

Perspectives

AN EXECUTIVE COMPENSATION, BENEFITS,
& HUMAN RESOURCES LAW UPDATE

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 Print Newsletter

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QUESTIONS FROM OUR READERS...

Q. I heard the IRS has launched an employment tax compliance study and will be conducting tax audits of approximately 6,000 companies. What will be the focus for these audits and what can companies do now to minimize exposure in the event of an audit?

A. In September 2009, the IRS announced plans to audit approximately 6,000 companies over the next three years as part of the Employment Tax National Research Program (the "NRP"). The IRS will randomly select 2,000 companies a year for the next three years for these audits and expects to send out the first audit notices by the end of February 2010. Key areas of focus for the NRP audits include: worker classification, fringe benefits, executive compensation and payroll taxes.

All employers should review current employee-related plans and practices now to find any compliance issues and implement internal correction procedures. A comprehensive review of worker classifications, fringe benefit policies and payroll tax practices may mitigate future risks and penalties in these areas, in the event of an IRS audit. Employers should also review all nonqualified deferred compensation plans and arrangements for compliance with Internal Revenue Code section 409A. These 409A reviews should assess operational as well as documentary compliance. IRS corrections programs—including a recently-announced document corrections program—may be available if employers take such a proactive approach and find compliance issues in their nonqualified deferred compensation plans. This NRP is likely to be just the beginning of an IRS focus on employment-related tax issues for years to come. Now is the time for employers to be proactive and review their employee-related plans and practices.

Upcoming Events...

Times They Are a Changing: Employee Data Privacy Concerns During a Corporate Transaction
April 28, 2010
Webinar

The 409A IRS Document Correction Program: How to Cure Your Deferred Compensation Plan and 409A Violations
Tuesday, May 4, 2010
Webinar

Recent Publications...

How Effective is Your Clawback?

IRS Announces Correction Program for Nonqualified Deferred Compensation Plan Document Failures

EU Prospectus Directive to Exempt Employee Share Plans of U.S. Public Companies

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New Executive Compensation Corporate Governance Rules Proposed

by Susan P. Serota

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The Restoring American Financial Stability Act of 2010 was released by Senator Christopher Dodd (D-CT), Chairman of the Senate Banking Committee, on March 15, 2010 (the "Financial Reform Bill"). In addition to the many financial services reform items contained in the proposed legislation, there are a number of provisions that would affect the corporate governance of executive compensation at public companies, including provisions that will be mandatory for companies to continue being listed on a national securities exchange such as the NYSE or NASDAQ.

Non-Binding "Say on Pay" Vote on Executive Compensation

The Financial Reform Bill would require a separate non-binding vote by shareholders on the compensation reported in a company's proxy for the Principal Executive Officer, the Principal Financial Officer and the other Named Executive Officers disclosed, beginning with the proxy for an annual or other meeting of shareholders occurring after the end of the six-month period beginning on date of enactment.

Compensation Committee Independence

The Financial Reform Bill directs the SEC to issue rules prohibiting the listing of any security on a national securities exchange or national securities association (referred to as "Exchanges") of any issuer that does not comply with the independence requirements for members of the compensation committee, who must be members of the issuer's board of directors and must meet certain independence standards. In addition, the Exchanges would be required to consider certain relevant factors such as the source of compensation of a member of the compensation committee, including any consulting, advisory or other compensatory fee paid by the issuer to such member and whether the member is affiliated with the issuer, a subsidiary or an affiliate. The Exchanges may exempt a particular relationship of the member and the issuer as it deems appropriate in light of the size of the issuer and any other relevant factors.

Independence of Compensation Committee Consultant and Other Advisers

The Financial Reform Bill provides that compensation committees must have the authority, in their sole discretion, to hire independent compensation consultants, legal counsel and other advisers. The SEC is to issue rules that identify the independence standards that are to be used, including fees received from the issuer by the employer of the consultant, legal counsel or other adviser, the policies and procedures of such employer designed to prevent conflicts of interest, any business or personal relationship of such person with the compensation committee, and any stock of the issuer owned by such person. Disclosure in a proxy relating to a shareholder meeting occurring on or after one year after enactment of the Bill must include whether the compensation committee retained or obtained the advice of a compensation consultant and the whether the work has raised any conflict of interest, and if so, the nature of the conflict and how the conflict is being addressed. Funding of reasonable compensation to pay such independent persons is to be provided by the issuer. The SEC rules are directed to be issued within 360 days after enactment and the SEC is required to direct the Exchanges to prohibit the listing of any security of an issuer that is not in compliance with these independence requirements, subject to an opportunity to cure and an exemption applicable in appropriate circumstances and taking in the impact on smaller reporting issuers.

