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Client Alert

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Impact of The Sarbanes-Oxley Act and Current Legislative and Regulatory Proposals on Employee Benefits and Executive Compensation

Recently enacted and contemplated legislation and regulations will have a significant impact on the design and operation of employee benefit and executive compensation arrangements. In response to recent events involving corporate governance, Congress adopted the Sarbanes-Oxley Act of 2002 on July 30 of this year. In addition, Congress, the Securities and Exchange Commission (the "SEC"), the New York Stock Exchange (the "NYSE") and NASDAQ are all considering legislation and rulemaking proposals to supplement that Act.

This Client Alert briefly describes certain recent legislation that has impacted employee benefit and executive compensation arrangements and certain proposed legislation and proposed rules that, if enacted, will affect these arrangements. A discussion of certain other aspects of the Sarbanes-Oxley Act can be found on our website, which can be accessed at http://www.proskauer.com/news_publications/client_alerts/content/index.

I. The Sarbanes-Oxley Act

The recently enacted Sarbanes-Oxley Act was designed to address issues of corporate governance, securities regulation and the conduct and practices of the accounting profession. Some of its provisions directly or indirectly affect employee benefit and executive compensation arrangements.

Prohibition on Personal Loans for Insiders

In general, the Sarbanes-Oxley Act prohibits any public corporation from directly or indirectly extending or maintaining credit, arranging for the extension of credit, or renewing an extension of credit, in the form of a personal loan, to or for any of its directors or executive officers.

An extension of credit or loan existing as of July 30, 2002 is "grandfathered" and not subject to this prohibition on loans, provided there is no material modification to, or renewal of, such extension of credit after enactment. For example, any further draw downs under an arrangement may be deemed to be a series of loans or credits, even if the arrangement was first entered into prior to July 30, 2002, and may be prohibited. The Sarbanes-Oxley Act also contains several narrow exceptions for loans made or provided in the ordinary course of a corporation's regular business (*e.g.*, consumer credit companies, registered U.S. broker-dealers and certain banks).

While it appears that Congress enacted the loan prohibition with the intent of curbing employer-provided personal loans to executives, it is drafted broadly and could prohibit, among other compensation arrangements, relocation loans and advances, certain split-dollar life insurance arrangements, option exercise loans, tax loans, indemnification advances, company-provided or arranged home mortgage loans and certain cashless option exercise programs. In addition, the loan prohibition may require withholding obligations with respect to restricted stock or other property subject to vesting to be collected immediately on vesting or exercise rather than the common practice of advancing the tax deposit and withholding the taxes in future payroll periods.

Accelerated Disclosure of Section 16 Transactions

Effective August 29, 2002, the Sarbanes-Oxley Act requires directors, officers and 10% beneficial owners of any company with a class of publicly-traded equity securities to file reports as to most transactions involving company stock generally within two busi-

ness days (which, in certain instances, may be extended to five business days for discretionary transactions involving an employee benefit plan). This change accelerates the timing of reports for stock option and restricted stock grants, option exercises and discretionary transactions such as "intra-plan" transfers between an employer stock fund and another investment vehicle.

The SEC has adopted rules and forms to implement this new requirement. For additional information on this subject, please review our recent Client Alert (found at http://www.proskauer.com/news_publications/client_alerts/content/2002_09_00_e/get_data?k=PDF&lang=en).

Forfeiture of Certain Bonuses and Profits

The Sarbanes-Oxley Act imposes significant personal liabilities on a publicly-traded company's CEO and CFO if the company is required to prepare an accounting restatement due to the material noncompliance of the company, as a result of misconduct, with any financial reporting requirement under federal securities laws. In such an event, the company's CEO and CFO must reimburse the company for any bonus or other incentive-based or equity-based compensation received from the company and for any profits realized from the sale of the company's securities during the 12-month period following the first public issuance or filing with the SEC of the financial document containing the financial reporting error. The statute does not define "misconduct" and does not indicate whose "misconduct" is relevant. This provision was effective July 30, 2002.

