Advisory Council on Employee Welfare and Pension Benefit Plans

Report to the Honorable Eugene Scalia, United States Secretary of Labor

Examining Top Hat Plan Participation and Reporting

December 2020

NOTICE

This report was produced by the Advisory Council on Employee Welfare and Pension Benefit Plans, usually referred to as the ERISA Advisory Council (the "Council"). The Council was established under section 512 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") to advise the Secretary of Labor (the "Secretary") on matters related to welfare and pension benefit plans. This report examines issues arising in connection with unfunded, nonqualified deferred compensation plans covering a "select group of management or highly compensated employees" (commonly referred to as "top hat" plans).

The contents of this report do not represent the position of the Secretary or of the Department of Labor (the "Department").

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ABSTRACT

The 2020 ERISA Advisory Council examined the ERISA carve-outs for unfunded, nonqualified deferred compensation plans covering a "select group of management or highly compensated employees" (commonly referred to as "top hat" plans) and the alternative reporting option for such plans.

Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA provide an exclusion from the requirements of Parts 2, 3 and 4 of Title I of ERISA (pertaining to participation, vesting, funding and fiduciary responsibilities, respectively) for "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." Under a regulatory exemption under Part 1 of Title I of ERISA (reporting and disclosure), an employer maintaining a top hat plan is also exempt from all ERISA reporting and disclosure requirements if the employer utilizes an alternative reporting option requiring the filing of a one-time registration statement with the Department of Labor that identifies the employer, the plan administrator and the number of plans the employer maintains, and certifies that the plan only covers a select group of management or highly compensated employees.[1]

The Department has not published formal guidance in this area but its long-standing view is that, in providing relief for top hat plans from the broad remedial provisions of ERISA, Congress recognized that certain individuals, 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.[2] In addition, the Department has not addressed the eligibility criteria for appropriate inclusion of employees in a top hat plan, for example, the types of jobs, roles, salary levels, access to information, or sophistication that are necessary to influence plan terms. Additional approaches to defining eligibility may also be worthy of consideration.

[1] 29 C.F.R. § 2520.104-23.
[2] See DOL Advisory Opinion 90-14A (May 8, 1990).

In January 2020, at the behest of three U.S. Senators, the U.S. Government Accountability Office ("GAO") published a report on top hat plans titled "Private Pensions: IRS and DOL Should Strengthen Oversight of Executive Retirement Plans."[3] The Report recommended that the Department determine:

- whether its reporting requirements for top hat plans should be modified to provide additional information;
- whether employers are inappropriately including rank-and-file employees in top hat plans; and
- whether the Department should provide specific instructions for companies to follow to correct eligibility errors that occur when rank-and-file employees are found to be participating in top hat plans.

The 2020 Council's objective in reviewing top hat plan participation and reporting was to determine whether guidance is needed to define a "select group of management or highly compensated employees" and whether enhanced reporting would be helpful and appropriate.

[3] GAO-20-70 (Jan. 2020).

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I. RECOMMENDATIONS

Based on the testimony and research received and for the reasons stated below, the Council recommends that the Department:

1. Require that top hat plan sponsors notify eligible participants of the risks associated with the absence of ERISA's substantive protections, including the risk of nonpayment in the event of insolvency and, if applicable, any risks of forfeiture or repudiation.

2. Revise the alternative reporting regime for top hat plans to:
    a. Require reporting every 3 years or, if earlier, upon ceasing to cover any employees;
    b. Include, at a minimum, the following data elements (treating all plans as a single plan):
        i. Number of employees of the employer;
        ii. Number of employees eligible to participate in the plan;
        iii. Number of employees eligible to participate in the plan who are earning less than the amount in effect under section 401(a)(17) of the Internal Revenue Code of 1986, as amended (the "Code");
        iv. Number of employees who are eligible to elect to defer compensation to the plan;
        v. Number of eligible employees who accrued deferred compensation in the plan under a formula used for determining benefits in a qualified plan of the employer but applied without regard to one or more limits applicable to qualified plans under the Code;
        vi. Number of eligible employees whose benefits are "funded" through a rabbi trust; and
        vii. The present value of deferred compensation owed under the plan, determined using any consistently applied method, provided that this reporting requirement should not apply if the present value is less than $5 million or fewer than five employees are eligible for the plan.

3. Issue a Request for Information (an "RFI") seeking comments from interested stakeholders on possible regulatory definitions of a "select group of management or highly compensated

employees," including possible bright-line definitions and/or safe harbor/unsafe harbor definitions. The RFI should specifically request comments on:

a. whether anchoring top hat plan eligibility to an employee's "ability to affect or substantially influence, through negotiation or otherwise, the design and operation of the deferred compensation plan", as suggested by Advisory Opinion 90-14A, is useful, and
b. whether expansive definitional criteria undermine the level of benefits and contributions provided under tax-qualified retirement plans.

4. Consult with the Treasury Department on whether current access to top hat pension plans undermines coverage or benefits provided under qualified plans.

II. PRIOR COUNCIL REPORTS

The Council has not previously addressed top hat plans.

III. BACKGROUND

A. Overview

Top hat pension plans are a type of nonqualified deferred compensation (NQDC) arrangement. Employers maintain NQDC plans for a number of reasons, including recruiting employees, incentivizing employees to remain employed for a specified period (sometimes referred to as a "golden handcuffs" arrangement), and supplementing retirement benefits provided under tax-qualified retirement plans.

NQDC plans are almost always offered alongside qualified retirement plans, not in lieu of qualified plans. NQDC plans are not subject to statutory limits that apply to qualified plans, such as limits on the annual amount of benefits received under a defined benefit plan, the annual amount of contributions made on behalf of a participant under a defined contribution plan, and the annual compensation level used to determine benefits and contributions.[4] Nor is a NQDC plan subject to the minimum coverage and nondiscrimination rules applicable to qualified plans, designed to ensure that rank-and-file

[4] I.R.C. §§ 401(a)(16), (a)(17), 415.

employees, and not merely highly compensated or key employees such as owners and executives, participate in and receive benefits from the plan.[5]

In a NQDC program, compensation earned in one year is paid in a subsequent year, which may or may not be at or after retirement. The amount deferred under a nonqualified plan can be left to the employee's choice, by giving the participant an election to direct a portion of her compensation (salary or bonus) into the plan, or the amount deferred may be set by the employer under a nonelective program. Under an elective deferral program, the election is generally made before the start of the taxable year in which the employee earns the compensation.[6] Alternatively, employers may require that a portion of an employee's compensation be paid at a future date pursuant to the terms of a nonelective NQDC plan. Nonqualified plans can be structured in many different ways. Some plans promise payment of the participant's account balance (contributions plus notional earnings) at a future date (defined contribution). Others promise payment of a specified sum on a future date or determine the amount payable based on a formula (defined benefit). Elective contribution programs typically credit the amount deferred to a bookkeeping account to which notional interest or earnings are also periodically credited. Some NQDC plans are designed to mimic qualified plans, providing the employee the right to direct his or her deferred compensation, typically among the same menu of investment options that are available under the employer's qualified plan.[7]

Many NQDC plans take the place of—indeed, they are often designed to substitute for—deferred compensation that the employee cannot accrue in a qualified plan due to the operation of one or more applicable legal limits. For example, a voluntary deferral NQDC plan may permit employees who are prevented from making larger elective deferrals under a qualified 401(k) plan (such as by application of the limit on elective deferrals or the nondiscrimination tests applicable to elective deferrals) to instead contribute the larger amount to the NQDC plan.[8] Other NQDC plans "make up" for matching contributions or nonelective employer contributions under a defined contribution plan or accruals under a defined benefit plan that would otherwise have been earned under the qualified plan but for the limit

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[5] I.R.C. §§ 401(a)(3)-(5), 410(b).
[6] I.R.C. § 409A(a)(4)(B).
[7] Because NQDC plans are unfunded and may represent only a contractual commitment to pay specified amounts in the future, such participant-directed investments merely serve to define the notional earnings credited to the account.
[8] I.R.C. §§ 402(g), 401(k)(3), (m).

on compensation that may be taken into account in determining contributions or benefits.[9] Until the contribution and benefit accrual limits under qualified plans were increased substantially in 2001, it was also common for nonqualified plans to make up for such limits.[10]

NQDC plans are invariably structured as unfunded plans, that is, they represent unsecured promises by the employer to pay compensation in the future.[11] Distributions of unfunded NQDC are simply paid from available corporate assets when they fall due. An employer may set aside assets to pay future benefits, but to defer taxation all assets associated with the plan must remain subject to creditor claims in the event of the plan sponsor's bankruptcy or insolvency. For that reason, and because they are not subject to ERISA anti-cutback provisions, a NQDC plan participant is exposed to counter-party risk, for example, the risk that the employer will choose not to pay because of an employment dispute, or will be unable to pay due to insolvency. As to the first risk, many NQDC plans are informally "funded" through a so-called "rabbi trust," a device that ensures that benefits will be paid according to the terms of the plan, provided that the employer does not become insolvent.[12] Put differently, rabbi trusts mitigate concerns about a refusal to pay in the event of an employment dispute or a change in control of the employer, but the assets of the trust remain subject to the claims of the employer's general creditors.

An employee is not subject to current taxation upon receipt of an unfunded, unsecured promise to pay, even if the employee has an unconditional right to future payment.[13] Instead, the employee is ordinarily

[9] I.R.C. § 401(a)(17).
[10] See I.R.C. § 415(b), (c). Providing contributions or benefits beyond the limits of section 415 makes a NQDC program an excess benefit plan to that extent. Unfunded excess benefit plans are wholly exempt from ERISA. See ERISA §§ 3(36), 4(b)(5).
[11] As discussed below, a promise of future payment that is backed by assets that are protected from the claims of creditors of the transferor can trigger taxation in advance of distribution under I.R.C. § 83. A nonqualified program that is funded through a trust would generally be taxable under Code § 402(b).
[12] See, e.g., IRS Priv. Ltr. Rul. 92-28-026 (Apr. 13, 1992); Rev. Proc. 92-64, 1992-2 C.B. 422 (IRS model rabbi trust). The name "rabbi trust" comes from the initial private ruling concerning such an arrangement, which involved a trust established by a religious congregation for the benefit of its rabbi. Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980).
[13] An unfunded unsecured promise to pay is not "property" that would trigger taxation under I.R.C. § 83, Treas. Reg. § 1.83-3(e), and an employee using the cash receipts and disbursements method of accounting who has earned a right to future payment ordinarily does not include the amount in income until it becomes payable. To assure that result, the right to future payment should be non-transferrable (to avoid application of the cash equivalence doctrine) and the arrangement must comply with the requirements of I.R.C. § 409A. In contrast, the beneficiary of a funded NQDC plan is subject to current income tax as of the earliest date the employee has a vested right to payment. I.R.C. §§ 402(b), 83. For that reason, funded NQDC arrangements are avoided. Ordinarily they are encountered only when a program intended to be a qualified retirement plan (for which advance funding is required) becomes disqualified.

subject to income tax upon receipt of payment. The employer, however, is correspondingly not entitled to a deduction until such amount is includible in the employee's income.[14]

Special income tax rules apply to tax-exempt employers, including state and local governmental employers, in recognition of the absence of tension between the timing of income inclusion and deductibility.[15] Different timing rules also apply for employment tax purposes, generally taking amounts deferred into income as of the earliest date such amounts are reasonably ascertainable and not subject to a substantial risk of forfeiture.[16]

A number of rules trigger income tax prior to payment based on the control that an employee can exercise over NQDC, including the doctrines of constructive receipt and assignment of income. Further, Internal Revenue Code section 409A imposes penalties that in practice restrict the events that may trigger distribution of NQDC and limit the acceleration or further deferral of NQDC.[17]

B. Application of ERISA

As an initial matter, whether ERISA applies to a NQDC plan turns in the first instance on whether the plan is classified as a "pension plan." ERISA defines a pension plan as "[a]ny plan, fund or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund or program –

i. provides retirement income to employees, or
ii. results in a deferral of income by employees for periods extending to the termination of covered employment or beyond."[18]

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[14] I.R.C. § 404(a)(5); *Albertson's. Inc. v. Commissioner*, 42 F.3d 537 (9th Cir. 1994).
[15] I.R.C. § 457. Limited amounts may be deferred annually on a tax-advantaged basis under a program that meets the requirements of an "eligible deferred compensation plan." I.R.C. § 457(a), (b). Deferred compensation that does not satisfy those requirements causes employees to be taxed on the present value of the NQDC as of the date such compensation is no longer subject to a substantial risk of forfeiture. I.R.C. § 457(f).
[16] I.R.C. § 3121(v)(2).
[17] See generally H.R. Rep. No. 108-548, Pt. 1, at 341-48 (2004); Michael Doran, *Executive Compensation Reform and the Limits of Tax Policy*, Tax Policy Center Discussion Paper No. 18 (Nov. 2004), available at https://www.taxpolicycenter.org/publications/executive-compensation-reform-and-limits-tax-policy.
[18] ERISA § 3(2)(A), 29 U.S.C. § 1002(2)(A).

Thus, a deferred compensation program that does not provide retirement income or defer compensation to the termination of employment or beyond is generally not subject to ERISA because it is not a pension plan (or a welfare benefit plan). For example, an employer's unfunded, unsecured promise to pay $X to an employee in 5 years will ordinarily not be considered a pension plan but rather a bonus program that is outside the ambit of ERISA.[19]

If a nonqualified plan (other than an excess benefit plan[20]) provides pension benefits, it is subject to the full panoply of ERISA requirements unless the plan is unfunded and "maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." Such top hat plans are exempt from all of the substantive requirements of ERISA, including its participation, vesting, spousal protection, funding, and fiduciary responsibility rules. As a result, a top hat plan may, for example, impose forfeiture conditions that apply for a far longer period than ERISA tolerates, and need not grant the employee's spouse any survivorship interest in, nor any say over, the disposition of plan benefits.

