to assassinate exiled political dissidents; and (ii) Riggs had administered accounts and CDs for the government of Equatorial Guinea (E.G.), the president of E.G., his wife and other relatives and E.G. government officials with aggregate deposits ranging from $400 million to $700 million, with evidence suggesting that these accounts held the proceeds of profits skimmed off the country's substantial oil revenues.

Riggs Bank was also the subject of at least one class-action suit alleging that its failure to comply with BSA regulations resulted in funds being funneled from high-risk Saudi Arabia embassy accounts to at least two September 11 hijackers. Although the evidence supporting this Saudi connection is apparently unclear, the BSA compliance failures have exposed Riggs Bank to extremely damaging and costly litigation.

The Riggs Bank case is also a landmark in the AML enforcement world for the perceived enforcement failures of the relevant federal functional regulators. In 2003, the United States Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs initiated an investigation to evaluate the enforcement and effectiveness of key AML provisions of the Patriot Act, using Riggs Bank as a case history. The Subcommittee delivered its 112-page report in July 2004, which contains a number of factual findings involving the compliance failures of Riggs Bank and the enforcement failures of the Office of the Comptroller of the Currency (OCC), the federal functional regulator responsible for overseeing Riggs Bank: [12]

> **(4) Regulatory Failure at Riggs**. For many years, OCC examiners accurately and repeatedly identified major anti-money laundering deficiencies at Riggs Bank, but OCC supervisors failed to take strong action to require improvements. OCC regulators were tolerant of the bank's weak anti-money laundering program, too willing to rely on bank promises to correct repeat deficiencies, and failed initially to use available enforcement tools. Federal Reserve regulators were slow and passive.
>
> **(5) Conflicts of Interest**. By taking a job at Riggs in 2002, after the OCC failed to take enforcement action against the bank in 2001 and 2002 for AML deficiencies, the former OCC Examiner-in-Charge at Riggs created, at a minimum, an appearance of a conflict of interest. In addition, despite federal law barring former employees from appearing before their former agencies on certain matters, and OCC rules barring former employees from attending meetings with the agency for two years without prior approval from the OCC ethics office, the former Examiner attended multiple meetings with OCC personnel related to Riggs' AML compliance, without obtaining the required clearance.

In addition, the report noted that current AML enforcement efforts by federal agencies were uneven and, at times, ineffective. The report observed that there were instances where federal regulators had permitted AML compliance problems to persist at some financial institutions for years, had taken three years to issue final regulations that would enforce the Patriot Act's due diligence requirements, and had failed to issue revised guidelines for bank examiners testing AML compliance with the Patriot Act's due diligence requirements combating money laundering and foreign corruption.

B. ABN AMRO BANK, N.V. (July 2004)

This case put the enforcement spotlight on the largest foreign bank operating in the United States as well as on compliance issues surrounding the correspondent banking market and the requirements of sections 312, 313 and 319(b) of the Patriot Act. Generally, these provisions require special due diligence measures for correspondent and private banking accounts, and prohibit correspondent accounts with foreign shell banks.

In July 2004, ABN AMRO Bank, N.V., a foreign bank as defined in section 310(7) of the International Banking Act (12 U.S.C. 3110(7)), and its New York branch entered into a consent agreement with various federal and state bank regulators under which the bank agreed to take various steps to address a number of compliance and risk management deficiencies relating to the bank's significant business operations in the area of correspondent banking services.

The Patriot Act defines a "correspondent account" as an account established to receive deposits from, make payments on behalf of a foreign financial institution, or handle other financial transactions on behalf of such an institution.[13] U.S. banks provide a wide range of cash management services to foreign correspondent accountholders, including providing access to international fund transfer systems (*e.g.,* SWIFT, CHIPS and Fedwire), demand deposits, check clearing and payable through accounts.

Even before the 9/11 attacks, a 2001 Congressional report had highlighted the inadequate controls by U.S. banks to prevent money laundering through their correspondent accounts.[14] Section 312 requires institutions with foreign private banking and correspondent account relationships to establish due diligence policies, procedures and controls that are reasonably designed to detect and report money laundering activity through such accounts. Enhanced due diligence (EDD) is required for correspondent accounts considered to be "high-risk" (*e.g.,* foreign banks operating under an offshore banking license or under a license issued by a country that is designated as non-cooperative or as warranting special measures).

EDD standards include (i) ascertaining the identity of each owner of the foreign bank and the nature and extent of each ownership interest; (ii) conducting enhanced scrutiny of each account to guard against money laundering; and (iii) ascertaining whether the foreign bank provides correspondent accounts to other banks.

Although there has been little regulatory guidance further defining the due diligence requirements of section 312, the ABN AMRO case has raised the international AML compliance bar another notch by effectively requiring that, even in the absence of such guidance, U.S. banks and their Canadian and other foreign bank clients must have an effective compliance program in place for dealing with correspondent account risks. Moreover, the ABN AMRO case and concerns over section 312 enforcement can be expected to have a chilling impact on the willingness of financial institutions worldwide to do business even with legitimate accountholders located in perceived "high-risk" countries.

C. AMSOUTH BANK (October 2004)

On 12 October 2004, AmSouth Bank of Birmingham, Alabama, consented to the assessment of a $10 million civil penalty by FinCEN and the Board of Governors of the Federal Reserve System, and a $40 million deferred prosecution agreement with the Office of the U.S. Attorney for the Southern District of Mississippi and the Criminal Investigation Division of the IRS for violations of the BSA. FinCEN charged that:

> AmSouth wilfully violated the anti-money laundering program and suspicious activity reporting requirements of the Bank Secrecy Act and its implementing regulations. AmSouth failed to develop an anti-money laundering program tailored to the risks of its business and reasonably designed, as required by law, to prevent the Bank from being used to launder money and finance terrorist activities and to ensure compliance with the Bank Secrecy Act. AmSouth's program lacked adequate board supervision and management oversight, lacked fully implemented policies and procedures across the Bank to provide for appropriate due diligence and capture of suspicious activity information, lacked adequate training to ensure compliance and had a materially deficient internal audit process that failed to detect these inadequacies. The result was a fragmented program in which areas of the Bank had information on suspicious activity that was

never communicated to those responsible for Bank Secrecy Act compliance. These systemic deficiencies in AmSouth's anti-money laundering program resulted in AmSouth's failure to timely file suspicious activity reports in circumstances where the Bank was aware of suspicious activity by its customers.[15]

The case has signalled new federal standards of enforcement and has become "must-read" material for AML compliance officers in ensuring that regulated financial institutions maintain a robust and effective AML compliance program, supported by effective internal controls and board and management oversight, and that they file suspicious activity reports when required.

In its penalty order, FinCEN provided a list of SAR reporting failures to support its findings:[16]

- The perpetrators of a fraudulent investment scheme maintained accounts at AmSouth to handle funds contributed by individual investors. AmSouth did not perform adequate due diligence on the perpetrators, which could have revealed financial and prior regulatory problems. Further, AmSouth ignored red flags, including concerns communicated to Bank management by several employees at various AmSouth branches indicating the accounts were being used in furtherance of a Ponzi scheme. Despite such warnings, AmSouth failed to file a suspicious activity report until two years after it knew or should have known about the suspicious nature of the activity and millions had been deposited and then withdrawn from related accounts at the Bank. The perpetrators ultimately were convicted of money laundering and money laundering conspiracy.
- The Chief Financial Officer of an AmSouth corporate customer embezzled several million dollars from the corporation over three years using forged and improperly authorized checks. Although AmSouth employees noticed that the Chief Financial Officer was conducting a number of highly unusual transactions, the Bank did not file a suspicious activity report because it suffered no loss.
- A municipal official contacted the manager of a local AmSouth branch regarding the suspected misappropriation by another municipal official of approximately $450,000 through the fraudulent endorsement of a number of city checks. Shortly thereafter, the responsible party acknowledged the misappropriation in a suicide note. Nonetheless, AmSouth did not file a suspicious activity report because the suspect was dead. Another municipal employee was eventually indicted for his role in the fraud.
- Another matter involved an employee of AmSouth's broker-dealer who allegedly committed fraud in clients' accounts by, among other things, forging customer signatures on numerous documents. The broker-dealer reported this employee's misconduct to the National Association of Securities Dealers ("NASD"). The broker-dealer also had a duty to report what it knew to be suspicious activity by its own employee to FinCEN, and it failed to do so. AmSouth now acknowledges that a SAR should have been filed in this matter, and recently filed a SAR.
- An employee of a car dealership formed his own corporation and then opened an account at AmSouth under the name of the corporation "dba" (doing business as) the name of the car dealership. Over a year, the employee deposited several hundred thousand dollars worth of checks made payable to his employer into the AmSouth account. The employer ultimately sued AmSouth concerning these transactions. AmSouth handled the litigation without conducting a review to determine whether a SAR should be filed.
- An individual operated a fraudulent multi-million dollar trading operation for five years before being arrested. More than $20 million in assets from investors in the program were frozen in various banks, including AmSouth. AmSouth received Securities and Exchange Commission and grand jury subpoenas seeking information on the matter. Months after the individual pleaded guilty to felony charges of securities fraud, money laundering and wire fraud, AmSouth closed the last of his accounts without ever having filed a suspicious activity report.
- A corporate customer deposited into its AmSouth account an official check for $220,000 drawn on another U.S. bank. Six days later, the customer initiated a wire transfer of $190,000 from its AmSouth account to a bank in a foreign country. All but $30,000 of the wired funds were then withdrawn from the foreign bank. Nine days after its deposit, the check was returned unprocessed to AmSouth because the amount had been altered. Although AmSouth notified local law enforcement of the incident and fully cooperated with the government investigation, it did not file a suspicious activity report.
- A bank cashier at another bank embezzled money from his employer by wiring funds from an account maintained by his employer to deposit

accounts at AmSouth held in his or his wife's name. The bank cashier then invested these funds in investment accounts at AmSouth's broker-dealer subsidiary. The employer contacted AmSouth about the bank cashier's account. Although AmSouth notified federal law enforcement of the incident, it never filed a suspicious activity report.

- In addition, the Federal Reserve's June 2004 examination disclosed that AmSouth had not filed suspicious activity reports on a number of instances of check kiting activity involving possible losses above $5,000, which appeared on an AmSouth internal report. In response to the examination, AmSouth has now filed suspicious activity reports on several of the matters identified by the Federal Reserve. Various cases involving fraudulent activity by customers of the bankcard business unit, and matters identified by the fraud prevention unit, also were not reported.

The agreement which AmSouth entered into with the Board of Governors of the Federal Reserve provides for a broad array of immediate remedial actions, including requiring that AmSouth retain a qualified independent consultant to conduct a comprehensive review of the bank's AML compliance program, including reviewing customer due diligence policies and procedures and internal controls; reviewing the bank's governance, management and reporting structures for the bank's AML, customer due diligence and fraud detection programs; strengthening compliance testing for all business lines by qualified staff who are independent of the bank's compliance function; implementing formal documented work programs; assuring review of independent testing results by senior management and procedures to ensure that senior management institutes appropriate actions in response to test results; establishing direct lines of reporting between the independent testing function and the bank's board of directors; implementing management of the AML compliance program by a qualified officer responsible for timely, accurate and complete reporting of suspicious activity or known or suspected criminal activity, management of the bank's AML compliance and of corrective action required for previously identified violations; and organizing effective training for all appropriate personnel (including customer contact personnel across all business lines), with an emphasis on accurate form completion.

D. Other Enforcement Actions

A long list of other BSA enforcement actions were taken by U.S. federal and state regulatory and law enforcement agencies over the past year, including, for example, in these financial matters:

- *Cowboy State Bancorp, Inc., and its subsidiary bank, the Cowboy State Bank of Ranchester, Wyoming (February 2004)*: a cease and desist order requiring stepped-up internal controls to ensure enhanced AML compliance, including, specifically, with respect to the currency transaction reporting requirements; independent review and frequent audits of compliance, personnel training, and the establishment of a compliance committee responsible for overseeing compliance with the order and reporting the Bank's progress on a monthly basis to the board of directors.
- *Traders Bank, Spencer, West Virginia (13 July 2004)*: a "written agreement" addressing AML testing and customer risk assessment deficiencies.
- *County Bank, Merced, California, and the Federal Reserve Bank of San Francisco (October 2004)*: a "written agreement" addressing the bank's system of internal controls for ensuring compliance with the BSA, suspicious activity reporting and customer due diligence procedures and the auditing of such functions.
- *The Community State Bank, Poteau, Oklahoma (October 2004)*: a "written agreement" addressing AML compliance matters among other issues.
- *Amribanc Holdings and its subsidiary the Bank of Durango, Colorado (October 2004)*: a cease and desist order mandating enhanced SAR reporting and compliance with OFAC.

V. The Current Compliance Challenges

With U.S. regulators having been roundly accused of lax oversight in the Riggs Bank matter, it is reasonable to assume that regulatory agencies in the United States will continue to step up investigations and enforcement actions and that zero tolerance will increasingly become the norm in the AML compliance world in the United States.

For Canadian financial institutions, the AML and CTF compliance stakes are rising, but not only because of the geographic proximity and natural dependence of Canadian institutions on the U.S. financial system. The stakes are rising because, in the absence of major enforcement cases in Canada and in most other countries, these recent high-profile enforcement actions in the United States may become the new roadmap for best practices and the new minimum standards for compliance.

Moreover, Canadian and other foreign financial institutions which do not factor in these developments may expose themselves to increasingly sweeping legal and reputational risks (*e.g.*, the threat of a section 311 designation).