NEW EXECUTIVE COMPENSATION CORPORATE GOVERNANCE RULES PROPOSED (CONTINUED)**New Disclosure Required of Executive Compensation**

A clear description of any compensation required to be disclosed in the annual proxy would be required to include information showing the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions.

Clawback Policy Required

Exchange-listed issuers are required to develop and implement a policy providing (A) for disclosure of the issuer's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws and (B) that in the event an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options) during the three-year period preceding the date on which the issuer is required to prepare a restatement, based on erroneous data, any amount in excess of what would have been paid to the executive under the restatement.

Disclosure Regarding Hedging by Employees and Directors

To the extent any employee or director of the issuer (or any of their designees) is permitted to purchase financial instruments (including prepaid variable futures contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities granted as compensation by the issuer to the employee or director or held, directly or indirectly, by the employee or director would be required to be disclosed in the annual proxy statement of the issuer in accordance with rules to be issued by the SEC.

Excessive Compensation of Bank Holding Companies

The Board of Governors of the Federal Reserve System would be required to establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company that provides an executive officer, director or principal shareholder of the bank holding company with excessive compensation, fees or benefits or could lead to a material financial loss to the bank holding company.

The Financial Reform Bill is substantially different from Senator Dodd's bill that was released in November 2009, and from the legislation passed by the House in December 2009. We will continue to follow and report on the legislation as it develops.



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Department of Labor Proposes New Rules on 401(k) Plan Investment Advice

by John J. Battaglia

Print this article 

On February 26, 2010, the Department of Labor (DOL) released new proposed regulations under the Employee Retirement Income Security Act (ERISA) relating to the provision of investment advice to participants and beneficiaries of participant-directed individual account plans such as 401(k) plans and IRAs. The new proposed regulations replace the final regulations that were issued in January, 2009, but then deferred and finally withdrawn in November in response to commenters' concerns that the administrative class exemption in the regulations might not adequately mitigate potential self-dealing by investment advisors. The DOL has addressed these concerns by excluding the class exemption from the new proposed regulations.

Aside from the removal of the class exemption, some clarifications on the "level-fee" requirements described below, and a new condition relating to computer models, the new proposed regulations are substantially the same as the withdrawn final regulations. When finalized, the proposed regulations will implement the prohibited-transaction exemption for the provision of investment advice in ERISA sections 408(b)(14) and 408(g) that was enacted under the Pension Protection Act of 2006 (PPA).¹

Background

Absent an exemption, ERISA's and the Code's prohibited-transaction rules bar a fiduciary from rendering investment advice to plan participants on investments that result in additional fees to plan fiduciaries or their affiliates. The PPA added a new statutory exemption from the prohibited-transaction rules covering the provision of investment advice. Subject to certain safeguards and conditions, the new exemption was intended to expand the availability of investment advice to participants in 401(k) plans, IRAs and similar individual account plans that permit participants to direct the investment of their plan accounts.

On January 21, 2009, the DOL published final regulations implementing the statutory exemption for investment advice added by the PPA. The final regulations also contained an administrative class exemption expanding the prohibited-transaction relief to certain circumstances not covered by the statutory exemption. For example, the class exemption would have permitted individualized follow-up advice to participants who previously received generalized computer-generated advice or IRA participants who received investment education materials ("off-model advice"). More important to institutional advisers, the class exemption would have provided relief at the fiduciary-advisor-entity level, so long as the individual employee, agent, or registered representative providing the advice met the level fee requirements, even if the entity would receive varying fees based on participants' investment elections ("modified fee leveling").

The effective date of the 2009 final regulations was originally March 23, 2009, but, at the request of new administration, the DOL delayed the effective date of the regulation and reopened the notice and comment period. The DOL determined that the issues raised by the commenters, particularly with respect to the modified fee leveling, were indeed sufficient to cast doubt on the whether the class exemption's conditions were adequate to mitigate the potential for investment advisor self-dealing. Based on such determination, the DOL withdrew the 2009 final regulations on November 20, 2009.

