

# Employee Benefits Update

## SARBANES-OXLEY ACT: EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION ASPECTS

The Sarbanes-Oxley Act of 2002 (the "Act"), signed into law by President Bush on July 30, 2002, primarily addresses corporate governance and accounting matters. The Act, however, contains a number of provisions that affect executive compensation and employee benefits, including:

- Executive Compensation – Accelerated Insider Reporting Rules
- Executive Compensation – Forfeiture of Certain Bonuses and Profits
- Executive Compensation – Personal Loan Restrictions
- Executive Compensation and Employee Benefits – Defined Contribution Plan Blackout Period Restrictions and Notices
- Employee Benefits – ERISA Criminal Penalties

*The Act's provisions generally became effective as of the enactment of the law on July 30, 2002. The Act's provision relating to accelerated insider reporting rules became effective as of August 29, 2002. The Act's provisions regarding the blackout period restrictions are effective as of January 26, 2003.*

The Act uses the term "issuer" rather than company or corporation. The Act defines "issuer" by referring to the definition of issuer under the Securities Exchange Act of 1934. For convenience, we use the term "company" rather than "issuer." If you are uncertain whether your business falls within the scope of the Act, you should contact us.

### Executive Compensation – Accelerated Insider Reporting Rules

The Act significantly changed the reporting requirements under Section 16 of the Securities Exchange Act of 1934 for directors, executive officers and 10% shareholders of public companies. These insiders (sometimes called Section 16 officers) are now required to file their Form 4 reports by the second business day after execution, instead of by the tenth day of the month following the month in which the transaction occurs. They are also required to report on Form 4 many of the transactions that were previously eligible for deferred reporting on Form 5, including employee benefit transactions such as stock option

grants and other acquisitions of derivative securities. The Act's two-day filing requirement is effective for transactions occurring on or after August 29, 2002.

Public companies that offer employer stock as an investment feature in their 401(k) plans should pay particularly close attention to fund switching by their insiders involving company stock to avoid Section 16 reporting violations. In addition, most transactions involving company stock, phantom stock or other derivative securities in nonqualified plans will also trigger accelerated reporting requirements. These companies should notify their insiders of the new two-day filing requirement and should assess the adequacy of their internal compliance procedures quickly, since pre-existing compliance programs will be obsolete.

### Executive Compensation – Forfeiture of Certain Bonuses and Profits

The Act requires CEOs and CFOs to forfeit bonuses and profits if the company is required to restate its financial statements. The CEO and CFO must reimburse the company for the following:

- *Bonuses.* Bonuses received in the 12 months following the release of the financial statement.
- *Incentive compensation.* Incentive-based or equity based compensation in the 12 months following the release of the financial statement.
- *Stock profits.* Profits from the sale of corporate stock realized in the 12 months following the release of the financial statement.

The Act's forfeiture provisions became effective on July 30, 2002.

### Executive Compensation – Personal Loan Restrictions

The Act makes it unlawful for a company "directly or indirectly, including through a subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that [company]." The prohibition covers not only traditional loans; it appears to cover guarantees of third-party loans. The ban could be interpreted to prohibit the following company loans to directors and executive officers:

- Broker-assisted cashless stock option exercises.
- Stock issued on credit.
- Home mortgage or relocation loans.
- Tax loans.

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- Split-dollar life insurance.
- Leverage ESOPs.
- Retirement plan loans.

As noted, due to the breadth of the prohibition, the ban appears to prohibit retirement plan loans to directors and executive officers. At the same time, ERISA requires that loans be available to all participants and beneficiaries on a reasonably equivalent basis. To date, there has been no guidance on these conflicting provisions. Until guidance is available, companies should advise directors and executive officers that the company would violate the Act if it permits them to obtain a loan from the retirement plan. Note: We recommend that companies do not amend their retirement plan loan provisions to prohibit loans to directors and executive officers until guidance has been issued. The Act's prohibition on personal loans became effective on July 30, 2002.

A violation of the prohibition on personal loans is a violation of the Securities Exchange Act. The Act substantially increased the criminal penalties for violations of the Securities Exchange Act.

- *Individual monetary penalties.* The Act raised the maximum monetary penalty for individuals from \$1 million to \$5 million.
- *Individual criminal penalties.* The Act raised the maximum prison sentence for individuals from 10 years to 20 years.
- *Corporate monetary penalties.* The Act raised the maximum monetary penalty for corporations from \$2.5 million to \$25 million.

