2020 ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFIT PLANS

EXAMINING TOP HAT PLAN PARTICIPATION AND REPORTING

WRITTEN TESTIMONY (SUMMARY)
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OCTOBER 23, 2020

I would like to start by thanking the Employee Retirement Income Security Act (ERISA) Advisory Council (the Council) and the staff of the Employee Benefits Security Administration (EBSA) of the Department of Labor (DOL) for inviting me to provide commentary regarding top hat plan participation and reporting.

As Senior Director, Executive Benefits Practice Lead at CAPTRUST Financial Advisors, I serve more than 200 nonqualified deferred compensation plan sponsors in a consulting capacity. These plan sponsors represent a broad industry cross section who look to my organization for guidance and support related to the management of their nonqualified plans. That responsibility requires regular interaction with third-party administrators, rabbi trustees, legal counsel, insurance brokers, and other industry practitioners. This experience forms the basis for my opinions included in this testimony.

Summary Comments

Nonqualified deferred compensation plans are intended to be exempt from the most substantial parts of Title I of ERISA. The most common exemption is referred to as the "top hat" exemption. A top hat plan is outlined in Sections 201(2) of Part 2, 301(a)(3) of Part 3, and

401(a)(1) of Part 4 of Title I of ERISA as "a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." A plan that satisfies this definition is exempt from the participation, vesting, funding, and fiduciary responsibilities under Title I. A top hat plan is subject to Part 1 of Title 1, the reporting and disclosure rules, and Part 5 of Title 1, the preemption and enforcement rules.

The scope of this testimony centers around recommendations from the U.S. Government Accountability Office (GAO) in its report titled "Private Pension: IRS DOL Should Strengthen Oversight of Executive Retirement Plans." Specifically, this report suggests that the DOL should (1) determine if top hat reporting requirements should be modified to provide additional information, (2) explore actions to help companies prevent the inclusion of rank-and-file employees in top hat plans, and (3) provide specific instructions to companies to correct eligibility errors that occur when rank-and-file employees are found to be participating in top hat plans. Collectively, the recommendations are aimed at minimizing the risk that rank-and-file employees participate in top hat plans and at providing a remedy if they are found to have been erroneously included.

My summary opinion is that, while there is not a need for additional top hat plan reporting requirements, the industry would be well-served by more descriptive eligibility guidelines and correction procedures.

Top Hat Reporting Requirements

The GAO report recommends that the Secretary of Labor "review and determine whether its reporting requirements for executive retirement plans should be modified to provide

additional information DOL could use to oversee whether these plans are meeting eligibility requirements." Without additional information, it is noted that the DOL will "continue to lack insight into the composition of these plans and, as a result, may be missing opportunities to ensure that companies with executive retirement plans are meeting the eligibility requirements for the plan." It is my opinion that additional reporting requirements are unnecessary to address top hat plan eligibility issues. These requirements would place an undue burden on plan sponsors for an issue that has not been proven to exist.

Preventative Actions

While I do not subscribe to the notion that a significant number of rank-and-file employees are being included in top hat plans, it is my experience that there is still confusion around the eligibility topic. In my opinion, the most common top hat eligibility issue is when the highly compensated pool is broader than what eligibility guidelines would suggest constitutes an appropriate group. This is often the case in certain industries—or at certain companies—where pay levels on average exceed the highly compensated threshold. In those cases, under current doctrine, a portion of the top hat group should be excluded from the top hat plan to adhere to general accepted eligibility parameters.

The GAO report recommends that the Secretary of Labor explore actions that the agency can take, which might help companies prevent the inclusion of rank-and-file employees in a top hat plan. Suggestions include "providing information to companies on factors to consider when determining a 'select group' to aid companies in establishing plan eligibility." While the DOL noted its authority to issue guidance regarding top hat plan eligibility, it also stated that it has "not encountered eligibility problems during plan audits and enforcement actions" and did not

"believe it advisable to shift resources from other projects to undertake a guidance project in this area." I agree with the DOL's position that eligibility issues are not pervasive across the rank-and-file employee group. However, I do think that the DOL should consider the GAO's recommendation to better define what constitutes a top hat group. I believe that this direction would be more helpful for determining eligibility across a broad highly compensated group than addressing any issues related to rank-and-file employees.