Retirement Plan Blackout Periods

Under the Sarbanes-Oxley Act, new requirements apply to senior executives and retirement plans when retirement plans that permit participants to direct the investment of their accounts (*e.g.*, 401(k) or profit sharing plans) restrict for a designated period (referred to as a "blackout" or "lockdown" period) certain plan functions. These functions include, for example, the ability to change investments, take distributions and obtain loans.

If a majority of the participants under all applicable retirement plans of an employer are restricted from purchasing, selling, or otherwise transferring an interest in any employer stock held in a retirement plan for more than three consecutive business days, any director or executive officer is prohibited during the same period from trading any employer stock acquired in connection with his or her service or employment (this restriction does not apply to equity securities acquired on the open market). It is unclear whether this restriction applies to a blackout period under a plan that requires matching contributions (or other employer contributions) to be invested in employer stock even if participant contributions may not be invested in employer stock. In such a plan, if a blackout period affects the ability of participants to take withdrawals from the plan of employer stock (either in-service withdrawals or post-termination distributions), thereby taking away the ability to sell the stock, executive officers and directors of the employer may be restricted under the Sarbanes-Oxley Act from purchasing, selling or otherwise transferring an interest in employer stock.

In addition, the Sarbanes-Oxley Act generally requires the administrator of an individual account plan, with certain exceptions, to give at least 30 days' advance notice to all affected participants and beneficiaries of any blackout period. For this purpose, a blackout period includes periods when loans, investment changes or plan distributions are restricted for at least three consecutive business days. This rule applies regardless of whether the employer's stock is publicly-traded or if employer stock is an available investment under any of the employer's retirement plans. In addition, this requirement applies regardless of the number of participants affected.

This 30-day advance notice requirement does not apply if (1) a deferral of the blackout period would violate the fiduciary duty provisions of the Employee Retirement Income Security Act ("ERISA"), and a fiduciary of the plan reasonably so determines in writing; or (2) the inability to provide the 30-day advance notice is due to events that were unforeseeable or circumstances beyond the reasonable control of the plan administrator, and a fiduciary of the plan reasonably so determines in writing.

The blackout period provisions of the Sarbanes-Oxley Act are effective January 26, 2003.

Corporate & Criminal Fraud Accountability

The Sarbanes-Oxley Act increases the length of imprisonment and fines for crimes relating to conspiracy, mail fraud, wire fraud, and willful violations of the Securities Exchange Act of 1934 (the "Exchange Act")(including violation of the new loan prohibition) and ERISA's reporting and disclosure requirements.

An individual who willfully violates the Exchange Act can now be fined up to $5 million (increased from a previous maximum of $1 million) and/or sentenced to up to 20 years in prison (increased from a previous maximum of 10 years). A company that willfully violates the Exchange Act can be fined up to $25 million (increased from a previous maximum of $2.5 million).

An individual who willfully violates the reporting and disclosure requirements of ERISA can now be fined up to $100,000 (increased from a previous maximum of $5,000) and/or imprisoned for up to 10 years (increased from a previous maximum of one year). A company that willfully violates the reporting and disclosure requirements of ERISA can

be fined up to $500,000 (increased from a previous maximum of $100,000).

II. Proposals Affecting Deferred Compensation

Congress has recently expressed concern about the perceived abuse of nonqualified deferred compensation plans. Under applicable tax law, deferred compensation is not taxable to executives if the funds to be used to pay an employer's deferred compensation obligations are not secured and could be reached by the employer's creditors. However, companies continue to design deferred compensation arrangements that Congress believes may, de facto, provide executives with enhanced security while attempting to avoid immediate taxation. These efforts to further secure deferred compensation have created in the minds of certain members of Congress a question as to whether an executive's benefits are really available to general creditors.

Congress is currently considering two bills that, if enacted, would impact what are now considered ordinary deferred compensation arrangements. The National Employee Savings and Trust Equity Guarantee Act of 2002 (S. 1971, or the "NESTEG Bill") has been approved by the Senate Finance Committee and is pending in the Senate. The American Competitiveness and Corporate Accountability Act of 2002 (H.R. 5095, or "ACCAA") is pending before the House Committee on Ways and Means. Both bills address arrangements that move assets allocated to payment of deferred compensation out of the reach of creditors through the use of offshore trusts.