As in the new post-Sarbanes-Oxley corporate governance world, the lessons learned from the new post-Patriot Act AML and CTF world are of universal application. They include the critical importance of the following:

- *Enforcing a top-down culture of compliance and a review and control structure that stresses compliance and independent review.* As a result of Riggs, there is a now widespread regulatory expectation that the board of directors will assume front-line supervisory responsibility for AML compliance.
- *Anticipating ongoing regulatory scrutiny and responding to it swiftly and effectively.* In most cases, the toughest penalties have been imposed upon institutions that have failed to take appropriate remedial actions in response to past compliance failures.
- *Ensuring that available compliance and financial resources are directed appropriately through risk-based compliance efforts*. This begins with an ongoing risk assessment of an institution's customers, products and services.
- *Filing timely, accurate and complete suspicious activity reports.*
- *Providing for effective AML and CTF training and ongoing self-assessments and external audits.*

Endnotes

1. See http://www1.oecd.org/fatf.
2. *See, e.g.,* Wolfsberg Anti-Money Laundering Principles for Private Banking, revised in May 2002; the Wolfsberg Statement on the Financing of Terrorism of January 2002; the Wolfsberg Anti-Money Laundering Principles for Correspondent Banking of November 2002; and the Wolfsberg Statement on Monitoring Screening and Searching, of September 2003. See http://www.wolfsberg-principles.com. The site also includes an FAQ series on Beneficial Ownership, Politically Exposed Persons and Intermediaries.
3. Section 302 of the Patriot Act (Findings and Purposes).
4. *The Forty Recommendations* (Revised), 20 June 2003, at 1.
5. SOR/2001-317 (as amended by SOR/2002-185 and by SOR/2003-358) ("SOR/2001-317").
6. SOR/2002-184 (as amended by SOR/2002-413 and by SOR/2003-358) ("SOR/2002-184").
7. SOR/2002-412 (as amended by SOR/2003-358) ("SOR/2002-412").
8. R.S.C. 1985, Chap. U-2.
9. Among other responsibilities, OFAC administers the List of Specially Designated Nationals and Blocked Persons.
10. "US moves to banish foreign banks suspected of money laundering," *Agence France Presse*, 24 August 2004 [emphasis added].
11. United States of America Department of the Treasury Financial Crimes Enforcement Network, *Assessment of Civil Monetary Penalty in the matter of Riggs Bank, N.A. (Document No. 2004-01),* 13 May 2004 [Online: http://www.fincen.gov/riggsassessment3.pdf].
12. Report of the United States Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, *Money Laundering and Foreign Corruption: Enforcement and Effectiveness of the Patriot Act, Case Study Involving Riggs Bank*, 15 July 2004 [Online: http://hsgac.senate.gov/_files/ACF5F8.pdf].
13. See Section 311 of the Patriot Act.
14. Minority Staff of the Permanent Subcommittee on Investigations Report, *Correspondent Banking: A Gateway for Money Laundering* (5 February 2001).
15. United States of America Department of the Treasury, Financial Crimes Enforcement Network, In the Matter of AmSouth Bank, No 2004-2, Assessment of Civil Money Penalty, at 1 and 2.
16. *Id*.

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A Canadian Perspective: Choice of Law and Choice of Forum

By Barry Leon and Graham Reynolds

I. Introduction

Canadian law with respect to choice of law and choice of forum favors party autonomy, particularly in international business-to-business contracting. In the contexts of these aspects of choice, only infrequently do Canadian courts act to limit party autonomy. This article focuses on party autonomy and the limits thereof in these contexts in the area of Canadian conflict of laws. Mandatory rules are discussed only to the extent that they are present in Canadian conflict of laws.

II. Choice of Law

A. Party Autonomy

In Canada, parties to a contract can choose the law that they want to govern their contract, subject to certain limits. The law governing a contractual dispute is sometimes described as the "proper law." The seminal Canadian position on party autonomy in choice of law in contract is set out in *Vita Food Products Inc. v. Unus Shipping Co.*,[1] a 1939 decision of the Judicial Committee of the Privy Council (JCPC). *Vita Foods* wound its way to the JCPC through the courts of the Canadian province of Nova Scotia, where the case originated.

Vita Foods states that "by English law . . . the proper law of the contract 'is the law which the parties intended to apply.' That intention is objectively ascertained and if not expressed will be presumed from the terms of the contract and the relevant surrounding circumstances."[2] Parties can expressly indicate which law is to govern the contract through a choice of law clause. Subject to certain limitations, this law will govern the contract.[3]

B. Limits on Party Autonomy

Vita Foods outlined three limits to party autonomy with respect to choice of law: the choice of law must be bona fide; the contract must be legal; and there must be no reason for avoiding the choice of law on the grounds of public policy. Each of these limitations is discussed below.

There are other limits to party autonomy in the context of choice of law, including the need for the express choice of law to have meaning, limitations on the proper law, limitations on the choice of law, and mandatory laws. These limitations on party autonomy are also discussed below.

1. Choice of law must be bona fide

A choice of law that appears to the court to make no commercial sense will be scrutinized under the bona fide limitation. *Nike Infomatic Systems Ltd. v. Avac Systems Ltd.*,[4] citing *Dicey and Morris on the Conflict of Laws*,[5] discusses the bona fide limitation on party autonomy, noting the following:

> No court . . . will give effect to a choice of law (whether English or foreign) if the parties intended to apply it in order to evade the mandatory provisions of that legal system with which the contract has its most substantial connection and which, for this reason, the court would, in the absence of an express or implied choice of law, have applied.

2. Contract must be legal

Parties will not have their choice of law respected by the courts if the contract in which this choice is embedded is found to be illegal. Determining whether a contract is legal requires that it be evaluated against a set of legal standards. As noted in *Castel and Walker*, "this begs the question by what law the legality is to be tested":[6] the law of the place of contracting, the proper law, or the law of the place of performance?[7]

The fact that the contract is illegal in the place where the contract was made does not necessarily render it illegal.[8] The determining factor is whether the contract is illegal under the proper law. A contract that is "illegal or whose performance is illegal by its proper law will not be treated as a legal contract in Canada."[9]

The law regarding the validity of a contract that is illegal in its place of performance is unsettled. There is "considerable authority" to support the proposition that a contract lawful by its proper law but illegal in its place of performance is unenforceable.[10] However, it is unclear "whether this is a rule of the conflict of laws or whether it reflects the fact that contracts which have been held unenforceable for this reason have also offended against local public policy, or have been invalid by their proper law."[11]

As long as the contract is legal under the proper law and the law of the place of performance, it is irrelevant whether it is legal under the law where a party is "resident or domiciled or of which he or she is a national, or where he or she has his or her place of business, provided the law of that place is not the proper law or the law of the place of performance."[12] Finally, contracts are illegal in Canada if they are "illegal under a federal statute having extraterritorial effect, such as exchange control legislation, or other revenue laws . . ."[13]

3. Contract must not be contrary to public policy

Contracts are illegal in Canada if they, or parts of them, are contrary to concepts of public policy or morality. For example, it is very clear that a contract for slavery would be contrary to public policy. However, some less offensive contracts are moving targets. At one time gambling was considered contrary to Canadian public policy, and gambling contracts would not be enforced by Canadian courts. Canadian courts have held that gambling is no longer against the public policy of Canada.[14] In *Boardwalk Regency Corp. v. Maalouf*, the Court of Appeal for the province of Ontario held that the enforcement of foreign default judgments regarding gambling debts is not contrary to public policy.[15] Another topic that Canadian courts have considered is damage awards that go beyond compensatory damages. In *Old North State Brewing Co. v. Newlands Services Inc.*,[16] the Court of Appeal for the province of British Columbia held that the enforcement of treble and punitive damage awards in Canada was not contrary to public policy.

4. Connection between the contract and the chosen law not required

Canadian law does not require a connection between the contract (e.g., its subject matter or parties) and the law selected to govern the contract.[17] However, as noted in *Castel and Walker*, "if the parties choose a legal system with which the transaction has no connection at all, the *bona fides* of their choice may be in doubt and the courts may disregard it."[18]

5. Choice of law must have meaning

If a court finds that the express choice of law is meaningless, it will disregard it, and will determine the proper law "according to other indications of the intentions of the parties."[19]

6. Limitations on the proper law

Party autonomy is limited by restrictions on the capacity of the proper law to govern the entire contract. The proper law does not necessarily apply to every contractual term or every potentially disputable issue.[20] For instance, the parties may decide to allow certain terms to be governed by different laws, in a process called *depeçage*.[21]

The court may decide that the "objectively ascertained proper law varies according to the contractual issue involved."[22] However, courts rarely choose to act in this manner and will not vary the proper law without good reason.[23]

In addition, certain types of contractual issues, including issues relating to the formation of the contract, the formal validity of the contract, and the parties' capacity to enter into the contract, are not "referable" to the governing law.[24] For example, issues of offer and acceptance are determined by the "'putative proper law' . . . the law that would be the proper law if the contract was validly created."[25]

In a similar manner, though compliance with the requirements of the proper law will generally suffice to allow the contract to be declared formally valid, "enforceability of the contract may depend upon compliance with certain rules prescribed by the forum . . ."[26]

A party's capacity to enter a commercial contract could be governed by three different laws: the law of the place of contracting; the law of the domicile of the parties (particularly in the case of corporate entities); and the proper law of the contract (the latter having the support of more recent Canadian case law).[27]

7. Limitations on choice of law

Canadian courts will not give "extraterritorial effect to certain types of foreign statutes or judgments," including foreign blocking legislation, foreign penal laws, foreign revenue laws or foreign public laws. [28] Furthermore, Canadian courts will not allow conflict of laws rules to be used to "evade local substantive rules of law otherwise applicable."[29]

8. Mandatory laws

Some Canadian statutes limit party autonomy by imposing mandatory laws or mandatory choice of law rules. These statutes can be grouped into four classes. The first class, exemplified by the *Bills of Exchange Act*,[30] provides "choice of law rules that must be applied when determining the proper law."[31] The statutes in the second class, in which the *Canada Shipping Act*[32] is included, "limit the scope of their own application and provide choice of law rules for contractual issues covered by them, but leave unaffected the determination of the proper law in relation to issues outside the ambit of the statute."[33] The third class "provides for the application of particular substantive laws," if the proper law of the contract is the law of the place that enacted the statute.[34] Statutes belonging to the third class include the *Frustrated Contracts Act* (Ontario)[35] and the *Insurance Act* (Ontario).[36] A fourth class of statutes "prescribes rules for certain kinds of contracts regardless of the parties' choice or the close connection the contract may have with another legal system."[37] Statutes in this class include those implementing international agreements for the harmonization of certain areas of the law[38]—for example, the *Carriage by Air Act*[39] and the *Carriage of Goods by Water Act.*[40]

In addition to these four classes of statutes, international agreements influence party autonomy by harmonizing laws, limiting choice or imposing mandatory laws and rules. Three examples of international agreements of this kind are the *Bretton Woods Agreement*,[41] the 1980 *United Nations Convention on Contracts for the International Sale of Goods*,[42] and the *Rome Convention*.[43]

III. Choice of Forum

A. Party Autonomy

Party autonomy in the context of jurisdiction refers to the ability of contracting parties to choose the forum in which disputes arising from the contract will be adjudicated. This choice is executed through the vehicle of a forum selection clause.[44] Such a clause, often contained within international commercial contracts, confers "exclusive or concurrent jurisdiction on a particular court to resolve disputes arising out [of] the contract or in respect of legal relationships relating to the contract."[45]

In Canada, forum selection clauses are presumptively enforceable. Canadian courts tend to uphold agreements between parties to international contracts to resolve their disputes in a specific forum. The Canadian approach to the enforceability of forum selection clauses, while similar to that of most U.S. states,[46] differs from that of the European Union (EU). In Europe, the "Brussels and Lugano Conventions govern the enforceability of many international forum selection clauses involving one or more European parties."[47] In Canada, as in the United States, forum selection clauses are not governed by conventions, but by the principles of the common law.

Questions regarding the enforceability of forum selection clauses arise when a party commences court proceedings not in the chosen forum. As noted in *Castel and Walker*:

> No problem arises if both parties submit to litigation in the selected court and that court has jurisdiction over the subject matter of the dispute. The question whether a forum selection clause is enforceable outside the chosen court arises if one of the parties to the agreement commences a proceeding in another court in violation of its provisions.[48]

Canadian courts, under their "inherent or statutory jurisdiction," have power to "stay a court proceeding begun in the province in breach of an agreement to submit to the exclusive jurisdiction of the court to which the parties would not otherwise be subject."[49] Proceedings will be stayed unless the plaintiff can satisfy the court that there are "strong reasons from the point of view of convenience and the interests of justice" for allowing the lawsuit to proceed. The plaintiff's burden is not simply to upset a delicate balance. The forum selection clause "will be enforced unless the balance of convenience strongly favors the opposite conclusion."[50]

This is the position in the common law jurisdictions in Canada. Under the Quebec Civil Code, a Quebec court must decline jurisdiction where the parties have selected a court in another jurisdiction as the exclusive forum for the resolution of their dispute.[51]

The following "strong cause" test, initially set out in 1969 in *The Eleftheria*, was affirmed by the Supreme Court of Canada in 2003 in a case known as *The Canmar Fortune:*

> (1) Where plaintiffs sue in England in breach of an agreement to refer disputes to a foreign Court, and the defendants apply for a stay, the English Court, assuming the claim to be otherwise within the jurisdiction, is not bound to grant a stay but has a discretion whether to do so or not. (2) The discretion should be exercised by granting a stay unless strong cause for not doing so is shown. (3) The burden of proving such strong cause is on the plaintiffs. (4) In exercising its discretion the Court should take into account all the circumstances of the particular case. (5) In particular, but without prejudice to (4), the following matters, where they arise, may be properly regarded: (a) In what country the evidence on the issues of fact is situated, or more readily available, and the effect of that on the relative convenience and expense of trial as between the English and foreign Courts. (b) Whether the law of the foreign Court applies and, if so, whether it differs from English law in any material respects. (c) With what country either party is connected, and how closely. (d) Whether the defendants genuinely desire trial in the foreign country, or are only seeking procedural advantages. (e) Whether the plaintiffs would be prejudiced by having to sue in the foreign Court because they would (i) be deprived of security for that claim; (ii) be unable to enforce any judgment obtained; (iii) be faced with a time-bar

> not applicable in England; or (iv) for political, racial, religious or other reasons be unlikely to get a fair trial.[52]

B. Limits on Party Autonomy

1. Public policy/unconscionability

As noted in *Fairfield v. Low,* a stay will not be granted if the agreement "offends public policy or was the product of grossly uneven bargaining positions."[53] *Castel and Walker* states that

> exclusive jurisdiction agreements made in a commercial setting will generally be given greater deference unless they involve a small business that was not capable of negotiating a feasible dispute resolution clause; and those involving consumers, workers and other individuals who may not be of equal bargaining power will be subject to greater scrutiny.[54]

Thus, party autonomy is limited on principles similar to the doctrine of unconscionability. The choice of jurisdiction expressed in a forum selection clause will not be given effect if the decision is revealed to have been made unilaterally or achieved through oppressive measures. However, as the Supreme Court of Canada noted in *Canmar Fortune*, "parties should be held to their bargain."[55] If the parties are sophisticated and of equal bargaining power, the forum selection clause will generally be upheld.

2. Jurisdiction in Canadian courts

Party autonomy is limited through the application of principles of jurisdiction. If a Canadian court decides that, for some reason (such as the subject matter of the dispute), the forum named in the forum selection clause—whether a forum outside Canada or another Canadian province or territory—does not have jurisdiction to hear the dispute, it will decline to stay the lawsuit.

