The Evolution of Nonqualified Plan Governance

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Nonqualified retirement plans continue to be widely used tools in the attraction and retention of executive talent. These plans provide tax-deferred benefits over and above the amounts available in a qualified plan such as a 401(k). More than 75% of Fortune 500 companies provide an employer-paid nonqualified plan, and over 80% offer nonqualified voluntary deferral plans that allow executives to defer their own pay on a pre-tax basis (Mercer's Executive and Broad-based Employee Retirement Tool 2014).

The governance of nonqualified plans is becoming increasingly complex. Executive pay and benefits are subject to growing scrutiny from shareholders, proxy advisers and the media. Regulatory requirements can also make plan oversight challenging for employers. But while governance and oversight of nonqualified plans is critical, many employers put limited emphasis in this area. Board compensation committees tend to have rigorous oversight processes for the executive pay program, and internal plan committees typically have thorough processes for the oversight of the company's qualified 401(k) or pension plans. But many employers

lack similar rigor in the oversight of the nonqualified retirement plans. The Wells Fargo 2014 Nonqualified Plan Benchmarking Survey found that 30% of nonqualified plans are not on a formal review schedule.

Although there may be varying reasons for this, one contributing factor is that it is sometimes unclear to the employer where to categorize the nonqualified plan. Although nonqualified plans are elements of both executive pay and employee retirement programs, they sometimes are excluded from the governance and oversight of both programs. For example, while nonqualified retirement benefits (if employer-paid) can be a meaningful component of executive pay, the plans are often not included when total executive pay is benchmarked against market practice. And while most employers hold quarterly plan committee meetings for the qualified retirement plan, many do not hold similar meetings or have committees established for the nonqualified plan, according to the Wells Fargo study.

NONQUALIFIED PLAN GOVERNANCE

One of the reasons that nonqualified plans are sometimes omitted from retirement plan governance is the difference in fiduciary requirements between qualified and nonqualified plans. Nonqualified plans are not required to have formal fiduciary oversight, as are qualified plans. However, unlike qualified plans, nonqualified plans are subject to IRC Section 409A rules that impose restrictions on the timing of deferral and distribution elections, among other things.

Section 409A was added to the Internal Revenue Code effective Jan. 1, 2005. At that time, nonqualified plans were front and center as companies attempted to understand the new rules and make necessary changes to their plans to comply with the law. After a series of delays, the IRS provided final guidance and all plans subject to Section 409A were required to come into written compliance with the law by Dec. 31, 2008. Once in documentary compliance, many companies essentially took a big sigh of relief and have not revisited 409A compliance since.

While most plan sponsors satisfied the 409A written compliance requirements years ago, many are not sufficiently focused on operational compliance with 409A. An operational 409A violation, even if unintentional, can create significant penalties for plan participants, including immediate taxation, a 20% penalty tax, state penalty taxes and interest from the date of violation.

While 409A violations penalize the plan participant, those violations are typically the result of a plan administration error, creating an expectation that any penalties levied to the participant will be made up for by the employer. Some employers have learned firsthand about the high costs of 409A violations, both in terms of hard-dollar costs via taxes and penalties and soft-dollar costs in company resources and participant communication.

In 2014, the IRS announced a limited scope audit initiative focused on compliance with 409A, targeting the 10 highest paid executives at about 50 large employers.

These Compliance Initiative Project audits are frequently performed as a measure to guide broader initiatives, indicating that this limited audit may be laying the groundwork for future audits.

In addition to 409A requirements, nonqualified and qualified plan governance requirements differ in several other ways. (See Table 1.) While nonqualified plans are required to meet limited Employee Retirement Income Security Act (ERISA) reporting and disclosure requirements, they are not subject to certain other ERISA requirements, such as vesting, nondiscrimination or fiduciary requirements.

