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Employee Benefits and Executive Compensation Issues in the Sarbanes-Oxley Act of 2002

In the wake of recent corporate scandals such as Enron, Adelphia and WorldCom, Congress recently passed corporate reform legislation. The Sarbanes-Oxley Act of 2002, also referred to as the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002, (the "Act") was signed into law by President George W. Bush on July 30, 2002. Among other things, the Act creates an oversight board to monitor the accounting industry, provides more money for the Securities and Exchange Commission (the "SEC") to help defrauded investors and increases penalties for corporate fraud. The Act also contains provisions that will affect employee benefits and executive compensation. These provisions are discussed below.

I. Blackout Periods.

a. Notice. At least thirty days in advance of a blackout period with respect to an individual account plan (certain one participant plans are exempt), the Act requires that plan administrators provide a written notice to participants and beneficiaries setting forth: (1) the reasons for the blackout period, (2) the investments and other rights affected by the blackout period and (3) the estimated beginning date and length of the blackout period. The notice must be written in a manner that would be understood by the average participant, and also must contain a statement that the participant or beneficiary should evaluate the appropriateness and diversity of their current investment decisions in light of the blackout period. The notice may be provided in electronic or other form if such form is reasonably accessible to the recipients. If the beginning date or length of a blackout period changes after the notice is provided, then the plan administrator must provide notice to participants and beneficiaries of such change as soon as reasonably practicable.

For purposes of the notice requirement, the term "blackout period" includes any period of more than three consecutive business days that temporarily suspends, limits or restricts the ability of participants or beneficiaries under the individual account plan to direct or diversify assets held in their accounts, to obtain plan loans or to obtain distributions. Certain situations will not be treated as blackout periods, including situations that occur by reason of (1) restrictions that are incorporated into the plan and properly disclosed to participants and beneficiaries, (2) the application of securities laws or (3) the receipt of a qualified domestic relations order.

An exception to the minimum 30-day notice period requirement is available in limited circumstances where: (1) a plan fiduciary determines in writing that deferring the beginning of the blackout period would violate ERISA's fiduciary standards or (2) a plan fiduciary determines in writing that the inability to provide the notice at least thirty days prior to the start of the blackout period is due to unforeseeable events or circumstances beyond the plan administrator's control. In these cases, the notice must be provided as soon as reasonably possible (unless a notice in advance of the blackout period is impracticable). Further guidance is needed in order to identify the circumstances under which a fiduciary may determine one of the above exceptions is applicable.

A special exception is available in connection with a merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor. The Act provides that when the blackout period applies only to one or more participants or beneficiaries in connection with such a merger, acquisition, divestiture or similar transaction and occurs solely in connection with becoming or ceasing to be a participant or beneficiary under the plan, the notice only is required to be provided to those participants or beneficiaries affected by the blackout period and must be provided to them as soon as reasonably practicable.

In order to enforce the notice provisions, the Act amends the Employee Retirement Income Security Act ("ERISA") by imposing a civil penalty against the plan administrator of up to $100 a day from the date of the plan administrator's failure or refusal to provide the notice; each failure with regard to a single participant or beneficiary is regarded as a separate failure. The effective date of this notice provision is 180 days from the date of the Act's enactment (or January 26, 2003). The Act requires the Department of Labor to issue interim final rules not later than 75 days after enactment (or October 13, 2002), and also requires the Department to issue initial guidance and a model notice before January 1, 2003.

b. Insider Trading. The Act generally prohibits any director or executive officer of an issuer (i.e., a publicly traded company) from directly or indirectly purchasing, selling or transferring any equity security of the issuer acquired in connection with his or her service or employment during any blackout period.[1] The Act does not specifically exempt from the prohibition against insider trading during a blackout period transactions made pursuant to an arrangement under Section 10b-5 of the Securities Exchange Act of 1934 (the "Exchange Act") established on behalf of an executive or director. It is not clear whether Congress intended to impact Section 10b-5 plans in this manner and further guidance may address this issue. It also is not clear whether the employer will have any burden to monitor compliance or ensure compliance. Specific burdens may be imposed on the employer through rules issued by the SEC in consultation with the Department of Labor. The Act specifically directs the SEC to issue rules to clarify the application of these requirements and to prevent evasion, and also authorizes the SEC to create exceptions to the general prohibition.

For this purpose, the term "blackout period" is defined to mean any period of more than three consecutive business days during which the ability of fifty percent or more of the participants or beneficiaries to purchase, sell or otherwise acquire or transfer interest in any equity of such issuer held in an individual account plan (once again certain one participant plans are exempt) is temporarily suspended by the issuer or a fiduciary of such plan.[2] The Act excludes from the definition of blackout period any regularly scheduled restriction or suspension periods that are incorporated into the plan and that are timely disclosed to the employees either before beginning participation or through a subsequent amendment. The Act also excludes any suspension or restriction that is imposed solely in connection with individuals becoming or ceasing to be participants or beneficiaries under a plan by reason of corporate merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor.

