

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

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A. Introduction

1. Employee benefits lawyers are well familiar with the effect the Sarbanes Oxley Act, 15 U.S.C. §7245 (the "Act") has had on their practices. In particular, they have had to deal with restrictions on executive loans (Act §402); the tightening of the 16(b) reporting rules (Act §403); the executive trading restrictions during qualified plan blackout periods (Act §306; Regulation BTR); enhanced criminal penalties under ERISA (The White-Collar Crime Penalty Enhancement Act of 2002, Section 906 of Sarbanes-Oxley Act of 2002); and the documentation, assessment, and testing of the control infrastructures to which CEOs and CFOs must attest (Act §302). 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 struggle to develop procedures to comport with these new rules, that significant issues arise as to their application to practice areas tangentially related to traditional securities law practice. In particular, a close examination of the rules

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reveals a host of unanswered questions about their applicability to corporate ERISA practice.

2. Caution is demanded when fashioning section 307 practices, so as to reflect the need to cover the ERISA practice. The broad "supervising attorney" rules contained in the SEC's rules implementing part 307 place 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 that are broad enough to cover the ERISA practice then has potential of disrupting the general legal practice within publicly traded companies.

B. General Description Of The New Professional Responsibility Rules

1. 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." Act §307. 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 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 that they represent or, under certain circumstances, directly to the board of directors of the company.
2. 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-securities law practices in the rules. The final rule (the "Rule"), issued on February 6, 2003, and effective August 5, 2003, Release No. 33-8185 (February 6, 2003), 17 C.F.R. Part 205, 68 Fed. Reg. 6296, 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; and the Rule was not fully responsive to the important concern

of being over-inclusive. The ABA'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.

Comments of the ABA to the SEC, at 12. *See* 68 Fed. Reg. at 6297-98.

3. Although 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 the harsh implications under the "supervising attorneys" rules, broadly affects law departments and law firms providing employee benefits advice in ways in which we are unaccustomed and which we have not yet fully realized.
4. *Overview Of Part 205*
 - a. The Rule imposes new "up the ladder" reporting requirements upon any attorney appearing and practicing before the SEC 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 Officer (CLO) or the Chief Executive Officer 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 (QLCC) (17 C.F.R. §205.2(k)), 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 needs only then to report its findings to the board itself. (The QLCC 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.)

- b. 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 SEC broadly deems a supervising attorney to be appearing and practicing before the SEC to the extent a subordinate attorney appears and practices before the SEC. 17 C.F.R. §205.4 (This includes the duty to make reasonable efforts to ensure 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.) 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's or CEO's response. 17 C.F.R. §§205.4, 205.5. 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. Rule §205.5 In all instances, the CLO is always considered a supervising attorney and, therefore, responsible for the reporting activities of his or her subordinates.
- c. 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 events such as improprieties of the client's officers (and the attorney's ultimate employer) with whom they deal on a daily basis and the possibility that other lawyers may be involved in the improprieties; as well as 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 directors of the company or its audit committee. 17 C.F.R. §205.3(b)(4). Further, the Act itself expands "whistleblower protection" under the Securities Exchange Act of 1934. Act §806. 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 provides 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. 17 C.F.R. §205.7.

- d. The sanctions for failing to comply with Part 205 are the civil penalties and remedies available to the SEC in an action brought by the SEC, including censure and a prohibition on practicing before the SEC. 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 C.F.R. §205.6

C. Part 205's Impact On Employee Benefits Practice

1. Three sections of Part 205 implicate employee benefits 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 benefits plan practices, responding to SEC proposed rules that 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.
2. Second, the language defining when a lawyer is “representing the issuer before the Commission” brings employee benefits lawyers into play. The 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 question will be important in the application of Part 205.
3. Finally, there are important, unresolved issues as to what sort of employee benefits 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.”* Part 205’s definition of what it means to appear and practice before the SEC 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;

17 C.F.R. §205.2

i. *"Transacting Any Business With The Commission"*

(1) This is by far the broadest of the categories that could implicate the benefits practice. There are a number of activities that, under the unsettled state of the law, could possibly cause employee benefits lawyers to be considered practicing before the SEC. 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 used by retirement plans, and with 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 that tangentially involve securities and may necessitate communications with the SEC or its staff, all of which could also trigger coverage by these rules.

ii. *Representing An Issuer Before The Commission*

(1) It is clear that any attorney representing the issuer in any SEC action involving an employee benefits plan will be considered as practicing before the SEC. But it is unclear what level of involvement

of the employee benefits lawyer, who does not directly practice in front of the SEC, 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 to be representing the issuer before the SEC?

iii. *Advice With Regard To Documents*

(1) 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 benefits 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 filed with the SEC, would impose a reporting obligation upon attorneys if those documents were eventually filed with the SEC 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.