In addition to the statutory exemptions from substantive pension plan requirements, Department of Labor regulations provide complete relief from the reporting and disclosure requirements of Part 1 of Title I of ERISA if an employer utilizes an alternative compliance option.[21]

Under the Department's alternative compliance regulation, a top hat plan administrator is exempt from filing a Form 5500 annual return/report for the plan and need only file a one-time statement with the

[19] It is the longstanding position of the Department that the manner in which a deferred compensation arrangement is administered or represented to participants can constitute "surrounding circumstances" that might cause a bonus or savings program to be categorized as a pension plan, even if the terms of the plan call for in-service distributions or short-term deferral. See, e.g., ERISA Advisory Opinion 81-16A (Jan. 23, 1981) (suggesting that if employees selected to participate in a public drilling fund estimated to last for 10 years are likely to retire or terminate employment within that time the discretionary bonus program could be a pension plan); ERISA Advisory Opinion 81-18A (Feb. 2, 1981) (employee stock purchase plan that did not restrict the resale of stock might be a pension plan if communicated to participants in a way that discouraged them from requesting distribution of their shares and selling the stock). Whether or under what circumstances in-service distribution opportunities preclude classification of a deferred compensation program as a pension plan if amounts can be deferred to the termination of employment remains an unsettled question. Compare *Wilson v. Safelite Group, Inc.*, 930 F.3d 428, 436-38 (6th Cir. 2019) with *Emmenegger v. Bull Moose Tube Co.*, 197 F.3d 929, 933 (8th Cir. 1999).

[20] An excess benefit plan is an unfunded plan that is maintained solely to make up for the Code section 415 limits on benefits and contributions under a tax-qualified plan. Unfunded excess benefit plans are wholly exempt from ERISA, while funded excess benefit plans are exempt from Parts 2 and 3 of Title I and Title IV. ERISA §§ 3(36), 4(b)(5), 201(7), 301(a)(9), 4021(b)(8), 29 U.S.C. §§ 1002(36), 1003(b)(5), 1051(7), 1081(a)(9), 1321(b)(8).

[21] ERISA § 110, 29 U.S.C. § 1030; 29 C.F.R. § 2520.104-23.

Department within 120 days of establishing the plan and provide plan documents to the Secretary upon request. The one-time filing need only include:

- the name and address of the employer;
- the employer identification number (EIN);
- a declaration that the employer maintains plan(s) primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees; and
- a statement of the number of such plans and the number of employees in each plan.

The one-time filing does not collect information on job title or salary or the percentage of the company's workforce participating in these plans, nor does the information that is initially reported need to be updated as circumstances change. Since 2019, top hat filings need to be made via electronic fillable form.[22] The electronic form does not expand in any way the information that must be reported, though it does contain an "Optional" text box which an administrator could voluntarily use to add up to 5,000 characters of additional information.

The sponsor is also excused from all disclosure obligations, including the requirements to supply participants with a summary plan description and summary annual reports.[23]

A top hat plan is an employee benefit plan, notwithstanding the inapplicability of the substantive provisions of ERISA, and therefore ERISA broadly preempts state law.[24] As a result, a participant claiming benefits under a top hat plan would ordinarily be unable to assert causes of action or pursue remedies provided under state law. This sharply contrasts with the treatment of participants in governmental plans or church plans; because those programs are totally exempt from ERISA, their participants have recourse to state law and state remedies. Moreover, because top hat plan participants must rely on ERISA's civil enforcement mechanism, ERISA's procedural limitations, including required exhaustion of administrative remedies and review under the deferential abuse-of-discretion standard,

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[22] *See Electronic Filing of Notices for Apprenticeship and Training Plans and Statements for Pension Plans for Certain Select Employees*, 84 Fed. Reg. 27,952 (June 17, 2019). The electronic form had been available and had been used by 54% of top hat filers for the three years from 2015 to 2017. *Id.,* at 27953 and n.5.
[23] 29 C.F.R. § 2520.104-23.
[24] ERISA §§ 3(3), 514, 29 U.S.C. §§ 1002(3), 1144.

apparently apply in tandem with ERISA's remedial limitations. As Professor Norman Stein has observed, top hat plan participants, who have "few protections and diminished judicial remedies, are worse off than they would have been had ERISA never been enacted."[25]

C. Prevalence of Top Hat Plans

There is very little data regarding the number of top hat plans, the number of participants, the amounts deferred, and the manner in which eligibility is determined. As mentioned above, the alternative reporting regime for top hat plans merely requires a one-time registration statement that notes the existence of a plan and the number of participants and does not require updating when plans are amended, expanded, terminated or combined. The SEC requires reporting of some NQDC benefits provided by public companies. This reporting, however, is limited to financial information about the deferred compensation payable to the company's top five employees and is not focused on whether the amounts are owed under a top hat plan or some other form of NQDC. Moreover, there is no such reporting for non-public companies.

There is very limited survey data from service providers to NQDC plans and from trade associations, as discussed below.[26]

D. Select group of management or highly compensated employees

There are no regulations defining the statutory phrase "select group of management or highly compensated employees," nor any of its component terms.

[25] Norman Stein, Examining Top Hat Plan Participation and Reporting (Sept. 17, 2020) (written statement submitted to the ERISA Advisory Council). Stein points out that this treatment stands in stark contrast to the treatment of excess benefit plans, which are pension plans that make up solely for the limits on contributions and accruals under Code section 415. Unfunded excess benefit plans are entirely exempt from ERISA, which affords covered participants with access to state law judicial remedies.

[26] See discussion, *infra*, at 33-34. See also Principal, *Trends in Nonqualified Deferred Compensation* (Feb. 2020), available at https://www.principal.com/businesses/trends-insights/trends-nonqualified-deferred-compensation-plans; Newport Group, Inc., *Newport/PLANSPONSOR Executive Benefit Survey*, 2020 Edition, available at https://www.newportgroup.com/knowledge-center/september-2020-1/newport-executive-benefits-survey-details/.

1. Legislative History of the Top Hat Plan Exemption

ERISA's legislative history fails to supply specific guidance on the intended scope of the top hat plan exemption. It does, however, demonstrate a general congressional expectation that the exemption would apply narrowly.

The initial Senate pension reform bill in the ninety-third Congress, S. 4, included an exemption from its vesting and funding rules for a plan that "is unfunded and is established or maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management employees and is declared by the employer as not intended to meet the requirements of section 401(a) of the Internal Revenue Code."[27] (This language was carried forward from pension reform bills sponsored by Jacob Javits dating as far back as 1967.[28]) The introduction of S. 4 was accompanied by a summary of its provisions, which described the top hat exemption as covering "key executives."[29] The report of the Committee on Labor and Public Welfare on S. 4 states:

> It is intended that coverage under the Act be construed liberally to provide the maximum degree of protection to working men and women covered by private retirement programs. Conversely, exemptions should be confined to their narrow purpose.[30]

In the Senate, members of the Finance Committee introduced competing tax-based pension reform legislation, which placed new vesting, funding, and fiduciary rules under the jurisdiction of the IRS.[31] The new standards applied to qualified plans and thus did not include exemptions; a non-qualified plan would simply be stripped of preferential tax treatment. A subsequent Senate Finance bill would have

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[27] S. 4, § 104(b)(6), 93d Cong. (Jan. 13, 1973) (as introduced), *reprinted in* 1 SUBCOMM. ON LABOR OF THE SENATE COMM. ON LABOR AND PUBLIC WELFARE, LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, at 93, 113 (Comm. Print 1976) [hereinafter ERISA LEGISLATIVE HISTORY].

[28] S. 1103, 90th Cong. § 101(b)(6) (Feb. 28, 1967), *reprinted in* 113 CONG. REC. 4653 (1967); *id.* at 4659 (statement of Jacob Javits); *see Pension and Welfare Plans: Hearing on S. 3421, S. 1024, S. 1103, and S. 1255 Before the Subcomm. on Labor of the S. Comm. on Labor and Public Welfare*, 90th Cong. 91, 106, 164, 210 (1968). This bill was the first comprehensive pension reform proposal introduced in Congress. JAMES A. WOOTEN, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: A POLITICAL HISTORY, at 129-30 (2004).

[29] Summary of Major Provisions of S. 4—Williams–Javits Pension Reform, *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra*, at 191, 192.

[30] S. Rep. No. 93-127, at 18 (1973), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra*, at 587, 604.

[31] See WOOTEN, *supra*, at 193-96; Peter J. Wiedenbeck, *"Ninety-Five Percent of Them Will Not Be Missed": Recovering the Tax Shelter Limitation Aspect of ERISA*, 6 DREXEL L. REV. 515, 522-25 (2014).

granted tax-favored treatment to plans that did not comply with the vesting and funding rules if the coverage of such plans was restricted to 5% shareholders or corporate officers.[32]

The leadership of the Senate Finance and Labor committees ultimately crafted compromise legislation. The vesting and funding provisions were housed in the Internal Revenue Code and the fiduciary rules incorporated in both federal tax and labor law.[33] The fiduciary rules did *not* include an exception for plans covering select management employees.[34]

As was the case in the Senate, pension reform proceeded on two tracks in the House, with pension bills emerging from both the House Committee on Education and Labor and the House Committee on Ways and Means. The Ways and Means bill, which made vesting a qualification condition, did not include a top management exemption. The House committees ultimately crafted a joint bill, H.R. 2, which amended both the Internal Revenue Code and federal labor law with virtually identical vesting and funding requirements.[35]

The labor provisions of the House legislation included the exemption for unfunded deferred compensation but with an important addition: the exemption now applied to "unfunded plans maintained primarily for the purpose of providing deferred compensation to a select group of management *or highly compensated employees*" (emphasis added).[36] This first appearance of "highly compensated employees" in the demarcation of the exemption's scope passed without remark in the written record. The report of the Committee on Education and Labor describes the exemption in one place as applicable to "[e]xecutive deferred compensation plans," and in another place indicated that the exemption covered

[32] S. 4, 93d Cong. §§ 222, 262(a) (Sept. 17, 1973), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra*, at 1271, 1305, 1336; Analysis of Amendment No. 496, 119 Cong. Rec. 30134, 30135 (1973), *reprinted in* 2 ERISA LEGISLATIVE HISTORY, *supra*, at 1718, 1720.
[33] S. 4, 93d Cong. §§ 221 (vesting), 241 (funding), 511 (labor fiduciary rules), 521 (tax fiduciary rules) (substitute bill, Sept. 17, 1973), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra*, at 1271, 1288, 1307, 1440, 1454.
[34] S. 4, 93d Cong. §§ 511 (proposed WPPDA § 15(k)), 521(a)(2), *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra*, at 1451, 1454.
[35] H.R. 2, as passed by the House on February 28, 1974, was an amalgam of H.R. 12906 (the Labor Committee bill) as title I, and H.R. 12855 (the Ways and Means Committee bill) as title II. 3 ERISA LEGISLATIVE HISTORY, *supra* at 3505, 3596.
[36] H.R. 12906, 93d Cong. §§ 101(b)(6), 201(b)(4), 301(b)(5) (Feb. 20, 1974), *reprinted in* 2 ERISA LEGISLATIVE HISTORY, *supra*, at 2761, 2781-82, 2834, 2859.

"[u]nfunded deferred compensation schemes of top executives."[37] This was the bill passed by the House, which was considered along with S. 1179, by the Conference Committee.

The conference committee report on H.R. 2 included an example that seems to contemplate a quite restrictive application of the exemption:

> [T]he labor fiduciary rules do not apply to an unfunded plan primarily devoted to providing deferred compensation for a select group of management or highly compensated employees. For example, if a "phantom stock" or "shadow stock" plan were to be established solely for the officers of a corporation, it would not be covered by the labor fiduciary rules.[38]

Officers, of course, constitute the top echelon of corporate management and are ordinarily the *most* highly compensated employees.

2. Advisory Opinions

The Department's earliest guidance on these issues merely examined the facts presented in requests for advisory opinions and concluded that the plans were or were not top hat plans.[39]

In 1990, however, the Department for the first time articulated a standard for defining a select group of management or highly compensated employees. In Advisory Opinion 90-14A, the Department gave its view of the rationale behind Congress's enactment of the top hat exemption.

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[37] H.R. Rep. No. 93-533, at 18, 22 (1973), *reprinted in* 2 ERISA LEGISLATIVE HISTORY, *supra*, at 2348, 2365, 2369. *Accord id.* at 3298, 3301 (explanatory statement in the nature of a committee report on the labor law provisions of H.R. 2, the joint House bill).

[38] H. R. Rep. No. 93-1280, at 296 (Conf. Rep.), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra*, at 4277, 4563. The conference report refers to the top hat exemptions from the labor title's vesting and funding requirements as "unfunded deferred compensation arrangements" or "unfunded plans maintained by the employer primarily to provide deferred compensation for select management or highly compensated employees." *Id.* at 261, 267, 291, *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra*, at 4277, 4528, 4534, 4558.

[39] DOL Adv. Op. 85-37A (Oct. 25, 1985); 75-48 (Dec. 23, 1975); DOL Adv. Op. 75-64 (Aug. 1, 1975); DOL Adv. Op. 75-63 (July 22, 1975). ERISA advisory opinions may be relied on only by the parties involved and are generally issued only with respect to planned or prospective transactions. They are not binding on the Labor Department if the facts diverge from the representations on which the opinion was based. ERISA Procedure 76-1, §§ 5, 10, 41 Fed. Reg.36,281 (Aug. 27, 1976). Although they lack precedential value, specialists routinely resort to advisory opinions for the insight they offer into the Department's analytical approach to unresolved issues.

> It is the view of the Department that in providing relief for "top-hat" plans from the broad remedial provisions of ERISA, Congress recognized that certain individuals, 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.

Under this view, an employee must have the ability to affect or substantially influence the design and operation of the deferred compensation plan, "taking into consideration any risks attendant thereto."