Correcting Eligibility Errors

If the DOL chooses to offer more transparent direction around eligibility guidelines for top hat plans, then it should also consider guidance for correcting potential eligibility errors that may be identified through this process. In my opinion, this guidance should cover the remediation process for not only correcting eligibility issues of rank-and-file employees who may have been included in a top hat plan, but also for plans that inadvertently allow for too broad a portion of the highly compensated group to participate.

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My summary opinion is that, while there is not a need for additional top hat plan reporting requirements, the industry would be well-served by more descriptive eligibility guidelines and correction procedures.

Top Hat Reporting Requirements

The current reporting and disclosure rules for top hat plans are prescribed under 29 C.F.R Section 2520.104-23, which allow for an "alternative method of compliance for pension plans

for certain selected employees." Those requirements necessitate a one-time filing statement with the Secretary of Labor within 120 days of plan inception. The contents of the filing are limited in scope to include the name, address, employer identification number (EIN) assigned by the Internal Revenue Service (IRS), a declaration of the plan's purpose of providing deferred compensation for a select group of management, and a statement of the number of similar plans and employees in each. The requirements also provide for a plan sponsor to make available plan documents to the Secretary of Labor upon request. Additional layers of oversight exist through the IRS's role in collecting tax revenue on top hat benefit payments and the Securities and Exchange Commission (SEC) annual proxy disclosure requirements for public companies.

The GAO report recommends that the Secretary of Labor "review and determine whether its reporting requirements for executive retirement plans should be modified to provide additional information DOL could use to oversee whether these plans are meeting eligibility requirements." Without additional information, it is noted that the DOL will "continue to lack insight into the composition of these plans and, as a result, may be missing opportunities to ensure that companies with executive retirement plans are meeting the eligibility requirements for the plan."

It is my opinion that additional reporting requirements are unnecessary to address top hat plan eligibility issues. These requirements would place an undue burden on plan sponsors for an issue that has not been proven to exist. The GAO report cites Bond v. Marriott Int'l Inc., 637 Fed. Appx. 726 (4th Cir. 2016)(Nos. 15-1160(L) & 15-1199) as an example where ERISA protections may have been denied to rank-and-file employees in an executive retirement plan. Notably, that case was dismissed by the 4th Circuit Court of Appeals based on statute of limitations prior to a top hat determination.

The GAO report also cites a 2019 "Plan Sponsor of America Nonqualified Plan Survey" as primary evidence that some companies "may be extending employee eligibility to a relatively high percentage of their workforce—in some cases, more than 30 percent—and to relatively lower-paid or lower-ranked employees." The report in reference seems to reflect that 10 percent of top hat respondents are offering eligibility to more than 15 percent of their workforces, 8 percent are offering eligibility to between 20 and 30 percent of their workforce, and 4 percent are offering eligibility to more than 30 percent of employees. These numbers would be out of step with the general accepted eligibility guidelines.

As a member of the PSCA committee responsible for producing this report, I believe the survey information was misconstrued. The information quoted reflects the number of highly compensated employees reported at these firms and not the number of employees eligible to participate in a top hat plan. In fact, the survey goes on to suggest that the average percentage of employees eligible to participate in a top hat plan is 5 percent with a median of 4 percent. These numbers are more consistent with current doctrine as well as my personal experience.

Preventative Actions

In practice, it has not been my experience that plan sponsors are willfully trying to circumvent eligibility guidelines. There would appear to be very little incentive for a non-highly compensated employee to want to participate in a top hat plan. There would also appear to be limited reason for a plan sponsor to want to include a non-highly compensated employee in a top hat plan. Contemporary top hat plan design favors defined contribution style plans as opposed to defined benefit style plans. These plans generally allow for participant contributions and discretionary and/or matching employer contributions beyond qualified plan limits. Typically,

non-highly compensated employees have the ability to reach their savings objectives through qualified plan contributions. Meanwhile, plan sponsors also have the ability to make employer contributions to the non-highly compensated group within the context of a qualified plan. This would appear to be preferable to both based on the protections of this environment for the plan participant and the testing relief that the plan sponsor would get by making additional contributions to the non-highly compensated employee.