Table 1 | Key Qualified and Nonqualified Plan Regulatory Differences

	Qualified Plans / 401(k)	**Nonqualified Plans**
ERISA filings	• Annual 5500 and audit • IRS Determination / Opinion Letter	• Initial filing of "top-hat" letter with Department of Labor
Plan committee has fiduciary responsibility	• Yes	• No
IRC limits on contributions, benefits and compensation apply	• Yes	• No
Proxy disclosure for named executive officers	• Employer contributions disclosed in Summary Compensation Table • Pension Benefit Table (defined benefit plans)	• Employer contributions and any "above-market" earnings disclosed in Summary Compensation Table • Pension Benefit Table (defined benefit plans) • Nonqualified Deferred Compensation Table (defined contribution plans)
Subject to nondiscrimination testing	• Yes	• No
Plan committee members have personal liability	• Yes	• No
409A requirements apply	• No	• Yes
Benefit security and funding	• Formal funding required with assets in a qualified plan trust outside the reach of corporate creditors	• No funding requirements • Assets can be set aside "informally" in a grantor trust but must remain subject to the claims of the company's general creditors • Funding may be prohibited if qualified pension plan is underfunded

Because of this, corporate governance processes have tended to overlook nonqualified plans and the linkage these plans have to both executive compensation and employee retirement plan governance.

WHAT ARE THE RISKS?

In addition to the significant 409A penalties discussed earlier, lack of nonqualified plan oversight/governance can lead to several issues:

- **Lack of Market Alignment.**

Looking at executive compensation or executive benefits in a vacuum, without reviewing the total pay picture, can lead to inappropriate decisions. For example, employer-paid nonqualified benefits that are above market may be appropriate if other elements of pay, such as cash and equity, are less competitive. Conversely, employer-paid nonqualified benefits may not be warranted at all if the market positioning of other pay elements is already above market norms.

It's important for employers to understand all elements of the executive pay package when evaluating pay relative to the market. The inclusion of employer-paid nonqualified plans in particular can have a meaningful impact. For example, a company might decide to increase its annual incentive targets for executives if its benchmarking results indicate that cash compensation is below market. However, if the company also provides generous nonqualified plan contributions that include incentive pay in the formula, increasing the annual incentive targets could cause total pay to exceed desired market positioning. Including total executive pay (compensation plus benefits) in benchmarking efforts provides a more holistic assessment and fully accounts for the impact that pay changes can have on benefits.

- **Inappropriate Investment Fees.**

Nonqualified plan structures have followed the qualified plan trend of shifting away from defined benefit (DB) to defined contribution (DC) plans, which typically allow participants to allocate account balances among an array of investment options. This may be the same as the investment lineup offered in the qualified 401(k) plan, or a completely different array of investment choices.

Because of qualified plan fiduciary requirements, most companies regularly review the 401(k) investment options to assess fees, relative performance, fund holdings relative to stated guidelines, asset manager changes, etc. When the nonqualified plan offers the same investment lineup as the 401(k), this process can easily cover both plans.

However, for nonqualified plans that offer a different array of investment options, the employer may lack a similar review process for the fund lineup. This lack of oversight can become apparent when an executive compares the nonqualified plan investments with personal holdings and notices a disparity in performance and/or fees. While nonqualified plan rules do not require fiduciary oversight of the investments offered in the plan, more and more employers are taking the stance

that nonqualified plan investments should be reviewed with the same rigor that is applied to 401(k) investment oversight.

- **Negative Impact on Executive Retention.**

Market interest rates can have a material impact on DB plan values. Changes in the interest rate used in valuing a DB plan can affect not only the accounting impact of the plan, but also can drive unintended participant retirement behaviors. An increase in interest rates can be helpful for the employer by driving down the plan liability.

However, this also has the effect of reducing lump-sum benefit values. In an environment where interest rates are expected to rise, plan participants may find it more beneficial to retire earlier and lock in a lower discount rate (and therefore higher benefit value) rather than continue working and face the risk of higher interest rates eroding benefit value. This can create a disruption in current management and trigger gaps in succession planning. As such, it is critical for nonqualified DB plan sponsors to regularly review how rates can impact the plans and potentially influence participant behaviors.

- **Lack of Process Oversight.**

As discussed earlier, significant tax penalties can result from 409A violations, whether the violations are intentional or not. Violations are most often due to administrative errors, such as processing an improper deferral election, paying a benefit at the incorrect time or in the incorrect form, etc. While it is not possible to completely eliminate the risks of errors, having an independent operational review of the plan can significantly mitigate this risk. Operational reviews typically cover three areas:

- *Documentation*. Identify any inconsistencies between the plan document terms and other documentation at the plan sponsor or record keeper (plan brochure, plan administration manual, enrollment forms, participant communication materials, etc.).
- *Processes*. Analyze key processes at the level of the record keeper, plan sponsor and any other parties involved in plan administration to identify potential areas of risk, manual processes and other inefficiencies.
- *Transactions*. Review a sampling of actual transactions for a given plan year(s) to confirm transactions align with elections, with plan provisions and with 409A.

