

# Executive Compensation, Benefits, Employment and Labor Focus

March 2010

## DOL "Re-Proposes" Investment Advice Rules; Eliminates Class Exemption

On February 26, 2010, the Department of Labor ("DOL") re-proposed regulations that would implement the statutory exemption for the provision of investment advice to participants and beneficiaries in participant-directed retirement plans (such as 401(k) plans) and individual retirement accounts ("IRAs"), which was enacted as part of the Pension Protection Act of 2006 ("PPA"). The PPA exemption and the proposed regulation generally seek to make professional investment advice more accessible to participants and beneficiaries of individual account plans by permitting a broader array of investment advice providers to offer their services.

### Background

**Plan Participants.** Participant-directed retirement plans provide an opportunity for participants and beneficiaries to select the manner in which the assets in their accounts are invested, typically through the offering of a broad range of investment alternatives. The DOL determined, however, that many individuals in such plans have made poor investment decisions that resulted in higher investment fees, poorly timed trading and/or inadequate diversification.

**Investment Advisers.** A "prohibited transaction" generally arises when an investment adviser provides investment advice to a plan participant or beneficiary with respect to a plan investment offering that pays the adviser fees and, pursuant to such advice, the plan participant or beneficiary makes investments that generate additional income for the investment adviser. In the absence of a statutory or administrative exemption, the prohibited transaction restriction under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and related sanctions under the Internal Revenue Code of 1986, as amended (the "Code"), generally precluded conflicted investment advisers from offering investment advice to plan participants and beneficiaries, other than in certain circumstances specifically permitted by the DOL in Interpretive Bulletins or Advisory Opinions. For example, the DOL has issued guidance indicating that (a) investment "education" is not investment advice, (b) the investment advice function can be outsourced to an independent financial expert and (c) certain reductions of investment adviser fees through "fee-offset" approaches can eliminate a prohibited transaction concern.



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**Statutory Exemption.** Responding to the need to afford participants and beneficiaries with greater access to professional investment advice, the PPA created a new statutory prohibited transaction exemption that allows greater flexibility for investment advisers to render investment advice to plan participants and beneficiaries. One of the ways in which investment advice may be provided under the exemption is through the use of a “computer model” that has been certified by an eligible investment expert as unbiased. The other way is through an investment adviser that is compensated on a “level-fee” basis, where the investment adviser’s fees do not vary depending on the investment option selected.

**Implementing Regulations.** In early 2009, during the last days of the Bush Administration, the DOL published final regulations that implemented the statutory prohibited transaction exemption under ERISA and the Code, and permitted an administrative class exemption that granted additional relief under circumstances not encompassed in the statutory exemption. Unlike the statutory exemption, the class exemption (1) permitted investment advisers to provide investment advice “after” the recommendations were generated from a computer model, thereby allowing such advice to vary from that generated by the computer model in a manner that could result in greater income for the investment adviser; and (2) applied the fee-leveling rules solely to employees, agents and registered representatives providing advice on behalf of the investment adviser, and not to the investment adviser as an entity. Concerned that the class exemption would result in “conflicts of interest” for investment advisers, the DOL deferred, and, in November 2009, ultimately withdrew those regulations and the administrative exemption.

## New Proposed Regulations

The newly proposed regulations, which are nearly the same as the withdrawn regulations, provide guidance on the statutory exemption’s requirements with respect to fee-leveling arrangements and computer model certification. However, they do not provide for the class exemption. Therefore, there is no prohibited transaction exemption for investment advice given after a participant or beneficiary has been provided with a recommendation generated by a computer model. These requirements are summarized below.

### Fee Leveling Arrangements

Under a fee-leveling arrangement, no investment adviser (including any employee, agent or registered representative) that provides investment advice may receive from any party (including an affiliate of the investment adviser) any fee or compensation that

is based on a participant’s selection of an investment option. Further, the advice must—

- be based on generally accepted investment theories;
- take into account fees and expenses related to the recommended investments; and
- take into account, to the extent provided to the investment adviser, participant information relating to age, time horizon (e.g., life expectancy, retirement age), risk tolerance, current investments in the plan’s offerings, other assets or sources of income and investment preferences.

