PM&P | Pearl Meyer & Partners
Comprehensive Compensation®

NEW YORK
570 Lexington Avenue
New York, NY 10022
Tel (212) 644-2300
Fax (212) 644-2320
newyork@pearlmeyer.com
www.pearlmeyer.com

July 13, 2012

LuAnn Hart
Department of State
One Commerce Plaza
Albany, NY, 12231

Re: Addition of Part 144 to Title 19 NYCRR

Dear Ms. Hart,

Pearl Meyer & Partners ("PM&P") is pleased to submit comments on the proposed regulations ("Proposed Rules") issued by thirteen New York State Agencies to implement Executive Order 38 (the "Order"), Limits on State-Funded Administrative Costs & Executive Compensation.

By way of background, Pearl Meyer & Partners is one of the nation's leading independent compensation consulting firms, serving Board Compensation Committees as advisors and assisting organizations in the creation and implementation of innovative, performance-oriented compensation programs to attract, retain, motivate and appropriately reward executives, employees and Board Directors of public companies as well as not-for-profit and tax-exempt organizations. We help Boards and Committees establish and maintain sound governance practices, particularly as this relates to executive and director pay decision-making. Since its founding in 1989, PM&P's compensation professionals have advised hundreds of organizations in virtually every industry, ranging from Fortune 500 companies to smaller private firms and not-for-profit organizations.

As compensation consultants, we focus on the compensation-related aspects of the Order and Proposed Rules in this letter.

<u>Background – Executive Order 38 and Proposed Rules</u>

Executive Order 38, signed by Governor Andrew M. Cuomo in January, 2012, applies limits to the compensation that can be paid out to executives at state-funded organizations. The Order requires that:

- State-funded administrative "***executive compensation***" for "***covered executives***" at these organizations be capped at $199,000 per executive; and
- At least 75% (increasing annually by 5% to 85% in 2015) of state-authorized payments must be used to provide "direct care or services," rather than administrative costs (including compensation costs for those not providing direct services).

The Order instructed state agencies to provide further guidance with respect to the compensation-related aspects of the Order. In late May, thirteen[1] agencies issued Proposed Rules, which provided clarifying guidance for covered organizations in implementing the Order, including:

- "***Covered Executives***": Individuals covered by the compensation limits are defined broadly to include directors, trustees, managing partners, officers or employees whose salary and benefits cannot be attributed to particular program services (as opposed to administrative duties), such as the executive director or chief executive officer, controller or accounting personal, and public relations personnel.

- "***Executive Compensation***": Similarly, covered compensation is defined broadly to include all forms of cash and noncash payments, including salary, wages, bonuses, housing, certain perquisites and educational benefits, but excludes Social Security, health insurance premiums and pension contributions generally provided to non-executive employees.

- ***Exceptions to $199,000 Cap:*** Payment above the Order's cap may be permitted if the following requirements are met:
    - The excess compensation must come from sources other than state funds or state-authorized payments;
    - The organization must show that the executive's compensation is below the top 25% in the field, according to a compensation survey recognized by the relevant agency and the Division of the Budget; and
    - The executive's compensation must be approved by the organization's Board or equivalent (including at least two independent directors or voting members) after a review of comparability data.

- ***Waivers of $199,000 Cap:*** Upon a showing of good cause, an agency may grant a waiver to the compensation limit upon consideration of the following factors:
    - The nature, size and complexity of the organization's operations;
    - Probable effects on program services if a waiver is not granted;
    - Efforts to monitor and control administration expenses or to secure a comparable executive at a lower level of compensation;
    - Efforts to find other sources of funding for administrative expenses;
    - Comparability of executive compensation to compensation levels at similarly situated organizations; and
    - The organization's review and approval process for executive compensation.

    Waivers would be in effect for a defined period of time, unless revoked by the agency due to an executive compensation increase of more than 5% a year, or due to "additional relevant circumstances." Waivers for executive compensation limits will only be provided where an organization can show "compelling circumstances" supporting the waiver.

[1]Entities directed to promulgate regulations included, but were not limited to: (1) the Office for People with Developmental Disabilities; (2) the Office of Mental Health; (3) the Office of Alcoholism and Substance Abuse Services; (4) the Office of Children and Family Services; (5) the Office of Temporary and Disability Assistance; (6) the Department of Health; (7) the Office for the Aging; (8) the Division of Criminal Justice Services; and (9) the Office of Victim Services. The following entities also issued regulations: (1) the Department of Corrections and Community Supervision; (2) the Division of Homes and Community Renewal; (3) the Department of Agriculture and Markets; and (4) the Department of State.

