Unraveling the Complexities of Compensation

Experts offer their perspectives on how tax law is reshaping pay-plan design, Elon Musk's potential $50 billion payday, and other concerns.

Consider some of the recent events affecting the decisions of compensation committees: a tax code overhaul, pay ratio disclosures, and increasing competition for talent. Then there's the challenge of designing pay packages that properly reward, motivate, and retain talented executives. These were some of the topics explored by a panel of experts at NACD's Leading Minds of Compensation event at the Grand Hyatt in New York.

Attendees gained insights into how to approach these and other issues at a panel discussion moderated by *NACD Directorship* Publisher Christopher Y. Clark. The panel featured the following compensation experts: **R. David Fitt**, partner, Pay Governance LLC; **Steven Hall**, founding partner and managing director, Steven Hall & Partners; **Daniel Laddin**, founding partner, Compensation Advisory Partners; **Kathryn L. Neel**, managing director, Semler Brossy Consulting Group; **John V. Trentacoste**, partner and head of the New York office, Farient Advisors; and **Steven Van Putten**, senior managing director and Northeast region head, Pearl Meyer. Highlights from their conversation follow.

Tesla CEO Elon Musk's incentive package was set at $2.6 billion—and could extend to more than $50 billion. Thoughts?

Steven Hall: Those are great numbers, aren't they? And by the way, the plan that Musk has was just approved by 80 percent of the shareholders, excluding Musk and his brother.

Let's talk about the design of the program first. It's a grant with a 10-year option. It is only based on performance around three criteria: market cap attainment; earnings before interest, taxes, depreciations, and amortization; and revenue. The goals, if met, are going to grow the company by about 13 to 15 times. In order to meet those different goals, there are tranches along the way. The grant is for 12 percent of the outstanding shares of the company, which dilutes everybody's, including Musk's, current ownership. There is no automatic vesting in the event of a change of control, and no accelerated vesting if he's terminated by the company. He's required to either be the CEO or executive chair and chief product officer. Finally, the award includes post-exercise holding requirements and a clawback provision to recoup shares that incorrectly vest in the event of a financial restatement.

From left: Steven Hall, Kathryn L. Neel, R. David Fitt, Daniel Laddin, John V. Trentacoste, and Steven Van Putten

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Both Institutional Shareholder Services (ISS) and Glass, Lewis & Co. came out against the plan, saying it was too much. A question I think that comes out of this situation is, Why do you make a grant like that, especially to someone who already owns more than 20 percent of the company? My guess is that the compensation committee, in doing some reading and looking at the other activities Mr. Musk is engaged in with his other companies, thought, Here's someone who's very talented, has a lot of interests, has done spectacular things to grow value for the company. Let's have some kind of blockbuster plan that doesn't make him take those talents somewhere else.

> "Why do you make a grant like that, especially to someone who already owns more than 20 percent of the company?" —STEVEN HALL

Then there's the question of, is this too much? There are great rewards for shareholders if he ends up meeting those goals. There's no way that you can turn around and do what we consultants normally do, which is look at four other companies in the auto industry and see what the CEOs make and therefore pay him on the same basis. These numbers are just completely out of sight. Someday there's got to be a book that reports how this came out and how the numbers were arrived at. Obviously, there was more going on behind the scenes that made them get to this point.

How will recent changes to Section 162(m) of the tax code, which lifted the $1 million cap on deductible executive pay, impact performance-based executive pay?

R. David Fitt: As a general matter, I don't believe the elimination of 162(m) is going to have a dramatic impact on the structure of executive pay. Specifically, I think it's unlikely that salaries will increase in any substantial way just because the million-dollar deductibility limitation has been eliminated. The 162(m) limit applied to only a relatively small population of executives whose salaries approached $1 million. And in many of those cases, if the market substantiated a salary higher than $1 million, most had already crossed the threshold. Further, if we think that total compensation values generally are competitive and reasonable, then the only way to increase salaries without increasing total pay would be to shift it out of incentive compensation opportunity, which would result in a more guaranteed total pay mix. In my opinion, performance-based pay is such a critical part of the fabric of executive pay that it's unlikely many companies will reduce that portion in favor of guaranteed salary.

