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Top 10 questions for compensation committees in 2018

Compensation committees don't turn on a dime; they have to be prepared to satisfy legal and regulatory changes as well as expectations—ideally way ahead of time. This year the top three of our 10 questions concern the anticipated impact of the new tax law, followed by a new regulatory disclosure. Additionally, we examine evergreen topics that should be top of mind for compensation committees this year.

1. How does the cap on deductibility under the new tax law impact top executive pay?

For years, companies designed their compensation plans to capture the maximum deductibility under tax provisions requiring performance-based criteria for the compensation of the CEO and three other top executives in excess of $1 million annually. Now, with the loss of the performance-based exemption to that deductibility, will companies abandon performance-based criteria in their bonus and long-term incentive plans? That seems unlikely. Most companies are expected to continue with performance-based compensation, provided those plans are well-designed from a governance perspective.

Companies have invested significant time and energy into designing performance-based bonuses and incentives to not only capture deductibility, but also to meet the scrutiny of shareholders and institutional advisory firms. Bonus plans typically use a formulaic approach that can be easily calculated when presented to shareholders for approval.

Over time, there could be changes in the design of bonuses and long-term incentives. While good governance weighs on the side of maintaining high standards for these programs, now that companies no longer will have to meet IRS deductibility criteria, they may use more discretion in these plans. Some flexibility can be good, because financial metrics alone don't always tell the full performance story.

With more discretion in how they establish performance criteria, board compensation committees will be able to devise and implement plans with the right levers to incentivize performance, using metrics and measures that are in the best interests of the company and its stakeholders.

Further, without having to default to IRS deductibility criteria, companies may want to revisit their compensation plans. But to maintain good governance, a rigorous process around creating a performance-basis for bonuses and long-term incentives will continue.

2. How would firms rebalance their CEO pay mix given tax law changes?

Since Internal Revenue Code section 162(m) was enacted under the Clinton administration, the deductibility of non-performance-based pay has been capped at $1 million. Given that this amount was not indexed, over the years it has artificially suppressed the salary levels of CEOs and other named executive officers (NEOs) to a level ($1 million) that is likely below where they otherwise would be. If we look at the ratio of salary to the overall pay package for non-U.S. global company CEOs versus U.S. company CEOs, the proportion of salary for non-U.S. CEOs is much higher. This is due to non-U.S. global companies setting salaries at what they believe is an appropriate level without regard to this type of limitation.

Given such history and facts, we anticipate that many U.S. companies will step back and reconsider what should be the right proportion of salary as part of the total compensation package for these top executives. While various companies have disregarded this limitation (and set salaries above the $1 million deduction cap) and may not feel the need to rethink

this issue, a significant number have tried to stay within the $1 million salary deduction level. We expect many of these companies will consider raising the salary component to a more equitable percentage of the overall compensation package; incentive pay awards would be reduced commensurately.

So why would companies readjust NEOs' pay mixes? We believe there is an appropriate balance between retention and performance in any compensation package. The ideal proportion will depend on the particular business situation of the company and the unique skills, experiences and desired motivation of the executive. Accordingly, it is important given the recent changes to section 162(m) that companies step back and take a holistic review of each top executive's overall pay mix. Companies need to ensure that the appropriate components of pay align with the company's business strategy and achieve a suitable balance between retention and performance.

3. What's in store for public company stock options following 2017 tax reform?

Boards need to determine, with respect to their company, how new tax legislation signed into law by President Trump in late 2017 may affect the role of stock options in the design of the compensation programs for their top executives.

Stock options as long-term incentives (LTIs) at public companies generally have been on the decline for over a dozen years ever since they first were required to be expensed for financial statement purposes. This loss of this favorable accounting treatment, combined with a trend favoring more-focused performance-based awards (e.g., performance shares) by proxy advisors and shareholders, have caused most compensation committees to reduce the role of stock options in LTI programs. A further blow was struck by the 2017 tax act, under which stock options (as well as performance awards) lost their exemption from the $1 million cap imposed by Internal Revenue Code section 162(m) on deductible compensation paid to a public company's CEO and certain other highest-paid executives.

