

back to the employee when they are ready to accept their compensation. Since the S&P 500 typically has positive returns, a company understands that this can accumulate to a large liability if left unmanaged.

How does the company provide the benefit if they aren't allowed to direct funds to a product? The tax rules governing NQDC allow a company to use hedging as a way to manage the liability of the investment exposure. Ideally, an employee electing an S&P 500 index fund could just direct his deferred compensation to a fund and let the fund pay him out in the future when they are ready to claim their compensation. In the absence of such a fund, the company can partner with an investment bank to use derivatives markets (as opposed to cash markets) to enter into a Total Return Swap (TRS) that swaps the (floating) returns of an index for a (fixed) cash (typically the short term AA rate like 3-month SOFR, plus a spread) payment on the desired exposure.

ILLUSTRATION

Compensation covered: \$100,000

Fixed Rate 0.25%

Floating Index: S&P 500

Term: 1 Year

Assume the S&P 500 returns 10% during the year.

Fixed Leg Payout: $100,000 * 0.25 / 100 = \$250$