Most companies constructed programs that were 162(m)–compliant and also provided them the flexibility they desired; that is, to have some element of non-formulaic or strategic measures and the use of some discretion. Could we see some increase in the use of these non-formulaic elements? Possibly. However, the problem with increased use of non-financial measures is that shareholders want to be able to clearly understand the rationale for incentive metrics—how the compensation committee determines performance and the direct relationship to payouts. So, just because the formulaic aspects of 162(m) are no longer technically required, it doesn't mean that companies can or will go substantially to straight discretionary plans, because shareholders are unlikely to accept it.

I think there will be some design feature changes, but nothing widespread. I've heard some say that they may extend exercise periods post-termination in order to maintain a degree of deductibility. I read a recent opinion suggesting that caps on the annual amount of option exercises in a given year could be used to maximize deductibility. Technically, some of these approaches could work, and there may be some who adopt them. However, I don't think we're going to see a dramatic trend in this area.

We all created a number of design features to jump through the hoops required by 162(m) and still allow plans to operate in the way the board deemed was appropriate. We don't need that complexity anymore, so I expect that there will be a good bit of simplification of plan design details and related documentation. However, much of that is on hold until there is clarity around possible grandfathering of existing arrangements. When it happens, plan documents will get cleaned up; so will committee charters. So, all said, the tax law and the elimination of 162(m) will have some impact on the structure of executive pay, but I don't think it will be dramatic.

> "The tax law and the elimination of 162(m) will have some impact on the structure of executive pay, but I don't think it will be dramatic." —R. DAVID FITT

Would you talk us through what's happening in the US with pay ratio disclosures, and also the UK's gender pay gap?

Kathryn L. Neel: The gender pay gap disclosure in the UK, for those who are unfamiliar, is a requirement for any employer in the U.K. with more than 250 employees to publish by April 4, 2018, the gap between the median and the mean compensation of their female employees and their male employees, unadjusted for differences in titles or tenure. Companies also have to report the percentage of females and males that comprise the four quartiles of each company's paid population. I guess we all knew there would be a gap if you were to look at just the mean or the median, but in some cases, the gaps are pretty large.

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>
> —KATHRYN L. NEEL

Compensation committees of global companies with operations in the UK that we work with are now asking, How does this look across our entire employee population? And it's really started some interesting dialogue at the committee level.

The UK disclosure is a bit crude, but it is spurring discussions about female advancement in the workplace. So it's partially about pay, but it's also about gender diversity in the highest-paid quartile of your employee population. If, for example, you see that only 14 percent of that quartile is female, ask why is that the case when women comprise, say, 50 percent of the total employee population.

On the CEO pay ratio side of things, I've yet to really participate in many meaningful discussions about that ratio and what it means relative to median employee pay. I do have a couple of clients where discussions are shifting more toward what constitutes a living wage, and after tax reform came out, we saw some companies raise their minimum wage. So at most companies, it feels a lot less about CEO pay and the ratio of that to employee pay, and a lot more about median employee pay and what it means when half of our population is paid under $23,000 a year to us?

There have been a few thoughtful pieces about what to make of the CEO pay ratio disclosure, and one that was most interesting was about AT&T and Verizon and why those two companies, which seem so similar on the surface, would have such a big difference in the median employee compensation. I think what we're likely to see is a lot of analysis on this disclosure over the summer. Experts can take this into account going forward, but it still remains to be seen how investors will take it into account, if at all.

When it comes to proposed adjustments on incentives, what do you think directors should be thinking about?

Steven Van Putten: Adjusted EPS [earnings per share], income, adjusted operating income, non-GAAP metrics, free cash flow—those are some of the more common metrics you'll see in incentive programs, and I think there's good reason for that. You want to make sure you're rewarding for core operating performance—things that are within management's control that are not subject to the bay breeze of outside conditions. You also want to make sure that management is being held accountable and that they're rewarded appropriately or taking actions that are in the best long-term interests of shareholders.

