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AUTHOR: Toth, Robert

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Application of SOX's Professional Responsibility Rules to Corporate Employee Benefits Practice

Robert J. Toth, Jr.
Associate General Counsel
Lincoln Financial Group

Employee benefit lawyers are well familiar with the affect Sarbanes Oxley Act[1] (the "Act") has had on their practices. In particular, they have had to deal with restrictions on executive loans[2]; the tightening of the 16(b) reporting rules[3]; the executive trading restrictions during qualified plan blackout periods;[4] enhanced criminal penalties under ERISA[5]; and the documentation, assessment and testing of the control infrastructures to which CEOs and CFOs must attest[6]. Often overlooked by the benefits bar, but no less important, has been the impact of Section 307, the Act's Rules of Professional Responsibility for Attorneys on the corporate practice of law. It is becoming apparent, as corporations and law firms implement procedures to comport with these new rules, that significant issues arise as to their application to practice areas tangentially related to the traditional security law practice. In particular, a close examination of the rules reveals a host of unanswered questions about their applicability to the corporate ERISA practice.

Caution is demanded when fashioning Section 307 practices, so to reflect the need to cover the ERISA practice. The broad "supervising attorney" rules contained in the SEC's rules implementing Part 307 places ultimate accountability for compliance on the company's Chief Legal Officer. Failure on the part of law firms or in-house corporate staffs to adopt procedures which are broad enough to cover the ERISA practice then has potential of disrupting the general legal practice within publicly traded companies.

I. General Description of the new Professional Responsibility Rules

Section 307 of the Act required the SEC to issue rules, within 180 days of the Act's enactment, "in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission *in any* way in the representation of issuers."[7] The SEC first published its proposed rule on November 21, 2002. Referred to as the "Part 205" rules, they are titled the "Implementation of Standards of Professional Conduct for Attorneys." The

[1] Sarbanes-Oxley Act of 2002 (15 U.S.C. 7245)
[2] Act Section 402
[3] Act Section 403
[4] Act Section 306, Regulation BTR
[5] The White-Collar Crimes Penalty Enhancement Act of 2002, Section 906 of Sarbanes-Oxley Act of 2002
[6] Act Section 302
[7] Act Section 307

fundamental premise of these new professional responsibility rules is that attorneys, whether in-house or outside counsel, have a duty to report evidence of certain acts of corporate malfeasance to the senior officers of the company which they represent or, under certain circumstances, directly to the board of directors of the company.

These types of rules are not new to the bar. They are conceptually based upon parts of the American Bar Association's Model Rules of Conduct. However, there are significant departures in the SEC's rules, which generated what the SEC refers to as "significant comment and extensive debate" within the legal community. Of particular concern was the impact of the Part 205 rules on each state's ethical codes of conduct; the requirement for both in-house and outside counsel to withdraw from certain matters and report such withdrawals to the SEC (the so-called "noisy withdrawal rule); and the potential for inadvertent over-inclusion of non-security law practices in the rules. The final rule (the "Rule"), issued on February 6, 2003 and effective August 5, 2003[8], attempted to partially address these issues. There is now threatened litigation on the state ethics rules impact; the noisy withdrawal rule was withdrawn and has been re-proposed; while the Rule was not fully responsive to the important concern of being over-inclusive. The American Bar Association's comment to the proposed rule described the over-inclusion problem. The ABA stated that it would unfairly:

> subject to the rules attorneys who do not practice securities law and may have only limited or tangential involvement with particular SEC filings and documents. For example, it could inappropriately encompass non-securities specialists who do no more than prepare or review limited portions of a filing, lawyers who respond to auditors' letters or prepare work product in the ordinary course unrelated to securities matters that may be used for that purpose, and lawyers preparing documents that eventually may be filed as exhibits. . . . We also believe it is inappropriate for the Commission to include lawyers who simply advise on the availability of exemptions from registration.[9]

Though the Rule attempts to minimize the impact of the issue described by the ABA, its final language is still broad and ambiguous. It appears that the provision of legal advice related to many large retirement plans for many publicly traded companies falls well within the Rule's scope, as well as the otherwise expected inclusion of executive compensation programs. This, when combined with harsh implications under the "supervising attorneys" rules, broadly impacts law departments and law firms providing employee benefits advice in ways with which we are unaccustomed and which we have not yet fully realized.