As a matter of first impression, the loss of this exemption may impact stock options more than performance awards as the technical standards for satisfying section 162(m) were much simpler for stock options than for performance awards. In any case, compensation committees may decide to reduce the dollar amounts represented by future LTI awards now that they no longer have a tax reason to limit the salaries of these covered executives (and put the remainder of such executives' compensation packages in LTIs). Simply stated, a top executive may be targeted to receive the same total compensation amount, with more in salary and less in LTIs.

In evaluating the likely impact of the new tax act on stock options, changes made to the alternative minimum tax (AMT) on individuals also should be considered. Basically, the AMT is calculated under a separate system of taxation with different exemptions, deductions, phase-outs and tax rates than under our standard tax system. If the AMT produces a higher amount of tax, the additional amount is added to the tax otherwise due from the taxpayer. The key point is that the new tax law increases both the exemption and phase-out amounts for the imposition of the AMT, thereby reducing both the number of taxpayers who will be hit by the AMT and the amount of AMT paid by other taxpayers.

While the nuances of the AMT can be especially complicated, our focus is on the

relationship between AMT and incentive stock options (ISOs). ISOs are stock options which meet certain statutory requirements that allow recipients to delay the taxation of any gain on exercise (i.e., the spread) until the subsequent sale of the shares obtained. A disadvantage of ISOs is that the spread is a preference item which must be added back to the taxpayer's income for calculating the AMT. With the changes made by the 2017 tax act to the workings of the AMT, the impact of preference items may be reduced, making ISOs more attractive to employees. With these changes, some employers may begin or increase awards of ISOs.

4. **What internal communications are needed regarding the CEO pay ratio?**

In 2018, public companies will need to comply with CEO pay ratio determination and disclosure requirements imposed by the 2010 Dodd-Frank legislation, which will require companies to disclose the ratio of its CEO's total compensation to the total compensation of its median employee. While companies clearly must prepare to proactively address possible consequences of the CEO pay ratio disclosure to a wide-range of stakeholder groups and anticipate how to respond if the disclosure is perceived poorly, a company should pay particular attention to the potential reactions of its employees.

Starting with the obvious, when the disclosure is made, half of a company's employee population will learn that they are paid below the level of the median employee. This could have a significant impact on employee morale, engagement and retention, especially for the half of employees falling below the median compensation number. At companies with a highly-paid workforce, an employee who has been satisfied with his/her pay may become discontent upon learning he/she is paid below the company's median level. Also, a high ratio may attract union attention and bolster representation drives and demands for wage increases.

We don't find the new CEO pay ratio disclosure rule particularly meaningful, because there are many variables that make potentially useful comparisons almost impossible. Nonetheless, companies will still have to comply starting this year. Human resources departments should be prepared with an internal communications plan to address these concerns prior to the disclosure being made. We believe a company should focus on helping employees understand its employee value proposition and total rewards philosophy, how pay is determined, and how pay practices are fair and competitive.

5. **How do we plan to address gender pay equity?**

Gender pay equity continues to be a pressing issue facing company boards heading into 2018. Boards should be ready for:

- shareholders who continue to push companies via proxy ballot proposals or possible litigation requiring full disclosure on gender-specific employee compensation data,
- proxy advisor policy development that generally aligns with shareholder concerns and would likely require a compelling rationale for any identified gender pay disparities, and
- possible regulatory action being introduced if voluntary company- or market-initiated best practices do not materialize.

Denying that a gender pay gap exists is not likely going to be considered a sufficient board response to this issue. Boards need to be proactive and demonstrate that they are

committed to pay equity for all employees and ensuring that they do not discriminate based on gender or any other protected category when making compensation decisions. A board should review the underlying methodology used to develop and set compensation within the company's pay programs to ensure it is "blind" to gender. If you are a board member, you should work with any needed resources to:

- analyze your company's internal pay practices including factors taken into consideration in determining pay levels,
- statistically assess the compensation paid to employees within the same job categories, and
- develop a protocol for addressing situations where a significant difference exists between men's and women's compensation.