DOL Advisory Opinion 90-14A also contained a footnote addressing a technical question under the top hat exemption. It stated that "it is also the Department's position that the term 'primarily' [as used in the top hat plan definition] refers to the purpose of the plan (i.e., the benefits provided) and not the participant composition of the plan." Others have suggested that as long as a top hat plan was maintained primarily for a select group of management or highly compensated employees, it could include employees outside that group.[40]

3. Case Law

Several cases considering the top hat plan exemption have been decided since DOL Advisory Opinion 90-14A. A number follow the conceptual framework in the Advisory Opinion.[41] However, the Department's opinion has rarely been dispositive, suggesting that a standard based on one's ability to negotiate the terms of the plan has not been easy to apply in practice.

[40] *See Demery v. Extebank Deferred Comp. Plan (B)*, 216 F.3rd 283, 289 (2d Cir. 2000) (suggesting that "primarily" modifies "select group," so that a plan covering a small number of employees who are not managers or highly compensated might still qualify for the top hat plan exemption).

[41] *See Duggan v. Hobbs*, 99 F.3d 307, 310-11 (9th Cir. 1996); *Demery*, 216 F.3d at 289-90 (viewing the ability to negotiate plan terms as relevant, but concluding plaintiffs failed to offer evidence showing absence of bargaining power); *Carrabba v Randalls Food Markets, Inc.*, 38 F.Supp.2d. 468, 478 (N.D. Tex. 1999) (observing that the "evidence does not persuade the court that any significant number of the participants" had "such influence that they can protect their retirement and deferred compensation expectations by direct negotiations with the employer"); *see also Bakari v Venture Manufacturing Company*, 473 F.3d 677 (6th Cir. 2007) (noting that, along with other qualitative factors, plaintiff had had little ability to negotiate compensation or plan terms).

In contrast, some courts have expressly rejected the Advisory Opinion approach. The First Circuit, in *Alexander v. Brigham & Women's Physicians Organization, Inc.*, found that the two plans maintained for surgeons of Harvard Medical School were top hat plans, concluding that individual bargaining power was not relevant to a determination of top hat status.[42] The surgeon participants were subject to a University-imposed compensation cap but their "excess" earnings were placed into unfunded deferred compensation plans. The court held that the plans met the definition of top hat plans because the plans were maintained for a select group of highly compensated employees based on qualitative and quantitative factors. The group was quantitatively select, as the percentage of participants was small (actual participation never exceeded 8.7 percent of the relevant workforce), and qualitatively select, because the participants were the highest-earning surgeons of the employer (on average, earning five times more than the average workforce salary). The court rejected an individual bargaining power requirement for top hat plans because (1) there is no Congressional intent, and (2) Advisory Opinion 90-14A merely interprets Congress's intent in creating top hat plans and does not demand a separate requirement of independent bargaining power. The Third Circuit Court of Appeals has since held that the bargaining power of the participant in a nonqualified top hat plan had no bearing on whether the participant was a member of a "select group" and concluded, like the *Alexander* case noted above, that individual bargaining power was not relevant to a determination of top hat plan status.[43] Thus, there is a circuit split on whether individual bargaining power is relevant or dispositive.

Courts addressing the top hat exemption have instead considered several factors such as percentage of the workforce eligible to participate,[44] average salary of plan participants compared to that of employees generally,[45] management or highly compensated.[46]

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[42] 513 F.3d 37 (1st Cir. 2008).
[43] *Sikora v. UPMC*, 876 F.3d 110 (3d Cir. 2017).
[44] *See Dugan*, 99 F.3d at 312-13 (5% coverage), *Belka v. Rowe Furniture Corp*., 571 F. Supp. 1249 (D. Md. 1983) (4.6% coverage); *Alexander*, 513 F.3d at 46 (8.7% coverage); *Demery*, 216 F.3d at 289 (15.34% coverage "at or near the upper limit of the acceptable size for a 'select group'").
[45] *Belka*, 571 F. Supp. at 1252 (average salary of plan participants 3½ times that of average employee); *Demery*, 216 F.3d at 289 ("average salary of plan participants was more than double that of the average salary of all Extebank employees.").
[46] *Carrabba*, 38 F. Supp.2d at 478("[Court] cannot find from the evidence that the participants of the MSP were "a select group" out of the broader group of management employees or the broader group of highly compensated employees"); *Demery*, 216 F.3d at 289 ("While [the plan] participants did include assistant vice presidents and branch managers, and therefore swept more broadly than a narrow range of top executives, it was nonetheless limited to highly valued employees.").

4. Top Hat Plans and ERISA's Policies

In its declaration of policy, Congress announced the central goal to protect "the interest of participants in private pension plans and their beneficiaries by improving the equitable character and the soundness of such plans" by imposing vesting, minimum funding, and termination insurance requirements.[47]

> ERISA's four principal policies—promoting informed financial decision making; preventing mismanagement and abuse of benefit programs; protecting the reliance interests of plan participants and beneficiaries; and preserving substantial employer autonomy with respect to plan sponsorship and design—are directed to eliminating misunderstandings and injustices in the operation of a voluntary system of employer-provided pension and welfare benefits.[48]

The top hat plan exemptions, when viewed through the lens of these objectives, illustrate the tension between the exemption and ERISA's policies. Top hat plan participants enjoy no statutory safeguards against exploitation (mismanagement, abuse, and frustrated reliance). And the prevailing alternative reporting system denies them assured access to information (mandatory disclosure) that would equip them to make balanced career and financial planning decisions. The employer, however, is accorded virtually complete autonomy in setting top hat plan terms. Complete, that is, save for one vital matter: plan membership cannot extend beyond a "select group of management or highly compensated employees." Clearly, a functional reading of ERISA would define the scope of the "select group" with reference to the need for participant protections.

ERISA's labor title only incidentally addressed private pension plan coverage: "That wasn't its focus. Its focus was saying, 'You can promise whatever you want, but if you promise it, you got to deliver it.'"[49] Title II, ERISA's qualified plan provisions, did speak to coverage, however. Although frequently overlooked, several Code amendments took aim at the rapidly escalating exploitation of corporate

[47] ERISA § 2(c), 29 U.S.C. § 1001(c).
[48] Wiedenbeck, *supra*, 6 DREXEL L. REV. at 516. For an overview of ERISA's policies, see Peter J. Wiedenbeck, ERISA: PRINCIPLES OF EMPLOYEE BENEFIT LAW 14-19 (2010) [hereinafter ERISA PRINCIPLES].
[49] Remarks of Daniel I. Halperin, *in* Panel Discussion, *Some New Ideas and Some New Bottles: Tax and Minimum Standards in ERISA, in* Symposium: *ERISA at 40: What Were They Thinking?, 6* DREXEL L. REV. 385, 399-400 (2014).

pension plans as a tax shelter by high-income professionals.[50] Central to that effort was the enactment of the workforce aggregation rules, which treat all employees of a commonly controlled group of businesses, whether or not incorporated, as employed by a single employer in applying the tax law coverage and amount nondiscrimination rules.[51] The effect of that consolidation is to deny preferential tax treatment to retirement savings programs that fail to provide contributions or benefits to rank-and-file employees on a reasonably consistent basis with their highly paid counterparts. The workforce aggregation rules, added by ERISA Title II, are essential to implementing the complex tax subsidy redistribution mechanism that the nondiscrimination rules aim to achieve.[52]

Taken as a whole, ERISA suggests another metric for defining a "select group of management or highly compensated employees." If top hat plan coverage of a group of workers would threaten to materially depress their demand for qualified plan contributions or benefits—demand that could only be accommodated by increasing savings on behalf of rank-and-file employees—then top hat plan membership would undercut Title II's goal of broad distribution of retirement savings.

IV. GAO REPORT

At the request of United States Senators Ron Wyden (D-OR), Patty Murray (D-WA), and Bernie Sanders (I-VT), GAO studied executive retirement plans and issued its findings in the January 2020 report titled: "Private Pensions: IRS and DOL Should Strengthen Oversight of Executive Retirement Plans."[53] The report focuses on (1) the prevalence, key advantages, and revenue effects of top hat plans; (2) potential outcomes for top hat plan benefits in corporate bankruptcy; and (3) how federal oversight protects benefits and prevents ineligible participation.

GAO used data from Securities and Exchange Commission ("SEC") disclosures applicable to public companies from 2013 to 2017, interviews with a range of industry experts and a random sample of companies that sponsored top hat plans and filed for bankruptcy in recent years. The GAO also

[50] Wiedenbeck, *supra*, 6 DREXEL L. REV. at 517-28; S. Rep. No. 93-383, at 119-22, *reprinted in* 1 ERISA LEGISLATIVE HISTORY, *supra*, at 1187-90.
[51] I.R.C. § 414(b), (c).
[52] *See* ERISA PRINCIPLES, *supra*, at 303-11.
[53] GAO-20-70 (Jan. 2020). The report can be found at: https://www.gao.gov/assets/710/704097.pdf.

interviewed officials from the Department of Labor, Department of the Treasury, the Internal Revenue Service ("IRS"), the SEC, the Pension Benefit Guaranty Corporation ("PBGC"), and the United States Trustee Program.

GAO recommended that the Department (1) review and determine whether its reporting requirements for top hat plans should be modified to provide additional information that the Department could use to oversee whether these plans are meeting eligibility requirements; (2) explore actions that the Department could take to help companies prevent the inclusion of rank-and-file employees in top hat plans and determine which, if any, actions should be implemented; and (3) provide specific instructions for companies to follow to correct eligibility errors that occur when rank-and-file employees are found to be participating in top hat plans, coordinating with other federal agencies on these instructions as appropriate.

V. WITNESS TESTIMONY

A. GAO

The Council heard testimony from members of the team who worked on the GAO report, including Kris Nguyen (Director of GAO's Education, Workforce, and Income Security), Tamara Cross (Assistant Director), David Lin (Analyst in Charge), and Ted Burik (Senior Analyst).

GAO representatives emphasized the challenges of obtaining reliable data about top hat plans and the employees who participate in them. They found the Department's database to be of limited use, noting that the one-time, single-page statements filed by top hat plans do not collect key information and are not required to be updated when information changes or when plans terminate. As a result, most of their findings and recommendations relied on SEC disclosures, court cases, and discussions with industry experts. They acknowledged that using SEC disclosure information is less than ideal for two reasons: (1) disclosures only cover a company's five most highly-paid employees and offer no information on top hat benefits that may be offered to other employees, and (2) only publicly-traded companies are subject to SEC disclosure requirements, so no information is available for non-publicly-traded companies.

When asked how they would have the Department expand reporting requirements for top hat plans, the GAO team brought up suggestions they heard most often from industry experts. This included moving from one-time to ongoing reporting and collecting some or all of the following data:

- Salaries and job titles of employees participating in the plan,
- The percentage of the company's workforce that is eligible to participate, and the percentage actually participating,
- A compensation comparison between eligible employees and other employees.

The GAO team lacked sufficient data to quantify the extent to which top hat plans may be permitting participation by ineligible employees. They did, however, cite evidence to suggest there was reason for concern. For example, they pointed to a 2018 Plan Sponsor Council of America survey that indicated some companies extend eligibility to more than 30 percent of their workforce, and to relatively lower paid and lower ranked employees. They also highlighted a court case that found a top hat plan that covered 18.7 percent of employees too large to be considered “select.”

GAO estimated that 20 percent of top hat plans are funded exclusively by voluntary employee deferrals while 80 percent include company contributions. Among plans with company contributions, the report did not delineate between plans that are exclusively company-funded versus those with a mix of employee and company contributions.

Responding to questions about how likely it is that some top hat plans displace or curtail benefits in qualified plans, the GAO team indicated that the interplay between top hat and qualified plans was outside the scope of their research. Their main observation on this subject was that executives often receive benefits from both types of plans.

With respect to top hat benefit claims in company bankruptcy, the GAO’s analysis of 30 cases, both public and private, found that outcomes ranged from complete loss to full recovery. The analysis made no distinction based on company size, industry sector, or ownership (public versus private), but did show evidence that executives fare better with recoveries when companies file for reorganization versus liquidation.

B. Plan Sponsor Council of America

Every year, the Plan Sponsor Council of America (PSCA) conducts a survey of its member companies regarding NQDC plans. The GAO prominently featured a particular and highly concerning data point from the PSCA survey in its report:

> Recent industry surveys we reviewed have suggested 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. For example, results from a recent survey of executive retirement plan sponsors suggested that just over 8 percent of respondents offer eligibility to between 20 to 30 percent of their workforce and just over 4 percent offer eligibility to more than 30 percent of their employees. Further, over 20 percent of respondents indicated that over 15 percent of their workforce was considered highly compensated employees and eligible to participate in an executive retirement plan.[54]

The Council heard testimony from Jason Stephens who was involved in compiling the 2018 survey results. He stated that the actual survey responses paint a different picture and pointed the Council to another portion of the survey results, which states that the mean and median percentage of employees eligible to participate in respondents' NQDC plans were 8.6 and 4.1 percent respectively. The Council has reviewed the 2018 survey and finds that the questions regarding the level of NQDC plan participation were ambiguous and therefore that the results are of little probative value.[55] We also note that, while Stephens focuses on the express data on plan eligibility percentages, employers were instructed to respond to the underlying survey questions on that issue only with respect to their single

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[54] GAO 20-27, at 51 (footnote omitted, citing 2018 PSCA survey).

[55] Question 5 asks in relevant part:

"5. Does your organization offer its highly compensated employees Non-qualified Deferred Compensation Plans …?

* * *

a. If yes, approximately what percentage of employees are considered Highly Compensated Employees [(HCEs)]?

* * *

b. If yes, what criteria do you use to determine who is an HCE?
- IRS Limit
- Other limit …."

largest (liabilities) plan.[56] Without knowing more about the other top hat plans offered by survey respondents, that result must be taken with some skepticism. Overall, as with other available data in this area, the PSCA surveys were not designed to, and do not provide comprehensive data specific to top hat plans. As GAO determined and this Council observes, the lack of such data in itself is an issue the Department should address.

C. Consultants

The Council heard testimony from four consultants who specialize in nonqualified deferred compensation arrangements: Jeffery Acheson (Independent Financial Partners), Alexander Yaffe (Pearl Meyer), Jason Stephens (CAPTRUST Financial Advisors), and Michael Webb (Cammack Retirement Group).