Overview of Part 205

[8] Release 33-8185 (February 6,2003), 17 CFR Part 205, 68 FR 6296
[9] Comments of the American Bar Association to the SEC, at 12

The Rule imposes new "up the ladder" reporting requirements upon any attorney appearing and practicing before the Commission in any way in the representation of an issuer. The attorney, either in-house or outside counsel, who "becomes aware" of evidence of a material violation of a U.S. or state securities law or breach of fiduciary duty, or any similar violation of state or federal law by the company or any its officers, directors, employees or agents must report such evidence "up the ladder." This report must be made to either (or both) the company's Chief Legal Counsel (CLO) or the Chief Executive Office of the company (or equivalent). The CLO or CEO must make an inquiry and respond to the reporting attorney in a reasonable period of time. If the reporting attorney does not "reasonably believe" that the CLO or CEO has appropriately responded to the evidence (by adopting as necessary, appropriate remedial measures or sanctions with respect to the violation), that attorney may report the evidence to the audit committee of the company's board of directors, an independent committee of the board, or the board itself. If the company establishes a so-called "Qualified Legal Compliance Committee,[10]" the reporting attorney only needs to report to the QLCC, and is relieved of any obligation to determine the appropriateness of the response. The QLCC need only then to report its findings to the board itself.

The SEC's view of the roles of the "supervising attorney" and "subordinate attorney" in fulfilling this "up the ladder" requirement complicates the issue further. Unlike the ABA's Model Rules, the Commission broadly deems a supervising attorney to be appearing and practicing before the Commission to the extent a subordinate attorney appears and practices before the Commission[11]. The subordinate attorney fulfills his or her obligations by reporting a potential material violation to the supervising attorney, which then relieves that subordinate attorney of reviewing the CLO or CEO's response. [12] The subordinate attorney may report a violation "up the ladder" if he or she reasonably believes that the supervising attorney has failed to do so.[13] In all instances, the CLO is always considered a supervising attorney and therefore responsible for the reporting activities of his or her subordinates.

The rule recognizes some of the unique difficulties in-house lawyers may have in complying with the Rule. There are unique pressures when dealing with improprieties of the client's officers (and the attorney's ultimate employer) with whom they deal with on a daily basis; the possibility that other lawyers may be involved in the improprieties; and potential difficulties in dealing with shareholders. Addressing this, the Rule established a futility outlet. An attorney who reasonably believes that it is futile to report evidence of a material violation to the CEO or CLO may report the violation directly to the board of

[10] Rule Section 205.2(k). The Qualified Legal Compliance Committee may be any committee of the issuer (such as the board's audit committee) which consists of one member of the issuer's audit committee (or equivalent committee of independent directors) and two or more outside members of the issuer's board of directors.
[11] Rule Section 205.4 This includes the duty to make reasonable efforts to insure that a subordinate attorney complies with these rules; and the duty of the supervising attorney to report a violation "up the ladder" that was reported by the subordinate lawyer.
[12] Rule Sections 205.4, 205.5
[13] Rule Section 205.5

directors of the company or its audit committee.[14] Further, the Act itself expands "whistleblower protection" under the Securities Exchange Act of 1934.[15] An attorney fired for reporting as required by the Act has the right to file with the Department of Labor, and then in U.S. District Court, for reinstatement, back wages, interest, attorney fees and certain compensatory damages. Finally, neither the Rule nor the Act provide for a private cause of action against an attorney for compliance or noncompliance with the Rule. The authority to enforce compliance resides solely in the Commission.[16]