In addition, ACCAA could result in the immediate taxation of vested amounts currently considered to be deferred if the deferred compensation arrangement includes:

- Early distribution provisions (*e.g.*, payments prior to termination of service based on a "haircut"); or
- A "rabbi" trust; or
- Payment acceleration provisions upon the occurrence of a specific event (*e.g.*, a change in control).

III. Pension Reform

Several bills addressing pension reform are currently pending in Congress in reaction to the recent impact of accounting issues on 401(k) plans. Each bill would require plans to permit participants to diversify employer stock held in their retirement plan accounts. The bills would impose limits on holding employer stock, require enhanced disclosure of plan benefits and investments to plan participants, and ease restrictions on giving investment advice to plan participants. The Pension Security Act of 2002 (H.R. 3762, or the "Pension Security Act") was passed by the House of Representatives on April 11, 2002. The Senate is currently considering the NESTEG Bill, which has been approved by the Senate Finance Committee, and the Protecting America's Pensions Act of 2002 (S. 1992, also referred to as the "Kennedy Bill"), which has been passed by the Senate Health, Education, Labor, and Pensions Committee.

Diversification/Restrictions on Holding Employer Stock

The Pension Security Act would prohibit 401(k) plans from requiring participants to invest their elective deferrals and after-tax contributions in employer securities. In addition, where employer contributions are automatically invested in employer securities, participants would have to be given the opportunity to elect to diversify their investments in employer securities after the later of three years of service or after having held such securities for three years. Generally, ESOPs and plans that do not hold publicly-traded employer securities would be exempt from these requirements.

The diversification provisions of the NESTEG Bill and the Kennedy Bill are substantially similar to those contained in the Pension Security Act. The Kennedy Bill also provides that if employer contributions held in an individual account plan (other than elective deferrals) are required to be invested in employer securities, the plan may not also permit participant contributions to be invested in such employer securities unless the employer also maintains a traditional defined benefit pension plan.

Disclosure of Plan Benefits and Investments

The Pension Security Act would require that pension benefit statements be provided to participants in defined contribution plans (other than stand-alone ESOPs) on a quarterly basis. Participants in stand-alone ESOPs would have to receive a pension benefit statement at least annually. Participants in defined benefit plans would have to be provided a pension benefit statement at least once every three years.

A pension benefit statement would need to indicate the participant's total accrued benefits (both vested and unvested) and the portion that has become vested (or the earliest date on which benefits will become vested). Quarterly statements to participants in defined contribution plans would also need to contain the value of any assets held in the form of employer securities, an explanation of any limitations on participant-directed investments, a discussion of the importance of a well-balanced and diversified investment portfolio and the risk of holding more than 25% of a portfolio in the security of one entity (such as employer securities).

The Pension Security Act also would require the distribution of "investment education notices" that describe principles of risk management and diversification. The notices would

need to be provided to participants upon their enrollment in a plan and at least annually thereafter.

The plan benefits disclosure requirements of the NESTEG Bill and the Kennedy Bill are substantially similar to those in the Pension Security Act (described above), except that the Kennedy Bill does not require distribution of "investment education notices" and the plan benefit statement would only have to disclose the value of assets held in the form of employer securities (if any).

Provision of Investment Advice

The Pension Security Act would enable certain qualified investment advisors with a potential conflict of interest to provide investment advice to plan participants by creating an exemption from ERISA's prohibited transaction requirements. Under the terms of this exemption, companies would be required to disclose to participants the availability of third-party investment advisors and the potential conflicts of interest. The Pension Security Act would also permit employees to pay for "qualified retirement planning services" provided by a qualified investment advisor on a pre-tax basis.

Under current law, Section 404(c) of ERISA generally relieves retirement plan fiduciaries of liability for participant directed investment decisions if certain regulatory conditions are met. The NESTEG Bill would amend Section 404(c) to provide that the plan sponsor and administrator of an individual account plan must ensure that each plan participant is provided with all material investment information regarding investment of their plan accounts in employer securities. The NESTEG Bill would also provide safe harbor protection from ERISA's fiduciary duty provisions if a plan sponsor or other plan fiduciary chose to designate and monitor a qualified investment advisor.