In general, the consultants would welcome formal guidance around top hat plan eligibility and suggested that the guidance take the form of a safe harbor framework. In the absence of clear-cut guidance, they have had to rely upon various tests set out by the courts, such as the percentage of the workforce covered by the plan and the compensation disparity between covered and non-covered employees. However, the fact that courts in different circuits have examined and focused on different factors has created ambiguity, making it difficult to ensure compliance.

All consultants were consistent in their view that the inclusion of rank–and-file employees in top hat plans is rare and is not a pervasive problem. This view, of course, is dependent on how one defines "rank-and-file." When asked how they would have the Department define "highly compensated employee" for top hat plan purposes, all advocated adoption of the qualified plan definition under Code section 414(q) ($130,000 for 2021), although one consultant indicated he "could live with" the Code section 401(a)(17) compensation threshold ($290,000 for 2021).

The consultants cautioned against overly restrictive guidance that might hamper smaller companies' ability to compete with large companies in recruiting and retaining talent. According to one consultant, a common tool for smaller companies is a "golden handcuffs" arrangement, *i.e.*, a nonqualified plan that

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[56] Questions 9 and 10 addressed percentage of eligible employees. The survey Instructions for Questions beginning with Question 8 (therefore clearly including the percentage eligible questions) state: "NOTE: If your organization offers multiple plans, please answer the remaining questions based on your largest (in terms of liabilities) active account balance plan."

is fully employer funded and designed to retain mission critical employees (*e.g.*, software engineers, salespeople) for some period, in some cases until retirement. Employees covered by these plans might not be in management and might not meet an overly restrictive compensation threshold, but they tend to be a small group with meaningfully higher compensation than that of other company employees.

Some of the examples cited by the consultants suggest there may be confusion between top hat plans and retention bonus plans (more typical "golden handcuffs" arrangements, which have no restrictions on who can participate, and are not subject to ERISA). In general, ERISA does not apply to retention bonuses that do not defer compensation to the termination of employment or provide retirement income. Yet, at least one witness talked about an employer who wanted to promise certain employees additional compensation if they stayed with the company for a specified period of time unrelated to termination or retirement. Such a plan would not be considered a pension plan within the meaning of ERISA and therefore would not need to satisfy the top hat plan eligibility restrictions.

With respect to reporting requirements, the consultants' collective view was that the regulations in place today are appropriate and that no changes are needed. However, one consultant opined that employers would be on board with collecting some additional data for the purpose of shaping clear guidance and not to punish sponsors for lack of compliance with a vague rule.

D. Recordkeepers

The Council heard testimony from two companies that provide recordkeeping services for nonqualified deferred compensation plans: Trisha Morrison (The Pangburn Group) and Mark West (Principal Financial Group). Both recordkeepers target their services to small and mid-sized companies. The Council also heard testimony from Jack Towarnicky from the American Retirement Association, which represents recordkeepers.

The testimony from these witnesses was remarkably consistent. The witnesses stated that, contrary to the perception of many, top hat plans are small in total size and that most participants had only modest account balances. Mark West noted that 77 percent of participants on Principal's recordkeeping system have account balances that are less than $100,000. Trisha Morrison noted that 67 percent of the plans on Pangburn's recordkeeping system were under $100,000.

In general, the recordkeeper witnesses did not believe there was a systemic problem with including rank-and-file employees in top hat plans. For over 40 years, the industry has managed by relying on the existing Department and judicial guidance. They believe it would be difficult to create a definition that would work across the entire country, different industries, and small to large-sized businesses. Jack Towarnicky believes a safe harbor definition could lead to a very limiting and restrictive rule, which essentially could curtail the adoption of top hat plans. Trisha Morrison pointed to the difficulty of a one size fits all approach by stating that "[a]ny singular rule that we've been offered through the courts in their judgments has a counter argument to it."

When asked about the actual negotiation power of participants in top hat plans, the witnesses were in general agreement that participants did not have much negotiation power. The power to negotiate may exist for participants in smaller sized companies but the power lessened the larger the company. Many smaller companies sponsor top hat plans because of the need to recruit new employees who may have left compensation behind at a prior company. These companies need to provide something comparable and competitive to attract new employees, which empowers them with negotiating leverage. With larger employers, however, it generally is a "take it or leave it" mentality. Trisha Morrison stated that top hat plans do not compete with qualified plans but rather supplement benefits for individuals whose compensation cannot be taken into account under a qualified plan.

With respect to reporting, the recordkeeping witnesses were concerned with the burdensome aspect of additional annual reporting, which could impact certain industries disproportionately. One witness pointed out that small private companies would be concerned about disclosing information to competitors. Witnesses believed that capturing some information, such as when a plan closed out, could be useful. One witness believed that a one-time clean-up of already filed top hat statements would be appropriate rather than requiring a new ongoing disclosure requirement.

If the Department did believe it was necessary to revise the reporting rules, one witness thought adding a mandated disclosure about risk on enrollment or benefits statements would be useful. It also was mentioned that best practice already incorporated this type of disclosure through participation

agreements, so participants usually understand the terms and risks of the plans. Another witness testified that it had been his experience that participants do not read mandated disclosures.

E. Attorneys

The Council sought input from a number of attorneys whose practice has concentrated on matters relating to executive compensation and employee benefits. The lawyers who testified before the Council were Bruce J. McNeil (Stoel Rives LLP), Richard W. Skillman (Caplin & Drysdale, Charted), Brian W. Berglund (Bryan Cave Leighton Paisner LLP), Sheldon H. Smith (Bryan Cave Leighton Paisner LLP), Mark Poerio (The Wagner Law Group), Barry K. Downey (Smith & Downey, P.A.), and Arthur A. Kohn (Citigroup Inc.). Each of these attorneys has many years of experience representing clients (predominately plan sponsors) on ERISA matters, and several have taught courses or written influential books or articles on employee benefits law.

These practitioners' recommendations were not uniform, but most advised against a Department regulatory initiative to define top hat plan eligibility. The majority view was that, despite definitional ambiguity, no significant number of rank-and-file employees has been allowed to participate in top hat plans and, therefore, the nonqualified deferred compensation system is functioning properly.[57] In effect, the dominant message was, "It ain't broke, so don't try to fix it." One of the attorneys was supportive of administrative action to provide greater clarity to employees but advocated adoption of a very accommodating approach to top hat plan participation. There was broad consensus that the eligibility standard set forth in Advisory Opinion 90-14A, which looks to the ability to substantially influence the design and operation of a deferred compensation plan, does not reflect the reality of top hat plan membership today.

The attorneys' views on possible top hat plan reporting and disclosure reforms were somewhat more varied. Some felt that no change from the longstanding one-time notice regime was necessary or would be cost justified. Others thought that periodic updating would be helpful. One witness supported imposition of a requirement that the employer must educate every prospective top hat plan participant of the risks of loss presented by the plan. To implement that requirement, participating employees would

[57] Again, witnesses varied as to how they would define "rank and file."

be obliged to certify in writing that they understand those risks and the sponsor's report to the Department would certify compliance with this education and disclosure mandate.

F. Public Interest Advocates

The Council heard testimony from Norman Stein, professor of tax and employee benefits at the Thomas R. Kline School of Law at Drexel University and Senior Policy Advisor at the Pension Rights Center, a consumer advocacy organization dedicated to protecting and promoting retirement security, and Mark Iwry, who is a fellow at the Brookings Institution, a visiting scholar at the Wharton School of the University of Pennsylvania, has previously held senior positions in the Treasury Department with responsibility for employee benefits, and has been a law firm partner.

Professor Stein emphasized that top hat plans hold a singular position under ERISA, being both exempt from ERISA's various substantive consumer protection rules (vesting, funding, spousal protections, fiduciary standards, etc.), but also protected by ERISA's liability-limiting rules (preemption, exhaustion of administrative remedies, deferential judicial standard of review, limited judicial remedies). Observing that the scope of the top hat plan definition is not easily discerned from the statutory language alone, Professor Stein opined that, based on that language, the statutory history, and the canon of statutory construction that exemptions to remedial statutes should be narrowly construed, the top hat exemption was intended to have a narrow scope, limited only to key executives and non-management employees whose high compensation makes them the functional equivalent, at least in terms of bargaining power and of importance to the business, of key executives.

Professor Stein opined that employers and courts (to the limited extent these plans have been subject to challenge) have extended the scope of the top hat exemption far beyond what Congress intended. Recognizing that good data is not readily available, Professor Stein nonetheless stated that it was his belief that top hat plans now cover many hundreds of thousands of participants, including many mid-level and relatively modestly compensated employees. In his view, this expansion has resulted in two problems that must be addressed.

First, a large number of moderately compensated employees who are covered by these unfunded benefit arrangements have no leverage, little information about the risks inherent in these plans, no financial

cushion to withstand losses, few protections, and limited remedies. Consequently, they are actually worse off than they would have been had ERISA never been enacted. Second, demand for benefits under qualified plans is suppressed because employers are able to provide top hat plan benefits to middle management and other employees who are considered highly compensated employees under the tax rules rather than providing such benefits under a qualified plan, in which case benefits must be provided on a comparable basis to rank-and-file employees.

With respect to reporting, Professor Stein believes that the current regime falls short both in providing important data that regulators and legislators should have and in providing participants with information they need relative to their benefit security. In his view, reporting should include data such as percentage of participation, range of compensation, job titles and value of benefits across the plan or plans.

Mark Iwry expressed the view that the Department's traditional focus on employees' ability to protect themselves without the substantive protections of ERISA is misguided. In his view, the central public policy issue presented by the scope of the top hat plan exemption is the impact such plans have on the qualified plan system, specifically the level of benefits and contributions provided to nonhighly compensated employees in qualified plans.

As a threshold matter, Mr. Iwry stressed that impacts on the qualified plan system were appropriate policy considerations for the Department, notwithstanding that the Department does not have interpretive authority for the tax provisions of ERISA. He shared that the Reorganization Plan No. 4 of 1978,[58] which allocates interpretive authority for ERISA between the Department and the Department of the Treasury, should not stand in the way of a holistic approach to retirement policy.

Mr. Iwry encouraged the Council and the Department to consider whether top hat plans, particularly "top up" or "spill over" plans, are undermining the contributions and benefits provided to nonhighly compensated employees in qualified plans. He highlighted that top hat plans are often closely integrated with qualified plans and that such plans may undermine the "constructive tension" in the qualified plan system, which depends on the nondiscrimination rules to ensure that nonhighly compensated employees

[58] 43 Fed. Reg. 47713 (Oct. 17, 1978), available at: https://www.dol.gov/agencies/ebsa/laws-and-regulations/laws/executive-orders/4.

receive contributions or benefits that are comparable to those provided to highly compensated employees. He shared that in practice the tax differences between top hat plans and qualified plans are modest, particularly from the perspective of the participant, and that top hat plans provide an easy way to provide relief from the nondiscrimination rules to the detriment of rank-and-file employees.

With respect to data, Mr. Iwry agreed that there is a distinct lack of data about top hat plans and the universe of employees who are eligible to participate in such plans. He agreed that additional reporting would be appropriate provided that it is not too onerous for employers, but he argued that this lack of data should not forestall action by the Department. In his view, additional data would be helpful but it will not answer whether top hat plans are undermining benefits and contributions under qualified plans. He argued that it is apparent on its face that certain types of top hat plans, i.e., make whole or top up plans, are undermining the qualified plan system and that action is needed.

Using protection of the qualified plan system as a north star, Mr. Iwry suggested that the Department consider safe and unsafe harbor rules. He pointed out that other regulators had taken on similar issues and that this was a solvable drafting challenge. Finally, Mr. Iwry emphasized the need to provide appropriate transition relief to ensure that participants and employers who acted in reasonable good-faith are not adversely affected.

VI. COUNCIL OBSERVATIONS

A. The Data Problem

As discussed above, there is very little information about the prevalence and characteristics of top hat plans and nonqualified deferred compensation more generally. The Department's current one-time alternative reporting method provides virtually no information about the nature of the plan, such as amount contributed or deferred, eligibility, number of participants or even whether the plan is still in existence. Other reporting sources are limited at best. We note also that much of the survey information is about nonqualified deferred compensation in general, not top hat plans specifically. Many nonqualified deferred compensation plans are not pension plans, but rather retention or bonus programs, so survey information about compensation and prevalence may be of very limited utility.

This lack of information makes it difficult to assess whether there are problems with top hat plans that need to be addressed. It is not currently possible to determine whether the coverage of a top hat plan created in the early 1980s has grown over time at the expense of benefits provided under qualified retirement plans, because the plan sponsor need never update its one-time registration statement. Similarly, we simply have no objective basis for determining whether rank-and-file employees are being covered. Attorneys representing employers assured the Council that rank-and-file employees are not being covered but, in the absence of any definition or objective data, these assurances constitute personal opinions and anecdotal assessments at best and self-serving opinions at worst.

B. Adverse Outcomes

The Council did not hear testimony reflecting that significant numbers of top hat plan participants have been denied retirement income as a result of the employer's insolvency or repudiation. Similarly, the Council did not hear testimony that the lack of ERISA's other substantive protections, such as vesting or spousal rights, has adversely affected top hat plan participants. That said, the Council was not able to procure appropriate witnesses with experience representing participants in bankruptcy or employment disputes. The Council observes that there are a significant number of cases in which top hat plan participants are claiming benefits due and recognizes that insolvencies are sensitive to the business cycle. There is simply no record on which to determine whether there are systemic problems with the lack of ERISA's protections.