DEPARTMENT OF LABOR PROPOSES NEW RULES ON 401(K) PLAN INVESTMENT ADVICE (CONTINUED)**The New Proposed Regulations**

The new proposed regulations replace the guidance contained in the 2009 final regulations, but are limited in scope to the implementation of the PPA statutory exemption for investment advice. The administrative class exemption that was included in the 2009 final regulation has been eliminated.²

The proposed regulation confirms that the PPA's addition of a statutory exemption for the provision of investment advice does not in any way impose an obligation on any plan fiduciary or other party to offer, provide or otherwise make investment advice available to any participant or beneficiary. For plan fiduciaries that want to provide such advice, however, the proposed regulation allows "eligible investment advice" to be provided under the ERISA statutory exemption in either of two ways: (1) through an advisor who is compensated on a "level fee" basis or (2) through the use of a computer model that is certified as unbiased.

Level Fees

Under the "level fee" alternative, the fees or other compensation received by a fiduciary adviser (including any employee, agent or registered representative of the adviser) from another party (including an affiliate of the advisor) cannot vary based in whole or in part on a participant's selection of a particular investment option.³ In addition, the investment advice provided must be based on generally accepted investment theories that, at a minimum, take into account each of the following factors:

- The historic risks and returns of different asset classes over defined periods of time;
- Investment management and other fees and expenses relating to the recommended investments;
- To the extent such information is furnished to the adviser, information relating to the participant's age, life expectancy, retirement age, risk tolerance, current investments, investment preferences and other sources of income.⁴

Computer Models

Under the "computer model" alternative, the investment advice must be generated by a computer model that meets the following requirements. The computer model must be designed and operated to—

- Apply generally accepted investment theories that, at a minimum, take into account each of the three factors described above with respect to the level-fee alternative;
- Use objective criteria to provide asset allocation portfolios of plan investment options;
- Avoid investment recommendations that inappropriately (i) favor investment options offered by the adviser (or a person with a material affiliation or contractual relationship with the adviser) over other options available under the plan, (ii) favor investment options that may generate greater income to the adviser (or a person with a material affiliation or contractual relationship with the adviser) or (iii) distinguish among investment options in a single asset class based on a factor that cannot confidently be expected to last into the future;
- The requirement to avoid investment recommendations based on factors that can't confidently be expected to last into the future is a new limitation that is intended to exclude consideration of historic rates of return of investments within the same asset class. Thus, while historic rates of return are required to be considered for purposes of allocating assets among the various asset classes, they cannot be considered for purposes of recommending particular investments within an asset class.

DEPARTMENT OF LABOR PROPOSES NEW RULES ON 401(K) PLAN INVESTMENT ADVICE (CONTINUED)

- Take into account all available investment options under the plan without giving inappropriate weight to any option, although the model need not make recommendations regarding qualifying employer securities, target funds, guaranteed annuity options or self-directed brokerage accounts.
- Prior to the use of the model, the advisor must obtain a written certification from an “eligible investment expert” that the model meets the requirements of the regulation. For this purpose, an “eligible investment expert” is a person (other than a person with a material affiliation or contractual relationship with the adviser) who, through employees or otherwise, has the appropriate technical training or experience and proficiency to analyze, determine and certify whether the model meets the requirements.

Additional Requirements

To qualify for exemption under either the level-fee or computer model alternatives, each of the following additional requirements must be satisfied:

- **Fiduciary Authorization.** The investment advice arrangement must be authorized by a plan fiduciary (or in the case of an IRA, the IRA beneficiary), other than the person offering the arrangement, a person providing any of the investment options offered under the plan, or an affiliate of either. For plans sponsored by the person offering the arrangement (or an affiliate of such person), the arrangement may be authorized by the plan sponsor, so long as the same arrangement is offered to unaffiliated plans in the ordinary course of its business.
- **Annual Audit.** At least annually, the fiduciary adviser must engage an independent auditor to conduct an audit of the arrangement’s compliance with the requirements of the regulation and provide a written report to the fiduciary adviser and authorizing fiduciary within 60 days following completion of the audit. If the auditor’s report identifies noncompliance with the regulations, the fiduciary adviser must submit a copy of the report to the DOL within 30 days after it receives the report.
- **Fiduciary Adviser Disclosures.** Before the initial provision of investment advice, the fiduciary adviser must provide to the participant or beneficiary, without charge, written notification of the following—
 - The role of any party that has a material affiliation or material contractual relationship with the fiduciary adviser in the development of the investment advice program, and in the selection of the options available under the plan;
 - The past performance and historical rates of return of the designated investment options under the plan if such information is not provided elsewhere;
 - All fees or other compensation the adviser or any of its affiliates will receive in connection with the provision of the advice or the participant acting on the advice;
 - Any material affiliation or material contractual relationship of the fiduciary adviser or its affiliates in the recommended securities;
 - The manner, and under what circumstances, participant information provided under the arrangement will be used or disclosed;
 - The types of services provided by the fiduciary adviser in connection with the provision of investment advice;
 - That the adviser is acting as a fiduciary of the plan in connection with the provision of the advice; and
 - That the recipient of the advice may separately arrange for the provision of advice by another adviser that has no material affiliation with and receives no fees or other compensation in connection with the security or other property.

