SIFMA

Securities Industry and Financial Markets Association

TESTIMONY OF ELIZABETH VARLEY
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BEFORE THE
CONNECTICUT FINANCE, REVENUE AND BONDING COMMITTEE
MARCH 1, 2010

Chairman Daily, Chairman Staples, and members of the Committee:

My name is Liz Varley, and I am Managing Director of Government Affairs at the Securities Industry and Financial Markets Association ("SIFMA")[1]. I appreciate the opportunity to testify before this Committee on S.B. 1. SIFMA applauds the legislature for making job creation its top priority. I, however, am here today to express our opposition to the provision which would tax the bonuses of employees of TARP recipients.

The financial services industry is certainly grateful to the American taxpayers for the unprecedented support they gave to the nation's financial system by underwriting the Troubled Assets Relief Program (TARP) in October 2008. The financial services industry takes very seriously its responsibility to repay taxpayers' investment - with interest and dividends - as quickly as possible. Indeed, substantial progress has been made on this front. Currently, out of the U.S. Treasury's original $250 billion in direct support of the financial system through the Capital Purchase Program ("CPP"), more than 50 financial institutions, including the largest banks, have paid back $175 billion plus $16 billion in interest, dividends and warrants. According to a January report from the U.S. Department of the Treasury, taxpayers have received an 8.8 percent return on the CPP investment thus far.

In response to the crisis, the U.S. financial services industry is also making significant changes to the way it operates, including increased transparency and accountability and implementing changes in compensation practices. In June 2009, SIFMA released a set of guidelines which encouraged firms to establish compensation policies consistent with effective risk management, link compensation to sustainable performance, make risk management professionals appropriately independent, and communicate compensation practices to shareholders.[2] These recommendations were in

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[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

[2] A copy of the guidelines can be found on SIFMA's website at http://www.sifma.org/legislative/savings/pdf/SIFMA-Comp-Guidelines-06-09.pdf

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line with those proposed by the Obama Administration and the G-20. Furthermore, the industry has consistently and publicly supported the Obama Administration's regulatory reform proposals that protect against systemic risk and create a resolution authority to wind down large failing institutions and end "too big to fail."

As you may know, bonuses paid to top executives and higher earning employees of TARP recipients are already subject to restrictions imposed by both federal statute and regulation. Executives are subject to clawback of bonuses if financial statements were found to be inaccurate. Golden parachutes are prohibited. The bonus payments, retention awards, and incentive compensation are also limited. TARP recipient firms and their Board of Directors compensation committee must evaluate the firm's employee compensation plans and the potential to encourage excessive risk. Firms that accepted TARP funds also must hold an advisory shareholder vote on compensation. Finally, the Obama Administration appointed a Special Master for TARP Executive Compensation with authority to review certain payments and compensation structures. The decisions of the Special Master have been formalized and are now being implemented by the affected firms. The Special Master does have authority to review compensation paid at all firms receiving TARP assistance as well.

In addition to the significant oversight of TARP recipient compensation programs, federal banking regulators have proposed new rules to oversee compensation programs. The Federal Reserve Board is close to finalizing a set of rules that will require banking institutions to ensure that their compensation programs are consistent with three core principles, including a balanced approach to risk-taking incentives; effective controls and risk management; and strong corporate governance. The Federal Reserve is taking a very hands-on approach and is already reviewing the compensation programs of the 28 largest banking organizations.

SIFMA, however, has serious concerns about legislation that would specifically tax the bonuses of employees of TARP recipients. We believe that such a tax is punitive and a misuse of the tax code. The firms impacted by S.B. 1 have been in compliance with the conditions required of them by the Congress and the U.S. Treasury Department. Many firms have already paid the money back. To impose additional requirements on TARP recipient money after the fact is inappropriate.

Importantly, the financial services industry has had a long-term mutually beneficial partnership with the State of Connecticut. It employs more than 118,200 people in the state and generates 19.2% of all corporate tax revenue.[3] While numbers are not readily available, it is probably safe to assume that personal income taxes paid by employees of these firms reflect a higher percentage of overall state income tax collected than would be indicated by the industry's size. SIFMA understands the legislature's frustration with the

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[3] This information was culled from the Bureau of Labor Statistics' December 2009 numbers. The financial services industry employs 7.23% of all Connecticut workers; the securities industry alone employs 22,800 people in the state. This number does not include individuals who live in Connecticut but work in New York City.

events of the last eighteen months but would encourage policymakers not to take punitive measures that could, as the market improves, discourage additional businesses to invest in the state or prevent current businesses from expanding their commitments.

Senate Bill 1 also raises potential constitutional concerns. First, the U.S. Constitution prohibits state legislatures from passing "bills of attainder."[4] Legislation amounts to a bill of attainder when it is in effect a "legislative punishment, of any form of severity, of specifically designated persons or groups,[5]" and is imposed without first affording the affected individuals or group a trial. Senate Bill 1 seeks to target a discrete group - highly compensated individuals associated with companies that received TARP funding - to pay a new tax, on the basis that such employees should be penalized by the state for participating in a federal program designed to support the nation's financial system. This interpretation is potentially strengthened by the fact that the tax applies to employees of firms that have repaid the funds, and "who must pay the tax" has no rational relation to the use of the funds or the purpose of the legislation.[6]

Second, S.B. 1 raises potential due process concerns. Under both the federal and state constitutions, an act of a state legislature violates due process when there is not a sufficient connection, and at least a rational relation, between the policy asserted by the state and the means the state chooses to accomplish it.[7] Here, there is no rational relation between seeking to "preserve jobs and encourage job creation in Connecticut" and increasing the tax rate for particular Connecticut residents who happen to work for often global companies that in prior years received, and in many cases repaid, federal TARP funds. Indeed, the only direct effect of raising the tax rate on this group of taxpayers is to increase the effective cost of employing Connecticut residents, providing an incentive for affected employers to hire employees elsewhere and for the potentially affected taxpayers to avoid Connecticut. This, of course, eliminates rather than preserves or creates jobs.

Finally, for Constitutional purposes, it is especially difficult to find a rational basis for legislation that defines the class of state taxpayers according to whether their employers were the beneficiaries of a *federal* government program. Any state program that interferes with and undermines the policies of a federal program is at least in tension with the principles underlying both the U.S. Constitution's Commerce Clause[8], which ensures that the federal government can regulate interstate commerce (such as the financial sector) free from interference by state legislatures, and the Supremacy Clause,[9] which pre-empts state legislation that is not consistent with "the supreme Law of the Land" passed by Congress.

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[4] U.S. Const. art. I, § 10, cl. 1.

[5] *United States v. Brown*, 381 U.S. 437 (1965).

[6] The purpose of SB 1 is "To preserve jobs and encourage job creation in Connecticut."

[7] *See* U.S. Const. amend. XIV; Conn. Const. art. I, § 8.

[8] U.S. Const. art. I, § 8, cl. 3.

[9] U.S. Const. art. VI, cl. 2.

SIFMA appreciates that many Americans are struggling in this economy, and our member companies are attempting to do their part to help the economy recover. We, however, believe that this help comes in such forms as repaying remaining TARP funds, providing additional job opportunities, helping America rebuild by raising financing for corporations, municipalities and small businesses, and working on structural changes that promote responsible reforms and stability. We do not believe that a highly discriminatory, punitive tax on a select group of Connecticut citizens is the answer.

I appreciate the opportunity to present SIFMA's views and would be happy to answer any questions.