(a) Canada: federal jurisdiction

In considering questions of court jurisdiction, it should be noted that Canada is a federal state, with twelve common law jurisdictions (nine provinces and three territories) and one civil law jurisdiction (Quebec). Each of these jurisdictions administers its own superior court system, with judges appointed by the federal government. These courts have inherent jurisdiction.

There is also a federal court system with limited statutory jurisdiction. Certain areas of federal law and certain types of claims, such as maritime law and patents, must (or may) be determined by the Federal Court of Canada or the Tax Court of Canada. However, the federal court has no diversity of jurisdiction or pendant or ancillary jurisdiction. The ultimate court for appeals from all these courts is the Supreme Court of Canada.

Although each Canadian jurisdiction determines its own approach to certain procedural aspects of jurisdictional matters, their approaches to determining the existence of jurisdiction and forum contests are similar. Supreme Court of Canada decisions[56] establish the approach to be taken across Canada.[57]

(b) Two-step approach

When a jurisdictional contest arises, the Canadian court first determines whether it has jurisdiction. The court then determines whether it is the most appropriate forum to determine the dispute (*forum conveniens*).

(c) Three ways to assert jurisdiction

There are three ways in which jurisdiction may be asserted in Canadian courts against foreign defendants: (i) presence-based jurisdiction; (ii) consent-based jurisdiction; and (iii) assumed jurisdiction.

Presence-based jurisdiction permits jurisdiction over a foreign defendant who is physically present within the territory of the court. Consent-based jurisdiction permits jurisdiction over a foreign defendant who consents to the forum, whether by voluntary submission, attornment or prior agreement. Assumed jurisdiction is initiated by service of the court's process on a foreign defendant (service *ex juris*). This process is governed by the procedural rules of each Canadian court system. In many of those court systems, service outside the jurisdiction is with leave—that is, the court must authorize service to be made outside the jurisdiction. Some Canadian jurisdictions have relaxed the rules for service outside the jurisdiction to permit service as of right in many circumstances, with an offsetting right of the foreign defendant to challenge the plaintiff's choice on the basis of *forum non conveniens*.[58] Once served, a foreign defendant may assert that the Canadian court lacks jurisdiction to hear the dispute.

Since 1990, the "constitutional requirements of order and fairness have permitted courts to exercise jurisdiction over matters with a real and substantial connection to the forum." As noted by the Court of Appeal for Ontario in *Muscutt v. Courcelles*, it is

> not possible to reduce the real and substantial connection test to a fixed formula. A considerable measure of judgment is required in assessing whether the real and substantial connection test has been met on the facts of a given case. Flexibility is therefore important.[59]

However, as "clarity and certainty" are also important, the Court of Appeal for Ontario has set out eight factors to be considered in determining whether a "real and substantial connection" exists between the forum and the parties:

- The connection between the forum and the plaintiff's claim.
- The connection between the forum and the defendant.
- Unfairness to the defendant in assuming jurisdiction.
- Unfairness to the plaintiff in not assuming jurisdiction.
- The involvement of other parties to the suit.
- The court's willingness to recognize and enforce an extraprovincial judgment rendered on the same jurisdictional basis.
- Whether the case is interprovincial or international in nature.
- Comity and the standards of jurisdiction, recognition and enforcement prevailing elsewhere.[60]

3. *Forum non conveniens*

Forum non conveniens may be another limitation to party autonomy in the context of choice of forum. The *forum non conveniens* doctrine allows the court to decline to exercise its jurisdiction on the ground that there is another more appropriate forum that may entertain the dispute. Thus the parties' choice of forum could be overturned in favor of what the court considers to be a more appropriate forum. The *forum non conveniens* analysis in cases where the parties have selected a forum for their disputes is somewhat different, as described above in the section dealing with *The Canmar Fortune.*

In *Amchem Products Inc. v. British Columbia (Workers' Compensation Board)*, Sopinka J., drawing from the House of Lords' decision in *Spiliada Maritime Corp. v. Cansulex*, [61] described the Canadian test of *forum non conveniens* as follows:

> In my view the overriding consideration which must guide the Court in exercising its discretion . . . must . . . be the existence of some other forum more convenient and appropriate for the pursuit of the action and for securing the ends of justice.[62]

Similarly, in *Frymer v. Brettschneider*, relying on the judgment of Sopinka J. in *Amchem*, Arbour J.A. (as she then was) for the majority articulated the test as follows:

> *In all cases, the test is whether there clearly is a more appropriate jurisdiction than the domestic forum chosen by the plaintiff in which the case should be tried.* The choice of the appropriate forum is designed to ensure that the action is tried in the jurisdiction that has the closest connection with the action and the parties. *All factors pertinent to making this determination must be considered.*[63]

The determination of the most appropriate forum is discretionary, and focuses on the specific facts of the parties and the case.[64] Accordingly, Canadian courts have developed a number of factors to guide them in their disposition of convenient forum disputes. These factors include the following:

- The location where the contract in dispute was signed.
- The applicable law of the contract.
- The location in which the majority of witnesses reside.
- The location of key witnesses.
- The location where the bulk of the evidence will come from.
- The jurisdiction in which the factual matters arose.
- The residence or place of business of the parties.
- Loss of juridical advantage.
- Contractual provisions that specify applicable law or jurisdiction.
- The avoidance of a multiplicity of proceedings.
- Geographical factors suggesting the natural forum.[65]

The application of the *forum non conveniens* doctrine requires the court to examine the balance of convenience with respect to the specific parties and the specific case. Determining the convenient forum is a factual inquiry, and as such, the list of factors described above is not exhaustive.[66]

For example, some courts have given greater weight to choice of law provisions when deciding these types of motions. Justice Adams in the court of first instance in *Frymer*[67] considered a number of factors relevant to determining the proper forum for resolving a trust dispute. In deciding that the province of Ontario was not the convenient forum, he emphasized the choice of law provision in the agreements between the parties, which provided that Florida law was to govern the contractual relationship. In addition, he noted generally that choice of law provisions, where all other factors are equal, also determine the *forum conveniens* for the trial.[68]

(a) Standard of proof

While the standard of proof remains that applicable in civil cases, "the existence of a more appropriate forum must be clearly established to displace the forum selected by the plaintiff."[69] The Court of Appeal for Ontario reiterated this elevated civil standard in *Mutual Life Assurance Co. of Canada v. Peat Marwick*.[70] In this case, the Court stated that for the motion to stay an action to succeed on the basis of *forum non conveniens*, there must be a clear preponderance in favor of the proposed substituted jurisdiction.[71]

(b) Burden of proof

Typically, where the defendant is served within the jurisdiction, the burden of proof will rest with the moving party. Accordingly, the defendant will be required to prove that another forum is clearly more appropriate than the forum selected by the plaintiff. However, the Ontario Court of Appeal has held that where the plaintiff serves the defendant *ex juris*, the burden will be on the plaintiff to establish that Ontario is the appropriate forum.[72]

4. Contrary to public international law principles

Although public international law principles are rarely (if ever) a practical limitation, a Canadian court would not exercise jurisdiction if doing so would be contrary to public international law principles that are part of the law of Canada.[73]

5. Statutes implementing international conventions

Canadian jurisdiction may be excluded or limited in the context of an international convention and the statute implementing it.[74] The Canadian *Carriage by Air Act,* implementing the Warsaw Convention, is one example. As noted in *Castel and Walker*, "an action for damages against a carrier by air arising out of international carriage may be brought at the option of the plaintiff in the territory of one of the high contracting parties to the Warsaw Convention, before the court having jurisdiction where the carrier is ordinarily resident or has its principal place of business or has an establishment by which the contract of carriage was made, or before the court having jurisdiction at the place of destination of the flight."[75]

The Canadian *Marine Liability Act*[76] is another statute implementing an international convention that limits Canadian jurisdiction. The *Marine Liability Act* implements the Hamburg Rules. Section 45 of the Act notes that "the Hamburg Rules have the force of law in Canada in respect of contracts for the carriage of goods by water between different states as described in Article 2 of those Rules."[77] Furthermore, the Act notes that "the Hamburg Rules also apply in respect of contracts for the carriage of goods by water from one place in Canada to another place in Canada, either directly or by way of a place outside Canada, unless the contract stipulates that those Rules do not apply."[78]

IV. Conclusion

Canadian law with respect to choice of law and choice of forum favors party autonomy, particularly in international business-to-business contracting.

Parties to a commercial contract are free to choose both the law that they want to govern their contract and the forum in which they want to adjudicate their disputes, subject only to a discrete number of limitations on the parties' autonomy to choose. As a practical matter, these limitations seldom hinder international commercial contracts in ways that would surprise contracting businesses. Most forum disputes arise not where the parties have made a clear choice in their contract, but where they have implicitly left it to the courts to determine jurisdiction on the basis of, first, whether there is a real and substantial connection and, second, whether the forum selected by the plaintiff is the convenient forum (or whether there is clearly a more appropriate forum).

In the contexts of choice of law and choice of forum, only infrequently do Canadian courts act to limit party autonomy. This is good news for international businesses that encounter Canada's jurisdiction—whether for the adjudication of their disputes or the enforcement of judgments obtained elsewhere. Canadian courts see an essential need for contracting parties to abide by their agreements, and these courts will honor most choices that parties make regarding choice of law and choice of forum. This respect for the choices of contracting parties, coupled with the tendency of Canadian courts to give increased deference to the determinations of courts of jurisdictions with essentially fair judicial systems, fits well with the increasing internationalization of Canada's economy and Canada's consequent interest in promoting efficient international commercial dealings.

Endnotes

1. [1939] 2 D.L.R. 1 (J.C.P.C.) [*Vita Foods*].
2. *Id.* at 8.
3. Janet Walker, CASTEL & WALKER: CANADIAN CONFLICT OF LAWS, 6th ed., looseleaf (Markham: LexisNexis Canada Inc., 2005) [CASTEL & WALKER]. This is Canada's leading text on conflict of laws. The authors extend their appreciation to Professor Walker for her guidance in the preparation of this paper.

4. (1980), 105 D.L.R. (3d) 455 at 459 (B.C.S.C.).
5. J.H.C. Morris, ed., DICEY AND MORRIS ON THE CONFLICT OF LAWS, 9th ed. (London: Stevens, 1973).
6. CASTEL & WALKER, note 3 *supra*, at 31-9.
7. *Avenue Properties Ltd. v. First City Development Corp.* (1986), 32 D.L.R. (4th) 40 (B.C.C.A.), *rev'g* (1985), 65 B.C.L.R. 301 (S.C.) (domestic statute tentatively construed as overriding law selected by the parties); *Agro Co. of Canada Ltd. v. The "Regal Scout"* (1983), 148 D.L.R. (3d) 412 (F.C.T.D.).
8. *Vita Foods,* note 1 *supra*.
9. *Etler v. Kertesz* (1960), 26 D.L.R. (2d) 209 (Ont. C.A.); cited in CASTEL AND WALKER.
10. CASTEL & WALKER, note 3 *supra*, at 31-61.
11. *Id*.
12. *Id*.
13. *Id*. at 31-62.
14. *G.N.L.V. Corp. v. Wan* (1991), 30 A.C.W.S. (3d) 1132 (B.C.S.C.).
15. CASTEL & WALKER, note 3 *supra*, at 14-32; *Boardwalk Regency Corp. v. Maalouf,* [1992] O.J. No. 26, 88 D.L.R. (4th) 612 (Ont. C.A.).
16. [1998] B.C.J. No. 2474 (B.C.C.A.).
17. *Vita Foods,* note 1 *supra*.
18. CASTEL & WALKER, note 3 *supra*, at 31-3.
19. *Id*.
20. *Id*. at 31-51.
21. This example, however, reflects not a restriction but a manifestation of party autonomy.
22. CASTEL & WALKER, note 3 *supra*, at 31-51.
23. *Id*.
24. *Id*.
25. *Id*.
26. *Id*.
27. *Id*. at 31-52.
28. *Id*. at 8-1.
29. *Id*. at 8-14.
30. R.S.C. 1985, c. B-4 as am.
31. CASTEL & WALKER, note 3 *supra*, at 31-54.
32. R.S.C. 1985, c. S-9 as am.
33. CASTEL & WALKER, note 3 *supra*, at 31-55
34. CASTEL & WALKER, note 3 *supra*, at 31-55
35. R.S.O. 1990, c. F.34, s. 2.
36. R.S.O. 1990, c. I.8 as am., ss. 122-23.
37. CASTEL & WALKER, note 3 *supra*, at 31-56.
38. *Id.*
39. R.S.C. 1985, c. C-26.
40. S.C. 1993, c. 21.
41. *Bretton Woods and Related Agreements Act,* R.S.C. 1985, c. B-7 as am.
42. Final Act, Vienna, 11 April 1980, C.T.S 1992/2.
43. (1980), 29 Int. Leg. Mat. 1492, as cited in CASTEL & WALKER, note 3 *supra,* at 31-57.
44. Alternatively, the parties may include an arbitration clause in their contract. Canada is a party to the New York Convention (Convention on the Recognition and Enforcement of Foreign Arbitral Awards) and the UNCITRAL Model Law on International Commercial Arbitration (1985) has been adopted (with few changes) in every Canadian jurisdiction.
45. CASTEL & WALKER, note 3 *supra,* at 13-55.
46. From Gary B. Born, INTERNATIONAL ARBITRATION AND FORUM SELECTION AGREEMENTS (Boston: Kluwer Law International, 1999) at 91.
47. *Id.* at 90.
48. CASTEL & WALKER, note 3 *supra,* at 13-55.
49. *Id*. at 13-55.
50. *Id*. at 13-55.
51. *GreCon Dimter Inc. v. J.R. Normand Inc.*, [2005] S.C.C. 46.
52. *Z.I. Pompey Industries v. ECU-Line N.V.*, [2003] 1 S.C.R. 450 [*Canmar Fortune*].
53. CASTEL & WALKER, note 3 *supra*, at 13-56, citing *Fairfield v. Low*, 71 O.R. (2d) 599 (H.C.J.).
54. *Id*. at 13-57.
55. *Id*. at 13-57, citing *Canmar Fortune,* note 52 *supra*.
56. Important Supreme Court of Canada decisions are referred to later in this paper.
57. Quebec has incorporated the common law doctrine of *forum non conveniens* by virtue of Article 3135 of the Quebec Civil Code, and Quebec courts make reference to common law Supreme Court decisions in interpreting the Article.
58. Some Canadian jurisdictions require leave of the court for all service outside the jurisdiction and restrict the types of cases for which leave can be applied. Others allow service outside the jurisdiction without leave in certain types of cases. Still others allow service without leave in any case, as long as the defendant is in Canada or the United States.
59. (2002), 213 D.L.R. (4th) 577 at 603 (Ont. C.A.).
60. *Id.* at 604-610; Janet Walker, *Beyond Real and Substantial Connection: The Muscutt Quintet* in T. Archibald & M. Cochrane, eds., THE ANNUAL REVIEW OF CIVIL JUSTICE, 2d ed. (Toronto: Thomson, 2003).
61. [1987] A.C. 460 (H.L.).
62. *Amchem Products Inc. v. British Columbia (Workers' Compensation Board)*, [1993] 1 S.C.R. 897 at 919 [*Amchem*], quoting with approval *Antares Shipping Corp. v. The Ship "Capricorn"*, [1977] 2 S.C.R. 422 at 448 per Ritchie J.
63. *Frymer v. Brettschneider* (1994), 19 O.R. (3d) 60 at 79 [emphasis added] (C.A.) [*Frymer*].
64. *Id.* at 66, per Weiler J. in partial dissent, but not on this point.
65. *Eastern Power Ltd. v. Azienda Communale Energia and Ambiente*, [1999] O.J. No. 3275 at paras. 19-20 (C.A.).
66. *Duncan (Litigation Guardian of) v. Neptunia Corp.* (2001), 53 O.R. (3d) 754 at 778 (S.C.J.).
67. (1993), 10 O.R. (3d) 157 (Gen. Div.), *aff'd*, note 63 *supra*. Both the majority and the dissenting opinions in the Ontario Court of Appeal decision agreed with Adams J.'s analysis of the relevant factors in determining the appropriate forum, irrespective of where the burden of proof lay (which was the issue on which the Court split).
68. *Id.* at 182, citing with approval *Jones v. Ontario White Star Products Ltd.* (1979), 15 C.P.C. 144 at 147 (Ont. H.C.). *See also Abaxial Associates v. Environmental One Corp.*, [1998] O.J. No. 3056 (Gen. Div.) at para. 14 (Master), wherein Master Peppiatt agreed with Adams J. that where all other matters were equal, choice of law provisions determined the *forum conveniens* for the trial. However, Master Peppiatt was unable to apply this principle in *Abaxial Associates,* since there was a dispute about whether an oral or a written contract governed the relationship between the parties.