(2) There are a variety of corporate securities filings that rely heavily on content provided by the benefits lawyer—content that 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 benefits programs maintained by the issuer; and, when 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 SEC.

(3) This section of the Rule particularly affects in-house benefits counsel in the financial services 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.

iv. *Advising An Issuer On The Filing Of Information*

(1) 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.

v. *Exclusions And, More Importantly, Non-Exclusions.*

(1) Part 205 also has certain “status” types of rules, intended to exclude from the Rule’s coverage certain classes of attorneys. Excluded are nonappearing foreign attorneys and attorneys who are licensed to practice law but do not render legal advice to the organizational client. 17 C.F.R. §205.2(a)(2). 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.

(2) 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.” 17 C.F.R. §205.2(g). 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” of the parent. 68 Fed. Reg. at 6303. 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 that involves appearing and practicing before the SEC.

(3) It is not clear whether the mandate under 17 C.F.R. §205.4(a) that the CLO be a “supervising attorney” also obligates him or her to comply with 17 C.F.R. §205.5(b) with regard to such “incidental” lawyers. (Section 205.5(b) requires the CLO to make reasonable efforts to ensure that subordinate attorneys conform to Part 205.) Coverage of these “incidental” lawyers creates, among other things, a severe logistical problem for the CLO. This problem could be particularly pronounced in financial services firms with large employee benefits practices that service large, registered retirement plans.

- b. *Representing The Issuer.* Coverage is not just triggered by appearing and practicing before the SEC. The attorney must also be doing so in the representation of the issuer. 17 C.F.R. §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.

Rule §205.3(a)

i. This part of the Rule heightens the importance of outside counsel clearly identifying its client. Employee benefits lawyers will recognize this conundrum, because 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 securities laws.

ii. 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 the interests of which diverge from those 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.

iii. This Rule also acts as a helpful limitation on the application of Part 205 for outside counsel who may appear before the SEC 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 independently 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 SEC will not trigger Part 205 coverage. This partic-

ularly may be an issue where the association's position is close to that of the attorney's employer.

iv. 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 SEC by a registered investment company is appearing before the SEC on behalf of the investment company. 67 Fed. Reg. at 71678-79. 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) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith....

Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

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.

17 C.F.R. §§205.3(b)(1); 205.2(i), and 205.2(d).

i. The Rule's reporting requirement differs for the ABA's rules in a couple of ways that will affect employee benefits 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 is retained by the plan's sponsor.

ii. Second, 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.

iii. 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.

iv. 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. When 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 that 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.

v. 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 benefits plan should the violative act cross the SEC's threshold of materiality for the issuer.

(1) *Reportable Employee Benefits Law Violations.* Are there instances where evidence of material violations within the employee benefits practice area would be reportable? It looks to be so, although it generally appears that the materiality standard would substantially limit application of the rule. Areas of the benefits practice that 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 that holds company stock. This sort of application of the Rule would impose a duty on the benefits lawyer in Enron-type situations.
- Fiduciary violations resulting in significant losses to a defined benefit plan, when such losses have a material impact on the issuer's financial statements.
- Malfeasance with regard to the valuing of plan assets, when the funding liability of the issuer may be underreported.
- Fiduciary violations under Title I welfare benefit plans that have the potential of exposing the issuer to material class action lawsuits.
- Prohibited transaction violations that may have 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.

(2) 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 so as to avoid Part 205 reporting obligations? It is these types of questions that will dog the in-house practice of law until time settles the issues.

(3) *Impact On Corporate Law Departments.* It appears that an issuer's CLO 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 ensure that these lawyers comply with Part 205. It is also possible that corporate activities under some employee benefits 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. Although it is not clear, the CLO may well have similar duties with regard to those attorneys who might be covered by Part 205 by the nature of their employee benefits practices.

D. Recommended Practices

1. 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 have 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.
 - a. *Adopt Sufficiently Broad Compliance Programs.*
 - i. 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 that are responsive to the risks that employee benefits lawyers may be covered attorneys.

b. *Train For Materiality*

i. 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 securities 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-securities lawyers on the materiality standard.

c. *Financial Services Firms*

i. The employee benefits lawyer providing legal services to a financial services 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, although there may be no "ladder" to "report up." These organizations may find it necessary to review the manner in which employee benefits legal services are being provided, and make appropriate accommodations for application of their Part 205 programs.

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