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Executive Compensation and Nonqualified Deferred Compensation

On October 1 the Senate Finance Committee voted 14-8 to deny compensation deductions for annual pay over \$500,000 for executives at certain health insurance companies. As we have discussed, the recent meltdown in the nation's financial services sector has emboldened lawmakers to try to impose federal restrictions on executive compensation. Executive compensation continues to receive scrutiny in four sectors. On the subject of nonqualified deferred compensation (NQDC), only one bill has been introduced, S. 651, and it has not received floor action since its vote out of committee in March. What follows is an analysis of the current state of play of executive compensation and NQDC.

Executive Compensation

1. Securities Exchange Commission (SEC)

The SEC's proposed rules, released July 10, focus on transparency and disclosure with respect to executive compensation at publicly traded companies. Specifically, the SEC would like disclosure: (1) for how a company — and its board — manages risks, (2) for a company's overall compensation approach, (3) for potential conflicts of interest by compensation consultants, including disclosure of relationships between the consultants and the company and their affiliates, so both compensation committees and investors will be better able to assess the advice the consultants provide, and (4) for director nominees, including their experience and qualifications to serve on the board or on particular board committees — and about why a board has chosen its particular leadership structure.

The proposed rules would be effective for the 2010 proxy season.

2. Federal Reserve (FED)

The FED is crafting a proposal that would provide the authority to review and reject pay policies—including salaries, bonuses, and other types of compensation—at banks for executives as well as certain other employees. The proposal would go beyond review of the top-level executives and would include traders and thousands of other bank employees nationwide. In addition, the

proposal would apply not only to banks who took TARP bailout funds from the government, but all U.S. banks regulated by the Fed. Currently, more than 6,000 U.S. banks are under the FED umbrella.

A final proposal is still a few weeks from completion and could be revised along the way, according to people familiar with the matter. It requires a vote by the central bank's board, but no congressional approval.

3. Treasury

In June, the Treasury Department issued an interim final rule on compensation and governance applicable to all recipients under the Troubled Asset Relief Program (TARP). Key requirements under the rule include:

- limits on compensation that might create incentives for senior executive officers to take excessive risks that would threaten the value of the institution;
- recoveries of any bonuses and awards granted based on materially inaccurate statements of earnings;
- prohibitions on employee compensation plans that would encourage manipulation of earnings;
- establishment of a compensation committee of independent directors to review compensation plans and the risks associated with the plans; and
- adoption of an excessive or luxury expenditures policy.

Continued:

4. Congress

Congress is weighing various legislative proposals that might place similar compensation restrictions on a broader group of regulated institutions.

a. The House of Representatives

Early in the year, the House passed an aggressive bill imposing a retroactive excise tax on bonuses paid to employees of TARP recipients. *See our Bulletin 09-33.* That bill went “no where” in the Senate. However, before the August recess, the House passed H.R. 3269, entitled the “Corporate and Financial Institution Compensation Fairness Act of 2009.” *See our Bulletin 09-90.* That measure would require a say-on-pay vote, set standards for independence of compensation committees and require federal regulators to disallow inappropriate or imprudently risky compensation practices as part of the solvency regulation of all financial institutions. This bill would apply to financial services firm with assets of \$1 billion or more though the concern is that it could be expanded to affect far more companies.

b. The Senate

As reported in the introductory paragraph, the Senate Finance Committee passed 14-8 an amendment to limit the deduction for executive pay at certain health insurance companies to \$500,000. Under current law, publicly-traded companies can deduct up to \$1 million annually for each of their top four executives. Under the amendment just approved by the Senate Finance Committee, the \$500,000 deduction limitation would apply to “all officers, employees and directors” of insurers that derive at least 25 percent of their premium income from people required to obtain coverage under the health care reform legislation. The proposed new deduction limits are similar to the restrictions placed on banks that received federal funds under the Treasury Department’s Troubled Asset Relief Program, which we reported on in our Bulletin 09-71. For example, the performance-based compensation and commission-based compensation exceptions that apply under the current \$1 million cap on compensation for publicly-traded companies would not apply to the proposed new \$500,000 deduction cap on certain health insurance companies. In addition, in contrast to the current \$1 million deduction limit, deferred compensation paid in a later year would also be subject to the proposed new \$500,000 deduction cap.

The Senate Banking Committee is considering the House’s H.R. 3269 (described above). In June, Chairman Chris Dodd (D-CT) issued the following statement on executive compensation proposals:

“I’ve always been a firm believer in strengthening shareholder voices through ‘say-on-pay’ requirements and tougher standards for those responsible for overseeing executive compensation. I included a ‘say on pay’ provision when we restricted excessive compensation from those companies relying on taxpayer funds to survive, and I will consider it as an integral part of our ongoing efforts to bring financial regulations up to 21st century standards.”

Chairman Dodd stated a different approach to financial services reform than that of House Financial Services Chairman Barney Frank (D-MA). Chairman Dodd plans to move a comprehensive bill through his committee this year, whereas, Chairman Frank plans to mark up separate bills in late October and move them to the floor for a vote in November.

NQDC

S. 651, The Compensation Fairness Act of 2009, was introduced by Chairman Max Baucus (D-MT) on March 19, and reported out of committee on March 23. *See our Bulletin 09-34.* Although it has been placed on the Senate’s calendar of business, the order in which legislation is considered and voted on is determined by the majority party leadership. With health care dominating the agenda, and other items like climate change, financial services reform, as well as the estate tax and other extenders, it is more likely than not that the Senate will not address this legislation before year end.

Conclusion

While there has been no salary cap imposed by the SEC, FED, Treasury or Congressional proposals, as was initially called for by the public and other officials, it is obvious that the structure of executive compensation for many businesses will change in the coming years. In fact, some companies are actively changing compensation structures to comply with the likely regulations.

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