- ***Applicability:*** The Proposed Rules clarify that the Order is applicable to organizations that have received state funds or state-authorized payments to render program services for at least two years prior to and during the covered reporting period in an average annual amount greater than $500,000 during those three years when this amount is equal to at least 30% of total annual in-state revenue during the most recent reporting period.

General Comments

We believe that the Proposed Rules add yet another level of unnecessary complexity to the variety of restrictions already governing executive compensation at tax-exempt organizations. As discussed in further detail in this letter, the burdens associated with enforcement and implementation of the rules will result in an increase in the very administrative costs that the Executive Order is intended to mitigate.

Moreover, federal tax rules and associated penalties already address many of the abuses that these rules are intended to abate. Requiring the covered organizations to monitor compensation pursuant to both the state and federal rules – which have vastly different thresholds, protocols, definitions and penalties – will add a layer of intricacy that will overwhelm administrators of compensation systems, and ultimately lead to inefficiency at best, and problems retaining key talent in the tax-exempt world, at worst.

While Section 4958 of the federal Internal Revenue Code provides some level of certainty and predictability for assessing “reasonable compensation”, the Proposed Rules provide limited guidance for determining how waivers of the $199,000 will be determined. Even more significantly, where compensation does not even come from state funds, the organizations will still need to prove that they do not fall within the top 25% of the comparables. This will result in 25% of organizations that have legitimate business, labor market and regulatory bases to provide compensation in excess of the Order’s cap being barred from doing so. These types of organizations are likely to be the entities that compete with the private sector or out-of-state organizations for talent, and consequently must pay above the Order’s cap to attract and retain key talent.

In sum, as discussed herein, we believe that the Order is so vague and will require so much administration that its purpose is defeated from the outset. The implementation of the Order through the Proposed Rules will have far more negative unintended consequences than benefits. We submit that compliance with Section 4958 is leading practice and should be the “safe harbor” standard for waivers, and even more so, for exceptions if funds are coming from sources other than the state.

Efficiency and Burdens

Policy Discourages Efficiency

The Proposed Rules contain both a limit on the percentage of total expenditures that can be used for administrative costs as well as a hard numerical limit for individual executives. We submit that this numerical limit for individual executives discourages certain measures of efficiency in organizations.

For example, if one executive can perform the duties of two, it makes fiscal sense to only have a single executive and to pay him or her a premium for performing more services.

The Proposed Rules, however, could encourage the hiring of multiple people at a lower salary which would increase total compensation, especially when the additional benefits and costs associated with each new hire are taken into account. This provision discourages economies of scale, which is counter-intuitive for rules that are meant to decrease administrative costs.

Additionally, poorly performing employees under the cap would not come under heightened scrutiny. In contrast, the 4958 standard considers the reasonable market value of the work performed, and takes into account proportionality as opposed to a simple hard limit.

Significant Additional Administrative Burdens in Implementation

Primary goals of the Proposed Rules include decreasing administrative costs while increasing the percentage of funds used for program services at covered providers. Counteractively, however, these rules are imposing a burden on the administration of these providers by requiring them to fill out additional forms, and possibly requiring the hiring of compensation consultants, paying for surveys and filling out waivers.

There is also an additional burden being placed on the State. State departments must handle surveys, either administering and putting out the comparative surveys or sorting through and assessing the validity of surveys put out by third parties. State workers will be forced to become de facto compensation consultants, benchmarking executives at organizations against survey data to enforce the 75^{th} percentile limit. They will also need to become experts in distinguishing administrative and program service costs so that the two can be properly separated for employees who receive only a part of their salary from administrative expenses.

Adding to the list of new administrative "to-do's," State workers would be required to assess and rule on the likely numerous waiver requests to the compensation limit, and will have to deal with the EO#38 paperwork every reporting period. They will also need to enforce the rules and apply penalties, design Corrective Action Plans, and handle appeals. We submit that the burden that will be placed on state workers and on non-profit organizations should be weighed against the utility of the $199,000 limit on individual executive compensation and the existing federal rules limiting unreasonable compensation.