The Kennedy Bill's provisions regarding investment advice are substantially similar to those contained in the NESTEG Bill (described above).

IV. Proposed Rule Changes for Listed and Publicly Traded Companies[1]

Shareholder Approval of Equity-Based Compensation Plans

NYSE - The NYSE has approved a rule change for its listed companies that (with limited exceptions) will require that any equity-compensation arrangement and any material revision to the terms of such an arrangement be subject to shareholder approval. The exceptions include employment-inducement options, option plans acquired through mergers and tax-qualified plans such as ESOPs and 401(k) plans. For the exceptions to apply, the grants under the plans must be subject to the approval of the company's compensation committee. In addition, treasury shares could no longer be used to avoid shareholder approval. Under the terms of this rule change, a broker would not be able to vote a customer's shares on any equity-compensation plan unless the broker has received that customer's specific instructions to do so.

NASDAQ - NASDAQ's proposal would require shareholder approval for all stock option arrangements (and any material modifications to such arrangements) in which officers or directors participate. Shareholder approval would not be required with respect to (1) inducement grants to new employees if such grants are approved by an independent compensation committee of the company's board of directors or a majority of a corporation's independent directors, (2) certain tax-qualified plans (*e.g.*, employee stock ownership plans) and (3) the assumption of pre-existing grants in connection with an acquisition or merger. Existing option plans will be unaffected under this proposal, unless a material modification is made to the plan.

SEC - Under the "ordinary business" provision of the Exchange Act's "shareholder proposal" rule, a publicly traded company may exclude shareholder proposals from its proxy materials if the proposals deal with a matter relating to the company's ordinary business operations. The SEC's Division of Corporate Finance has announced that, going forward, a public company may not rely on the "ordinary business" provision to omit from its proxy statement: (1) any proposal that focuses on equity compensation plans that may be used to compensate only senior executive officers or directors; and (2) any proposal that focuses on equity compensation plans that potentially would result in material dilution to existing shareholders, regardless of who participates in the plan.

Compensation Committees

The NYSE and NASDAQ have adopted rule changes affecting the composition and operation of compensation committees.

NYSE - The NYSE's proposal would require each of its listed companies to have a board-level compensation committee comprised solely of "independent" directors. For a director to be deemed "independent," the company's board of directors must affirmatively determine that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). In addition, no director who is a former employee of the listed company can be "independent" until five years after the employment ends. No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate of the auditor) can be "independent" until five years after the affiliation or the auditing relationship ends. No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed compa-

1 The rule changes proposed by the NYSE and NASDAQ must be approved by the SEC before becoming effective.

ny serves on the compensation committee of another company that concurrently employs the director. Directors with immediate family members in the foregoing categories are also subject to the five-year "cooling-off" provisions for purposes of determining "independence."

Unfortunately, the NYSE's definition of an "independent director" differs from both the definition of an "outside director" under Internal Revenue Code Section 162(m) (relating to the tax deductibility of performance-based compensation) and the definition of a "non-employee director" under Rule 16b-3 of the Exchange Act (relating to the short-swing profit recovery rules for insiders). NYSE-listed companies will need to review the membership of their compensation committees to ensure compliance with these various requirements.

The NYSE's proposal also mandates that each listed company adopt a written charter for its compensation committee. This charter must address the committee's purpose, duties, responsibilities, and an annual process for evaluating the performance of the compensation committee. Under this proposed rule change, the committee's purpose must be to discharge the board's responsibilities relating to compensation of the company's executives and to produce an annual report on executive compensation for inclusion in the company's proxy statement in accordance with applicable rules and regulations. In addition, the committee's duties and responsibilities include reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO's performance in light of those goals and objectives, setting the CEO's compensation level based on this evaluation, and making recommendations to the board with respect to incentive-compensation plans and equity-based plans. In order to facilitate the independence of the committee, the charter must give the committee the sole authority to retain and terminate its compensation consultants, including sole authority to approve the consultants' fees and other retention terms.