6. Are our annual performance targets rigorous enough?

We first saw this as an issue two years ago, and it continues to be a priority for clients as Institutional Shareholder Services (ISS) targets companies whose performance targets (as disclosed in the same proxy as their performance results) are not viewed as sufficiently tough. Increasing scrutiny from major shareholder advisory firms—including ISS—should put compensation committees on notice to become more proactive. With a new data-backed perspective on performance targets, ISS and others will be better positioned in 2018 to challenge companies' targets relative to industry and general market performance.

Historically, many companies have not disclosed forward-looking annual performance targets. However, looking ahead, as investors have more visibility into pay and more opportunities to critique executive compensation strategies, boards will need to up their involvement in disclosing their views of the business cycle, estimated market conditions, and other factors impacting how and why performance targets are set. The approach should be to proactively communicate whatever information is necessary to ensure stakeholders are comfortable with how annual performance objectives are established.

7. Do our executive incentive plans effectively incorporate strategically important long-term performance metrics?

Strategic operational metrics are an increasingly important element of executive incentive plans. In some cases boards are tying strategic performance objectives to as much as 20 percent of the total direct compensation package, according to the most recent Korn Ferry CEO Compensation Study.

With the addition of these strategic measures, however, comes the challenge of how to capture results that may span multiple years, and how to reward executives appropriately for performance against these goals. In establishing more long-term targets, boards are setting their sights beyond the annual planning cycle. Therefore, compensation strategies must also shift to account for new metrics for performance-based pay, even when those measures may not hit the bottom line of financial statements in a single year. In addition, compensation committees need to consider the challenges inherent in evaluating appropriate non-financial measures.

8. Do we have an effective CEO evaluation process in place?

The emphasis here is on "process." From our perspective, CEO evaluations are too often treated as isolated end-of-year events rather than as an ongoing conversation geared toward improving performance. More than half

of the organizations that Korn Ferry Hay Group polled conduct CEO performance evaluations only once each year, or even less frequently, while the research also found that many of the most successful chief executives carry on regular conversations with the board about their performance.

To ensure optimal CEO performance, compensation committees should schedule performance discussions more frequently and focus on identifying areas for growth and improvement, which should be revisited at regular intervals to measure progress and reward CEOs appropriately. This is likely to ensure closer alignment of key performance goals and foster a stronger, more productive relationship between the CEO and the board than the strict, isolated evaluation approach.

9. Are we preparing the next generation of leaders?

Perhaps you have a brand-new CEO or your current CEO is planning to step down soon. Regardless of where the organization currently stands within the overall CEO Life Cycle℠, boards, through their nominating or compensation committees, should be thinking about CEO succession planning as part of the overall talent management process.

CEO succession is fundamentally a board responsibility, one of the critical few. Here, too, the emphasis is on an ongoing process, not merely the event of passing the baton from one CEO to the next. The CEO succession planning process starts with strategic alignment of the board around the current and future strategy of the company as the basis for building consensus on the desired leadership profiles for future CEOs. The board must also ensure that a robust internal talent development pipeline and a tailored knowledge transfer and development program are in place for mid- to near-term CEO candidates.

While the CEO and CHRO generally manage the succession process, the board oversees the process so it should be a regular topic for discussion—most likely at each board meeting and a main focus at strategy off-sites, which normally link to talent management. Boards must be kept in the loop regarding candidate readiness and development of future leaders, and should have the opportunity to gain familiarity with front-runners in both formal and informal settings. In an increasingly complex business environment, CEOs accomplish many strategic objectives through the senior team, so interpersonal and leadership skills are as important as the skills and experience that comprise the résumé.

10. Is our compensation committee evolving to meet new responsibilities?

The role and responsibilities of compensation committees have broadened in recent years, particularly in reaction to expanded proxy disclosure requirements. We continue to see a trend among the compensation committees of leading companies to expand their charter—and change the name of the committee in some cases—to reflect their broader role in talent management. This makes sense given the growing complexity of compensation packages and the greater need for expertise regarding strategies geared to attract and retain key talent. It will mean an expanded demand for not only financial experts but also CHROs to populate compensation committees. The right top leadership is essential to successful execution of the strategy, and the right compensation committee members will be crucial to ensuring the best team is in place.

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