Only the latter contract contained the choice of law clause. *See also Polar Hardware Manufacturing Co. v. Zafir*, [1983] O.J. No. 1357 (H.C.J.) [*Polar*], where in finding that the cause of action was more closely connected to Ontario than Illinois, the Court stated, at para. 14:

> The parties in their agreement have stipulated that it is to be interpreted in accordance with the law of Ontario. It is implicit in that stipulation that they acknowledge the courts of Ontario as the most appropriate juridical authority to apply that law to the agreement. That would appear to be common sense. They did not specifically attorn to the forum of Ontario but they reasonably expected that the law of Ontario would govern their activities. They therefore implied that those activities would have a close link with Ontario.

However, *Polar* must be treated with caution, since the case applies the former *forum non conveniens* test, which required that the applicant show something vexatious or oppressive in the plaintiff's choice of forum. The Court made the statement quoted above in concluding that Ontario was the natural (i.e., obvious) forum for the plaintiff's action and therefore there could be nothing vexatious or oppressive about the plaintiff's choice.

69. *Amchem*, note 62 *supra*, at 921.

70. [1998] O.J. No. 5119 (C.A.).

71. *Id.* at para. 5.

72. *Frymer*, note 63 *supra*, at 84-85; *ABB Power Generation Inc. v. CSX Transportation*, [1996] O.J. No. 952 (Gen. Div) at para. 21.

73. Castel & Walker, note 3 *supra*, at 11-3.

74. *Id.* at 11-4.

75. *Id.*

76. *Marine Liability Act*, S.C. 2001, c. 6.

77. *Id.* at s. 45(1).

78. *Id.* at s. 45(2).

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Current Issues in Outsourcing Transactions: Canadian Privacy Laws, the Patriot Act and Other Considerations

By Richard F.D. Corley and Elizabeth L. McNaughton

I. Introduction

Cross-border outsourcing raises potential issues under Canada's various personal information protection and data privacy regimes. Privacy issues in Canada are dealt with at both the federal and provincial levels, with both comprehensive and sector-specific legislation. Where the cross-border outsourcing transaction involves the transfer, processing, collection, use or disclosure of personal information, whether the information is flowing to or from Canada, the parties to the transaction will have to be aware of these laws and their potential application. The purpose of this article is to briefly canvas the significant (though not exclusive) issues raised by the various privacy laws in Canada that would have to be understood by the parties to a cross-border outsourcing transaction involving a Canadian business. Outsourcing arrangements both to and from Canada are considered.

II. Federal

At a federal level in Canada, one must consider the implications of Part 1 of the federal *Personal Information Protection and Electronic Documents Act*[1] (PIPEDA) in connection with a cross-border outsourcing transaction. PIPEDA is a comprehensive data protection law that applies to all private sector organizations that collect, use or disclose personal information[2] in the course of a commercial activity.[3] Consistent with most private sector privacy legislation of general application, the central requirement of PIPEDA is that the knowledge and consent of the individual to whom personal information relates be obtained for any collection, use or disclosure of that information. PIPEDA also contains general requirements with respect to:

- limiting the collection, use, disclosure and retention of personal information in accordance with identified purposes;
- maintaining the accuracy of personal information;
- safeguarding personal information; and
- granting access to personal information.

For a Canadian organization considering outsourcing some of its business activities to another country, the first key issue under PIPEDA is whether consent is required from the Canadian organization's customers or clients to transfer their personal information outside Canada. In exploring the consent issue, the important provision in PIPEDA is Principle 4.1.3, which states that "an organization is responsible for personal information in its possession or control, including information that has been transferred to a third party for processing." This Principle suggests that a "transfer for processing" is not a disclosure under PIPEDA and thus would not require the knowledge or consent of the relevant individual when undertaken. This distinction between transfers and disclosures of personal information has been endorsed by the former federal privacy commissioner, whose office oversees the enforcement of PIPEDA.[4] However, it is not clear whether the courts would share that view, and the precise boundaries of what does and does not constitute a transfer for processing have yet to be settled. Despite this uncertainty, many organizations in Canada are generally taking a broad view of the business functions that can be performed by a third party on a "processing" basis without the requirement to obtain consent, particularly for outsourcing within Canada.[5]

Provided that the Canadian organization could reasonably take the position that the subject matter of the outsourcing transaction was a transfer for processing, they would have to observe Principle 4.1.3 of PIPEDA, which also provides that "organizations must use contractual or other means to provide a comparable level of protection while the information is being processed by a third party." Thus, in order to rely on Principle 4.1.3 to transfer information for processing, there is typically a written agreement in place that ensures the personal information is protected to the same extent as though it were in the possession or custody of the Canadian transferor and thus subject to all of PIPEDA's requirements. For example, a cross-border outsourcing agreement would have to provide, among other things, that:

- the service provider is prohibited from using or disclosing any personal information transferred to it for any purposes unrelated to the processing activity;
- while in the possession or custody of the service provider, the personal information is protected with security measures and safeguards that comply with PIPEDA; and
- that the Canadian transferor had immediate access to the personal information and the ability

to have it returned, corrected or destroyed upon request.

Recently, an additional and complex issue has arisen under PIPEDA that could affect the transfer of information under cross-border outsourcing transactions. The issue involves concerns about the ability of foreign authorities to access personal information of Canadians transferred to a foreign jurisdiction. Part of the issue has arisen from some uncertainty as to whether the phrase "comparable level of protection" in Principle 4.1.3 of PIPEDA implies an obligation not to transfer personal information for processing to third parties in jurisdictions, the governments of which have broad powers of access. The other part of the issue relates to specific exemptions in PIPEDA that allow Canadian authorities to obtain access, without the knowledge or consent of the individual, to personal information in the possession or control of organizations, since it is far from clear whether these exemptions could be relied upon by an organization to disclose personal information to foreign authorities.

In addressing this issue of transborder data flows, the federal Privacy Commissioner has recently suggested that, at a minimum, a company in Canada that outsources information processing to an organization based outside Canada should notify its customers that the information may be available to a foreign government or its agencies.[6] It is not clear from the Privacy Commissioner's comments whether she believes that PIPEDA prohibits the transfer of information into jurisdictions whose governments have broader rights of access to personal information relative to Canadian authorities. She has stated, however, that because of the obligation to provide security safeguards for personal information, "in some cases," this could mean not transferring personal information outside Canada.[7] Until this issue is settled, it may create some concerns among the customers and clients of Canadian organizations who are concerned about their personal information leaving the country.

In the event that the parties to a cross-border outsourcing transaction cannot rely on the "transfer for processing" exemption in PIPEDA, the only alternative would be for the Canadian organization to use reasonable efforts to ensure that the appropriate consent of the individuals to whom the personal information relates has been obtained in order to disclose the personal information to the service provider for processing. Depending on the contractual arrangements between the Canadian organization and its clients or customers and the information practices of such clients or customers, this may be a difficult issue to overcome.

When considering outsourcing of business activities of a U.S. organization to facilities in Canada, a key issue will be the extent to which such information becomes subject to PIPEDA. Indeed, it is likely that Canadian organizations must comply with PIPEDA in respect of personal information about foreign nationals that the organization maintains in Canada because Parliament's intent in enacting PIPEDA was, in part, to satisfy European requirements regarding international data transfers. However, it is not clear to what extent a Canadian service provider would be required to comply with PIPEDA in respect of such personal information. For example, while it would be reasonable that the Canadian service provider apply PIPEDA-compliant security safeguards and procedures to protect such information from unauthorized access or disclosure, it would seem unreasonable to expect the service provider to ensure that the organization that has provided the personal information has obtained any necessary consents from the individuals.

As mentioned above, both sides will have to conduct a careful analysis of PIPEDA's requirements and its applicability to the proposed transaction.

III. Provincial Privacy Laws

Three provinces in Canada (Alberta, British Columbia and Quebec) have enacted comprehensive private sector privacy laws that apply to organizations in connection with the collection, use and disclosure of personal information within their respective provinces.[8] All of these laws are broadly similar to PIPEDA and would present many of the same issues as above. However, there are differences in each piece of legislation and they would each need to be specifically examined. For example, the Quebec Act does not contain the same distinction between transfers for processing and disclosures of personal information that appears to exist in PIPEDA.

In addition to PIPEDA and the general provincial private sector privacy laws in Alberta, British Columbia and Quebec, there are a broad range of statutes at the provincial level that apply to the collection, use and disclosure of personal information. Some of this legislation consists of public sector privacy acts that apply to government and government-run facilities, and some of it consists of privacy legislation specific to an industry, such as the various provincial laws that apply to the collection, use and disclosure of personal health information by health professionals (such as physicians, pharmacists, and dentists) and health care facilities (hospitals, personal care homes, psychiatric facilities, medical clinics and laboratories).[9] As a result of the different levels of government and overlapping legislation, the application and interaction of such legislation can be complex and unclear.

IV. Provincial Reaction to the USA Patriot Act

A recent amendment[10] to British Columbia's public sector privacy legislation, called the *Freedom of Information and Protection of Privacy Act*[11] (FOIPPA), has significant implications for cross-border outsourcing. The amendment, which came into force on 21 October 2004, was enacted in light of concerns that the expanded search and seizure powers found in the USA Patriot Act[12] could result in the disclosure of personal information that had been outsourced to a U.S.-based company or a Canadian-based company with U.S. ties. The amendment significantly restricts the circumstances under which a public body in British Columbia could disclose, store or access personal information outside Canada.

The USA Patriot Act was enacted in the wake of the terrorist attacks of 11 September 2001. Designed to aid in the war on terrorism, it amended several pieces of U.S. legislation. One aspect of the legislation was to grant greater investigative and search and seizure powers to American law enforcement agencies. In particular, section 215 of the Act, which attracted much of the concern in British Columbia, amends the U.S. Foreign Intelligence Surveillance Act (FISA) to permit the FBI, by way of a special court order brought on an *ex parte* basis to the Foreign Intelligence Surveillance Court, to require a party to produce "any tangible things for an investigation to protect against international terrorism or clandestine intelligence activities."

The issue of the potential impact of the USA Patriot Act on Canadians was first raised by the British Columbia Government and Services Employees' Union (BCGSEU), in reaction to proposed outsourcing. In the middle of 2003, the British Columbia government issued a request for proposals to find a private-sector partner to manage the operation of certain components of its medical services plan. The BCGSEU launched a public campaign to stop the outsourcing. As part of that campaign, the BCGSEU filed a petition to block the outsourcing, arguing that the transfer of personal data out of the province to the U.S. would violate British Columbia's FOIPPA. The basis of the argument was that outsourced personal information about Canadians would be subject to the new investigatory powers granted by the USA Patriot Act, such as those found in FISA, and that the service provider would be compelled to disclose the personal information without the consent of the individuals, in violation of Canadian privacy laws, and specifically British Columbia's FOIPPA. There was a concern that such disclosure could be compelled in one of two situations: (1) where the personal information had been outsourced for processing to a U.S.-based service provider and was stored in the U.S., making it subject to U.S. laws like the newly-amended FISA and its expanded investigatory powers; or (2) where the personal information had been outsourced for processing to a Canadian-based service provider with an American parent or affiliate, in which case it would be stored in Canada, but nevertheless subject to U.S. laws due to the service provider's ties to the U.S.

The British Columbia government reacted by enacting legislation that amended FOIPPA. Due to the broadly defined and widely construed definition of "public body," a broad range of British Columbia entities are subject to FOIPPA, and thus to its recent amendments, including hospitals, universities, provincial crown corporations and professional governing associations. Furthermore, one of the key amendments to the legislation is that many of the restricted activities (discussed below) apply to not only public bodies, but also to the directors, officer and employees of those public bodies, as well as to their service providers and the associates and employees of these service providers.