C. Interplay with the Qualified Plan System

A number of witnesses raised questions about whether top hat plans are undermining the fundamental policy choice inherent in the qualified plan system: that the availability of generous tax benefits is conditioned on rank-and-file participation on a comparable basis to highly compensated employees, and that the contributions or benefits provided not discriminate in favor of highly compensated employees.[59] Many witnesses testified that top hat plans are not discouraging the formation of qualified plans. Witnesses agreed that top hat plans are offered in conjunction with qualified plans; they provide a supplement to, rather than a complete substitute for, qualified plan savings. However, a number of witnesses suggested that the ability to provide retirement benefits to a broad group of middle

[59] *See* I.R.C. §§ 401(a)(3)-(5), 410(b).

management through a nonqualified deferred compensation plan reduces the incentive for employers to provide greater benefits to their rank-and-file workers through qualified plans.

As discussed above, the Council is unaware of comprehensive, reliable, objective data that would support or refute the notion that top hat plans undermine the system. Yet as numerous witnesses pointed out, top hat plans are often closely coordinated with their companion qualified plans and explicitly designed to provide benefits that cannot be provided under the companion plan due to various limits imposed by the qualified retirement plan rules. These limits include the actual deferral percentage/actual contribution percentage (ADP/ACP) tests (the special nondiscrimination tests for 401(k) plans), the limit on elective deferrals, the limit on annual compensation that may be taken into account under a qualified plan, and the limits on contributions and benefits.[60] The very design of these plans takes pressure off the nondiscrimination rules applicable to qualified plans. It is entirely plausible that, without the ability to broadly offer top hat plan benefits, employers would choose to provide more robust benefits under qualified plans. In the absence of hard data, it is possible that top hat plans are materially undermining the qualified plan system. We view this issue as the central public policy question underlying this topic.

D. Importance of Top Hat Plans

A number of consultant-witnesses testified that top hat plans play an important role in human capital management, including recruiting and retaining key employees. The Council agrees that top hat plans have a role to play and that any definition of a "select group of management or highly compensated employees" should be sufficiently flexible to allow businesses to recruit and retain employees. It was striking, however, that some of the examples cited as support for the need for top hat plans involved plans that appeared not to be pension plans. For example, one witness talked about recruiting a key software engineer to a cash poor start up and how a narrow definition of top hat might prevent that employer from being able to recruit the prospective employee with a generous nonqualified deferred compensation plan. In this regard, there appears to be a need to clarify that nonqualified deferred compensation plans that do not defer compensation to the termination of employment or beyond or provide retirement income are not pension plans, and that such plans do not need to rely upon ERISA's top hat plan exemptions.

[60] I.R.C. §§ 401(k)(3), (m)(2), 402(g), 401(a)(1), 415.

E. Advisory Opinion 90-14A

Virtually all of the witnesses who work with top hat plans indicated that the notion reflected in Advisory Opinion 90-14A that top hat status should be limited to employees who have the ability to influence the design or administration of deferred compensation is not useful and is often not taken into account in determining eligibility. While one witness who worked with the nonprofit sector testified that employees in small companies and not-for-profit organizations often did negotiate the terms of their top hat plans, witnesses from larger for-profit organizations universally testified that individual negotiation was not a component of their top hat plans. The testimony of witnesses representing large employers and the experience of a number of Council members indicated that many plans are "take it or leave it" programs. Several witnesses spoke to the potential burden inherent in administrating scores of individually negotiated top hat plans. Many witnesses indicated that it would be highly unusual for all but the chief executive officer of a company to have the ability to shape the terms of a top hat plan, such as its vesting requirements or other forfeiture provisions. Moreover, the ability to negotiate the terms of employment simply does not translate easily to practical decisions about who is within the "select group" that can be covered by an unfunded pension plan that is meant to be a top hat plan. Rather, employers are deciding who can be in a top hat group based on criteria such as compensation levels, titles (*e.g.*, senior vice presidents and above), and the overall percentage of the employer's workforce that is eligible to participate.

The standard announced in Advisory Opinion 90-14A was apparently intended to communicate a restrictive approach to top hat eligibility focused on the absence of need for the substantive protections of ERISA Title I. That focus is appropriate and, in the Council's view, depends upon an employee's access to information and ability to understand and bear the risks associated with top hat plan participation. The Advisory Opinion focused on ability to appreciate the risk but also the ability to mitigate that risk by controlling the terms of the plan itself. The Council believes that the mitigation part of the "test" as articulated in the Opinion is not, at this point, a realistic or appropriate determinant of who should be eligible for top hat plan membership.

F. Coverage of Rank-and-file Employees

Employers appear to be well-intentioned and making good-faith efforts in determining who is eligible to participate in a top hat plan. However, the Council's impression is that the universe of eligible employees is broader than Congress intended. To be clear, the Council did not hear that rank-and-file employees were being covered by top hat plans. But the repeated assurance that top hat plans today do not cover rank-and-file employees may mean only that workers who are *not* "highly compensated employees," as defined for purposes of the qualified plan nondiscrimination rules[61] ("QP HCEs"), are systematically excluded from participation. There was some evidence to suggest that upper and middle management employees and a broad group of QP HCEs may be participating in top hat plans. More troubling, one survey found that 4% of nonqualified plans covered employees earning less than $120,000 a year, not even reaching the current level for QP HCE status. In effect, the Council's sense is that employers are effectively limiting participation to managers and QP HCEs, but not necessarily to a "select group" of management or highly compensated employees as intended by the top hat exemptions. Even the application of strict limits on the percentage of employees who are covered does not ensure that only a select group of management or highly compensated employees is covered.

G. Trade-off between Flexibility and Predictability

The phrase "select group of management or highly compensated employees" is effectively an undefined term with attorneys and consultants looking generally to case law for guidance. This provides employers with the flexibility to include employees who are important to the employer's business in unfunded pension plans. It also has the virtue of allowing for coverage that can be tailored to different geographic locations (pay is lower in some areas than others), business models (dealing with "talent", e.g., doctors, software engineers), and overall workforce composition (as in firms where all or most employees are very highly compensated). However, this flexibility raises the possibility that top hat plans are encroaching on the qualified plan system. It also results in greater compliance costs relative to a bright line rule.

[61] I.R.C. § 414(q). In 2020 and 2021, the compensation threshold for HCE status is $130,000. IRS Notice 2020-79, 2020-46 I.R.B. 1015.

H. Correction is Primarily a Tax Issue

GAO recommended that the Department create a method of correction for a top hat plan that inadvertently covers an employee who is not a member of a "select group of management or highly compensated employees." In response, the Department directed the GAO to a 2015 amicus brief it filed in which the DOL suggested that plans can be modified to exclude ineligible rank-and-file employees, awarding them the full vesting and other protections under ERISA, and distributing their benefits from the plan while maintaining the plan's status as a top hat plan for those executives who do qualify. The amicus brief suggests this "approach would avoid providing a windfall gain to the management and highly-compensated employees who could properly have been included in a plan covered by [ERISA Section 201(2)], who possess sufficient economic bargaining power to protect their own rights and are not the intended beneficiaries of the substantive ERISA provisions at issue."[62]

This raises a question about whether a distribution as a result of ineligibility would run afoul of Code section 409A's prohibition on accelerated distributions. When the IRS was presented with the scenario in the DOL amicus brief, the IRS responded that removing employees from the plan and awarding them full and immediate vesting and payout of benefits could violate Code section 409A, which does not generally permit acceleration of nonqualified deferred compensation. The IRS said it was willing to work with the DOL to create an exception to the accelerated payment rule for plans that seek to remove ineligible rank-and-file employees from a top hat plan. IRS officials stated that the DOL would first need to better define a top hat employee and then decide the proper approach for removing ineligible rank-and-file employees from a plan before any new regulations under section 409A could be considered.

Thus, the primary obstacles associated with correction of eligibility failures appear to be tax issues. For these reasons, correction is outside the remit of the Council.

I. Transition Relief

Any guidance interpreting a "select group of management or highly compensated employees" should provide transition relief for reasonable, good-faith interpretations of the statute. It would not be fair to

[62] Brief for the DOL as Amicus Curiae, p. 24, *Bond v. Marriott International, Inc.*, No. 15-1160 (4th Cir. 2016).

penalize employers and employees given the absence of meaningful guidance on the scope of the top hat exemption. There are a number of different approaches to transition, including cashing out ineligible employees, freezing accruals, or grandfathering existing participants and allowing ongoing accruals. These different approaches have pros and cons and may raise similar tax issues to correction, as discussed above. We note that one material negative would be the harm to employees who may effectively have their compensation reduced if they are no longer eligible to accrue benefits.

J. Alternative Reporting Scheme is Not Useful

The current alternative reporting regime is not useful. It is a one-time filing with no requirement for updating for plan expansions, termination, mergers or other material modification. The current alternative reporting scheme provides no data that would permit any substantive review that these plans are meeting the statutory requirements.

VII. RECOMMENDATIONS CONSIDERED

A. Do Nothing

The Council considered whether to recommend against further work in this area. This approach finds support in the fact that the statutory language has been unchanged, and there has been little to no guidance since ERISA was enacted in 1974. Over that time, in the absence of any formal guidelines for making coverage decisions, prevailing practice has been shaped by the various quantitative and qualitative factors that the courts have considered. A number of witnesses expressed that it makes little sense to disrupt existing practices at this point and that the potential costs of compliance with a new rule would far outweigh any benefit. These witnesses warned that changes could lead to large scale revisions with significant liability for plan sponsors and unexpected tax consequences for participants.

In contrast to this view, the Council heard testimony that uncertainties arising from inconsistent case law have not benefitted either employers or employees, nor have they advanced the policy objectives underlying the top hat exclusion in an optimal way. These witnesses expressed concern that, in some cases, court decisions have afforded too much leeway, spurring an expansion of top hat participation into middle compensation ranges.

The Council also considered whether changes were appropriate given the absence of evidence of significant problems in this area. Richard Skillman expressed this argument forcefully "We've lived with the uncertainty in this area for 46 years. As far as I'm aware, there is no evidence of widespread abuse or understanding that employers are crying out for greater certainty. [I] just don't think it's broke enough to try to fix it."

The first obvious counterpoint to this argument is that there is not enough data regarding participation in these plans to make a judgment about the level of abuse, if any. Indeed, the one-time filing statement required of top hat plans is devoid of any information to make such a determination. A separate but perhaps related flaw in this argument is that the Department has focused relatively little attention to examining these plans. GAO observed that while DOL has not apparently encountered eligibility problems or systematic abuses, DOL itself admitted top hat plan eligibility "is not a commonly reviewed issue" by the Department.

Next, the Council considered whether, as some witnesses suggested, it is better to do nothing because it is too difficult to define the statutory language "a select group of management or highly compensated employees" because such language is inherently fact-specific. Richard Skillman testified that attempting to define the scope is not only difficult but also dangerous, stating that "any attempt to more clearly define or delineate the scope of this exemption is going to be fraught with problems. . . there are just too many potentially relevant facts and circumstances with the courts or qualitative considerations when they looked at these issues, or any definition or set of guidelines not to be under-inclusive, over-inclusive, or both." Bruce McNeil testified that imposing specific requirements for top hats plans could cause employers to eliminate such plans completely or to reduce benefits offered under such plans and therefore would be adverse to the interests of plan participants in the aggregate. Jeffery Acheson expressed a concern that strict eligibility parameters could impair the ability of small and medium sized businesses to craft compensation agreements that allow them to compete with larger companies that have the wherewithal to create more elaborate opportunities for highly compensated employees.

On the other hand, Professor Stein opined that, although this particular statutory formulation is very difficult to precisely define, difficult line-drawing exercises are not uncommon in the law and that

perfection should not be the goal; that we should not let the perfect be the enemy of the good, so to speak.[63]

B. Bright-line Definitions

The Council also considered a variety of potential bright-line definitions. Clarity, simplicity and predictability can be achieved by adopting objective bright-line criteria to define a "select group of management or highly compensated employees." The definition could be mechanized, for example, by: (1) specifying a dollar threshold for total annual compensation that would constitute a "highly compensated employee;" (2) enumerating a set of executives who would be deemed "management … employees;" (3) designating the maximum proportion of the company's total workforce or of the group constituting highly compensated employees or management that would be considered a "select group;" or (4) some combination of those.

a. "Highly-Compensated Employee"

A bright-line definition of highly compensated employee is surely feasible, as similar quantitative classifications abound under the qualified plan provisions of the Internal Revenue Code. These include the varying definitions of "highly compensated employee" for purposes of the prohibitions on discrimination in plan coverage, contributions and benefits, the definition of "key employee" for purposes of the top-heavy plan rules, and the specification of the maximum annual compensation that may be taken into account under a qualified plan.[64] The Council recognizes that these rules arguably serve different purposes than the top hat plan exceptions of ERISA but they demonstrate that numeric definitions are possible and in fact foundational to the retirement plan system. If the qualified plan rules are leveraged, modifications may be needed. It makes little sense for snapshot compensation to drive top hat plan participation. For example, an employee who has an unusually large bonus in one year should not be eligible for top hat plan participation that will span many years. One solution would be using look-back compensation over a number of years or considering whether compensation is expected to persist.

[63] Professor Stein stated, "But if you wanted certainty, I think it's very hard because any classification system, no matter how carefully crafted, is going to . . . create interpretive questions at the margins . . . . I don't think you could draft this perfectly."
[64] I.R.C. §§ 414(q); 416(i) and 401(a)(17).

Such an approach would attain certainty but, as with any bright-line rule, would suffer the detriments of inflexibility. Compensation obviously is sensitive to a number of criteria, including: location (relative cost-of-living); industry (skill, supply and demand); and a range of business models (small vs. large, public vs. private, profit vs. not-for-profit), etc. However, in general, Congress has decided to accept a level of imprecision in favor of clarity in crafting mechanical taxation and benefit rules that mute those other variables.

In this case, any blunting of other variables by a bright-line rule on compensation would be mitigated by the disjunctive statutory language that permits top hat plan participation if an employee is part of a select group either of management *or* highly compensated employees. Failing to meet the compensation test alone therefore does not exclude any employee if he or she nonetheless meets the "management" test. Moreover, the top hat exemption is not needed for every nonqualified deferred compensation plan. Many such arrangements are entirely exempt from ERISA, may cover individuals who fall below any designated top hat compensation threshold, and are effective tools for recruiting and retaining talent across locations, industries, and business models.