#### Observation

In the proposed regulations, the DOL diverged from the wording in the withdrawn regulations to further clarify that the fee-leveling requirement does not extend to affiliates of the investment adviser. Accordingly, an affiliate of the investment adviser may receive fees that vary depending on the investment options selected by a participant or beneficiary, but none of those fees may be passed onto the investment adviser or any of its employees, agents or registered representatives.

### Computer Model Arrangements

Investment advisers may provide investment advice by way of a computer model that is designed and operated to—

- apply generally accepted investment theories;
- take into account fees and expenses related to the recommended investments;
- request information from participants and beneficiaries and, to the extent furnished, utilize such provided information;
- take into account all investment options under the plan (without giving inappropriate weight to any investment option), and utilize appropriate objective criteria to provide asset allocation portfolios comprised of the plan’s investment offerings;

#### Observation

The computer model need not take into account investment options designed to invest in employer stock, target-retirement-date funds, annuities or brokerage windows.

- avoid investment recommendations that inappropriately favor investment options offered by the investment adviser or generate greater income for the investment adviser; and

- avoid investment recommendations that inappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future.

#### Observation

This provision, which was not included in the withdrawn regulations, imposes a limitation on the ability to rely on historical performance, which could result in a significant change to the appropriate criteria generally applied for recommendations of asset allocation. The DOL explained that differences in historical performance are less likely to persist than differences in investment style and fees, and therefore less likely to constitute appropriate criteria for asset allocation. Notably, if past investment performance is not considered an appropriate criterion, recommendations of computer models will seemingly tend to be based, in large part, on low fees and expenses, regardless of historical performance.

Before making the computer model available to plan participants and beneficiaries (following its initial development or substantive modifications made thereto), the investment adviser must obtain written certification from an “eligible investment expert” that the computer model meets the statutory and regulatory requirements (with an explanation of the methodologies applied to reach this conclusion). An “eligible investment expert” is an individual, independent of the investment adviser, who has the appropriate technical training or experience and proficiency to analyze, determine and certify whether the computer model meets the necessary requirements.

#### Observation

The DOL does not specify the credentials necessary to qualify as an “eligible investment expert.” However, the investment adviser has a duty to prudently select an expert to certify its computer model.

### Additional Requirements

Several other requirements must be satisfied with respect to the fee-leveling requirement and the computer model arrangement.

*Authorization by a plan fiduciary.* A plan fiduciary, other than the investment adviser, must expressly authorize the investment advice arrangement.

*Annual audits.* The investment adviser must annually engage an independent auditor to audit the investment advice arrangements for compliance and, within 60 days following completion of the audit, issue a written report to the investment adviser (and each fiduciary who authorized the use of the investment

advice arrangement) setting forth the specific findings regarding compliance.

#### Observation

Similar to the eligible investment expert, the investment adviser must prudently select an independent auditor.

**Disclosure.** Prior to rendering advice, the investment adviser must furnish a plan participant or beneficiary with a written notice that includes the following: the role of the parties involved in the development of the investment advice program and selection of investment options available under the plan, all fees or other compensation that the investment adviser or any affiliate is to receive in connection with the advice and several other requirements set forth in the proposed regulations. A model disclosure that may be used by investment advisers accompanies the proposed regulations.

**Record Retention.** The investment adviser must maintain, for a period of at least six years after the provision of investment advice, any records necessary for determining whether the applicable statutory and regulatory requirements have been met.

### Noncompliance

In the event of noncompliance with the proposed regulation, the statutory exemptive relief from the prohibited transaction rules would not apply to the transactions associated with the applicable investment advice. Also, in the case of a pattern or practice of noncompliance, the exemptive relief would not apply to any transaction in connection with the provision of investment advice during the entire period over which the pattern or practice extended.

### Effective Date

The proposed regulations will be effective 60 days after publication of the final regulations. Public comments with respect to the proposed regulations are due by May 10, 2010.

### Conclusion

The proposed regulations do not require plans to make investment advice available to plan participants and beneficiaries. Rather, the proposed regulations outline approaches for providing investment advice to participants and beneficiaries of participant-directed retirement plans in accordance with the statutory exemption. Notably, the proposed regulations do not invalidate any existing DOL guidance pertaining to acceptable existing means of providing investment advice. Please contact White & Case if you have any questions or concerns regarding how plans may provide investment advice under the statutory exemption or existing DOL guidance.