The issuer of the equity securities is obligated to notify affected directors and executive officers about the occurrence of a blackout period, and also is obligated to notify the SEC of the same.

If the insider trading provision of the Act is violated, any profit realized by a director or executive officer inures to and is recoverable by the issuer, irrespective of any intent to violate the Act. If the issuer fails or refuses to bring an action to recover profits earned by a director or officer in violation of the insider trading provisions within sixty days of a request to do so or if the issuer fails to diligently prosecute such action, the Act provides that an action to recover the profits may be brought by the owner of any security of the issuer in the name and on behalf of the issuer. The Act imposes a two-year statute of limitations on such actions.

The effective date of this provision is 180 days after the date of the Act's enactment or January 26, 2003.

II. Prohibition on Personal Loans to Officers and Directors.

Generally, the Act amends the Exchange Act to prohibit any issuer, directly or indirectly (including through any subsidiary of such issuer), from 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 director or executive officer of the issuer. However, personal loans maintained on the date of the enactment, July 30, 2002, are grandfathered so long as there are no material modifications to the terms of the loan or renewal of the loan on or after enactment.

Generally, an issuer may make loans to executive officers and directors only to the extent that such loans are (1) made in the ordinary course of the issuer's consumer credit business, (2) generally made available by the issuer to the public and (3) made on market terms that are no more favorable than those offered by the issuer to the general public. Certain loans from regulated banks and thrifts are exempt.

These new limitations severely curtail an issuer's ability to make personal loans to its directors and executive officers. Each employer who is an issuer should review all of its loan arrangements with its executive officers and directors, if any. Questions have arisen as to whether these new restrictions apply to split-dollar life insurance arrangements, and whether the rules relate to cashless exercise programs under stock-based compensation programs and participant loans under retirement plans.

The Act does not contain effective date provisions relating to the new loan rules. Accordingly, it generally is assumed that the new rules are effective upon the date of the Act's enactment, July 30, 2002.

III. Penalties for Violations of ERISA.

The Act increases the criminal penalties imposed under Section 501 of ERISA for violations of reporting and disclosure rules. The maximum penalty that can be imposed on an individual upon conviction increases from $5,000 to $100,000, and the maximum penalty that can be imposed on a person other than an individual upon conviction increases from $100,000 to $500,000. The maximum length of imprisonment for an individual upon conviction also increases from one year to 10 years. These changes appear to be effective as of the date of the Act's enactment.

IV. Section 16 Reporting Obligations.

The Act modifies the reporting requirements under Section 16 of the Exchange Act. As currently written, Section 16(a) of the Exchange Act requires a Section 16 insider (i.e., a director, officer or beneficial owner of more than 10% of an issuer's equity securities as defined under the Exchange Act) to report certain nonexempt transactions that result in changes in ownership of an issuer's equity securities within ten days after the close of each calendar month; these monthly reports are filed on a Form 4. Certain exempt transactions can be reported currently on a Form 5 within 45 days after the end of the issuer's fiscal year end or, alternatively, can be reported earlier on a Form 4. Under the Act, the reporting period has been shortened for some or all of these transactions to the second business day following the day on which the transaction occurred.

The language used in the Act regarding the acceleration of a Section 16 insider's reporting obligations is unclear as to whether or not the new two-day reporting requirement applies to exempt transactions. However, the SEC recently issued guidance on August 6, 2002 (Release No. 34-46313) stating that the new reporting requirements set forth in the Act apply, with few exceptions, to all transactions involving an issuer's securities, whether or not those transactions are exempt. The SEC is considering extending the Form 4 reporting deadlines for a narrow range of transactions, including discretionary transactions involving employee benefit plans and certain transactions relating to pre-existing arrangements the timing of which are outside the knowledge of the insider before confirmation of the transaction is received by the insider. In these narrow exceptions, the SEC apparently will key the timing of the reporting to the notice of the transaction received by the insider. It is yet unclear how the timing for the reporting will be determined. In light of the new reporting requirements and the SEC's recent guidance, it appears the use of Form 5 will be discontinued.[3]

Within one year after the enactment of the Act (July 30, 2003), Forms 3, 4 and 5 (in the unlikely event that a Form 5 filing obligation remains) must be filed electronically. Currently, Section 16 insiders have the choice of filing such reports either electronically or in paper format.[4] Within one year after the enactment of the Act, the SEC is required to provide such reports on a publicly accessible internet site not later than the end of the business day following the date of the filing. In addition, the issuer must make such reports available on its corporate website (provided it maintains a corporate website) not later than the end of the business day following the date of filing.