From that review, a need for documentation cleanup may be identified, as may opportunities to streamline processes and reduce compliance risk. And if actual 409A violations are found in the transaction review, the employer can seek to remedy the violations through IRS voluntary 409A corrections programs.

The corrections programs can allow for reduction or waiver of penalties for unintentional violations, assuming the violations are identified and corrected in a timely manner. Periodic operational reviews are a proactive way to minimize risk in the management of the plan. It can also be efficient to undertake an operational

review of the qualified and nonqualified plans simultaneously, especially if the same record keeper administers both plans.

- **Inefficient Plan Financing.**

While not required, many employers choose to informally fund/finance nonqualified plan liabilities. The primary reasons for financing are to: 1) manage the accounting impact of the plan; 2) provide cash flow to pay future benefits; and 3) provide additional benefit security (however, nonqualified benefits cannot be completely secured without causing current taxation for participants).

If financing assets are not regularly monitored, a mismatch can develop where the asset costs/charges are higher than anticipated (due to inefficiencies) and/or are not properly aligned with the benefit liability. As an example, many deferred compensation plans offer participants an array of investment options from which to choose. If the financing assets are not regularly rebalanced to mirror the participant investment allocations, assets and liabilities can grow out of sync and create market exposure for the company.

This mismatch is more likely to occur when the company finances with corporate-owned life insurance (COLI). COLI can be a very effective nonqualified plan financing vehicle due to its tax advantages. However, it is a complex asset and requires careful structuring and monitoring to ensure it provides the desired results.

ELEMENTS OF EFFECTIVE NONQUALIFIED PLAN GOVERNANCE

While the rules under ERISA dictating standards of care for plan fiduciaries do not apply to nonqualified plans, more and more plan sponsors are implementing nonqualified plan governance standards that align with those required of qualified plan fiduciaries. The optimal nonqualified plan governance structure may vary from employer to employer depending on factors such as corporate structure, whether the plan is financed and whether the plan is DB or DC. However, best practices for governance generally include:

- Plan Committee
  - Often consists of the same committee that oversees the qualified plan or with some of the same members as the qualified plan committee.
  - Meetings may cover fund performance, plan activity, legislative developments affecting the plan, potential design changes, market trends in nonqualified plans, etc.
- Holistic Assessment
  - Understand the impact that nonqualified plans have on total executive pay and on total executive retirement benefits.
  - Include employer-paid retirement benefits when reviewing executive pay versus market practice.
  - Include both qualified and nonqualified plans when reviewing executive retirement benefits versus market practice.

- Operational Oversight
  - Conduct operational reviews periodically to minimize risk in plan management.
  - Provides opportunity to identify potential 409A errors in time to minimize or eliminate penalty.

Table 2 | Plan Governance Framework

STEP	FREQUENCY
1) Establish Plan Committee responsible for ongoing governance of the plan	One time
2) Define governance processes and oversight requirements	Initial setup and ongoing maintenance
3) Undertake plan operational review with independent third party	Every 3-4 years
4) Review internal administrative procedures and plan documentation	Annually
5) Assess changes in participation, plan liability, deferrals/contributions, expected plan distributions and if applicable, the impact of these items on the plan financing strategy	At least annually
6) Review regulatory/legislative developments that may affect the plan or the financing assets	At committee meetings, or off-cycle for material developments
7) Benchmark plan design relative to market best practices and incorporate employer-paid benefits in the review of total executive pay	Every 2-3 years
8) Plan operational review with independent third party	Every 3-4 years
9) Self-audit to review internal administrative procedures and plan documentation, using operational review results as a guideline	Annually

- Objective Assistance
  - Utilize an outside/independent third party to assist the committee in plan oversight.
  - Utilize an objective adviser who can work with the plan sponsor, the plan committee and the record keeper and is not compensated through plan administration fees or commissions on plan financing assets.

SUMMARY

Governance of nonqualified plans continues to evolve as employers look for opportunities to minimize risk in their executive pay and benefits programs. Best practices have significantly improved over the years, as more and more employers have approached nonqualified plan management with the same careful oversight applied to executive pay programs and qualified retirement plans. Establishing a thorough governance structure that coordinates with oversight practices for existing programs can help minimize risk and ensure that programs are being operated, communicated and maintained as intended. (See Table 2.)

AUTHORS

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