# IRS Audit Initiative Signals Greater Government Scrutiny of Employment Tax and Worker Classification Compliance

This month, the Internal Revenue Service (IRS) is expected to begin comprehensive employment tax compliance audits targeting approximately 2,000 randomly selected employers per year over a three-year period. The employers audited under this initiative are expected to constitute a representative sample of all employers, including large and small businesses, as well as tax-exempt organizations. One of the stated goals of this audit initiative is to enable the IRS to better compute the “tax gap,” which is the difference between the amount of taxes owed and the amount actually collected. Another stated goal is to enable the IRS to better focus on the most noncompliant employment tax areas. This significant audit initiative almost certainly signals enhanced IRS enforcement in the employment tax area with consequences extending far beyond the approximately 6,000 employers initially selected for audit over the next three years.

It appears that the IRS will focus on at least four general areas:

- **Worker classification.** Whether a worker is an employee or independent contractor (and, if he or she is an employee, in some cases, such as “professional employer organization” (PEO) or leased employee arrangements, who is the employee’s employer?) has significant employment tax and labor law implications, including, among other things, the following:
  - Employers are required to withhold and promptly remit income tax, withhold and promptly remit the employer’s and employee’s shares of Social Security and Medicare contributions (FICA) and pay federal unemployment taxes (FUTA) on wages paid to employees.
  - Employers are required to timely report employment taxes to the government and furnish information returns to employees concerning their wages, employment tax withholdings and other information.
  - Employees may be eligible for benefits under whatever employee benefit plans the employer maintains.
  - Proper testing of an employer’s tax-qualified retirement plans for compliance with nondiscrimination and other qualification rules under the tax code requires that the employer’s employee group be accurately identified.
  - Employers must comply with minimum wage and

overtime laws, laws prohibiting discrimination in employment and unemployment insurance and workers’ compensation laws.

Worker classification determinations can require a surprisingly complicated and fact-intensive analysis. Although courts and governmental agencies apply multifactor tests, and there is no universal test for all legal purposes (e.g., a different test may be applied for employment tax purposes than that for minimum wage and overtime law purposes), the classification of each worker generally depends on the extent to which the employer/ service recipient reserves the right to direct and control the details and means by which the worker accomplishes the results of his or her work.

The significance of the IRS audit program is reinforced by a recent General Accountability Office (GAO) report recommending, among other things, that the IRS, US Department of Labor, other federal agencies and state agencies enhance their coordination and information sharing in addressing worker misclassification issues. The IRS will certainly give close scrutiny to all the facts and circumstances relevant to an employer’s classification of workers as employees or independent contractors.

- **Fringe benefits.** Fringe benefits are property or services provided to an employee in lieu of or in addition to cash wages, (e.g., life insurance or use of a company car or aircraft). Fringe benefits are generally taxable income for an employee unless they meet the requirements of a specific exclusion under the tax code. Where an employer treats a fringe benefit as nontaxable, IRS agents conducting these audits can be expected to verify whether the applicable tax code requirements have been satisfied.
- **Employee business expense reimbursements.** Payments made by an employer to reimburse employees for business expenses are not considered wages subject to employment taxes if they are made under an “accountable plan.” An accountable plan generally requires that: (1) such expenses have a business connection to the employer, (2) the employee submits to the employer evidence substantiating such expenses and (3) any reimbursements that exceed such substantiated expenses are returned to the employer within a reasonable time. IRS agents conducting these audits can be expected

to confirm that these requirements have been satisfied for payments to employees that an employer treats as nontaxable business expense reimbursements.

- **Compensation of owner-employees and executive compensation generally.** Another area on which the IRS may focus is the reasonableness of compensation paid to employees who are also owners of closely-held corporations. There are no precise standards for reasonableness of compensation paid to owner-employees, which are taxed as wages and subject to employment taxes, and dividends or distributions paid to such owner-employees, which may be taxed at a lower rate and are not subject to employment taxes. Additionally, especially in light of the IRS's more limited executive compensation compliance audit initiative five years ago, as well as changes in executive compensation-related tax laws since then, the IRS can be expected to look at executive compensation tax compliance generally (to the extent not already covered by the areas of focus identified above, and whether or not involving owner-employees), including nonqualified deferred compensation, stock-based compensation, the US\$1 million deductible compensation cap for public companies and golden parachutes.