The sanctions for failing to comply with Part 205 are the civil penalties and remedies available to the Commission in an action brought by the Commission, including censure and a prohibition on practicing before the Commission. Any action for violation of the professional responsibility rules may be brought even if the actions were otherwise permissible under the ethical code of the state in which the attorney is licensed to practice.[17]

II. Part 205's Impact on the Employee Benefits Practice

Three sections of Part 205 implicate the employee benefit practice. First, the broad language of the "appearing and practicing before the Commission in any way" may well pick up a broad array of activity in which a corporate employee benefits attorney may engage. Not only are activities involving registered 401(a) plans, executive compensation, and stock based bonus programs covered by the Rule, but it may also embrace such practices as dealing with trust investments, responding to SEC plan inquiries into employee benefit plan practices, responding to SEC proposed rules which affect retirement plans (such as the hard close, redemption fee and 12(b)-1 rules), and—for attorneys working within the financial services industry—working on financial service products.

Secondly, the language defining when a lawyer is "representing the issuer before the Commission" brings employee benefit lawyers into play. They key to this set of questions—particularly for outside counsel—is the seemingly endless question of who the attorney is representing, the plan or the plan sponsor. The eventual resolution of this will be important in the application of Part 205.

Finally, there are important, unresolved issues as to what sort of employee benefit law violations need to be reported "up the ladder." Part 205 requires the reporting of material violations, material fiduciary breaches and similar material violations of state and federal law. It is unclear what that means in the employee benefits context.

A. Appearing and Practicing before the Commission

[14] Rule Section 205.3(b)(4)
[15] Act Section 806
[16] Rule Section 205.7
[17] Rule Section 205.6

Part 205's definition of what it means to appear and practice before the Commission attempted to be objective, but ended up being both broad and ambiguous:

"Appearing and practicing before the Commission:

(1) Means:

(i) Transacting any business with the Commission, including communications in any form;

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; ….[18]"

1. Transacting any business with the Commission

This is by far the broadest of the categories which could implicate the benefits practice. There are a number of activities which, under the unsettled state of the law, could possibly cause employee benefit lawyers to be considered practicing before the Commission. For example, the SEC is becoming very active in the retirement plan industry with its recent rules on the "hard close" and redemption fees, with the reviews of the manner in which 12(b)-1 fees are being utilized by retirement plans, and with the its focus on market timing practices. Commenting on these proposals to the SEC on behalf of the issuer, responding to SEC inquiries related to in-house plans, and possibly even direct involvement with the issuer's trade association involvement in these rules could trigger the coverage by Part 205. There are a number of other practices which tangentially involve securities and may necessitate communications with the Commission or its staff, all of which could also trigger coverage by these rules.

2. Representing an issuer before the Commission

[18] Rule Section 205.2

It is clear that any attorney representing the issuer in any SEC action involving an employee benefit plan will be considered as practicing before the Commission. But it is unclear what level of involvement of the employee benefits lawyer, who does not directly practice in front of the Commission, would trigger coverage. With the benefits lawyer being a valuable resource for the securities lawyer in any such proceeding, and likely being a prime source of much of the detail in any response to the SEC, will that benefits lawyer be considered representing the issuer before the Commission?

3. Advice with regard to documents

This part of the Rule likely picks up a significant percentage of in-house counsel, in the provision of legal advice to a company's registered employee benefit plans and executive deferred compensation programs. The ABA was concerned that documents prepared by attorneys, who did not know at the time of preparation that the documents were to be with the Commission, would impose a reporting obligation upon attorneys if that document was eventually filed with the Commission at a later date. The SEC's approach was that the attorney will be covered by the Rule if, at the time of the preparation of the document, the attorney has notice that the document will be filed with the SEC.