The increased criminal penalties became effective on July 30, 2002.

### **Executive Compensation and Employee Benefits – Defined Contribution Plan Blackout Period Restrictions and Notices**

In what appears to be a reaction to ENRON abuses, the Act prohibits insider trading during blackout periods for 401(k) plans and other defined contribution retirement plans. The Act also requires plan administrators to provide notice to participants regarding such blackout periods. The Act provides distinct definitions of “blackout period” for each of these requirements.

#### *Participant Notice*

The Act requires the plan administrator, which is usually the company sponsoring the plan, generally to issue a notice to participants at least 30 days in advance of a blackout period. For the purpose of this requirement, the Act defines a “blackout

period” as “any period of more than 3 consecutive business days” during which the ability of the participants or beneficiaries to direct or diversify assets, obtain loans, or obtain distributions is temporarily suspended. Exceptions include a blackout period due to a corporate merger or similar transaction and any regularly scheduled blackout period that has been disclosed to the participants.

The notice to participants must provide the following information:

- The reasons for the blackout period.
- The expected beginning date.
- The length of the blackout period.
- The investments and rights affected.
- A statement that participants and beneficiaries should evaluate whether their investments are appropriate given that they will not be able to change investments during the blackout period.
- Such other matters as may be required by future regulation.

The company must provide the notice to participants in writing or in electronic form “to the extent such form is reasonably accessible to the recipient.” It seems likely that any regulations the Department of Labor issues will refer to the regulations governing the electronic distribution of other materials. If there is a change to the starting date or length of the blackout period after the company provides the notice, then the company must provide notice of the change as soon as reasonably practicable. The Act provides that the Department of Labor may impose monetary penalties for failure to issue the notice. The Act permits a penalty of \$100 per day, starting as of the date the notice should have been issued, for each participant and beneficiary who does not receive a notice.

#### *Insider Trading*

The Act also prohibits directors and executive officers from directly or indirectly purchasing, selling, acquiring, or otherwise transferring during a blackout period any equity security of the company which the director or executive officer acquired in connection with his or her service with the company. For the purpose of this requirement, the Act defines a “blackout period” as “any period more than 3 consecutive business days during which the ability of not fewer than 50 percent of the participants or beneficiaries” of the company’s defined contribution plans to purchase, sell, or transfer equity interests in the company is

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temporarily suspended. Exceptions include a blackout period due to a corporate merger or similar transaction and any regularly scheduled blackout period that has been disclosed to the participants.

The Act requires the company to notify the directors, executive officers, and the Securities and Exchange Commission of the blackout period. The Act's remedy for violation of this prohibition is for the director or executive officer to disgorge to the company any profit. Shareholders may bring derivative suits to enforce this remedy.

#### *Department of Labor Guidance and Effective Date*

The Act requires the Department of Labor to issue initial guidance and a model notice by January 1, 2003. In addition, the Act requires the Department of Labor to issue interim regulations by October 13, 2002. The Act's prohibition on insider trading during blackout periods and notice requirements become effective on January 26, 2003.

#### **ERISA Criminal Penalties**

The Act substantially increased the criminal penalties for violations of ERISA.

- *Individual monetary penalties.* The Act raised the maximum monetary penalty for individuals from \$5,000 to \$100,000.
- *Individual criminal penalties.* The Act raised the maximum prison sentence for individuals from one year to ten years.
- *Corporate monetary penalties.* The Act raised the maximum monetary penalty for corporations from \$100,000 to \$500,000.

The increased criminal penalties became effective on July 30, 2002.

#### **Conclusion**

The Sarbanes-Oxley Act accelerates certain reporting requirements for transactions involving company stock and permits severe penalties to be imposed on directors and executive officers for a variety of violations. In addition, the Act imposes new notice requirements for defined contribution plan blackout periods. Companies should closely monitor their plans and work with plan service providers to develop a compliance strategy. The Act, however, may be only a beginning to changes that will be made this year to the laws governing retirement plans and

executive compensation. Several bills pending before Congress contain proposed provisions that address investment advice, limit participant investment in company stock, and make other changes to laws governing retirement plans.

If you have questions relating to the Sarbanes-Oxley Act or implementing notices for blackout periods, please contact the attorney you work with in the Employee Benefits Department. You can also call Mike Punt, our department's Communications Coordinator, at 612-340-2867 to be connected to an attorney.

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