NASDAQ - NASDAQ has approved a change in its listing standards which will require that executive officer compensation be approved by either an independent compensation committee or by a majority of the independent directors. NASDAQ has also tightened its definition of "independence" by excluding certain executive officers of not-for-profit organizations related to the company, large shareholders, relatives of executives and employees of the outside auditor. This proposed change would prohibit a director from being deemed independent if any family member of the director is, or has been employed within the past three years, as an executive officer of the NASDAQ-listed company or its affiliates. In addition, a three-year "cooling off" period would apply to directors who are not independent due to either interlocking compensation committees or the receipt by the director or a family member of the director of any payments in excess of $60,000 other than for board service.

V. Stock Option Reform

Expensing of Stock Options

There are a number of bills currently pending in Congress which would require companies to record the expense of stock option grants on their financial statements in order to receive a tax deduction for such grants when they are exercised. It is unclear whether Congress will pass any of these this year. Debate on this issue has evolved rapidly, and while several companies (including Coca-Cola, Freddie Mac, Fannie Mae and Citigroup) have announced that they will voluntarily begin to expense their stock option grants, certain companies have announced that they will not follow suit (*e.g.*, Intel and Texas Instruments).

Exclusion of Stock Options from Employment Taxes

The NESTEG Bill and the Pension Security Act would provide an exclusion from FICA and FUTA for amounts realized on transfers of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock, but only if it otherwise qualifies for favorable tax treatment.

The Rank and File Stock Option Act of 2002 (S. 2877)

Senator Joseph Lieberman (D-CT) has authored a bill which would promote broad-based option plans. Companies would be prohibited from claiming tax deductions when options are exercised if at least half of the total available stock options are not offered to employees making less than $90,000 annually. The bill also directs the SEC to finalize rules requiring majority shareholder approval of every stock option and stock purchase plan.

VI. Miscellaneous Provisions Affecting Employee Benefits and Executive Compensation

Tax on Bonuses and Commissions in Excess of $1 Million

The NESTEG Bill would increase the withholding rate on bonuses and commissions to employees to the highest income tax rate (38.6% for 2002) to the extent that such payments to an employee exceed $1 million in any year. Under current law, bonuses or commissions are subject to withholding based on the third lowest income tax rate under the Code (27% for 2002).

Excise Tax on Inversion Transactions

ACCAA would implement requirements affecting executive compensation to curb corporate restructuring in non-U.S. jurisdictions, like Bermuda. Under the bill, officers, directors

and ten percent owners of both private and publicly-held corporations would be subject to an excise tax of 20% on the value of all stock options and stock-based compensation held when a new non-U.S. corporation replaces the existing U.S. parent corporation as the parent of the corporate group (commonly referred to as an "inversion transaction").

Provisions of Pending Bankruptcy Legislation Affecting Employee Benefit Plans

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, designed to revamp the nation's bankruptcy laws, passed both the House and Senate on March 1, 2001 and March 15, 2001, respectively. The bill in its current form is published as H.R. 333 (Conference Report: H. Rept. 107-617). The bill has not yet been signed into law, but is expected to pass this session.

The applicable provisions of the bill generally shield a debtor's retirement plan assets from creditors in bankruptcy proceedings. The bill protects a participant's benefits under most tax qualified pension, profit-sharing and stock bonus plans, tax-sheltered annuities and 403(b) plans, Roth IRAs, and governmental and tax-exempt employer plans from creditors, provided that the plan has a favorable determination letter from the IRS or has been operated in substantial compliance with the Internal Revenue Code and not been found by a court or IRS to be in violation of applicable qualification rules.

Under the bill, a debtor's IRA assets would be protected from creditors in bankruptcy, up to a $1 million cap. Amounts over this level would be made available to satisfy creditors. Monies in the process of being rolled over are also protected under the legislation.

In addition to the protection of assets in retirement funds, the pending legislation would enable participants to continue to repay loans made under a pension, profit-sharing, stock bonus, or other plan established under the Internal Revenue Code after they have filed for bankruptcy.

Conclusion

The provisions of the Sarbanes-Oxley Act described in this Client Alert require the immediate attention of corporate officers and directors. The proposed legislation and rulemaking outlined above could have even a greater impact on both employee benefits and executive compensation than the Sarbanes-Oxley Act. We are actively monitoring events affecting employee benefits and executive compensation.

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Client Alert

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