<u>Lack of Consistency with Other Rules and Regulations</u>

Redundancies with Other Federal Rules

In many cases, the Proposed Rules are inconsistent with or contradict rules issued by other agencies in terms of limits, definitions and goals. Keeping track of the rules promulgated under the Order, as well as the rules issued by the IRS, the federal government and others, will be yet another administrative expense that must absorbed by the very organizations regulated by the Order.

For example, the IRS already has a rule in place which limits compensation of executives by non-profit organizations. Section 4958 of the Internal Revenue Code applies penalty taxes on excess benefit transactions, defined as transactions in which the economic benefit provided is in excess of the value of consideration (including the performance of services) received for providing such benefit. This section imposes a 25% tax on any excess benefit, rising to 200% if the excess benefit is not corrected within the taxable period.

More importantly, these rules provide organizations with a process for establishing a "rebuttable presumption of reasonableness." This process provides tax exempt organizations with a safe harbor in which to manage their executive compensation.

Inappropriate Linkage to Federal Executive Schedule

The Order allows discretion by each agency to adjust the $199,000 figure, but limits compensation to Level I of the federal government's Rates of Basic Bay for the Executive Schedule promulgated by the United States Office of Personnel Management. This figure is currently $199,700 and has been frozen since 2010.

We submit that linking the compensation of executives to that of government employees is inappropriate. In our experience, non-profit organizations are not only competing with the federal government and other non-profits for executives, but also (and sometimes more typically) with the private sector.

In addition, unlike the General Schedule and Locality Pay Tables, the Executive Schedule does not vary depending on location. Federal employees working in lower New York, for example, generally receive a 28.72% locality premium on base pay with only the highest grade limited by the Executive Schedule. If the executive compensation limit under the Order remains linked to the Executive Schedule, we submit that a premium for lower New York cost of living be incorporated into this limit.

Additionally, federal agencies have the discretion to pay recruitment and relocation bonuses of up to 25% of base pay, as well as additional retention allowances of up to 25% of base pay. Employees on the executive schedule also participate in performance reviews that can lead to performance awards between 5% and 20% of base pay, another item that the $199,700 limit does not take into account.

Negative Impact on New York State

State Parity

New York State should be encouraging more non-profit organizations to settle and work in its borders. Not only do they create jobs, but they also provide services to the area that aid and strengthen the communities and people they serve, most often at a lower cost than would be incurred by federal, state or for-profit organizations.

By the same token, the state should be encouraging the very best executives to work at non-profit organizations in New York. By placing an artificial cap on salary, the Proposed Rules are discouraging the most talented executives from working in New York. This could lead to a decrease in the quality of leadership at New York organizations as these highly qualified executives seek higher compensation in other states.

Proposed Penalties

We submit that the penalties imposed by the Proposed Rules are less advantageous for New York State as compared to the federal penalties. Instead of decreasing tax deductions or applying penalty taxes (both of which create revenue for the government), the Proposed rules penalize the covered providers by withdrawing state funding and licenses to perform services. This produces no additional revenue for the state and indirectly penalizes the people of New York by cutting program funding and services.

Exceptions and Waivers

More Information Regarding Comparability Surveys

The Proposed Rules set a limit on executive compensation at the 75th percentile of compensation provided to comparable executives at comparable organizations as established by a compensation survey identified or recognized by the department and the Director of the Division of the Budget. This data is especially important for large organizations which will seek to remain competitive by paying compensation out of private funds.

We request clarification on the number and types of surveys that will be so identified or recognized. We submit that current governmental surveys put out by the Bureau of Labor are not adequate for the purposes of these rules, especially for the large organizations most likely to require their use.

Further Clarification of "Geographic Area"

The language for identifying comparables includes the phrase within "the same or comparable geographic area." As this is critical for the comparable analysis, we submit that further clarification is needed as to:

- How areas will be compared. Comparing by population or by measured physical area will also produce very different results when comparing urban and rural areas.
- The methodology for determining such areas. Measuring geographic areas by organizational reach or by where organizations are headquartered can result in very different areas being used for comparison.
- The scope of comparable areas. Although the final rules will only apply to New York State, there will likely be organizations that are not comparable to any others in the state. We request clarification as to whether organizations outside of New York will be considered as possible comparables.