There are a variety of corporate securities filings which rely heavily on content provided by the benefits lawyer—content which the lawyer knows will be filed with the SEC. For example, the benefits lawyer will typically review the proxy disclosures involving executive compensation programs as well as employee benefit programs maintained by the issuer; and, where the issuer has a registered 401(a) plan, will often draft the documents to be filed. It is highly likely that such benefits lawyers will be considered as practicing before the Commission.

This section of the Rule particularly affects in-house benefits counsel in the financial service industry, who advise on the products and services provided by their firms. Whether it be advising on the necessary language in a registered product's prospectus or developing programs for investment managers of mutual funds, it appears that such lawyers may be covered by Part 205.

4. Advising an issuer on the filing of information

This part of the Rule appears to narrowly involve the benefits lawyer. The most typical involvement would be triggered by instances like the filing of S-8s for registered plans, where the securities law requirements incorporate what is required by benefits laws.

5. Exclusions and, more importantly, non-exclusions

Part 205 also has certain "status" types of rules, intended to exclude from the Rule's coverage certain classes of attorneys. Excluded are non-appearing foreign attorneys and attorneys who are licensed to practice law but do not render legal advice to the organizational client.[19] This means that the mere fact that a corporate employee is also a licensed attorney will not cause him or her to be swept into coverage.

Most troubling for the CLO, however, is who is _not_ excluded. Covered by the Rule is any attorney within the corporation who provides legal services to the issuer, "regardless of whether the attorney is employed or retained by the issuer."[20] The commentary states that the SEC's intention is to cover attorneys of the issuer's subsidiaries who are acting on behalf of, at the behest, or for the benefit"[21] of the parent. But it also appears that the Rule does not exclude attorneys who provide legal services to the issuer even though they may not be accountable to the CLO, and outside counsel directly retained by business lines within the company without the involvement of the CLO. This becomes a particular problem in the financial services industry, where there is extensive benefits law work related to financial products and services which involves appearing and practicing before the Commission.

It is not clear whether the mandate under Section 205.4(a) that the CLO be a "supervising attorney" also obligates him or her to comply with Section 205.5(b) with regard to such "incidental" lawyers.[22] Coverage of these "incidental" lawyers creates, among other things, a severe logistical problem for the CLO. This problem could be particularly pronounced in financial service firms with large employee benefit practices which service large, registered retirement plans.

B. Representing the issuer

Coverage is not just triggered by appearing and practicing before the Commission. The attorney must also be doing so in the representation of the issuer. 205.3(a) provides that:

> An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors or employees in the course of representing the issuer does not make such individuals the attorney's clients.[23]

[19] Rule Section 205.2(2)
[20] Rule Section 205.2(g)
[21] 68 Fed Reg at 6298
[22] Rule Section 205.5(b) requires the CLO to make reasonable efforts to ensure that subordinate attorneys conform to Part 205.
[23] Rule Section 205.3(a)

This part of the Rule heightens the importance for outside counsel to clearly identify its client. Employee benefit lawyers will recognize this conundrum, as it is a common problem with which we must deal in the representation of a retirement plan covered by Title I of ERISA. That is, the client and the attorney must determine if the attorney is representing the plan and its interests, or if the attorney is representing the issuer as plan sponsor. In-house counsel generally have standard positions on this with regard to their own staff. Outside counsel's decision as to who is their client is now becoming a matter of relevance under security laws.

Should the plan sponsor be the client, it is likely the company's Part 205 procedures could apply. Should the client be the plan, it may be possible under certain circumstances that Part 205 will not be triggered and, as such, there may be no reporting obligations. An example of where this may be possible is when the attorney represents a plan which interests diverge from that of the sponsor by operation of Title I. The caveat to this is the aforementioned position of the SEC, where an attorney acting for the benefit of the issuer, even if not retained by the issuer, will be considered as representing the issuer.