The new reporting rules are effective 30 days after the date of enactment of the Act (or August 29, 2002). It is unclear whether transactions that occur before the effective date but that have not been reported by this date are subject to the new rules.

V. **Corporate Responsibility for Financial Reports**.

The Act requires that the principal executive officer(s) and the principal financial officer(s) of the issuer (or persons performing similar functions) assume increased responsibility for the information provided in annual or quarterly reports filed or submitted pursuant to section 13(a) or 15(d) of the Exchange Act, such as Form 11-K filed for certain employee stock purchase plans and individual account plans that invest in employer stock. In each such report the officers must certify that, among other things, they have reviewed the report and that, to their knowledge, the information contained therein is not untrue or misleading. This certification rule is to become effective no later than August 29, 2002.

The Act also amends the United States Code to provide for criminal penalties for corporate officers who fail to properly certify each periodic report containing financial statements that are filed pursuant to section 13(a) or 15(d) of the Exchange Act. The maximum fine ranges from $1 million to $5 million and the maximum prison term ranges from 10 to 20 years, depending on whether the officer "willfully" certifies a report that does not comport with the requirements of section 13(a) or 15(d).

VI. **Forfeiture of Bonuses and Profits**.

If the issuer is required to prepare an accounting restatement due to material noncompliance, as a result of misconduct, with any financial reporting requirement under the securities laws, then the chief executive officer and chief financial officer are required to reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC (whichever occurs first) of the financial document embodying such financial reporting requirement and (2) any profits realized from the sale of securities of the issuer during that 12-month period.

VII. **Auditor Independence**.

The Act prohibits a registered public accounting firm (and any associated person of that firm) that performs any audit of the issuer to provide, contemporaneously with the audit, any non-audit services, including the following:

(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

(2) financial information systems design and implementation;

(3) appraisal or valuation services, fairness opinions or contribution-in-kind reports;

(4) actuarial services;

(5) internal audit outsourcing services;

(6) management functions or human resources;

(7) broker or dealer, investment adviser or investment banking services;

(8) legal services and expert services unrelated to the audit; and

(9) any other service that the Oversight Board (established by the Act) determines, by regulation, is impermissible.

The Act further provides that a registered public accounting firm may engage in any non-audit services, including tax services, that are not described above, but only if the activity is approved in advance by the audit committee of the issuer.

The audit committee pre-approval requirement for non-audit services is waived under the Act if:

(1) the aggregate amount of all such non-audit services constitutes not more than five percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the non-audit services are provided;

(2) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and

(3) such services are promptly brought to the attention of the audit committee of the issuer and approved by the audit committee (or by one or more members of the audit committee who are members of the board of directors and to whom authority to grant such approvals has been delegated by the audit committee prior to the completion of the audit).

The Act also requires that all approved non-audit services performed by the auditor of the issuer to be disclosed to investors in periodic reports required by section 13(a) of the Exchange Act.

This provision of the Act may affect the range of non-audit services that an issuer's accounting firm may perform for its employee benefit plans. However, there is much uncertainty about the type of services that actually will be prohibited. The extent of the impact will depend, in part, on how broadly the term "tax services" is defined. If the term "tax services" is defined narrowly and certain projects currently performed by accounting firms fall within the prohibited list, then the issuer's accounting firm would be prohibited from performing such work altogether. In any case, any such consulting work that the accounting firm does with respect to a plan presumably now will require approval of the company's audit committee and disclosure to the investors.

If you have any questions or comments regarding this HR Bulletin, please call Richard P. McHugh at 202-776-2540 or any member of the CERB group listed on our website http://www.dowlohnes.com.

[1] It is important to realize that this trading restriction does not seem to apply to equity securities that an affected director or executive officer holds that were not acquired in connection with his or her service or employment.

[2] Note that the definition of a "blackout period" for the purpose of the insider trading restriction is not identical to the broader definition used for purposes of the notice requirement, as outlined above.

[3] With the changes made by the Act and the SEC's recent guidance, it is uncertain how transactions that have occurred before the Act's enactment that were to be reported on a Form 5 after the end of a company's current fiscal year will be reported. If these transactions all have to be filed as of a date close to the effective date of the new reporting requirements (August 29, 2002), companies will have a lot of work to do in a short period of time to get these filings done on a timely fashion.

[4] Prior to the enactment of the Act, the SEC had indicated that it would require all Section 16 reports to be filed electronically in the near future. Thus, most Section 16 insiders already had anticipated this change.