Witnesses differed in favoring either certainty or flexibility. Those favoring flexibility mostly focused on the exceptional cases. For, example, Barry Downey argued that some small employers pay even their top executives less than what any reasonable bright-line definition of compensation might allow; and that a bright line could disfavor some professionals who work for more than one employer, such as a surgeon making $50,000 for limited part-time work. On the other hand, Jack Towarnicky opined that all employers should be allowed to determine coverage on whatever works best for each firm, arguing "that's part of the voluntary decision that employers have when they adopt this plan and essentially make it available to whoever they decide is a select group of management and how they define highly compensated." Those who favored a bright-line definition noted its simplicity, the certainty it would afford employers and participants and its dampening effect on overly aggressive interpretations under the existing limited guidance. Arthur Kohn approached the issue from a more macro policy level, noting that a clear rule would promote retirement savings by eliminating the current uncertainty, legal expense, and litigation risk inherent in case-by-case adjudication, which he views as preventing some employers from offering top hat plans. As discussed below, enthusiasm for a bright-line was fairly dependent on where such a line might be drawn.

i. Code section 414(q)

The specific tax law definition of "highly compensated employee" found in Code Section 414(q) was added to the Internal Revenue Code in 1986, 12 years after ERISA became law, although the qualified plan nondiscrimination rules banned favoritism of employees who are "officers, shareholders, or highly compensated" since 1942. Congress obviously could not have been cross-referencing to a nonexistent quantitative definition when it enacted the top hat exemptions.[65] Moreover, Treasury regulations provide that the tax law's QP HCE definition "is not determinative with respect to any provision of Title I of [ERISA], unless it is explicitly incorporated by reference."[66] Therefore, although Congress certainly was aware that the favorable tax treatment of qualified retirement plans depended among other things on comparable access to benefits by rank-and-file employees, it seems equally clear that Congress did not intend to import the non-existent 414(q) definition of "highly compensated employee" when it used that term in the top hat plan exemption.[67]

Witnesses were divided among those who felt the QP HCE level was much too low for a bright-line compensation test, and those who felt it could be too high in exceptional cases and therefore opposed a bright-line rule generally. Overall, the reaction to setting a safe harbor or bright-line test for top hat participation at $130,000 was exemplified by Brian Berglund, who observed that "employers would jump for joy if you put the line at 414(q)" but nonetheless opined that level is "probably too low."

As discussed above, however, the Council is sensitive to the interplay between nonqualified and qualified plans, and concurs that the QP HCE level is too low. As a matter of pension policy, equating ERISA's top hat plan usage of "highly compensated employee" with the Code's quantitative definition could undermine the qualified plan system. The Code definition of "highly compensated employee" (currently $130,000) is the foundation of the nondiscrimination rules that ensure that rank-and-file employees receive benefits that are comparable to those of highly compensated employees. If the compensation level for top hat participation is defined to mirror the testing definition, the tension

[65] When ERISA was enacted, the determination of which employees were highly compensated was a discretionary determination by the Internal Revenue Service, made based on all the facts and circumstances of each case. See Treas. Reg. § 1.410(b)-1(d)(1) (superseded 1994).
[66] Treas. Reg. § 1.414(q)-1T, Q&A-1(d) (as amended in 1994).
[67] Similarly, the compensation definition of key employee for the top heavy plan rules was not introduced until the 1980s.

inherent in the non-discrimination rules will be eliminated. If an employer's lower-paid workforce puts little value on saving for retirement, the employer could satisfy the demand for retirement savings among its higher-paid employees with a top hat plan. At its most extreme, by creating a work-around for every QP HCE, nothing would need to be put aside for rank-and-file employees who are unable or reluctant savers. Facilitating and incentivizing savings on behalf of those workers (i.e., inducing retirement savings that would not otherwise occur) is a main objective of the nondiscrimination rules.[68] Without that benefit for low to moderate income workers, the policy justification for the enormous tax expenditure afforded qualified plans (estimated to exceed $200 billion annually[69]) would be subverted.

Put simply, setting top hat plan eligibility at the Code's QP HCE threshold would seriously endanger the qualified plan system for delivering retirement income to middle and lower-income workers.

ii. Code section 401(a)(17)

Another alternative would be to define a "select group of highly compensated employees" by reference to the Code Section 401(a)(17) limit on compensation that can be considered under a qualified plan. The limit, which is periodically adjusted for changes in the cost-of-living, is $290,000 for the 2021 plan year.

This approach would have a number of virtues. First, it could effectively protect the qualified plan system by indicating that all retirement benefits for employees earning less than that limit should be provided for through the employer's qualified plan. Second, the 401(a)(17) limit, at more than twice the

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[68] *See generally*, ERISA PRINCIPLES, *supra*, at 303-311; Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs*: *Is It "Still" Viable as a Means of Increasing Retirement Income?*, 49 Tax L. Rev. 1 (1993). See Peter J. Brady, *Pension Nondiscrimination Rules and the Incentive to Cross Subsidize Employees*, 6 J. Pen. Econ. & Fin. 127 (2007), which uses a simulation analysis to model the impact of nondiscrimination rules on 401(k) plans and finds that only firms with a relatively low ratio of NHCEs to HCEs (less than about 4 to 6) would have an economic incentive to sponsor a plan.

[69] According to the Treasury, the net cost of the preferential treatment of qualified retirement plans is projected to be approximately $157 billion in fiscal year 2020 ($206 billion if IRAs and Keogh plans are included). EXECUTIVE OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2021, at 153 (2020), available at https://www.whitehouse.gov/wp-content/uploads/2020/02/ap_13_expenditures_fy21.pdf. Going by congressional estimates, the figure is $242 billion for employer plans ($285 billion if IRAs and Keogh plans are included). STAFF OF THE JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2019–2023, at 29-30 (2019), available at https://www.jct.gov/publications.html?func=select&id=5 .

414(q) limit, is a better marker for those who may be able to bear the risks, limitations and drawbacks of an unfunded plan that is not subject to the substantive requirements of ERISA.

As to the virtue of a compensation floor at or above the 401(a)(17) limit, Professor Stein opined that although it is not as limited as Congress intended, it would at least exclude some individuals without means to protect themselves financially in the event of forfeiture and would also result overall in fewer participants in these unprotected plans. Mark Iwry likewise favored a floor at the 401(a)(17) limitation, though observed it would be unpopular and would require some transition relief. Mr. Iwry emphasized that the 401(a)(17) limitation is an important part of the overall nondiscrimination regime in the qualified plan system, which must be considered in any top hat plan guidance.

iii. Other limits

The Department need not be constrained in choosing the 414(q), 401(a)(17) or any other existing limitation from the qualified plan rules, each of which was adopted for a different purpose.
A compensation floor that is significantly higher than any of those limits could be compatible with the proper functioning of the retirement savings system. Drawing the line is of course the tricky question. From the standpoint of ERISA's protective policy, it could be argued that a floor for a "highly compensated" employee should be set sufficiently high so that top hat plans cover only those employees whose disposable income would be sufficient to allow rapid recovery from forfeiture or other loss of NQDC, or so that they have sufficient stature vis-a-vis the employer to protect themselves financially in other ways. And, from the standpoint of the Code's nondiscrimination policy, it is important that a significant cohort of employees earning compensation above the QP HCE limit fall below the top hat floor, so that their employer may not evade the carefully constructed tensions within the qualified plan system that favor reasonably generous qualified retirement plan(s) for low-to-moderate income employees.

b. "Management"

Congress did not define "management" within the top hat exemption, and there has been no real attempt to define it in existing Department guidance or case law. On this point--more than any other issue--witnesses consistently opined that a definition, much less a bright line rule, based on function, or based

exclusively on title, would be exceedingly difficult to fashion, and might not work in all industries or firm structures. At the same time, a number of witnesses acknowledged that some titular "Managers" or even "Vice Presidents" might not belong in a top hat plan.

A few witnesses ventured a quantitative definition. Norman Stein opined that Congress intended the top hat exemption to cover, at most, five top executives or management employees per firm. Mark Iwry volunteered "top five employees" as a "very simple, very ascertainable, very workable standard." Similarly, the category of management employee might be defined with precision by reference to other laws. One candidate might be the compensation disclosure obligations under the Securities Exchange Act of 1934. Those obligations pertain to the company's chief executive officer, chief financial officer, and the three other most highly compensated executives.[70] Identification of the corresponding individuals in the much broader universe of employers not subject to SEC reporting obligations (non-publicly-traded companies) would be straightforward and objective but not without cost because the firms may not otherwise collect this information in quite that way.

Another natural candidate is the SEC's accredited investor rule which includes as permitted investors in non-registered investments "executive officers" of the issuer.[71] The term "executive officer" is defined in Rule 501(f) as "the president, any vice president in charge of a principal business unit, division or function, as well as any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer."[72] Again, witnesses tended to disfavor functional definitions as impracticable.

c. "Select Group"

Overbroad bright-line definitions of highly compensated or managerial employees could be remedied by specifying the maximum number of employees, or the maximum percentage of the workforce, that will be considered a "select group." Some judicial decisions look to the proportion of the workforce eligible to participate in the NQDC program, and consequently employers and their advisors are attentive to

[70] See I.R.C. § 162(m)(3) (defining "covered employee" by reference to SEC compensation reporting rules).
[71] See 17 C.F.R. § 230.501 (2020).
[72] *Id*. § 230.501(f).

coverage rates.[73] This expedient suffers from insensitivity to workforce composition, however. Firms in different industries employ workers with quite different education, skill level, and experience, so a flat percentage test seems somewhat arbitrary and unrelated to any policy rationale for the top hat exemption. For example, if 20 percent of an investment bank's employees have the financial sophistication to understand, and the financial security to protect themselves from, the risks associated with NQDC, there seems no good reason to bar them from participation just because only five percent of an engineering (or healthcare or computer software) firm's employees possess comparable understanding or security.

Any fractional/percentage limit would also require clear specification of the universe of employees considered in computing the fraction. A threshold question is whether the denominator should include all employees or just all "management" or "highly compensated" employees, and if the latter, whether the groups should be aggregated. Moreover, in order to avoid anomalous results, employees of related or commonly controlled businesses would need to be aggregated, as with the commonly controlled business and affiliated service group rules of the qualified plan regime.[74] In addition, if different limits are prescribed for different industries (to respond to variation in workforce composition, as described in the preceding paragraph), then rules would be needed to disaggregate the workforce, as with qualified separate lines of business under the qualified plan rules.[75] Thus, although a clear, objective measure could be devised, it likely would include significant QP details and therefore could be somewhat onerous for employers to apply, especially if it contained aggregation and disaggregation rules the employer was not already applying for purposes of a qualified plan.

Witnesses acknowledged the prevalent use of coverage percentage tests among employers and their advisors. Some were skeptical as to whether such a test is useful. Richard Skillman offered that, because many of the courts that have examined the issue have considered percentage of coverage, he has urged at least one client "to try to limit participation to 15 percent of . . . affected employees" even though it presents practical difficulties as workforces fluctuate. Though he advises his clients to weigh them carefully, Skillman finds percentages to be "almost a meaningless criterion because . . . five percent

[73] See written statement of Bruce J. McNeil at pp. 2-5 (discussing *Demery* and *Darden v. Nationwide Mutual Insurance Co.*, 717 F. Supp. 388, 397 (E.D. N.C. 1989), *aff'd* 922 F.2d 203 (4th Cir. 1991), *rev'd on other grounds*, 503 U.S. 318 (1992)).
[74] I.R.C. § 414(b), (c), (m).
[75] I.R.C. §§ 410(b)(5), 414(r).

could be way too generous depending on the makeup of the employer's workforce, or . . . 25 or 30 percent could be too restrictive." Indeed, notwithstanding that the statutory definition expressly refers to a "select group," Mr. Skillman opined that the range of appropriate participation levels for top hat plans is "probably one percent to maybe 50 percent depending on the facts and circumstances." Similarly, Bruce McNeil argued that using the percentage of employees covered as an indicator of true top hat status is "artificial" and would "be a moving target because [employers] could add some [employees] one year, subtract some one year." By way of example, Mr. McNeil pointed to "this pandemic, for example, where there have been a lot of layoffs and furloughs. So a plan that covered maybe 12 percent of the employees of the company, well, with all the layoffs that plan might suddenly be up to 20 or 22 percent, still covering the same people but the layoffs have skewed the percentage." In addition, although Professor Stein testified in favor of limiting top hat plan participation very narrowly, he also testified that coverage percentage, as a sole marker, can and has been abused by employers.[76]

C. Safe and Unsafe Harbors

Bright-line definitions, while potentially objective and apparently simple, would at best be poor proxies for the policy-relevant considerations. Those considerations involve the need for ERISA's worker protections and the need to maintain incentives for qualified plan sponsorship. Bright-line generic definitions—of management employees, of highly compensated employees, and of a select group of employees—will be over-inclusive, under-inclusive, or both. Yet bright-line rules could be enlisted to mark off clear-cut cases at the ends of the spectrum efficiently: to identify circumstances in which top hat plan membership either clearly would, or clearly would not, undermine ERISA's policies. Accordingly, the Council considered the possibility that the Department might establish an objective safe harbor for top hat plan eligibility, combined with an objective prohibition (or "unsafe harbor"). Between the under-inclusive safe harbor and the under-inclusive prohibition, context-sensitive discretionary determinations would be required, but the Department could set forth a set of criteria tending to show that top hat plan membership is either compatible or at odds with the accomplishment of ERISA's policies. If numerous examples accompanied the specification of criteria, the Department

[76] Stein, transcript of meeting of the ERISA Advisory Council held on September 18, 2020, at 156 ("I think that's actually a strategy that some employers have used to try and find room in the top hat exemption and say, well, I don't want to take a chance covering 20 percent of the workforce, so I'll have four top hat plans, each of which will cover five percent.").

could provide considerable certainty to plan sponsors by addressing common practices and could provide guideposts for the courts.