The amendments focus primarily on the storage, access and disclosure of personal information outside Canada by these public bodies. As regards storage, the above-noted parties are prohibited from storing personal information outside Canada, except where the individual consents or if it is for a purpose allowed under FOIPPA. As regards access, these parties must ensure that personal information in their custody or under their control is only accessed in Canada, subject to the same exceptions. On the issue of disclosure, the amendments prohibit the disclosure of personal information, except as authorized by the Act. In terms of the permitted forms of disclosure, the amendments provide for two sets of exceptions, one for disclosure inside or outside Canada and one for disclosure inside Canada only. Obtaining the consent of the individual allows an organization to disclose the information either inside or outside Canada. Also among the permitted forms of disclosure, personal information may be disclosed *inside Canada only* in response to a subpoena, warrant or court order issued by a court, person or body in Canada with jurisdiction to compel disclosure. Notably, there is no equivalent exception for disclosure outside Canada. Furthermore, when a party does receive a foreign demand for disclosure, which is defined to include a subpoena, warrant, order, demand or request by a foreign court, agency or other authority for the unauthorized disclosure of personal information, that party is obligated to notify immediately the Minister about the demand.

The new British Columbia legislation also provides for offenses that carry substantial penalties. Under the amended Act, it is an offense for any party to improperly disclose personal information. Furthermore, it is an offense for service providers and their associates and employees to contravene the obligations set out in the provisions dealing with storage, access and foreign demand for disclosure. Fines for offenses range from two thousand dollars for individuals (except service providers), to twenty-five thousand dollars for individuals or partnerships that are service providers, to five hundred thousand dollars for corporate entities.

The impact of these amendments on affected cross-border outsourcing transactions is obviously significant. Cross-border and data processing transactions with British Columbia public bodies are essentially prohibited if they involve the storage of or access to personal information outside Canada, subject to the limited exceptions found in the amended Act. Although restricted to public bodies in British Columbia, the Act, given its broad definition, actually captures a wider range of Canadian entities than may initially be thought. Grandfathering provisions have been put in place for some existing contracts, thereby shielding some existing outsourcing arrangements from the full impact of the amended legislation.

The British Columbia Supreme Court recently handed down its decision (under the new amendments) in the case of *BC Gov't Serv. Empl. Union v. British Columbia (Minister of Health Services),* which is currently under appeal by the union. Although the court dismissed the BCGSEU's challenge on the grounds that the decision to enter into the contract was not reviewable, the court continued to discuss the privacy issues in dispute. The court indicated that contractual provisions and the corporate structure provided sufficient protection in the event that a U.S. government authority attempted to use section 215 of the USA Patriot Act to compel production of information held by the service provider. The actions taken by the service provider were onerous, setting a high standard if they are to be followed in the future, and included: placing the shares of the service provider in trust with a third-party trust company, which shares would be transferred to the Province of British Columbia if an unauthorized disclosure threatens until the issue is resolved (once resolved, the ownership is reversed to the original structure); establishing a $35 million penalty if there is a breach of confidentiality; and providing that all of the personal information remains the property of the Province of British Columbia.

On a final note, the concerns over the impact of the USA Patriot Act on the personal information of Canadians are not limited to British Columbia. The Privacy Commissioner of Canada has indicated that she is reviewing the implications of the USA Patriot Act for Canadian privacy law and has stated that, in the meantime, organizations should provide notice if the organization stores or processes data outside Canada.

Endnotes

1. S.C. 2000, c. 5.
2. Defined as "information about an identifiable individual, but does not include the name, title or business address or telephone number of an employee of an organization."
3. Defined as "any particular transaction, act or conduct or any regular course of conduct that is of a commercial character, including the selling, bartering or leasing of donor, membership or other fundraising lists."
4. *See, e.g.,* Speech by the former Privacy Commissioner of Canada; Toronto, Ontario, 20 November 2002, at www.privcom.gc.ca/speech/02_a_021120_e.asp.
5. It is common for businesses to retain third-party service providers to provide a range of services from information-technology management to mailing and order fulfillment.
6. *Transferring Personal Information about Canadians Across Borders – Implications of the USA Patriot Act*, Submission of the Office of the Privacy Commissioner of Canada to the Office of the Information and Privacy Commissioner for British Columbia, dated 18 August 2004 and available at www.privcom.gc.ca.
7. Jennifer Stoddart, *Privacy Implications of the USA Patriot Act* 27:4 Canadian Parliamentary Review 17 at 19 (2004).
8. Applicable provincial privacy legislation includes the Quebec *Act Respecting the Protection of Personal Information in the Private Sector*, R.S.Q., c. P-39.1; the recently-enacted Alberta *Personal Information Protection Act*, S.A. 2003 c. P-6.5; and the British Columbia *Personal Information Protection Act*.
9. *See* Alberta's *Health Information Act,* R.S.A. 2000, c. H-5; British Columbia's *Freedom of Information and Protection of Privacy Act*, R.S.B.C. 1996, c. 195 and *Personal Information Protection Act*, S.B.C. 2003, c. 63; Manitoba's *The Personal Health Information Act*, C.C.S.M., c. P33, 5; New Brunswick's *Hospital Act*, S.N.B. 1992, c. H-6.1; Newfoundland's *Hospitals Act*, R.S.N.L. 1990, c. H-9 and *Access to Information and Protection of Privacy Act,* S.N.L. 2002, c. A-1.1; Ontario's *Personal Health Information Protection Act, 2004*, S.O. 2004, c. 3, *Public Hospital's Act*, R.S.O. 1990, c. P-40 and *Independent Health Facilities Act*, R.S.O. 1990, c. I-3; Prince Edward Island's *Hospitals Act,* R.S.P.E.Q. 1998, C. H-10; Saskatchewan's *The Health Information Protection Act*, S.S. 1999, c. H-0.021; and Quebec's *An Act Respecting Access to Documents Held by Public Bodies and the Protection of Personal Information,* R.S.Q., c. A-2.1 and *An Act Respecting Health Services and Social Services,* R.S.Q., c. S-4.2.
10. *Freedom of Information and Protection of Privacy Amendment Act*, 2004, S.B.C. 2004, c. 64.
11. *Freedom of Information and Protection of Privacy Act*, R.S.B.C. 1996, c. 195.
12. United States H.R. 3162, "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001," 107th Cong., 2001.

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How Far Does Sarbanes-Oxley Whistleblower Protection Extend?

By Aaron J. Schindel and Evandro C. Gigante

I. Introduction

Extraterritorial application of the Sarbanes-Oxley Act's whistleblower protection is an issue that Congress has not yet resolved. However, applying the longstanding presumption that federal statutes do not apply outside the United States—absent clear direction from Congress—the Act's whistleblower protection should not be extended overseas. Beyond the presumption, however, there are several policy arguments against applying federal anti-discrimination statutes, and in particular the Sarbanes-Oxley Act, abroad. In this article, we infer Congressional intent from the statute itself, including its enforcement provisions, explain the presumption against extraterritoriality, and highlight the policy concerns associated with foreign application of the Act's whistleblower protection.

II. Discussion

In response to a series of corporate scandals which shook the confidence of American investors, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002 (the "Act").[1] In addition to its corporate accountability measures, including creating a Public Company Accounting Oversight Board ("PCAOB"), ensuring the independence of corporate auditors, and requiring full and accurate disclosure of corporate financial information, the Act also extends whistleblower protection to employees of publicly-traded companies.[2] Employees who disclose activity that may constitute a violation of federal securities laws are protected from retaliation by their employer. As with many other anti-discrimination statutes, aggrieved employees may obtain reinstatement, back pay with interest, compensation for special damages as well as litigation expenses and attorney's fees.[3]

Whistleblower protection extends to those who work for companies that register securities under Section 12 of the Securities and Exchange Act of 1934 ("SEA"), or are required to file reports with the Securities and Exchange Commission ("SEC") under Section 15(d) of the SEA.[4] Many foreign companies issue such securities, or are required to file 15(d) reports. As a consequence, the issue arises as to whether whistleblower protection extends to employees working for these companies overseas.[5] We conclude, in concurrence with at least one U.S. district court opinion and in light of the Act's statutory construction, the presumption against extraterritorial application of U.S. statutes, and several policy considerations specific to Sarbanes-Oxley, that whistleblower protection should not extend overseas absent further guidance by Congress.

There are several provisions of the Sarbanes-Oxley Act that apply to foreign corporations, either by virtue of the statutory language or the SEC's interpretative rules.[6] In fact, many non-U.S. issuers have already begun complying with its requirements.[7] For example, the Act provides that foreign-based accounting firms preparing audit reports for publicly traded companies are subject to the same quality control and independence standards as domestic accounting firms.[8] As a result, the PCAOB regulates the auditing of public companies performed by both domestic and foreign accounting firms. Second, the Act requires that corporations assess the effectiveness of their internal auditing controls in their Section 13(a) or 15(d) reports.[9] The SEC has applied this requirement to foreign private issuers, although such foreign issuers are only required to perform this analysis on an annual basis, whereas domestic issuers are required to file reports on a quarterly basis.[10] Finally, the Sarbanes-Oxley Act requires that national securities exchanges (such as the New York Stock Exchange) only list companies that have established independent audit committees in order to oversee the work performed by public accounting firms, receive internal allegations of questionable accounting, or hire independent advisors to help maintain the integrity of financial disclosures.[11] The SEC has applied the concept of audit committees to foreign-based issuers, but has extended the date by which national securities exchanges much establish rules requiring foreign issuers to comply.[12] As stated by SEC Commissioner Paul S. Atkins, in a speech on the Sarbanes-Oxley Act, the statute "generally makes no distinction between U.S. and non-U.S. issuers. The Act does *not* provide any specific authority to exempt non-U.S. issuers from its reach. The Act leaves it to the SEC to determine where and how to apply its provisions to foreign companies."[13]

Viewing the statute broadly, one could conclude that all of its provisions apply to foreign-based issuers, regardless of whether they are based in the U.S. or abroad. However, a review of statutory construction and relevant policy considerations suggests that whistleblower protection does not extend to employees of foreign-based issuers. For example, both the statute and the SEC interpretations address extraterritorial application on a provision-by-provision basis, given that Congress did not address extraterritoriality of the statute as a whole. Second, to the extent that the Act's whistleblower protection is akin to other forms of statutory protection against discrimination, courts have been reluctant to extend the reach of employment discrimination statutes to companies operating in foreign countries without a clear statement by Congress.[14] Lastly, extending the Act's whistleblower protection overseas may interfere with foreign employers' right to manage their business and with the administration of foreign laws, while at the same time not *necessarily* protecting the interests of U.S. investors. For these reasons, the U.S. District Court for the District of Massachusetts and the Department of Labor's Occupational Health and Safely Administration (charged with the responsibility of enforcing the Act's whistleblower provision) have held that the whistleblower protection does not extend overseas.

Some guidance may be gleaned from the statute itself. In addition to the Act's substantive whistleblower protections, the statute also sets forth the procedure for bringing whistleblower actions.[15] First, it requires that an employee file a complaint with the Department of Labor ("DOL") within ninety days after the alleged discriminatory act and also requires that the DOL investigate the complaint and issue a decision in the matter within one hundred eighty days.[16] Upon receiving the complaint, the DOL is required, however, to follow the investigative procedure set forth in the Wendell H. Ford Aviation Investment and Reform Act for the 21st Century ("AIR 21 Act").[17] The AIR 21 Act provides whistleblower protection, similar to that found in Sarbanes-Oxley, to employees who provide information about "any violation or alleged violation . . . relating to air carrier safety."[18] The AIR 21 Act requires an aggrieved employee to file a claim with the DOL within ninety days after the alleged violation, and sets forth the specific procedural requirements that the DOL must follow when investigating a claim.[19] It is those procedural requirements, including the burdens that each party must satisfy, that are incorporated into Sarbanes-Oxley.[20] Importantly, however, the AIR 21 Act's scope is limited to U.S.-based air carriers only.[21] By defining "air carriers" as only those that are citizens of the United States, and subsequently limiting the protected class to only employees of "air carriers" (or contractors or subcontractors of air carriers) Congress specifically excluded *foreign* air carriers from the statute's reach.[22] As a result, AIR 21 Act whistleblower protection does not extend to employees of foreign air carriers. Notably, the Sarbanes-Oxley Act incorporates, by reference, the Air 21 Act's requirements for investigating claims. Although this point alone would not necessarily be dispositive, it suggests that, by not specifically affording foreign employees access to the DOL's administrative process, Congress implicitly rejected the notion of extraterritorial application. In fact, no exceptions were made, for example, extending the time within which foreign employees are required to file whistleblower claims with the DOL, and no modifications were made to the DOL's investigative process for claims made by employees working overseas. Yet, as discussed above, Congress and the SEC have enacted modifications to the Act's corporate accountability and disclosure requirements applying specifically to foreign issuers.

Under the Sarbanes-Oxley Act, the agencies responsible for enforcing the statute's provisions may also be responsible for defining the extraterritorial reach of those provisions. The SEC is the agency that defines the extent to which the Act's corporate accountability and financial disclosure sections apply to foreign issuers. Indeed, as discussed above, the SEC has already exercised this authority—clearly extending the reach of several provisions beyond the U.S. Meanwhile, Congress entrusted the Department of Labor with the responsibility of enforcing the Act's civil whistleblower protection.[23] Nevertheless, absent guidance from Congress as to the reach of this provision, and in light of the general presumption against extraterritorial application, whistleblower protection should only apply within the U.S. Other DOL-enforced statutes, such as the Worker Adjustment and Retraining Notification Act ("WARN") and the Occupational Safety and Health Act ("OSHA"), apply only to worksites within the United States, regardless of whether the affected employees are U.S. citizens.[24] Furthermore, the overtime and minimum wage requirements found in the Fair Labor Standards Act ("FLSA") apply only to employees working in the United States, Puerto Rico, the Virgin Islands, and other U.S. territories.[25]

On the other hand, Congress has at times extended the reach of employment discrimination statutes overseas. For example, in 1984, Congress amended the Age Discrimination in Employment Act ("ADEA") to cover American citizens working for American companies in foreign countries.[26] Moreover, in response to the Supreme Court's decision in *EEOC v. Arabian Am. Oil Co.*, which denied extraterritorial application of Title VII, Congress amended the Civil Rights Act of 1964 and the Americans with Disabilities Act of 1990 ("ADA") by extending the reach of both statutes to cover American employees working for American companies abroad.[27] Clearly, Congress has exercised its discretion in deciding whether federal anti-discrimination statutes should, or should not, apply overseas. These instances only support the notion that if Congress has *not* spoken on the issue, courts and the DOL should refrain from extraterritorial application.