This Rule also acts as a helpful limitation on the application of Part 205 for outside counsel who may appear before the Commission on matters not directly related to client representations. It is generally clear when such counsel owes a professional duty to a corporate client in such instances, and when he or she is acting independent of such obligations. More difficult is the question for in-house counsel, when participating in trade or special interest association activities. With only a single client, it is not entirely clear that the in-house attorney's advocacy of a trade association's position in front of the Commission will not trigger Part 205 coverage. This particularly may be an issue where the association's position is close to that of the attorney's employer.

There is a special rule governing attorneys who represent investment advisors. Any attorney employed by an investment advisor who assists in preparing material for a registered investment company that the attorney has reason to believe will be submitted to the Commission by a registered investment company, is appearing before the Commission on behalf of the investment company.[24] The attorney has a duty to report "up the ladder" within the registered investment company. For the benefits lawyer providing advice to an investment advisor, this becomes an issue.

C. The reporting requirement

Assuming the attorney falls within the ambit of the appearing and representation rules, then the Rule provides, in part, that:

> If an attorney ….becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof)

[24] 67 Fed Reg 71678-79

or to both the issuer’s chief legal officer and its chief executive officer (or the equivalents thereof) forthwith…[25]

Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duties arising under Untied States federal or state law, or a similar material violation of any United States federal or state law.[26]

Breach of fiduciary duty refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.[27]

The Rule’s reporting requirement differs for the ABA’s rules in a couple of ways which will impact employee benefit lawyers. First, it is not limited to information learned during the course of the attorney’s representation of the issuer. Thus, if the outside law firm learns of a material violation while not representing the issuer, it may trigger a reporting requirement once he or she falls within the Rule’s coverage with regard to that information by virtue of a new representation of the issuer. This could happen should a firm first be retained by a plan, then later retained by the plan’s sponsor.

Secondly, the SEC standard requires reporting when the attorney becomes aware of evidence of a material violation. This is dramatically different than the ABA’s standard, which applies only when an attorney knows that an officer or employee is engaged in a violative action. The SEC specifically has rejected the ABA’s “knows” standard as establishing too high of a threshold.

The Rule also poses certain definitional challenges. In determining the reporting standard for violations, the Rule uses the term “material,” but does not define it. The SEC has taken the position that the term has a well established meaning under federal securities laws, and the SEC intends for that same meaning to apply here. Effectively, materiality is based upon the concept of whether or not disclosure of the information would be material to the purchaser of a security of the issuer. But it is a term with which a number of covered attorneys who practice outside of the traditional securities law area have little experience or knowledge. Given the seriousness of reporting “up the ladder,” this can be a daunting proposition for such practitioners.

Further, the Rule attempts to limit the definition of material breach of fiduciary duties by qualifying it as the breach of the duty owed to the issuer, but then expands it by recognizing any such breach under other state and federal common law. This will include misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions. This seems to raise the ERISA issue, where the issuer serves in a fiduciary role to a qualified plan, such as serving as the plan administrator or named fiduciary.

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[25] Rule Section 205.3(b)(1)
[26] Rule Section 205.2(i)
[27] Rule Section 205.2(d)

Where an officer of the issuer is delegated a fiduciary role by the issuer, that officer then owes a fiduciary obligation to the issuer—even though it is in that issuer's plan fiduciary capacity not in its corporate fiduciary capacity. This potentially has the odd result of causing an attorney to have the duty to report evidence of a material ERISA breach "up the ladder." Even more absurd, but not out of the question, is whether those companies which are in the business of providing trust services have a duty to report material breaches of trust. Given the current expansive activities of the SEC in the retirement industry, the answers to these questions may well ride upon whether the breach would be considered material information for an investor, as defined by the SEC.

The breadth of the definition of a fiduciary breach may also trigger reporting requirements even without an ERISA violation. The benefits lawyer's status as a covered attorney under Part 205 may give rise to a duty to report other malfeasance (or other activity which may not trigger an ERISA fiduciary breach) involving the employee benefit plan should the violative act cross the SEC's threshold of materiality for the issuer.