In addition to these areas of focus, employers should also expect IRS agents to conduct a general review of the completeness and accuracy of the employer's Forms W-2, calculation of withholdings, compliance with backup withholding requirements for payments to independent contractors reported on Form 1099 without a

corresponding taxpayer identification number and timeliness of tax deposits and reports.

The IRS's employment tax audit initiative certainly signals greater scrutiny on employment tax compliance not only for those employers selected for audit under the initiative but also for all other employers in the future. All employers should consider reviewing their current employment tax (both federal and state, including unemployment insurance and workers compensation) compliance procedures and practices, modifying those procedures and practices to the extent appropriate going forward and taking any necessary corrective action—before they hear from the IRS or other agencies. Employers selected for the IRS audit initiative should also designate a person or group internally to manage and coordinate the employer's audit preparation and response, analyze their current compliance status (including a review of recent years' employment tax returns), review and organize relevant records and documents and engage the assistance of outside counsel and other expertise as early as possible in the process.

If you have any questions or require more information or assistance concerning this IRS audit initiative, or worker classification or employment tax compliance in general, please contact us.

## DOL Publishes Model CHIPRA Notice

The Department of Labor ("DOL") recently issued a model notice that can be used by employers to fulfill their notice obligations under the Children's Health Insurance Program Reauthorization Act of 2009 ("CHIPRA"). As we explained in a March 2009 article, CHIPRA extended and expanded the Children's Health Insurance Program ("CHIP") to allow states to subsidize the premiums for employer-provided group health coverage for eligible children and their families. In addition to requiring group health plans to offer new special enrollment opportunities to certain employees and their dependents who are eligible for, but not enrolled in, a group health plan, CHIPRA also requires that employers offering such a group health plan, in states that provide subsidized premiums, to notify employees residing in each such state of the potential opportunities available in that state for premium assistance under Medicaid and CHIP for health coverage of the employee and/or the employee's dependents. (Read our March 2009 article on CHIPRA's enrollment requirements [here](#).)

### Notice Requirements

CHIPRA requires that an employer provide notice of the potential opportunity for premium assistance to employees residing in states that provide premium assistance programs; however, the employer may send the notice to all employees, regardless of whether the employees' state of residence offers such a program, for sake of administrative ease. Approximately 40 states offer one or more such premium assistance programs, including California, Florida, New Jersey, New York and Virginia.

The model notice issued by the DOL meets CHIPRA's basic content requirements, including a very brief description of the premium assistance available and contact information for each state's specific program descriptions, and may be used by employers nationwide. Employers may choose to modify or supplement the DOL's model notice, but must still include the

relevant state contact information as required by CHIPRA. The model notice issued by the DOL must be provided by the date that is the later of (a) the beginning of the first plan year that begins after February 4, 2010 or (b) May 1, 2010. Therefore, group health plans with a calendar plan year are required to provide the notice by January 1, 2011, while group health plans with a plan year beginning between February 4, 2010 and April 30, 2010, must provide the notice by May 1, 2010.

Employers are not required to send the CHIPRA notice separately; they may include the notice in a single mailing along with other plan-related materials, such as open enrollment materials or the group health plan summary plan description, so long as (a) such materials are provided by the notification deadline discussed above, (b) such materials are provided to all employees entitled to receive the CHIPRA notice and (c) the CHIPRA notice appears separately and in such a manner that employees receiving the notice could reasonably be expected to appreciate its significance.

The CHIPRA notice must be provided annually and free of charge; it may be sent by first-class mail or, alternatively, may be sent electronically to the extent the DOL's electronic disclosure safe harbor rules are met. Failure to comply with CHIPRA's notice requirements may result in penalties of up to US\$100 per day, per violation, with respect to each affected employee.

### Additional CHIPRA Requirements

Note that, in addition to CHIPRA's notice requirement, CHIPRA also requires group health plans to provide, upon request, information about their benefits to state Medicaid or CHIP programs in order for states to determine whether premium assistance is a cost-effective way to provide medical coverage. Although the DOL has not yet released the model coverage coordination disclosure form that would satisfy such disclosure requirements, states may begin requesting such information beginning with the first plan year that begins after February 4, 2010.

As always, White & Case would be happy to discuss how the above CHIPRA notice and disclosure requirements affect your group health plan and how to implement a cost-effective strategy to meet the requirements. The DOL's model CHIPRA notice is available online at <http://www.dol.gov/ebsa>.

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