Although case law in this area remains undeveloped, there exists at least one judicial decision holding that the Act's whistleblower protection does not extend overseas, based on the presumption against extraterritoriality. In August 2004, the District Court of Massachusetts dismissed a Sarbanes-Oxley whistleblower claim brought by an Argentinian citizen working for a U.S.-based company in South America.[28] The plaintiff in *Carnero v. Boston Scientific Corp.* alleged that his former employer terminated him after he reported accounting irregularities within the company. OSHA dismissed his administrative complaint, stating that it was without jurisdiction to investigate the claim because nothing in the Act suggested that its protection extends to employees working overseas. The plaintiff then sought judicial review of OSHA's determination. The court found that whistleblower protection does not extend overseas for the simple reason, as stated above, "that Congressional legislation is meant to apply within the United States, absent any evidence of contrary intent."[29] As we have done here, the court in *Carnero* reviewed the statutory language, legislative history and administrative interpretations—only to conclude that "[n]othing in Section 1514A(a) remotely suggests that Congress intended it to apply outside of the United States."[30] Likewise, in response to a whistleblower charge brought by a foreign employee, the New York Region of OSHA's Whistleblower Investigations Unit found that Sarbanes-Oxley whistleblower protection does not apply overseas. Invoking the presumption against extraterritoriality, the Regional Administrator found that, where charging parties never actually worked in the United States, they could not avail themselves of the Act's whistleblower protection.[31]

Beyond statutory construction or the presumption, policy concerns also weigh against foreign application. For example, U.S. courts should not interfere with the day-to-day business and personnel decisions of foreign employers, where the result might conceivably be to award a foreign employee damages, and possibly even reinstatement.[32] Extraterritorial application should only occur when Congress clearly requires it, and where the conditions for such intrusion are limited. For example, when Congress enacted the 1991 Amendments to the Civil Rights Act, it extended protection only to U.S. citizens working for American companies, or foreign companies controlled by American firms, abroad.[33] Underlying this limitation is the rationale that American employees working for American companies overseas should be afforded the same protection as employees working in the United States. If either the employer or the employee is not an American citizen, U.S. courts should not intervene in the relationship at the risk of imposing liability upon foreign entities doing business outside the U.S. Indeed, foreign employers are subject to laws in the countries in which they operate, and any tension between foreign law and U.S. law should of course be avoided.[34] In fact, Congress provided a defense to extraterritorial application of Title VII and the ADA to foreign employers who demonstrate that compliance with these statutes would "violate the law of the foreign country in which [the employer] is located."[35] Clearly, the defense is designed to avoid creating a conflict between U.S. employment discrimination statutes and application of foreign law. For this very reason, where Congress has *not* delineated the contours of extraterritorial application, such as with the Sarbanes-Oxley whistleblower provision, courts and the DOL are left to apply the presumption.

Moreover, there exist policy considerations that are specific to the Sarbanes-Oxley Act. Some may suggest that, by not extending whistleblower protection overseas, U.S. investors may be left vulnerable to corporate misdeeds that occur outside the U.S. Indeed, the argument can be made that fraudulent accounting and disclosure in other countries may affect the value of a company's securities here in the U.S. and therefore the confidence of its U.S. investors.[36] However, the possibility of fraudulent accounting and reporting practices abroad does not *necessarily* expose U.S. investors to financial harm. To put it simply, not everything that happens overseas will harm U.S. investors. For example, if an employee working for a foreign-based issuer of U.S. securities in China discovers that his supervisor is submitting fraudulent purchase orders to the local accounting department, who in turn is responsible for reporting company earnings, it is unlikely that such practice would undermine the company's SEC disclosures, or harm U.S. investors. Thus, intervention by U.S. courts or the U.S. Department of Labor in response to a retaliation claim would not necessarily serve the purpose of the Act.[37] Instead, as discussed above, such intervention may give rise to a conflict between enforcement of Sarbanes-Oxley in a foreign country and application of that country's own law. Finally, assuming courts decide to apply the Act extraterritorially, it would seem that, when the alleged retaliation takes place in a foreign country, the complainant should be required to establish a nexus between the activity giving rise to his or her whistleblowing and the impact of that activity on the employer's U.S.-based securities and investors.

III. Conclusion

Extraterritorial application carries significant consequences for foreign employers that issue securities in the U.S. Notwithstanding these policy considerations, the fact remains that, absent clear Congressional intent suggesting otherwise, courts and the DOL will likely construe Sarbanes-Oxley whistleblower protection as applying only within the United States.

Endnotes

1. Pub L. No. 107-204, 116 Stat. 745 (2002).
2. 15 U.S.C. §§ 7201, 7211-7211, 7231-34, 7241-46, 7261-66; 18 U.S.C. § 1514A (2004). The Act's whistleblower protection provides that an "officer, employee, contractor, subcontractor, or agent of such company" may not:

   > 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 an investigation regarding any conduct which the employee reasonably believes constitutes a violation of [federal securities laws or regulations], or any provision of Federal law relating to fraud against shareholders [. . . .]

3. 18 U.S.C. § 1514A(c)(2).
4. 18 U.S.C. § 1514A(a).
5. For example, as of October 2004, there are four hundred sixty foreign companies listed on the NYSE based in forty-seven different countries, and three hundred thirty-nine foreign companies listed on the NASDAQ. NYSE: Non-U.S. listed companies, *available at* http://www.nyse.com/international/p1020656068941.html?displayPage=%2Finternational%2Finternationalr.html; NASDAQ International Companies, *available at* http://www.nasdaq.com/asp/NonUsOutput.asp.
6. For example, foreign private issuers of registered securities are covered by the Act. The regulations define a foreign private issuer as any foreign issuer of securities, except those which meet the following conditions:

   (1) More than fifty percent of the outstanding voting securities of such issuer are directly or indirectly owned by residents of the United States; and

   (2) Any of the following:

   (i) The majority of the executive officers or directors are United States citizens or residents;
   (ii) More than fifty percent of the assets of the issuer are located in the United States; or
   (iii) The business of the issuer is administered principally in the United States.

   17 C.F.R. § 230.405.

7. *The Global Stance on Sarbanes-Oxley*, NYSE Magazine, 4 Sept. 2003, *available at* http://www.nyse.com/events/1063105217282.html; Letter from NYSE Corporate Compliance to Executives of Foreign Private Issuers, 19 Nov. 2003, *available at* http://www.nyse.com/pdfs/transitionFPI.pdf.
8. 15 U.S.C. § 7216. The statute provides that "[a]ny foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to this Act and the rules of the Board and the Commission issued under this Act, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States or any State[.]"
9. 15 U.S.C. § 7262; 17 CFR § 229.308(2005).
10. 17 CFR §§ 240.13a-15(d), 240.15d-15(d); SEC Final Rule: Management's Reports on Internal Control of Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, *available at* http://www.sec.gov/rules/final/33-8238.htm#iih1.
11. 15 U.S.C. § 78j-1(m).
12. 17 CFR § 240.10A-3; SEC Final Rule: Standards Relating to Listed Company Audit Committees, *available at* http://www.sec.gov/rules/final/33-8220.htm#foreign. Under the SEC's rule, however, foreign private issuers are not subject to the Act's requirement that audit committees maintain independence, provided they are subject to substantially similar regulations under local law. 17 CFR § 240.10A-3(c)(3).
13. Commissioner Paul S. Atkins: *The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation*, Int'l Finan. L. Rev., 25 March 2003, *available at* http://www.sec.gov/news/speech/spch032503psa.htm.
14. EEOC v. Arabian Am. Oil Co., 499 U.S. 244 (1991), *superseded by* 42 U.S.C. §§ 12111(4), 2000e(f). In *Arabian Am. Oil Co.,* the Court held that Title VII of the Civil Rights Act of 1964 did not apply to U.S. citizens working for American companies abroad. Congress superseded this ruling in section 109 of the Civil Rights Act of 1991, when it extended the reach of Title VII and the Americans with Disabilities Act ("ADA"), to cover American employees working for U.S.-based employers abroad. See 42 U.S.C. §§ 2000e(f), 12111(4).
15. 18 U.S.C. § 1514A(b).
16. *Id*. Should the DOL fail to reach a decision within the one hundred eighty days, the employee may bring an action against his or her employer in federal court regardless of the amount in controversy.
17. 18 U.S.C. § 1514A(b)(2) provides that any action filed with the Secretary of Labor "shall be governed under the rules and procedures set forth in section 42121(b) of title 49, United States Code."
18. 49 U.S.C. § 42121(a).
19. 49 U.S.C. § 42121(b). For example, the statute requires that within sixty days after receiving the complaint, the DOL afford the respondent an opportunity to respond to the complaint in writing and present witness statements. The DOL is then to conduct its investigation and determine whether there is reasonable cause to believe that the respondent violated the Act and to notify the respondent of its decision. The parties may then appeal the decision and seek an administrative hearing which is only then subject to judicial review. *Id.*
20. *Id*.
21. 49 U.S.C. § 40102(a)(2).
22. 49 U.S.C. § 42121(a). "Foreign air carriers" are defined elsewhere in the statute as any "person, *not a citizen of the United States*, undertaking by any means, directly or indirectly, to provide foreign air transportation." 49 U.S.C. § 40102(a)(21) (emphasis added).
23. 18 U.S.C. § 1514A(b)(1)(A). Although the statute states that an administrative complaint must be filed with the Secretary of Labor, the Department of Labor has delegated the responsibility of investigating Sarbanes-Oxley whistleblower claims to the Occupational Safety and Health Administration (OSHA). 29 C.F.R. Pt. 1980 n.1.
24. The DOL regulations relating to the WARN Act provide that "foreign sites of employment are not covered under WARN." 20 C.F.R. § 639.3(i)(7). Congress also limited the protections afforded under OSHA to employees performing work in the United States, or one of the territories listed in the statute. 29 U.S.C. § 653(a).
25. 29 U.S.C. § 213(f).
26. 29 U.S.C. § (h). The Act specifically includes foreign corporations that are controlled by American employers, and sets forth factors to consider when deciding whether the foreign entity is in fact "controlled" by an American company.
27. *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244 (1991), *superseded by* 42 U.S.C. §§ 2000e(f), 12111(4).
28. *Carnero v. Boston Scientific Corp.*, No. Civ. A. 04-10031, 2004 WL 1922132 (D. Mass. 27 Aug. 2004).
29. *Id*. at *1, *citing Smith v. United States*, 507 U.S. 197, 204 (1993).

30. *Id*. at *2. The District Court's ruling was appealed by plaintiff to the Court of Appeals for the First Circuit in September 2004. However the appeal was voluntarily dismissed on 28 October 2004. (Docket for Report retrieved 28 July 2005, on file with authors).

31. Letter from Patricia K. Clark, Regional Administrator, Occupational Safety and Health, to Daniel J. Kaiser, Esq. (24 August 2004) (obtained in response to FOIA request, on file with authors).

32. *Id.* at 255 (The Court was "unwilling to [imply extraterritorial application of Title VII] which would raise difficult issues of international law by imposing this country's employment-discrimination regime upon foreign corporations operating in foreign commerce.").

33. 42 U.S.C. § 2000e(f). Congress set forth the factors which courts should consider in determining whether a foreign employer is controlled by an American company. 42 U.S.C. § 2000e-1(c)(2).

34. The court in *Carnero* echoed these concerns when it noted that application of "Section 1514A overseas may conflict with foreign laws, which is especially likely in this case where plaintiff seeks to be reinstated to his job." 2004 WL 1922132, at *2. In *Carnero*, the plaintiff not only invoked the Sarbanes-Oxley Act, but also sought relief in Argentina.

35. 42 U.S.C. §§ 2000e-1(b), 12112(c)(1).

36. For example, fraudulent accounting practices at Parmalat Finanziaria SpA, the Italian-based dairy company, have led to a precipitous drop in the value of the company's securities as well as a host of shareholder lawsuits. *How Parmalat Went Sour*, Business Week Online, 12 January 2004, *available at* http://www.businessweek.com/magazine/content/04_02/b3865053_mz054.htm; Gail Edmondson and Maureen Kline, *Can Parmalat Be Saved*, BUSINESS WEEK, 21 June 2004, at p. 82.

37. The Act states that its purpose is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

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Foreign Investment Disputes: A Practitioner's Roadmap

By Mark H. Alcott and Nicole R. Duclos

I. Introduction

Bilateral Investment Treaties ("BITs"), Multilateral Investment Treaties ("MITs"), and foreign investment promotion legislation have become common in the last two decades as a means of encouraging foreign direct investment in emerging markets. In this context, States have agreed to and participated in transnational dispute resolution processes that involve at least a partial surrender of their sovereign authority over foreign trade policy and the adjudication of foreign investment claims. States around the globe have thereby acknowledged not only the importance of transnational commerce and capital exportation but also the success of international arbitration in adjudicating foreign investment disputes.

The reluctance of Latin American countries to embrace arbitration has been the subject of extensive literature and analysis. The traditional Latin American hostility toward international arbitration has derived from several factors, including the "Calvo Doctrine,"[1] the nature of the rules of procedure in Civil Law countries, and the absence of widespread knowledge of arbitration in the region. For decades, the practice of arbitration in Latin America has been considered to be in a primitive stage, in comparison to European and North American countries. In the last decade, however, the unwillingness of Latin American countries to endorse arbitration has yielded to a new trend triggered by the increase of foreign direct investment in the region. To promote and protect foreign investment, Latin American countries have adopted multilateral and bilateral international conventions, which contemplate the submission of investment disputes to international arbitration.[2] This trend has also been characterized by the ratification of multilateral conventions that facilitate the extraterritorial recognition and enforcement of arbitration agreements and arbitral awards,[3] as well as by the improvement of national arbitration laws and the introduction of new arbitration statutes in several countries.[4] In addition to the enhancement of national laws and the growing adherence to international treaties, the number of arbitration cases involving Latin American parties has increased dramatically.[5]

The development of an international arbitration culture in Latin America encompasses not only the arbitration of private commercial disputes, but also the arbitration of investment disputes between private entities and sovereign States.[6]

In this article, we provide a general overview of some of the questions that counsel—and clients who seek their advice—may have to ask themselves when planning a strategy to pursue legal remedies in connection with foreign investment disputes.

II. International Commercial Dispute vs. Foreign Investment Dispute

While international commercial disputes concern purely private, commercial transactions, foreign investment disputes arise from transborder capital investments made by individuals or private entities in a foreign country. These investments generally involve a contract between the private entity and the sovereign State itself, a territorial unit of such state, or a state agency. Although transborder commercial disputes can also be resolved through international arbitration, our analysis is limited to foreign investment disputes.

In order to determine whether a given controversy is, in fact, an investment dispute, one should look at the disputing parties, the subject matter of the controversy, and the source of the client's potential legal remedies.