Purely for purposes of illustration, and without taking a position on appropriate line drawing, such a framework might look like this:

- *Safe harbor:* Total annual compensation exceeding 150% of the section 401(a)(17) limit;
- *Unsafe harbor*: Total annual compensation less than 150% of the section 414(q) limit;
- *Intermediate (discretionary) zone*: In this range, a "select group of management … employees" would be defined qualitatively by reference to indicia of financial sophistication demonstrating realistic understanding of the risks presented by the absence of vesting, funding, fiduciary standards, protection from accrued benefit reductions, etc., combined with sufficient resources (income or wealth) to bear that risk.

Several aspects of the illustrative framework merit comment. As proposed, the quantitative safe harbor definition of highly compensated employee would be set at an amount that is high enough to ensure that automatic eligibility would be granted only to employees whose disposable income should be sufficient to allow rapid recovery from loss of nonqualified deferred compensation. In addition, a high set point would typically assure that the employer would face substantial pressure to sponsor reasonably generous qualified retirement plan(s) due to demand from many highly-paid employees whose compensation falls below this cut-off.

The proposed unsafe harbor would be set at a level that would prohibit an employer from covering all of its QP HCEs under a top hat plan, regardless of their managerial or executive responsibilities. Qualified plan highly compensated employee inclusion is the driver of the coverage and amount nondiscrimination rules. As explained in the preceding section, the prospect of covering all QP HCEs under a top hat plan instead of including them as qualified plan participants is antithetical to the fundamental design principles of the U.S. retirement system. Moreover, as Professor Norman Stein's written statement demonstrates, top hat plan participants get the worst-of-all-possible-worlds when it comes to pension security: ERISA protections are inapplicable, state law protections are superseded because preemption applies, and ERISA's remedial limitations seriously curtail enforcement of the terms of the plan.

Intermediate between the bright-line safe and unsafe harbors the proposed "test" would look to all the facts and circumstances. The discretionary determination in this zone is of course more of a standard than a rule. In elaborating such a standard, the Department could specify factors tending to support (or undercut) the existence of financial sophistication and risk-bearing capacity. Such factors might include actual demonstrated ability to substantially influence the design and operation of their plan, as in Advisory Opinion 90-14A. Another factor, in the case of an employer that is not a publicly-traded company, might be the inclusion in the plan document of terms obligating the employer to annually provide top hat plan participants a copy of audited financial statements, if such statements are prepared for the use of owners, creditors, or government regulators. To facilitate planning by providing certainty in common situations, it would be helpful to supplement the standard with a large number of factually rich examples, illustrating both circumstances that support top hat plan inclusion and a range of situations in which it would be barred.

D. Participant Sophistication Test

Another possibility is to define eligibility for top hat plan participation by reference to the ability of management or highly compensated employees to understand and to bear the risks attendant to these plans. A number of witnesses indicated that the "select group of management or highly compensated employees" should include only those employees who can protect themselves and do not need the benefit of ERISA's substantive requirements.

Advisory Opinion 90-14A outlines one such definition, specifically requiring that top hat plan coverage include only those employees who have both the capacity for understanding the risks of such plans ("taking into consideration any risks attendant thereto") and the leverage to mitigate those risks by affecting "the design and operation" of the plan.

Witnesses were skeptical that participants' general bargaining power is a practical or workable limitation, and many flatly rejected the specific ability to negotiate plan terms as a realistic test in the modern context. Richard Skillman allowed that at least some top hat plan participants "have enough clout within the organization to have looked out for the bona fide[s of the] plan and the protection that it provides" and opined that those few will serve to protect the participants who lack such clout, and

would “serve as a check in terms of the basic structure of the plan.” Other witnesses, including Arthur Kohn, indicated that there is no one in the modern corporation who truly has the power to negotiate the terms of a top hat plan; that employees at even the very highest level are presented with standard, fully-formed benefit plans, and the terms and operation of such plans are never negotiated piecemeal. Instead, the suggestion was that the focus should be on whether a class of employees will effectively have control over the terms of their employment through their ability to “vote with their feet.” That too is an amorphous concept and would apply to very few in a large corporation. Nonetheless, a standard that combines capacity to understand risk, leverage to mitigate the risks, and ability to withstand losses makes good sense, especially in circumscribing an exception to ERISA's remedial effect.

There are also quantitative approaches to determining participant sophistication in the context of assumption of financial risk. The Securities Act of 1933 requires the registration of securities that are offered to the public but includes an exception for securities offered to “accredited investors.” The SEC has stated that the accredited investor definition is “intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or fend for themselves render the protections of the Securities Act’s registration process unnecessary.”[77] The SEC definition for accredited investor includes a natural person who “had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person’s spouse or spousal equivalent in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.”[78] There are other pathways for a natural person to be considered an accredited investor including being a “knowledgeable employee” of the employer or having a specified net worth.[79] The policy considerations in promoting retirement security and ensuring that employees receive the compensation they have been promised for work they have performed arguably are stronger than the policies underlying securities laws. Nonetheless, the policy considerations under both regimes somewhat overlap, and the SEC definition of accredited investor is a useful touchstone.

[77] See *Regulation D Revisions; Exemption for Certain Employee Benefit Plans*, Release No. 33-6683 (Jan. 16, 1987).
[78] See 17 C.F.R. § 230.501(a)(6); see also 85 Fed. Reg. 64234 (Oct. 9, 2020) (amending the definition of accredited investor and discussing the rationale for the treatment of various categories).
[79] 17 C.F.R. § 230.501(a)(5).

E. Enhanced Reporting

As discussed above, the Department allows top hat plans to forego filing an annual return/report on the Form 5500 in favor of a one-time registration statement filed when a top hat plan is first established. In doing so, the Department reasoned: (1) highly compensated or management employees generally have sufficient information and bargaining power to protect their rights without the protections of Part I of Title I of ERISA; (2) fiduciary breaches are less likely with unfunded or totally insured pension plans so reporting is less important; and (3) standard reporting and disclosure requirements would entail needless expense (preparation, printing and distribution) which might cause employers to eliminate or reduce such plans.[80]

No report is required when a top hat plan is terminated. Nor is any report required if the information originally reported changes, such as the number of participants covered, or the number of top hat plans offered. The "new" electronic form contains a check box to indicate whether it is an initial or "amended" filing, but the Department's instructions make clear that an amended filing is required to correct an outright error in the initial filing but is not to be used to report changes in the plan, even significant changes, including a new class of participants or other significant changes that could be fairly described as a "new arrangement." As the instructions state: "An existing top hat filing by an employer does not cover a new top hat plan that is subsequently adopted. A new filing, however, is not required when a top hat plan is amended to include a separate class of participants. Whether a new arrangement is a separate plan or rather is part of an existing plan is determined under all of the facts and circumstances."

There is no question that the current one-time filing requirement is very limited and very simple for employers. Professor Stein characterized the current reporting scheme as "modest bordering on trivial." The face of the form as well as Department research tends to bear that out. In finalizing its electronic filing rule, the Department estimated, pursuant to the Paperwork Reduction Act, that electronic filing reduces the burden on employers to a mere ten minutes by "in-house human resource professionals" to prepare and submit the form.[81]

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[80] See 40 Fed. Reg. 34526 (Aug. 15, 1975).
[81] 84 Fed. Reg. at 27,955.

Several witnesses indicated that requiring updated reporting would greatly increase the utility of the data collected via these reports. GAO witnesses pointed out significant shortcomings in the data resulting from the one-and-done nature of the filing. For example, David Lin noted that although the Department's data theoretically covers all employers, and covers a significant period of time, going back several decades, it essentially was of no value in their research as to prevalence and level of benefits offered because of the failure to require any notice of plan termination. For that reason, GAO was forced "for better or worse" to rely upon SEC data, limited to an employer's top five executives and reflecting only publicly-traded employers. Indeed, when asked how many top hat plans exist, Mr. Lin indicated that, due to the limitations of the Department data as well as the limited scope of the SEC data, GAO simply was not able to report on that basic question. GAO staff indicated that due to the limitations in what is collected, Department staff admitted to GAO that "the data currently collected can only be used for simple analysis or to facilitate the agency's ability to respond to requests from Congress, the media, or the public."

Richard Skillman indicated that periodic updates would not only improve the data, but would also serve a second important objective. First, he noted that the "information, particularly the number of participants, is likely to become outdated," and should be updated every five or ten years. In addition to making the data less stale, Mr. Skillman believes updates would serve an important compliance purpose. He believes a compliance purpose is served by the current reporting, which requires employers to certify that each top hat plan is maintained only for a "select group of management or highly compensated employees" and thus "hopefully to make a serious, good faith judgment on the applicability of the top hat exemption." Mr. Skillman opined that repeated filings "might cause employers to be more vigilant" in ensuring that their plan is eligible for top hat treatment.[82]

Several witnesses testified that collecting additional types of information is necessary for oversight as to whether top hat plans are covering ineligible employees. GAO's Kris Nguyen testified that the "current one-time, single-page filing statement" lacks "key information that could allow DOL to better identify plans that may be including ineligible employees" such as "the job title or salary of employees

[82] It is not clear that much soul-searching is encompassed in the unsigned form's check-the-box declaration, or even the former written statement, which DOL estimates to have taken just one hour to complete and submit (84 Fed. Reg. at 27,955), but to the extent there is any appreciable compliance benefit to the self-declaration, it certainly stands to reason that more frequent reporting would lead to more compliance.

participating in the plan, or the percentage of the company's workforce participating in these plans." Ted Burik agreed as to the utility of those data and clarified that reporting both "the percentage of the company's workforce that's eligible to participate [and] the actual percentage of employees who are participating in the plan" would be beneficial. He added that, in order to understand whether covered employees are "highly compensated," the report should "compare salaries of executives with rank-and-file workers."

Ted Burik testified that, in the course of the GAO study, industry experts had recommended reporting on each of those elements, i.e., job title and salary of the executives participating; the percentage of the workforce eligible to participate, and actually participating; and a comparison of participating executive salaries to those of rank-and-file employees. Indeed, GAO testified that an official from the Department itself confirmed that including such additional data could allow it to "increase oversight of executive retirement plans" and that for example "if a high percentage [of participation] was reported it would signal to DOL that the company might be permitting employees to participate who did not meet select group requirements [which] could actually prompt a DOL audit."

Professor Stein also opined that, under the current reporting regime, regulators and legislators are deprived of important data and top hat plan participants are deprived of important information "relative to their benefit security." He indicated that additional information would help not only regulators and legislators, but also plan participants who might be better able to affect how these plans are shaped or designed if they had better information regarding percentage of participation, range of compensation, job titles and value of benefits across the plan or plans.

Witnesses opposed to collecting such additional data suggested that it would be worthless because, as they argue separately, the Department should not draw definitional lines around such criteria. For example, Richard Skillman testified that he did not see "any good reason for more extensive information reporting than we have. I just don't see what additional information the Department of Labor might request or what it would do with it when it got it." Similarly, Bruce McNeil queried, "what would the Department of Labor do with that information?" Interestingly, much of the objection to refining definitional criteria is that the lines are difficult to draw. In that case, information about how employers themselves draw the lines would be especially valuable rather than worthless. Thus, the sum

of the rather circular and unconvincing argument against collecting data seems to be that the Department should not have a definition because it is hard to draw one, and that it should not collect the data that could help devise an appropriate definition because it currently has no definition.

F. Participant Disclosure

By design, all top hat plan participants face risk of nonpayment in the event of insolvency; in some plans, they also risk nonpayment should the employer have a change of heart. These are significant risks that should be made clear, along with other gaps in ERISA protections, such as the lack of an anti-cutback rule, fiduciary liability and spousal protections.

Several witnesses testified that employers go out of their way to provide information to top hat plan participants. Some emphasized that, due to the stature of top hat plan participants within firms, employers go out of their way to explain the various risks inherent in these plans. However, a significant subset of those witnesses also allowed that they had seen plans that had failed in regard to these disclosure best practices. Other witnesses shared their impression that many top hat plan participants did not appreciate the risks associated with participation and may not even realize that they are not participating in a qualified plan. This confusion may be heightened in circumstances where the nonqualified plan is closely integrated with the qualified plan, for example, a nonqualified plan designed to fill a gap in matching contributions for participants with compensation above the section 401(a)(17) limit or where the plan's investment options and investment process mirror the qualified plan options and processes. Thus, witnesses agreed that disclosure about plan risk is a best practice, that many (but not all) employers do conscientiously make disclosures either at the start of participation or annually, and that gaps in understanding and appreciating risks abound.

There is little to no downside in requiring disclosure. Many employers are doing so already, and all employers should. Employees may not read boilerplate, but that is no reason not to disclose significant risk such as losing your entire retirement savings. Where top hat plan design includes employee deferrals, employees certainly should make a knowing election of whether and how much to voluntarily defer, and for all plan designs, employees should have information they need to evaluate their compensation and consider alternatives. Whether or not employees, as a practical matter, can negotiate the terms of any deferred compensation plan they are offered, they can negotiate their overall

compensation package, or find an employer who offers the package they want. Employees with no such leverage should not be in a top hat plan to begin with.

Yet another approach might be to require employers to provide the financial information necessary for an employee to evaluate the risk of nonpayment in the event of insolvency, such as access to the employer's financial statements. This would not be a material burden for publicly-traded employers who are subject to standardized reporting requirements under securities laws. It could, however, be a significant ask for privately-held employers who may view their financial statements as highly confidential and proprietary information. Further, understanding financial statements is not a ubiquitous skill, even among management and highly compensated employees, and it is fair to ask whether this information would be useful. Still, as part of an enhanced alternate reporting and disclosure system, disclosure of some information as to financial strength and credit worthiness bears consideration.

VIII. REASONS FOR RECOMMENDATIONS

A. Enhanced Disclosure

The Council recommends that the Department revise the alternative reporting requirement for top hat plans to require prominent disclosure of the risks associated with participation. These risks will invariably include the risk of nonpayment due to the employer's insolvency but may also include the risk of repudiation (if the plan is not fully funded through a rabbi trust or other similar arrangement) as well as risks that are unique to the plan terms, such as forfeiture in the event of a violation of a noncompetition provision or a vesting requirement. Our purpose is not to create a standardized disclosure but rather require employers to create one that is tailored to the terms of the top hat plan.