1. <u>Reportable employee benefit law violations</u>

Are there instances where evidence of material violations within the employee benefits practice area would be reportable? It looks to be so, though it generally appears that the materiality standard would substantially limit its application. Areas of the benefits practice which could potentially be affected, where a covered benefits lawyer would gain knowledge of evidence of a material breach, could include some of the following:

-Breaches by officers of the company in dealing with a 401(a) plan which holds company stock. This sort of application of the Rule would impose a duty on the benefits lawyer in Enron type of situations

-Fiduciary violations resulting in significant losses to a defined benefit plan, where such losses have a material impact on the issuer's financial statements.

-Malfeasance with regard to the valuing of plan assets, where the funding liability of the issuer may be underreported.

-Fiduciary violations under Title I welfare benefit plans which have the potential of exposing the issuer to material class action lawsuits.

-Prohibited transaction violations which have the potential of having a material impact on the issuer, or where the prohibited transaction may be of such an intentional nature as to trigger criminal violations under ERISA.

It is possible that the ERISA fiduciary structure of the issuer could affect the duty to report, but that is not entirely clear. For example, should it make a difference whether the issuer has a fiduciary role or not? Should it make a difference as to whom is delegated responsibility and to what extent, and could an issuer completely delegate its fiduciary obligations as to avoid Part 205 reporting obligations? It is these types of questions which will dog the in-house practice of law until time settles the issues.

2. Impact on corporate law departments

It appears that an issuer's Chief Legal Officer will be considered the supervising attorney under Part 205 for the employee benefits lawyers employed by the issuer. This would trigger the duty on behalf of the CLO to make reasonable efforts to insure that these lawyers comply with Part 205. It is also possible that corporate activities under some employee benefit programs may fall well within the reporting requirements of the Act. The challenge for the corporate law department is that the employee benefits practice typically falls far outside of the securities law mainstream, and the law department may not have structured its practices or prepared itself to handle reports arising from those other practices.

This potentially has a much greater effect on the CLOs of large, diverse financial service companies, where business lines may be directly hiring either in-house or outside employee benefits counsel without involvement of the CLO. Though it is not clear, the CLO may well have similar duties with regard to those attorneys who may well be covered by Part 205 by the nature of their employee benefit practices.

III. Recommended Practices

Not only are there a lack of answers to some fundamental questions related to the impact of Part 205 on the employee benefits practice, but I would suggest we are yet to unearth important questions about the extent of its applicability. We do know, however, that there is a significant risk that the employee benefits lawyer will be covered in some way by these new professional responsibility rules. There are certain practices which a corporate legal department may wish to consider in addressing this potential risk.

Adopt sufficiently broad compliance programs

A number of corporate legal departments have adopted formal Part 205 programs which include training of affected lawyers as well as communications with outside counsel. Some departments have adopted broad programs because of the difficulty in determining which attorneys are covered, and because the practices are in many ways consistent with existing obligations under applicable professional responsibility rules. These sorts of broadly based programs are inclusive of all of the attorneys under CLO control, and apply "reporting up" obligations in areas well beyond the securities law requirements. It is these programs which are responsive to the risks that employee benefit lawyers may be covered attorneys.

Train for materiality

With the responsibility to report evidence of material violations "up the ladder" comes the need to be versed in the threshold definitions of materiality. The security bar is well acquainted with the SEC's application of materiality, but the rest of us are not. A necessary element of any broadly based program will be the training and continual updating of non-security lawyers on the materiality standard.

Financial service firms

The employee benefits lawyer providing legal services to a financial service firm outside of the corporate law department provides particular challenges to a CLO, which have been mentioned earlier. The nature of such practices makes it likely that these lawyers will be covered under Part 205. There is then the obligation on their part to report material violations "up the ladder," though there may be no "ladder" to "report up." These organizations may find it necessary to review the manner in which employee benefit legal services are being provided, and make appropriate accommodations for application of their Part 205 programs.