A. Is the Client a Private Investor or a Sovereign State?

A foreign investment dispute will always involve an "investor," that is, a natural person or private entity who is a national of a State ("Home State") other than the State in which the capital investment is made ("Host State"), and a sovereign. The Host State consists of the sovereign State itself, a political subdivision of that State, a state agency or a governmental body, including state-owned corporations.

A claimant's substantive and procedural strategy to assert its rights in the context of a foreign investment dispute will depend on whether it is a private investor or a Host State.

1. The Foreign Investor

While investment treaties are intended for the protection of nationals of both contracting States, investment laws are intended for the protection of foreign nationals who invest in the Host State. In both cases, the foreign investor is the natural person or the private company injecting capital in the Host State.

BITs, MITs, and foreign investment laws contain different tests for determining the nationality of the investor. The Washington Convention, for instance, limits jurisdiction of the International Centre for the Settlement of Investment Disputes ("ICSID" or "Center") to investment disputes between a contracting State and "nationals" of another contracting State, and it specifically provides that "national of another Contracting State" is either a natural or juridical person who has the nationality of a contracting State other than the Host State on the date on which the parties consent to submit the dispute to arbitration, as well as on the date on which the Request for Arbitration is registered with the Centre.[7]

In the case of companies, the Convention specifically provides that legal entities incorporated or registered in the Host State are to be considered foreign nationals if they are controlled by nationals of the Home State, provided that the parties to the investment dispute have agreed to treat them as such.[8]

In cases where the capital investment is conducted through a legal entity incorporated in the Host State, such entity is generally considered a foreign national if its shares are owned by foreign individuals or companies. It bears noting that the qualification of the "foreign control" over a domestic company for purposes of bringing a claim against a Host State has been the subject of jurisdictional challenges by sovereign defendants in several arbitration proceedings.[9]

2. The Host State

Investment treaties do not usually contain a definition of "Host State." As a result, whether the acts or omissions of publicly owned corporations, state agencies, or state governments of federal states can be attributed to the Host State has been a contentious issue. According to the Washington Convention, the conduct of constituent subdivisions or agencies of contracting States can give rise to investment disputes. However, the consent of such subdivisions or agencies to submit disputes to the Centre must be approved by the Host State, unless such State notifies the Centre that no such approval is required.[10]

Whether the acts or omissions of state agencies can be attributed to a Host State and, as a result, such State can be held liable for the conduct of those agencies, has been analyzed by international arbitrators in the context of jurisdictional defenses asserted by Host States to oppose the jurisdiction of the arbitral tribunal. Generally, according to State Liability principles in public international law, where a person or entity is empowered by the law of the Host State to exercise the State's powers, that person's conduct is attributed to the national government, and therefore the foreign investor has standing to assert against the Host State a claim arising out of such conduct.[11]

B. Has the Client Made an "Investment" in a Foreign State?

In order to bring an investment claim, the investor must demonstrate that it has made an "investment," as defined in a particular BIT, MIT, or foreign investment law. This is not the same as a mere transborder commercial transaction, which does not constitute an "investment," even though disputes arising therefrom might be resolved through arbitration.

Generally, BITs, MITs, and foreign investment laws contain broad definitions of "investment," and often list examples of the assets or ventures covered by the definition.[12] It bears noting, however, that notwithstanding that most treaties contain all-encompassing definitions of "investment," some treaties expressly exclude certain assets or commercial activities.[13]

Although the Washington Convention limits the jurisdiction of the Centre to disputes "arising directly out of an investment,"[14] it does not define the term. The ICSID's Secretary-General, however, can refuse to register a Request for Arbitration if it considers that the dispute is manifestly outside of the jurisdiction of the Centre; for example, because the dispute does not concern an "investment."[15]

The consensus among scholars and arbitrators is that an "investment," for these purposes, must (i) be of significance for the Host State's development; (ii) constitute a long-term venture; (iii) generate profit and return with regularity; (iv) involve the assumption of risk on the part of the investor and the Host State; and (v) involve a substantial contribution by the investor. Conversely, short-term commercial credits and ordinary sales of goods are not likely to qualify as "investments."[16] The inclusion by the contracting parties of a dispute resolution clause that provides for the resolution of disputes through ICSID arbitration creates a presumption in favor of the existence of an investment.

Although the definition of "investment" in a particular BIT or MIT, and the meaning of "investment" in Article 25(1) of the Washington Convention, might give rise to discrepancies, ICSID arbitral decisions suggest that such provisions do not exclude, but rather supplement, each other.[17]

Similar to what occurs with respect to the qualification of the "investor" or the "Host State," the issue of whether an investment has been made within the meaning of a BIT, an MIT, an investment protection law, or the ICSID Convention itself has been the subject of jurisdictional defenses by Host States.[18]

C. What is the Source of the Client's Rights?

While a party to an international commercial dispute will invoke the rights set forth in the contract governing the commercial transaction, a foreign investor will generally have recourse to different sources of rights. The investor might assert the legal remedies set forth in (i) an international treaty (furthermore, it might even have a choice of treaties); (ii) the domestic legislation of the Host State generally; (iii) foreign investment laws enacted by the Host State; and (iv) the contract (commonly, a concession contract) the investor might have entered into with the Host State itself, its agencies or subdivisions.

A preliminary question is whether the investor should pursue legal remedies or whether it should resort to diplomatic or political channels to resolve the dispute. In the event the investor decides to pursue legal remedies, the question becomes one of choice of rights; that is, whether it should assert contract claims or treaty claims. We discuss these questions below.

III. Should the Investor Pursue Legal or Diplomatic Remedies?

Originally, private entities and individuals had no standing to bring claims against States. They could enforce their rights only in the courts of the Host State or, in the alternative, they could resort to their Home State in order to have their government exert diplomatic pressure upon the Host State or bring a legal action in an international court on their behalf. Now, however, as a result of the liberalization and globalization of the world economy and the promotion of foreign direct investment, individuals and private companies have a private right of action against Host States.

Once it has been determined that an investment dispute has arisen, the question is whether the investor should pursue legal remedies or whether, instead, it should engage, through its Home State or other means, in political or diplomatic discussions with the Host State. Although, in most cases, investors will prefer to pursue legal remedies, there are circumstances in which measures adopted by a Host State—for example, in the event of economic or political crisis—might affect a whole category of foreign investors, who could benefit from resorting to political or diplomatic channels to enforce their rights as a group.

IV. Should the Investor Bring a Contract Claim or a Treaty Claim?

Once the investor[19] has decided to assert legal remedies, the question becomes one of choice of rights; that is, whether the investor should assert the rights set forth in the contract or in the investment treaty. A particular act or omission may constitute a breach of contract, a breach of a bilateral or multilateral treaty, or a violation of customary international law. Thus, the facts relevant to an investment dispute might constitute the factual support for both a contract claim and a treaty claim.[20] Which one should the investor assert? When does a breach of contract constitute a breach of international law? When does a breach of contract that amounts to a breach of international law constitute a treaty breach? These questions are not simple, and they have important procedural and substantive implications.

If the investor decides to bring a contract claim, it must do so against the state agency or governmental authority with which it executed the contract. If, on the other hand, the investor decides to bring a treaty claim, it must assert it against the Host State itself. Therefore, if the act or omission that serves as basis for the treaty claim was performed by a unit, agency or subdivision of the Host State, the investor must be able to demonstrate that such conduct can be attributed to the Host State under public international law, and that the Host State must be held liable under the terms of the treaty.[21]

The clear distinction between contract claims and treaty claims has been widely recognized by the arbitral jurisprudence.[22] Although an investor could theoretically assert a contract and a treaty claim simultaneously, such course of action would likely jeopardize the success of the treaty claim.

The investor’s decision to plead a contract claim or a treaty claim is crucial in several respects, as discussed below:

A. Causes of Action and Substantive Law

The decision to pursue a contract claim or a treaty claim will depend on the nature of the breach, and on whether such breach falls within the substantive protections provided in the contract or in the treaty. Most importantly, however, the decision will be determined by the projected substantive and procedural effects of the decision: the law applicable to the dispute, the *forum*, and the procedural rules governing the proceeding. While investors will generally frame their claims so as to invoke treaty rights and plead those rights in an international arbitration proceeding, sovereign States will cast their allegations as contract claims and resort to local courts.

Although the protection that contract rights and treaty rights provide to investors might be similar, the substantive law according to which those rights are defined is not the same.

1. Contract Claim

A purely contractual claim will be delineated according to the terms of the contract itself (*e.g.*, concession contract) and defined by the law of the Host State. Thus, the investor’s cause of action, the contents of the breached obligation, and the right asserted by the investor will be construed according to the Host State's laws. These laws will include, among others, general contract law, administrative law, and the investment protection law according to which the concession contract was executed.

2. Treaty Claim

If the acts or omissions of the State itself, its agencies or subdivisions (or at least some of them) fall within any of the substantive protections set forth in the treaty—even if they also amount to a breach of contract—the investor would be entitled to assert a treaty claim. These claims will be governed by the treaty itself, general principles of international law, and the law of the Host State.

Although the content of treaty rights is determined by the terms of the treaty that creates them, all BITs and MITs have a similar purpose, that is, to promote, facilitate, and protect foreign investment. As a result, there are treaty rights that are well settled in customary international law and that serve as basis for most treaty claims in international arbitration: (i) full protection and security; (ii) fair and equitable treatment; (iii) national treatment; (iv) most favored nation treatment; and (v) protection against expropriation or nationalization.[23]

In addition to the causes of action listed above, some investment treaties contain "umbrella clauses," that is, provisions whereby the contracting States agree to abide by the contractual obligations they assume with investors of the other State. In other words, "umbrella clauses" guarantee the observance of the contractual commitments assumed by States *vis-à-vis* foreign investors. Although an umbrella clause will generally elevate a contract claim to a breach-of-treaty claim, umbrella clauses do not "automatically" turn mere contractual breaches into BIT violations.[24] It should be noted that where an umbrella clause elevates a contract claim to a treaty claim, although the substance of the treaty claim is the same as the contract claim, the source of the claim is the treaty, not the contract.[25]

If a contract breach is pleaded as a treaty claim in an arbitration proceeding, the arbitral tribunal might be required to interpret the contract to determine whether the contract breach amounts to a breach of international law or a treaty obligation. In the context of this analysis, an arbitral tribunal might find that a State's responsibility under an investment treaty overlaps with that State's liability under the concession contract. For example, in circumstances where redress has been sought by the claimant before domestic courts, and such redress has been denied, the denial of justice has been considered a violation of treaty standards by the Host State.[26]

B. Forum: International Arbitration Tribunal vs. Domestic Court

Another implication of the investor's decision to assert a contract claim, as opposed to a treaty claim, is forum selection.

If the investor decides to assert a contract claim, it must do so before the courts of the Host State (*e.g.*, administrative). There is no question that sovereign States prefer to have investment disputes resolved in domestic courts according to local law. Furthermore, in most ICSID arbitration proceedings, sovereign States have challenged the tribunal's jurisdiction, alleging that the investor should have brought its claims before local courts.[27] Conversely, most investors resort to arbitration motivated by the lack of trust in the courts of the Host State. Thus, almost invariably, investors prefer to assert treaty claims over contract claims.[28]

If the investor asserts a treaty claim, it might have recourse to different forums: the courts of the Host State, international arbitration, or any dispute resolution mechanism agreed upon by the signatory States in the relevant treaty. The rules on forum selection vary from treaty to treaty. Some conventions mandate that the investor resort to local courts before invoking international forms of protection.[29] Other treaties give the investor freedom to choose among various fora.[30] Several BITs include a "fork-in-the road" provision, that is, a clause that directs claimant to choose between the domestic courts of the Host State or international arbitration, thereby preventing it from switching forums.[31] Finally, some treaties require that claimant waive its claims in any other forum as a condition precedent to the submission of a claim for arbitration.[32]

Needless to say, the investor's choice of forum will determine the ground rules for the proceeding, including (i) interim measures; (ii) summary judgment; (iii) discovery; (iv) evidentiary rules; (v) remedies (appeal versus annulment) and; (vi) enforcement of the decision (New York Convention or Panama Convention vs. ICSID annulment proceeding).

C. Procedural Rules

The investor's decision to plead contract claims and resort to the courts of the Host State, or to assert treaty claims and resort to international arbitration, determines the procedural rules that will govern litigation or the arbitration proceeding, respectively. In the event the investor asserts its contract rights in the local courts, the rules of procedure of the Host State govern. If, on the other hand, the investor chooses arbitration, the question becomes whether the investment treaty grants the investor the right to chose the applicable rules or, instead, they have been previously set by the contracting States.

It bears noting that most investment treaties provide for a negotiation period after a dispute has arisen and before litigation or arbitration proceedings commence. In other words, most BITs and MITs direct investors and sovereign States to attempt to settle their disputes.[33] The obligation to negotiate is as binding as any of the other obligations set forth in the treaty. Therefore, an investor who chooses to assert a treaty claim and start an arbitration proceeding must make sure that it has notified the Host State of the existence of the dispute, and has created a "record" showing that it made serious attempts to settle the dispute prior to commencing a proceeding.[34] In addition, some treaties provide for a "waiting period" before the claimant can resort to either litigation or arbitration. Therefore, in addition to engaging in settlement discussions, the investor might have to wait for the "waiting period" to expire before it can engage in arbitration.

Most BITs and MITs provide for one or more of the following alternatives:

- Ad-hoc arbitration under the UNCITRAL arbitration rules.[35]
- Institutional arbitration with the Court of Arbitration of the International Chamber of Commerce (ICC).
- Institutional arbitration with ICSID (including its Additional Facility Rules).[36]

Generally, investment treaties provide for institutional arbitration and, in most cases, with the Centre, which, along with the Permanent Court of Arbitration at the Hague,[37] are the only two international institutions that are exclusively concerned with disputes where one of the parties is a State or a state-entity.

ICSID was established by the 1965 Washington Convention, which became effective in 1966.[38] The Centre is based at the principal office of the World Bank in Washington, D.C., and it promotes the settlement of investment disputes through arbitration[39] and conciliation.[40] These dispute resolution procedures are available to investors and States, provided that (i) they have agreed to submit the dispute to the Centre; (ii) the dispute takes place between a national of a contracting State and another contracting State or any of its agencies or subdivisions; (iii) the dispute arises directly out of an investment; and (iv) the dispute has a legal nature.[41]

One of the distinctive features of the Washington Convention is that its contracting parties must recognize the binding nature of the arbitral awards rendered under its auspices, and must enforce their terms as if they were a final judgment issued by a local court. In other words, ICSID awards are not subject to any appeal, and are enforceable in the contracting States without the possibility of review by the courts of the State in which the award is enforced.[42]

The only remedies provided for in the Convention against arbitral awards are (i) the interpretation of the meaning or scope of the award;[43] (ii) revision on the ground of discovery of a previous unknown fact of decisive importance;[44] and (iii) annulment by an ad hoc committee.[45] The most important of the three remedies is the annulment. The arbitral award may be set aside (in whole or in part) by a special committee appointed by the Chairman of ICSID's Administrative Council from the ICSID Panel of Arbitrators. Although arbitral awards can only be annulled on certain limited grounds,[46] their content is left to the interpretation of the committee, whose decision is not binding on future committee decisions.