We believe that disclosure of the risks could be helpful for participants considering the value of their total compensation, deciding whether to defer compensation to a top hat plan and evaluating their retirement adequacy. The Council heard testimony that this would not be an overly burdensome requirement and that it is in fact generally considered best practice today.

Our recommendation does not specify frequency of disclosure. We understand that, in connection with annual enrollment, many plan sponsors routinely disclose that a plan is unfunded and may not pay

benefits in the event the employer becomes insolvent. We agree that disclosure makes sense at the time a participant is considering whether to elect to defer compensation to a top hat plan. However, in nonelective top hat plans, it may be sufficient to provide disclosure at the time of initial participation. There may also be other circumstances where disclosure is appropriate, for example, in the event of a material modification to the plan terms. There may also be arguments that disclosure should be required in the event of a material change in the employer's financial strength or risk profile. We encourage the Department to appropriately balance the complexity and burden of frequent or judgement-based disclosure against the benefit to participants.

The Council is cognizant of the risk that disclosure will be largely "boilerplate" and that employees who do not have the ability to negotiate the terms of their deferred compensation – which appears to be the large majority of top hat plan participants -- may not be able to do anything with the information. That is, disclosure may only be of value if a participant can act on that information. On balance, we believe that disclosure may be valuable in a number of circumstances, including making decisions about voluntary deferrals, whether to accept an employment offer and even whether to retire. Moreover, we believe the burden of mandatory disclosure along the lines we recommend will be modest, especially in light of uniform testimony that most employers already are making such disclosures.

B. Reporting

The Council recommends that the Department amend the alternative reporting regime to require periodic, rather than one-time, reporting and to require additional data elements on the report. In the Council's view, the alternative reporting scheme has resulted in an enormous regulatory blind spot. Under current law, reporting is only required upon adoption of a top hat plan. There is no subsequent updating based on changes in participation, material modifications, plan mergers or plan terminations. Moreover, the data elements provide very little information other than to note the existence of a top hat plan. The Council is not aware of any other meaningful source of data about top hat plans. This information vacuum leaves both the Department and top hat plan participants in the dark.

The lack of reliable, comparable data about top hat plans makes it very difficult to gauge whether top hat participation is appropriately limited to a select group of management or highly compensated employees. The extant information about participation is derived from limited public company reporting

of deferred compensation and industry surveys. The latter generally do not distinguish between top hat plans and other forms of nonqualified deferred compensation and generally do not provide standardized reporting across time periods. This results in challenges in evaluating whether top hat plan participation is appropriately limited to a select group of management or highly compensated employees. We are also skeptical of the Department's ability to appropriately allocate compliance and enforcement resources in the absence of even baseline plan information. Perhaps most importantly, we also believe that the alternative reporting regime sends a message that the Department does not prioritize top hat plan issues, which may encourage aggressive practices.

Additional data could also be helpful to participants. Information about the total number of top hat plan participants, total amount deferred and whether benefits are funded through a rabbi trust at least provides some indication of the extent to which the participant's interest is protected. This data might, for example, provide insight into whether the interests of the participant are aligned with the interests of other employees or whether the employer is likely to pay benefits due either because the employer's total liability is modest or assets are set aside in a rabbi trust.

Although the Council is convinced that enhanced reporting would be appropriate and helpful, the Council is sensitive to the burdens that could be associated with enhanced reporting. For these reasons, the Council did not recommend reporting analogous to the Form 5500 annual return/report. We are comfortable with the structure of the current reporting system. We do not believe it is necessary to develop a sophisticated reporting system.

We also did not think it was necessary to obtain annual reporting. The Council agreed that a three-year reporting cycle should provide adequate information.

In terms of additional data elements, we started from the premise that reporting should focus on participants, rather than plans. In contrast to qualified plans, there is no crisp definition of a plan in the context of an unfunded top hat plan.[83] Thus, our approach to reporting starts with all of the plans maintained by an employer treated as a single plan. We believe this will simplify the reporting process and provide meaningful information.

[83] I.R.C. § 414(l) (defining plan by reference to whether assets are available to pay benefits).

With respect to data elements, we believe it would be helpful for the Department to have a sense of the size of the employer and the number of employees covered by a top hat plan. The percentage of the workforce covered has sometimes been a critical metric in the case law, although the Council is reluctant to elevate the percentage covered as a factor. The Council considered including a greater level of detail about how to determine the employer, for example, to define the employer by reference to the controlled group rules, and the number of employees, for example, to reference the coverage and nondiscrimination rules, which permit the exclusion of certain categories of employees. We believe that it is important to provide guidance around these issues and that the rules applicable to qualified plans are a natural fit to provide consistency, simplicity and economies of scale. Ultimately, we concluded that these more granular issues are better left to the regulatory process.

We specifically suggest including as a data point the number of employees who are eligible to participate in the plan who earn less than the section 401(a)(17) compensation limit. As reflected elsewhere in this report, a number of witnesses raised questions about whether broad coverage by top hat plans undermines the qualified plan system. The section 401(a)(17) limit is particularly germane to this issue. This is not to say that covering employees who earn more than the section 401(a)(17) limit is without issues, but the argument that top hat plans are undermining the qualified plan system is most compelling for participants all of whose compensation could be taken into account under a qualified plan. Moreover, we believe that gathering this information will serve a useful role by suggesting that employers should be sensitive to covering employees who earn less than the section 401(a)(17) limit in their top hat plans. There may be legitimate reasons--for example, a relatively modestly paid workforce with executive employees earning less than the limit--but requiring reporting at least calls attention to the issue. This may encourage greater consideration of coverage determinations and suggest an appropriate use of the Department's enforcement resources.

The Council suggests including information identifying the number of participants who are eligible to defer compensation on a voluntary basis. Top hat plans that permit voluntary deferrals of compensation raise questions about sidestepping limits applicable to 401(k) plans.[84] These plans may provide relief

[84] Key findings from Principal's report, *Trends in Nonqualified Deferred Compensation* (2020), include that "helping participants save for retirement above qualified plan limits is the #1 reason" employers offer NQDC, that "[r]etirement

from the actual deferral percentage test and reflect a "make up" matching contribution. In the absence of a top hat plan of this sort, it may be that mid-level employees would pressure the employer to offer greater contributions under the qualified plan. A so-called "mirror 401(k)" top hat plan may allow participants to make salary reduction contributions in excess of the limit on elective deferrals of Code section 402(g) ($19,500 in 2021); absent that outlet, the employer would likely face pressure to increase matching or nonelective employer contributions to its qualified 401(k) plan. Similarly, the Council recommends identifying plans that are designed to coordinate with--or function as a seamless extension of--a qualified plan of the employer.

Additional questions focus on the prevalence and use of rabbi trusts. This information may be useful to plan participants but it is also a relevant data point in determining whether repudiation risk is relevant.

We think it would also be appropriate to require reporting of the present value of deferred compensation. The Council's intent is not to require detailed actuarial reports and complicated determinations with respect to amounts that are subject to a risk of forfeiture. We believe that it would be useful to have a sense of the total amount at issue, for one thing, to assist participants in evaluating the risk to their own retirement savings. For that reason, we suggest that reporting should be based on any consistently applied method. Thus, for example, an employer that values its top hat plans for financial reporting purposes could use such a metric. Alternatively, an employer that provides an individual account plan could simply total the account balances without regard to vesting schedules. The Council notes that privacy concerns make it inappropriate for the reporting to highlight individual deferred compensation amounts. Thus, we suggest an exception for employers with smaller deferred compensation programs.

We did not accept recommendations to require nominal or functional titles as a data element. The Council's collective experience is that business practices around titles vary widely and are not standardized. Further, it would be challenging to create functional titles and burdensome for employers to apply such a regime. We also rejected recommendations to include reporting comparing the compensation of top hat plan participants to the average compensation of the workforce as a whole. We

continues to be the #1 reason to participate in the plan" and the observation that NQDC "is extremely critical in helping me reach my financial goals *because of the opportunity to defer significantly above 401(k) limits*." (At p. 1, emphasis added.)

do not see how such reporting would be helpful and we are sensitive that employers, particularly smaller employers, will resist reporting data they believe is proprietary or which undermines competition.

C. Request for Information

As reflected above, the Council believes it is possible that the lack of guidance on top hat eligibility is inviting broader coverage than Congress intended. Broad availability of top hat plan participation may be putting employees inappropriately at risk and undermining the qualified plan system. The former goes to the heart of the exemption (ERISA's protective policy) and the latter raises a matter vital to retirement policy.

The Council heard consistent testimony reflecting that the standard articulated in Advisory Opinion 90-14A – whether an employee has the ability to negotiate the terms of their deferred compensation – is not followed in practice and provides relatively little direction. It has been rejected by a number of federal courts of appeal and the courts have essentially created their own standards. These standards, however, do not appear to be particularly useful. The federal courts have addressed the issue in the context of specific employment disputes and the resolutions are highly fact-specific, providing relatively little guidance to those tasked with determining who should be eligible to participate.

The Council also believes that witnesses raised legitimate questions about whether top hat plan participation undermines coverage or benefits under qualified plans. The qualified plan system fundamentally rests on a "constructive tension" by providing tax-preferred benefits to highly compensated employees and management only if comparable benefits are provided to rank-and-file employees. We heard testimony that the tax differences between top hat plans and qualified plans are not so great that a top hat plan benefit cannot substitute for a qualified benefit.[85] Witnesses indicated that top hat plans are often structured to replicate qualified plans, for example, by crediting pre-tax earnings on deferrals with no adjustment for the tax cost to the employer.[86] We also heard testimony that the tax

[85] Since 2018 the corporate tax rate (21%) has been substantially lower than the highest individual income tax rate (37%). Under those conditions, nonqualified deferred compensation (under which investment returns are effectively taxed at the employer's rate) offers substantial tax savings for high-income employees, compared to individual savings. *See generally*, Michael Doran, *The Puzzle of Nonqualified Retirement Pay*, 70 TAX L. REV. 181, 185-200 (2017).

[86] There is cause for concern even under programs that require participants to bear the burden of the employer's tax on investment returns credited to their accounts. Because top hat plan participants get income tax deferral — and likely because they believe they must be getting special benefits as members of a "select group"--they probably widely assume that they are getting favorable tax treatment akin to that accorded qualified plan saving.

cost to the employer is sensitive to whether the employer pays any corporate income tax or uses a deferral vehicle like corporate-owned life insurance (COLI).

We realize that the interplay with the qualified plan system raises jurisdictional questions. The Department of Labor does not have jurisdiction over the tax aspects of the qualified plan system. However, we do not think the split jurisdiction for the retirement plan system envisioned by the Reorganization Plan No. 4 of 1978 should be a barrier to considering the qualified plan system. There is little question that ERISA was enacted with the expectation that the qualified plan system would continue to be the primary means of providing pension benefits, and that the top hat plan exemption was not intended to undermine qualified plans.

For these reasons, we think that guidance from the Department of Labor would be appropriate and helpful. As discussed above, there are a number of different approaches that the Department could take to define a "select group of management or highly compensated employees," including safe harbors, bright-line tests, and more holistic facts-and-circumstances standards. Drafting such guidance does not strike the Council as something unique or particularly challenging and is in fact the type of issue taken on by a variety of regulators.

We are, however, mindful that nonqualified deferred compensation in general, and top hat plans in particular, play a role in how businesses manage, retain and acquire talent. The Council heard testimony about the importance of nonqualified deferred compensation where equity compensation is not feasible, for example, because a company is not and has no intention of becoming publicly traded. Similarly, we heard testimony about the importance of top hat plans where a business is cash poor and cannot otherwise offer a competitive salary. Particularly given the absence of good data, we are reluctant to suggest changes that could adversely affect important business practices.

We also cannot ignore that the Department has not issued any guidance with precedential value in the nearly 50 years since ERISA was enacted. Business practices have arisen over the years that should not be disrupted without good reason. We do not want to recommend guidance that will only result in business for attorneys and consultants without accomplishing important public policy goals.

Moreover, we did not hear testimony that suggested widespread abuse or practices that would warrant immediate new regulation. Instead, we heard testimony that suggests a steady downward creep in the universe of employees who are covered by top hat plans. This increasing coverage of middle management suggests that some employees who should receive the substantive protections of ERISA may not be receiving it.

And even though we cannot disregard the lurking fundamental public policy question of whether top hat plan participation is undermining the level of benefits and contributions provided in qualified plans, and although there are certainly some red flags, we do not have compelling, quantifiable evidence reflecting that this is, or the extent to which it is, in fact happening.

For these reasons, we recommend that the Department issue a Request for Information that asks interested stakeholders for input on various potential definitional regulatory approaches. We think the Department can proceed quickly to implement the reporting and disclosure changes we recommend, but do not think the Department should wait until it has received and evaluated the information provided under the enhanced alternative reporting regime to address the definitional issues. That new data may very well not be sufficient to answer the issues at hand. An RFI would more precisely and expeditiously solicit the relevant information, and, in any event, we are convinced the public policy issues are of sufficient import that time is of the essence.

D. Coordination with the Treasury Department

We recommend that the Department of Labor work with the Treasury Department's Office of Tax Policy to gauge the interplay between top hat plans and qualified plans.

This recommendation is in addition to the recommendation to require enhanced reporting and to conduct an RFI because the Council does not believe that enhanced reporting and responses to an RFI will shed sufficient light on the fundamental question of whether top hat plans are undermining qualified plans. It will take many years before there is sufficient longitudinal data to assess whether qualified plan contributions and accruals are inversely correlated with top hat plan coverage or benefits. Moreover, even with the enhancements suggested by the Council, the reporting will shed only limited light on the interaction between top hat plans and qualified plans.

For these reasons, we encourage the Department of Labor to explore with the Treasury Department ways of evaluating and addressing the impact top hat plans have on qualified plans.