DEPARTMENT OF LABOR PROPOSES NEW RULES ON 401(K) PLAN INVESTMENT ADVICE (CONTINUED)

The notice must be written in a clear and conspicuous manner, calculated to be understood by the average plan participant. The proposed regulation includes an optional model disclosure notice that fiduciary advisers can use to satisfy the notice requirement.

- **Other Conditions for Exemption.** The fiduciary adviser must also comply with all applicable disclosure requirements under the federal securities laws in connection with the sale, acquisition or holding of the security or other property, and any such sale, acquisition or holding of the security or other property must occur solely at the direction of the recipient of the advice. In addition, any compensation received by the fiduciary adviser and its affiliates in connection with the sale, acquisition or holding of the security or other property must be reasonable and the terms of the transaction must be at least as favorable to the plan as the plan would have obtained under an arm's length transaction.
- **Record Retention.** The fiduciary adviser must maintain records needed to determine compliance with the requirements for exemption for at least six years after the advice is provided.

Effect on Other Guidance

Like its predecessor, the new proposed regulations keep intact all prior regulations (other than the withdrawn 2009 final regulations), exemptions, interpretive or other guidance issued by the DOL pertaining to the provision of investment advice and the circumstances under which such advice may or may not constitute a prohibited transaction under section 406 of ERISA or section 4975 of the Code. Thus, for example, an investment advice arrangement that fails to meet either the level-fee or computer model requirements of the new proposed regulations might still pass muster under prior DOL guidance, such as the DOL's SunAmerica letter.⁵

What's Next?

Comments on the new proposed regulations are due on May 5, 2010. The DOL has specifically requested comments on the conditions applicable to investment advice provided under the computer model alternative, including without limitation responses to questions relating to—

- The identification and application of generally accepted investment theories and the investment practices associated with such theories;
- The historic data that should be taken into account in determining expectations for future performance, and the minimum standards for such data; and
- The appropriate criteria for asset allocation; and
- Whether and to what extent investment management style (i.e., active vs. passive management, should be taken into account.

The new proposed regulations will become effective 60 days after publication of the final regulations in the Federal Register. notice that can be used by employers to satisfy the CHIP notice requirement. The model notice is in the form of a template and is available on the EBSA website at www.dol.gov/ebsa. The notice covers situations in which employees or their family members reside in states that provide premium assistance and provides contact information for state-specific program descriptions. An employer providing medical benefits to such employees must provide the CHIP notice whether or not the employer itself is located in one of those states.

Employers are required to provide the initial notice by the later of (i) the first day of the first plan year after February 4, 2010, or (ii) May 1, 2010. Accordingly, employers with plan years beginning between February 4, 2010 through April 30, 2010 must provide the CHIP notice by May 1, 2010. Employers whose next plan year begins on or after May 1, 2010 must provide the CHIP notice by the first day of the next plan year (January 1, 2011 for calendar year plans).