The ICSID annulment procedure has not been exempt from criticism by both scholars and practitioners. The criticism stems from the fact that the annulment is an internal procedure that substitutes the judicial review that is ordinarily available before the national courts of the State in which the award is enforced. In addition, the Convention provides for no limit on the number of annulment actions that a party can bring, which could turn an arbitral proceeding into an endless chain of annulments. Also, the grounds for annulment are subject to the interpretation of the members of the committee, and the parties can invoke those grounds to assert a wide range of objections to challenge the validity of the awards.[47]

Endnotes

1. The Calvo Doctrine was formulated by Carlos Calvo, an Argentinean diplomat and scholar who published a six-volume treatise (*Le Droit International Théorique et Pratiqué*) in 1868. Calvo postulated that sovereign States are free and independent, and therefore foreign States should not interfere with their sovereignty. Consistent with this principle, Calvo advocated the "equal treatment" of nationals and aliens, who could resort only to local courts to seek redress for a State's breach of investment obligations. In Calvo's view, affording aliens greater protection or more ample privileges than those afforded to nationals placed the most powerful States in a privileged position, thereby harming the interests of weaker countries. Eventually, this doctrine turned into the "Calvo Clause," which Latin American sovereigns and state-owned entities incorporated into investment contracts to prevent the international arbitration of investment disputes. On the Calvo Doctrine, *see, e.g.*, García-Mora, *The Calvo Clause in Latin American Constitutions and International Law*, 33 Marq. L. Rev. 205, 206-207 (1950).
2. The North American Free Trade Agreement ("NAFTA") of 1992 (among U.S., Canada, and Mexico); the Colonia Investment Protocol of the Common Market of the Southern Cone ("MERCOSUR") of 1991 (among Argentina, Brazil, Paraguay, and Uruguay); and the Cartagena Free Trade Agreement of 1994 (among Colombia, Mexico, and Venezuela) embody important regional integration efforts. In addition, a considerable number of BITs have been entered into by Latin American countries in the last decade.

3. Such as the New York Convention on the Recognition and Enforcement of Arbitral Awards (the "New York Convention") of 1958; the Inter-American Convention on International Commercial Arbitration (the "Panama Convention") of 1975; and the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (the "Washington Convention") of 1965, which has been ratified by over a dozen Latin American countries.

4. For example, in September of 2004, Law No. 19.971, the first law to regulate international commercial arbitration in Chile, came into effect. (The previous arbitration law had been in effect for over a century.)

5. For instance, as of October of 2004, fifty-eight percent of the pending cases before the International Centre for the Settlement of Investment Disputes—the institution created by the Washington Convention for the resolution of investment disputes—involve Latin American parties. (www.worldbank.org/icsid/cases/pending.htm).

6. For recent developments in international arbitration in Latin America, *see* Grigera Naón, *Recent Trends Regarding Commercial Arbitration in Latin America*, in Cremades, ed., ENFORCEMENT OF ARBITRATION AGREEMENTS IN LATIN AMERICA 95-105 (1999); Mantilla-Serrano, *Major Trends in International Commercial Arbitration in Latin America*, 17 J. INT'L ARB. 139-142 (2000); Blackaby, Lindsey, Spinillo (eds.), *International Arbitration in Latin America*, 1-16 KLUWER L. INT'L (2002).

7. Although ICSID is not the only institution to which parties can resort to resolve investment disputes, it is one of the two international institutions that are exclusively concerned with disputes where one of the parties is a State or a state entity. In addition, hundreds of BITs and over a dozen foreign investment laws contain the Host State's advance consent to ICSID arbitration in the event an investment dispute arises. Therefore, we will mainly refer to the ICSID rules and case law throughout our analysis.

8. Article 25(1) and (2) Washington Convention.

9. For example, in *CMS Gas Transmission Company v. The Republic of Argentina*, (ICSID Case No. ARB/01/8), Decision of the Tribunal on Objections to Jurisdiction, 17 July 2003, 42 I.L.M. 788 (2003), the Tribunal held that a foreign minority shareholder of a local concessionaire could bring claims in its own name for damage caused to the concession and the concessionaire. The Tribunal rejected the respondent's argument that the principle of legal personality precluded BIT claims by the foreign minority shareholders of a local company. Similarly, in *Lanco International Inc. v. The Argentine Republic*, (ICSID Case No. ARB 97/6), Preliminary Decision on Jurisdiction, 8 December 1998, 40 I.L.M. 454 (2001), the Tribunal found that an investor did not have to have control over the administration of the company, nor did it have to be a majority shareholder of the company, in order for the investment to be protected by the BIT.

10. Article 25(3) Washington Convention.

11. In *Compañía de Aguas del Aconquija S.A. and Compagnie Générale des Eaux v. Argentine Republic*, (ICSID Case No. ARB 97/3), Award of the Tribunal, 21 November 2000, 40 I.L.M. 426 (2001) (hereinafter "*Vivendi*") (¶ 49), the arbitral tribunal held:

> [U]nder international law, and for the purposes of jurisdiction of this Tribunal, it is well established that actions of a political subdivision of a federal state, such as the Province of Tucumán in the federal state of the Argentine Republic, are attributable to the central government. It is equally clear that the internal constitutional structure of a country cannot alter these obligations.

See also Article 5 of the International Law Commission's Articles on State Responsibility:

> [T]he conduct of a person or entity which is not an organ of the state . . . . but which is empowered by the law of that state to exercise elements of the governmental authority shall be considered an act of the state under international law, provided the person or entity is acting in that capacity in the particular instance.

12. Generally, public concessions conferred by law or contract; rights over movable and immovable property; title to shares and other forms of ownership interest in local companies; monetary claims; and intellectual property rights, are, among other assets, categorized as "investments."

13. For example, Article 1139 of the NAFTA expressly excludes certain assets from the definition of "investment," including, among others, (i) debt securities of states enterprises; (ii) loans to state enterprises; and (iii) monetary claims that arise from commercial contracts for the sale of goods or services.

14. Article 25(1) Washington Convention.

15. Article 36(3) Washington Convention.

16. *See Salini Costruttori S.P.A. and Italstrade S.P.A. v. Kingdom of Morocco*, (ICSID Case No. ARB/00/4), Decision on Jurisdiction, 23 July 2001 (English version), 42 I.L.M. 609 (2003) (hereinafter "*Salini* v. *Morocco*") (¶ 52).

17. *See Azurix Corp. v. The Argentine Republic*, (ICSID Case No. ARB/01/12), Decision on Jurisdiction, 8 December 2003, 43 I.L.M. 262 (2004), where the Tribunal held that, if the requirements set forth in the BIT definition of "investment" were met, the requirements in Article 25(1) of the Washington Convention would also be fulfilled.

18. For an analysis of jurisdictional defenses in ICSID arbitration proceedings, *see* Freyer and Schnabl, *How a New Generation of Bilateral Investment Treaties Spurs ICSID Arbitration—And Creates a New Generation of Jurisdictional Defenses*, discussion and working paper presented at the Second Annual Miami International Arbitration Conference (January 2004).

19. Although most of the questions addressed in this paper are equally relevant for investors and Host States, our analysis focuses on the former. Both investors and Host States can resort to international arbitration to assert an investment claim, but the experience shows that Host States rarely do so. Instead, sovereigns resort to local courts. For example, in all of the cases currently pending before the ICSID, the claimant is a private investor and the defendant is a sovereign State or a state entity. Similarly, of the concluded cases, only one was brought by a State against a foreign investor. For this reason, we explore the subject of international arbitration of investment disputes from the investor's angle. (http://www.worldbank.org/icsid/cases/pending.htm) (www.worldbank.org/icsid/cases/conclude.htm).

20. For a detailed analysis of contract claims and treaty claims, *see* Cremades, *Contract and Treaty Claims and Choice of Forum in Foreign Investment Disputes*, paper presented at the Second Annual Miami International Arbitration Conference (January 2004).

21. *See* note 11 *supra*.

22. *See Compañía de Aguas del Aconquija S.A. and Vivendi Universal (formerly Compagnie Générale Des Eaux) v. Argentine Republic*, (ICSID Case No. ARB/97/3), Decision on Annulment, 3 July 2002, 41 I.L.M. 1137 (2002) (¶ 96), where the Tribunal held:

> [W]hether there has been a breach of the BIT and whether there has been a breach of contract are different questions. Each of these claims will be determined by reference to its own proper or applicable law – in the case of the BIT, by international law; in the case of the Concession Contract, by the proper law of the contract . . . .

See also SGS Societé Générale de Surveillance S.A. v. Islamic Republic of Pakistan, (ICSID Case No. ARB/01/13), Decision of the Tribunal on Objections to Jurisdiction, 6 August 2003, 42 I.L.M. 1290 (2003) (hereinafter "*SGS v. Pakistan*") (¶¶146-148).

23. The analysis of these claims exceeds the scope of this paper, but they have been extensively examined by scholars, as well as by arbitral tribunals in the context of international arbitration of foreign investment disputes.

24. *See*, *e.g., SGS v. Pakistan,* note 22 *supra,* at ¶¶ 163-174. The Tribunal rejected the claimant's argument that the "umbrella clause" contained in the BIT automatically elevated any pure contract claim to a treaty claim, stating that, unless expressly stated, umbrella provisions were not to be interpreted as derogating from the widely accepted international law principle that a contract breach is not by itself a violation of international law. As a result, the Tribunal declined jurisdiction in part, refusing to hear and decide upon purely contractual claims submitted by claimant, because they did not fall within the scope of the BIT.

25. For a detailed analysis of "umbrella clauses," *see* Wälde, *The "Umbrella" (or Sanctity of Contract/Pacta sunt Servanda) Clause in Investment Arbitration*, OGEL-TDM, November 2004.

26. *See, e.g.*, *Vivendi*, note 11 *supra*.

27. *Id*.

28. The decision in *Maffezini v. The Kingdom of Spain*, Decision of the Tribunal on Objections to Jurisdiction, (ICSID Case No. ARB 97/7), 25 January 2000, 40 I.L.M. 1129 (2001) (¶ 55), illustrates this point:

> Traders and investors, like their States of nationality, have traditionally felt that their rights and interests are better protected by recourse to international arbitration than by submission of disputes to domestic courts, while the host governments have traditionally felt that the protection of domestic courts is to be preferred.

29. Note that, although these treaties do not require that the investor "exhaust" local remedies prior to commencing international arbitration, they do mandate that the investor first assert its claims before domestic courts.

30. The forum selection clause in the U.S.-Chile BIT, for example, gives claimant the right to select the forum in which to settle the dispute. But, once the claimant has made its selection, such forum shall be used to the exclusion of others. (Article 22.3).

31. For example, the France-Argentina BIT, which provides that investment disputes shall be submitted, at the request of the investor, to the courts of the Host State or to international arbitration. Once made, the forum selection is final. (Article 8(2)).

32. The NAFTA mandates that, in order for a private investor to submit a Chapter 11 claim to arbitration, it must first waive its right to commence (or continue) any proceedings before the tribunals of any State party, except for proceedings seeking injunctive, declaratory or other extraordinary relief. (Article 1121(2)).

33. For example, the NAFTA mandates that the parties "first attempt to settle a claim through consultation or negotiation." (Article 1118). Similarly, the U.S.-Chile BIT mandates that the contracting parties "make every attempt through cooperation and consultations to arrive at a mutually satisfactory resolution of any matter that might affect [the] operation [the treaty]." (Article 22.1).

34. *See*, *e.g., Salini v. Morocco*, note 16 *supra.*

35. It is unlikely that an investment treaty will provide for pure ad hoc arbitration.

36. Since 1978, under the Additional Facility Rules, ICSID is authorized to administer arbitration and conciliation proceedings which are outside the jurisdiction of the Centre, provided that they fall within any of the following categories: (i) investment disputes in which either the State party to the dispute or the investor's country is not a contracting state; (ii) disputes that do not arise directly out of an investment, provided that either the State, or the country to which the investor belongs, is a contracting party to the Convention; and (iii) fact-finding proceedings. Since the proceedings under these rules are, by definition, outside of the Washington Convention, they depend on national law for their efficacy, and not on the especial enforcement provisions set forth in the Convention. In fact, the Additional Facility Rules provide that proceedings of this nature may only be held in countries that are parties to the New York Convention. For a commentary on the Additional Facility, *see* Broches, *The "Additional Facility" of the International Centre for Settlement of Investment Disputes*, IV YB COMM. ARB. 373 (1979).

37. The Permanent Court of Arbitration at the Hague ("PCA") provides arbitration and conciliation services for States and foreign investors, provided that the State concerned is a party to either of the two Hague Conventions (1899 or 1907). The parties can choose the procedural rules that will apply to the proceedings (*i.e.*, the 1899 or 1907 Conventions, the PCA Optional Rules, or the UNCITRAL rules on arbitration or conciliation).

38. *See* www.worldbank.org/icsid/constate/c-states-en.htm, for a current list of signatories and ratifying states.

39. Articles 36 through 55 Washington Convention.

40. Articles 28 through 35 Washington Convention.

41. Article 25 Washington Convention.

42. Article 53 Washington Convention.

43. Article 50 Washington Convention.

44. Article 51 Washington Convention.

45. Article 52 Washington Convention.

46. The grounds are the following: (i) the arbitral tribunal was improperly constituted; (ii) it manifestly exceeded its powers; (iii) one or some of its members were corrupt; (iv) there was a serious departure from a fundamental rule of procedure; or (v) the tribunal failed to provide reasons for its determination in the award.

47. Carbonneau, CASES AND MATERIALS ON THE LAW AND PRACTICE OF ARBITRATION 911-915 (3d rev. ed. 2003). For more on criticism of ICSID's annulment proceeding, *see* Redfern, *ICSID—Losing its Appeal*, 3 Arbitration International 98 (1987); Reisman, *The Breakdown of the Control Mechanism in ICSID Arbitration*, 4 DUKE L.J., 739 (1989).

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