While I do not subscribe to the notion that a significant number of rank-and-file employees are being included in top hat plans, it is my experience that there is still confusion around the eligibility topic. In my opinion, the most common top hat eligibility issue, which is indicated by the PSCA survey data that the GAO reviewed, is when the highly compensated pool is broader than what eligibility guidelines would suggest constitutes an appropriate group. This is often the case in certain industries—or at certain companies—where pay levels on average exceed the highly compensated threshold. In those cases, under current doctrine, a portion of the top hat group should be excluded from the top hat plan to adhere to general accepted eligibility parameters.

The DOL's most recent advisory opinion related to top hat plan participant eligibility comes from DOL Advisory Opinion 90-14A. In that Advisory Opinion, the DOL clarifies the view that a top hat plan should be limited to "a select group of management or highly compensated" who "by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan, taking into consideration any risks attendant thereto, and, therefore, would not need the substantive rights and protections of Title I." The DOL has never issued regulations defining the formal meaning of the "select group" requirement.

In the absence of definitive regulations, much of the guidance around what constitutes a "select group" has come from various court filings. In making these assessments, the courts have pointed to several factors that have helped shape their opinions. In *In re New Valley Corp.*, 89 F.3d 143, 149 (3d Cir. 1996), the Third Circuit required that the plan document reflect the intention of the plan to constitute a top hat plan. In that case, the court also focused on the percentage of employees allowed to participate in the plan, the average salaries of the participants in comparison to the entire employee base, and the titles and responsibilities of the participants. In *Demery v. Extebank Deferred Compensation Plan (B)*, 216 F.3d 283, 290 (2d Cir. 2000) the Second Circuit Court of Appeals determined that a plan that consisted of over 15 percent of employees was still a top hat plan. The court noted that this group was likely at the "upper limit" but its decision was weighted by the fact that all employees were part of a "select group."

The GAO report recommends that the Secretary of Labor explore actions that the agency can take, which might help companies prevent the inclusion of rank-and-file employees in a top hat plan. Suggestions include "providing information to companies on factors to consider when determining a 'select group' to aid companies in establishing plan eligibility." While the DOL noted its authority to issue guidance regarding top hat plan eligibility, it also stated that it has "not encountered eligibility problems during plan audits and enforcement actions" and did not "believe it advisable to shift resources from other projects to undertake a guidance project in this area." I agree with the DOL's position that eligibility issues are not pervasive across the rank-and-file employee group. However, I do think that the DOL should consider the GAO's recommendation to better define what constitutes a top hat group. I believe that this direction

would be more helpful for determining eligibility across a broad highly compensated group than addressing any issues related to rank-and-file employees.

Correcting Eligibility Errors

In light of the GAO's position that there may be a high incidence of eligibility errors occurring inside of top hat plans, their report recommends that the Secretary of Labor provide specific instructions for companies to follow for correction purposes. It is noted that current guidance is limited to a 2015 amicus brief filed by the DOL for a particular case. The GAO takes the position that the guidance described in the brief could potentially create a violation of Internal Revenue Code Section 409A (IRC 409A). While there are exceptions for accelerated payments under IRC 409A, it is mentioned that "there is no current exception permitting an accelerated payment to be made to a rank-and-file employee in order to correct a violation of Title I of ERISA." Per the GAO report, IRS officials are willing to work with the DOL to create a corrective procedure, but they would first need the DOL to define top hat eligibility.

If the DOL chooses to offer more transparent direction around eligibility guidelines for top hat plans, then it should also consider guidance for correcting potential eligibility errors that may be identified through this process. In my opinion, this guidance should cover the remediation process for not only correcting eligibility issues of rank-and-file employees who may have been included in a top hat plan, but also for plans that inadvertently allow for too broad a portion of the highly compensated group to participate.