Pearl Meyer

ADVISOR BLOG

Tax Reform and Executive Pay: Is it Time to Rethink the Pay Mix?

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Compensation benchmarking helps us understand the proportion of salary, annual incentives, and long-term incentives to total pay and ensures these ratios are competitive relative to market. It has become a common and accepted piece of the process for setting pay.

But today, given the recent changes to the corporate tax laws—in particular, the elimination of 162(m)—we may have a real opportunity to reset pay mix even if these potential changes are not aligned with the benchmarking results. Why? Because *competitive practice* does not always equal *best practice*. This means that compensation committees can put more weight on factors beyond competitive pay mix when setting competitive pay packages. Let's talk about why.

We need to remember that Section 162(m) influenced pay mix. In some cases, salaries experienced slow or no growth to avoid or minimize non-deductible, non-performance-based pay. This resulted in pay mixes dominated by short- and long-term incentives (STI and LTI). Proxy advisory firms supported this slow, but progressive, trend by commenting on the importance of aligning pay to market levels and maintaining tax-efficient programs.

But now that Section 162(m) no longer muddies the waters, is it time to consider increasing salaries while reducing incentive opportunities? Heresy you say? Perhaps not.

Let's look at an example of a CEO whose base salary represents 15% of total pay and the remaining 85% of total pay is represented by the variable incentive piece (STI and LTI). Assuming that the peer group and general industry data confirm the salary should represent 15% of total pay, it's easy to conclude the CEO's salary is aligned with the market and that's the end of the discussion, right? Not so fast …

Other than alignment to market practices, what's so important about maintaining this ratio? If we change the salary ratio to 25% with a corresponding reduction in LTI target awards,

will the CEO be less motivated? That's unlikely, given that incentives still dominate the total pay package.

"Hold on Pete. Doesn't that reduce the incentive plan leverage and the potential impact on pay-for-performance?" Nope, it's not an issue. Remember, in this example, 75% of pay is still subject to performance. And if de-leveraging is still a concern, consider adjusting threshold and maximum performance goals and award levels.

"But raising the CEO's salary is going to raise other things—like eyebrows and questions!" That's true. But we can address these questions one by one.

1. *"If we increase the CEO's salary, don't we have to increase the salaries of all members of the senior leadership team?"* No, the CEO pay mix is the most heavily weighted toward incentives. So, it's not a stretch to say that increasing the CEO's salary better aligns his or her pay mix with that of the senior leadership team.
2. *"Will it be okay to use more cash in our executive compensation program?"* Maybe this is a good thing. Using more cash means using less equity, resulting in less shareholder dilution.
3. *How do we handle objections from the proxy advisory firms? Will this result in a negative recommendation?* ISS recently published a comment in its Governance Insights that wholesale shifts to fixed pay components will likely result in adverse vote recommendations. But we are not discussing wholesales shifts to guaranteed pay. We are saying that increasing salaries doesn't impact the design of the LTI program or the percent of the LTI grant subject to performance vesting. Further, slightly lowering target LTI awards reduces compensation risk with no reduction in motivational value—it's actually a pretty good trade-off.
4. *"What about our shareholders?"* It is unlikely any institutional shareholders would object to this change for companies that have met or exceeded performance expectations over the long haul. But as always, compensation committees should look at the big picture and will probably want to avoid increasing CEO salaries in challenging environments.
5. *"Won't reducing target LTI awards diminish pay-for-performance results?"* This is not likely. Most public companies require CEOs to hold stock through disclosed stock ownership guidelines to reinforce the importance of stock price performance. The amount is expressed as a multiple of salaries in most cases. In turn, increasing CEO salaries means CEOs have to hold more stock, not less.

A committee may decide that no CEO pay mix changes are needed. That might be the right decision for many companies, but it's worth adding the pay mix topic to an upcoming committee meeting agenda in 2018 and asking the question, *"Do we have pay mix right?"*

About the Author

Pete Lupo is a senior managing director and head of the Atlantic Region. Pete has worked extensively with compensation committees and management covering a variety of needs including the development of total compensation programs covering the senior leadership team, aligning pay to performance, designing annual and long-term incentive plans, developing board of director pay programs, advising on change-in-control, executive benefits, perquisites and governance-related matters.

About Pearl Meyer

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