DEPARTMENT OF LABOR PROPOSES NEW RULES ON 401(K) PLAN INVESTMENT ADVICE (CONTINUED)**Endnotes**


1. The PPA also added parallel provisions to sections 4975(d)(17) and 4975(f)(8) of the Internal Revenue Code of 1986, as amended (Code). Any references contained herein to sections 408(b)(14) and 408(g) of ERISA include corresponding references to sections 4975(d)(17) and 4975(f)(8) of the Code.
2. In the preamble to the new proposed regulations, the DOL noted the statutory exemption does not provide prohibited- transaction relief for individualized “off-model” advice rendered to individuals who would have been covered by the withdrawn class exemption unless such advice on its own meets the requirements of the statutory exemption.
3. Both the 2009 final regulation and the new proposed regulations permit receipt of varying fees by an affiliate of a fiduciary adviser. However, in response to concerns raised by commenters that the 2009 final regulations created an economic incentive for the adviser to recommend investments that pay varying fees to its affiliates, the DOL clarified in the new proposed regulations that the fee-leveling requirements do not permit any compensation received by affiliates in connection with the adviser’s recommendation to flow through to the adviser. See, also, DOL FAB 2007-1
4. Although the new proposed regulations require the fiduciary adviser to request such information, the adviser must consider such information only to the extent that the plan, participant or beneficiary actually provides it. Also, the new proposed regulations permit the adviser to request and consider any additional information that it considers appropriate.
5. DOL Advisory Opinion 2001-09A, Dec. 14, 2001. (Providing, generally, that a plan fiduciary who provides investment advice under a computer model that is generated, maintained and overseen by an independent third party under the facts and representations contained in the submission does not engage in a prohibited transaction under section 406 of ERISA because the investment decisions or recommendations provided are not the result of the fiduciary’s exercise of its authority, control or responsibility as a fiduciary).



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2010 Proxies: Action May Be Required to Preserve Executive Compensation Deductions

by Mark C. Jones

Print this article 

During the current proxy season, compensation committees of public companies will want to take into account the new position of the IRS regarding the deductibility of performance bonuses paid upon retirement or termination of employment. Committees should review their incentive pay plans to determine whether these plans need to be restructured to preserve the deductibility of performance-based bonuses before being put before shareholders.

Section 162(m) of the Internal Revenue Code generally limits a public company's federal income tax deduction to \$1 million for compensation paid to its chief executive officer and its three other top-paid officers (other than the chief financial officer). An exception from the \$1 million limit applies for compensation that is payable "solely on account of" attainment of one or more performance goals. The performance goals must be determined by its compensation committee, comprised of two or more outside directors. Additionally, the material terms of the plan, including the performance goals, must be disclosed to and approved by a majority of the company's shareholders, and the compensation committee must certify that the performance goals and any other materials conditions were in fact satisfied.

IRS regulations allow performance awards to be payable in the event of the participant's death or disability or a change of control, even if the performance goal was not attained, without jeopardizing the award's exemption from the \$1 million deductibility limit. In private rulings issued in 1999 and 2006, the IRS applied the same logic to awards that were paid out upon termination of employment. However, the IRS reversed this position in Revenue Ruling 2008-13, reasoning that awards that are payable upon a participant's termination of employment, voluntary resignation or retirement are not payable "solely on account of" performance, and, therefore, are not exempt from the \$1 million limit. Revenue Ruling 2008-13 does not apply to awards paid under a performance period beginning on or before January 1, 2009 or under an employment contract in effect on February 21, 2008. But awards to be paid under a performance period commencing after January 1, 2009 or under a newly adopted or revised plan or agreement that will be subject to the new rules. These arrangements, therefore, should be reviewed by the compensation committee to determine whether the awards will still be exempt from Section 162(m) under the IRS's new interpretive standards.

The exception for performance-based awards is not available to companies that have received \$300 million or more under the Troubled Assets Relief Program (TARP). In addition, the limit on the deductibility of compensation for the top executives of such companies (including the chief financial officer) is limited to \$500,000. These restrictions continue until the company repays the moneys received or for any other reason is no longer subject to TARP.

Public companies should also take this opportunity to review their procedures to ensure that all performance-based awards, including incentive pay, performance-based equity awards, stock options and stock appreciation rights, are approved by an independent compensation committee and that all plans and arrangements providing for these awards, including the performance goals, are put before their shareholders at least every 10 years (every five years if the compensation committee has authority to change the performance measures used to establish the goal). A grace period applies to performance-based plans in existence before a company's initial public offering (IPO) from the date of the IPO through the first shareholder

2010 PROXIES: ACTION MAY BE REQUIRED TO PRESERVE EXECUTIVE COMPENSATION DEDUCTIONS(CONTINUED)

meeting after the end of the third calendar year following the year in which the IPO occurred. Shareholder approval is necessary for any awards made from the plan after the expiration of the grace period. Newly public companies may want to consider seeking this shareholder approval soon after the IPO, when company ownership may be concentrated and shareholder enthusiasm especially high, rather than waiting until the end of the grace period.



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