As a board, you want to make sure you have rules of the road to evaluate the appropriateness of adjustments to incentive compensation results. Consider accountability. Is this within management's control or sphere of influence? Consider consistency. Is this something that you normally adjust for on a regular basis? Consider transparency. Is it consistent with how you currently disclose and report your adjusted metrics, or are there other factors coming into play that you would need to disclose along with that? Consider materiality. Should you set some threshold level below which you would not adjust for; above which you would have some adjustments? Consider comparability. Are there adjustments that you would commonly see among your set of peer companies? I think having those types of rules of the road for committees to evaluate the appropriateness of adjustments is important.

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And then tax reform. That's the big one I think that companies are currently discussing. I think most companies are adjusting for tax reform. They don't want to create windfall gains for management at the time they're giving employees a one-time $1,000 bonus. Certainly, that doesn't look good from an optics standpoint.

Roughly 90 percent of companies are getting passing say-on-pay votes. Is this a sign that proxy advisory firms' influence is waning?

John V. Trentacoste: Despite regularly high say-on-pay votes and the perception that ISS's and Glass Lewis's influence is declining, our internal research suggests otherwise. In fact, this year, we're seeing an uptick in early say-on-pay failures. Whether or not that carries through for the entire proxy season remains to be seen. The magnitude of the impact of an against vote from either ISS or Glass Lewis has been fairly consistent across three areas: say on pay, equity authorizations, and director elections.

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There, too, are three areas in which proxy advisor influence is growing. The first is globally. As more countries embrace tenets of good governance, especially in the emerging markets, investors rely more heavily on proxy advisors to help them chart these unchartered governance waters, using their philosophies and frameworks to help investors make sound decisions.

The second is director elections. There has been significant focus on director tenure, board diversity, and skills, even prompting some large investors to come out with principles around how they will evaluate directors and boards. I think that proxy advisors are likely to codify their thinking around key board issues to inform their recommendations for or against certain directors.

However, the biggest influence that they're having is actually, in my opinion, the most negative. Proxy advisors, I think, have led to a homogenization of pay—the idea that all pay programs should be the same. The proxy advisors will say that they are not advocating for a one-size-fits-all approach to pay, but when you think about the way in which they evaluate pay program design, it does seem to advocate a singular design philosophy.

And there are consequences for this. The first is it doesn't allow your compensation strategy to be a competitive advantage for your organization, especially in a highly competitive environment. The second is that this approach to plan design may not align with your business strategy and may actually lead to suboptimal outcomes. How many times have we seen incentive plans that pay high when performance is low? And third, a one-size-fits-all pay program doesn't allow compensation committees the ability and flexibility to adjust to the disruptive forces that are influencing business now. It's hard to find an industry that isn't being disrupted either by technology or outside forces. It may be time to shake up pay plans, too.

Companies are subject to all kinds of disruption. Are greater incentives part of the answer?

Daniel Laddin: I see boards and management really struggle with creating incentives to attract the talent needed to compete in this environment. I've also seen some really creative things being done as the company tries to tell its story around risk and reward, how its business is different, and how it can leverage opportunities—and then put in some creative incentives.

While not common, choice is something we're seeing more of these days. What I mean by choice is allowing employees to pick their risk profile by choosing what equity vehicles they get. A couple of examples are Expedia and Coach USA. By letting their employees choose between restricted stock and options, what that does is say you're really looking at the upside.

Some examples of really creative thinking is creating pockets of true equity in upstart entities. For example, Match Group created a Tinder equity plan, and you can see some of the numbers out there. What that turned into for the handful of people at Match who created Tinder and the dollars they earned were well beyond anything that more traditional business employees are earning. What's really important thing to think about as directors and executives is whether you're going to follow this route. What happens if it doesn't work? Some of these highly leveraged start-up plans don't tend to work out in the long run. I spent a lot of time in the late 1990s and early 2000s unwinding plans that didn't work out well after the dot-com bust.

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Think about who the key talent out there is and how you will attract, acquire, or retain them through a new incentive—not just how much you give them, but how much that potential is going to be worth and how you actually value that. Can you afford it?