Impact of Lack of Comparables

In order to "benchmark" compensation to understand where an individual's pay lies in comparison to others in the industry, there must be an adequate number of comparables – both in terms of job matches and organizational matches - to validate the statistical analysis. In our experience, it is not uncommon for an executive position or an organization to have either very few or even no comparables. This may be, for example, because an organization is extremely large or specialized or because an executive's role is especially specialized or broad.

We submit that an additional waiver factor be added that directly addresses the issue of organizations with no or very few comparables in the state by executive, size and/or sector.

More Guidance Regarding "Compelling Circumstances"

The Proposed Rules list five factors that will be considered in determining whether to grant a waiver, and then limits waivers to those organizations which demonstrate "compelling circumstances."

"Compelling circumstances" is not a defined legal term and basing the waiver standard around it introduces a level of uncertainty and subjectivity into the requirements. This lack of clarity will further burden those tasked with granting waivers, requiring judgment and discretion from state employees who are not experts in administrative expenses or compensation and will increase the likelihood of error, faulty analytics, favoritism, and inconsistency. The final rules should contain either a specific definition of the term or should use a more objective and defined term as its standard.

Rigid Limits on Increases Following Waiver

The Proposed Rules revoke any waiver received if the executive compensation that is subject to the waiver increases by more than 5% in any calendar year. In the current economic environment in which salaries may be artificially depressed, this rigid limit does not take into account compensation increases that might be necessary in the future to retain talent. We submit that this hard limit should be replaced with a reasonable discretionary limit.

Exceptions for Grandfathered Legal Contracts

The Proposed Rules provide no guidance on how organizations should handle existing commitments under legal contract where the agreement does not meet the Order's standards. We submit that rather than allowing the Order to interfere with contractual obligations, the final rules allow for existing legal commitments to run their course. The Order would become applicable to the covered individual's situation only once the employment agreement has expired (or is materially amended).

General Additional Guidance Needed

Better Guidance on Allocation Between Administrative and Program Services

The distinction between administrative and program services is critical under Executive Order 38 as only compensation related to administration costs comes under the proposed limit. While the Proposed Rules provide limited guidance, we request further clarification as to a process on which organizations can rely to separate "administrative" compensation from "specific program services" for executives.

More Guidance on Definition of Executive Compensation

The definition of covered compensation is broad yet does not address how the agencies will collect compensation of other companies for comparables to obtain a waiver. Pulling comparable numbers only from Form 990's is problematic as reporting is often times not consistent across organizations. For example, Schedule J requires reporting of amounts contributed to supplemental employee retirement plans (SERPs) and 457(f) plans, but contributions are reported only when they are earned. Depending on whether the amounts are vested, they are included in either reportable compensation (if vested) or deferred compensation (if unvested). Nonqualified deferred compensation amounts are generally reported in two different years – as deferred compensation when the benefits are earned (but not vested or paid) and as reportable compensation when the amounts are taxable (when no longer a substantial risk of forfeiture or paid). While Schedule J includes a column for "compensation reported on prior Form(s) 990," allowing organizations to identify amounts that would otherwise appear to be "double counted," we query if those individuals charged with conducting the comparability analysis will always capture this nuance, assuming it is correctly reported at the outset. On that note, we submit that clearer instruction is needed for how SERPs should be counted for purposes of the caps and whatever other comparability analysis needs to be conducted.

Closing Comments

We believe that the Proposed Rules, which will apply to a number of organizations with vastly different sizes, purposes, and administrative structures, attempts to apply a one-size-fits-all approach to compensation. We agree that keeping administrative costs down and program services high is best for the people of New York State. We believe, however, that the 75% (soon to be 85%) floor for program costs is the best way to achieve this goal without overburdening organizations or the state government. A one-size-fits-all approach with pre-set caps or limits that are not proportional to organization size is a poor construct for any compensation program. Allowing deviation from these limits only under certain ill-defined circumstances is not good public policy. In order to promote the long-term success of non-profit organizations compensation programs should always be specifically tailored to the organization's goals as well as the particular individual filling the role. No two organizations or executives are the same. Trying to homogenize compensation across or among organizations will jeopardize attraction, motivation and retention of talent, as well as impede organizational growth and innovation.

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We appreciate the opportunity to comment and share our views. We note that PM&P is submitting this commentary on its own behalf, and not on behalf of any specific client. Please contact us at 212-407-9517 if you have any questions.

Sincerely,

Dave Swinford

David N. Swinford
President and CEO
Pearl Meyer & Partners
david.swinford@pearlmeyer.com