A recent Fortune magazine poll asked, “Is it time for a maximum wage?”, and 65% of the 10,000 respondents said “yes.” It’s not difficult to understand why a majority of those polled feel this way.\(^1\) According to an August 2021 report by the Economic Policy Institute, the ratio of CEO pay to that of the average worker grew from 31.4x in 1978 to 351.1x in 2020.\(^2\) Said another way, from 1978 to 2020, CEO pay grew over 1300% while the average worker’s pay increased 18%. Whether one views it as a problem or not, the facts leave no doubt that the gap between CEO pay and worker pay has increased significantly.

For context, both laws and market forces have driven significant changes in CEO compensation in the United States. Beginning in the mid-1980s, the IRS limited the amount of compensation that could be deducted (for employees of public companies) to $1 million\(^3\); however, the provision allowed deductions over that level for “at risk” or performance-based components of compensation (e.g., stock options). In a related development, the accounting firms tasked with valuing stock options approved the use of the Black-Scholes formula to value the options, typically amounting to about one-third of the shares’ market value; thus, executives were granted three times the number of options relative to the number of shares.\(^4\) In addition, the SEC changed the rules restricting share repurchases in 1982, allowing stock buybacks with virtually no limits. Finally, boards typically retain executive search firms to identify, vet, and negotiate with

---

\(^1\) “How Much Is Too Much?”, Fortune, June/July 2022.

\(^2\) “CEO Pay Has Skyrocketed 1322% Since 1978”, Economic Policy Institute, August 10, 2021. This data reflects results for the 350 largest U.S. companies by revenue.

\(^3\) Via Section 162(m) of the Internal Revenue Service Code of 1986.

\(^4\) It should come as no surprise that at-risk compensation as a percent of overall realized pay is highest for U.S.-based CEOs than in any other developed country.
potential CEO candidates, and the fees the firms charge are often tied to the new CEO’s overall compensation package. Both the search firm and the candidate have incentives to maximize the initial pay package.

While we acknowledge the role of changing laws and market forces – and agree that the growing gap in pay raises legitimate concerns, we also believe many responses overlook important related questions. We’ll highlight some key problems first, then turn to overlooked questions.

**Problems with today’s approach to executive compensation**

To start, there are problems to be addressed with the way many CEOs are currently compensated. These problems include pay inflation resulting from how consultants advise compensation committees on setting pay levels, pay package incentives that can motivate (perhaps unintentionally) undesirable behaviors, the growing complexity of executive pay arrangements, and the misguided assumption that the right compensation package is the main motivating factor for the right long-term CEO.

**Executive pay inflation.**

Compensation consultants utilize a logical approach to assess the level of a company’s CEO pay, but the well-intended process almost always results in a pay increase. Here’s how it typically works: first, the compensation advisory firm identifies a group of peer companies (based on industry and size) and next, they document the compensation of the CEO (and other senior executives) for comparison purposes. So far, so good — but it’s often what comes next that’s the problem: the consulting firm advises that if the company in question has an above average CEO (performance-wise), then the CEO should be compensated above the median, e.g., in the 75th to 80th percentile, and recommends setting their pay accordingly. The compensation committee members may tweak the recommendation a bit, but they typically agree. The thinking goes that if the
current CEO is worth having, the person holding the position must be above average, and if the compensation committee and full board believe the CEO is underperforming, they rarely decrease the current CEO’s pay; instead, they are inclined to make a CEO change. Extrapolate this process to the universe of public companies, and it’s no surprise that average CEO pay is continually on the rise. Even relatively recent regulatory and/or stock exchange mandates\(^5\) that require compensation committee members to be independent directors – and the SEC’s “say on pay” advisory vote requirements – have not shifted the trajectory of CEO compensation.

**Incentives that miss the mark.**

A motto frequently associated with the medical profession could also be helpful when assessing components of CEO compensation: “first, do no harm.” If CEOs should be concerned with the long-term profitability and health of the business, then boards should be alarmed that as of 2018, the average duration of CEO pay components was just 1.7 years.\(^6\) RewardValue, a Netherlands-based non-profit, also cautions that most CEO compensation plans have annual targets and payouts associated with even those components that purport to be long-term in nature (“Managerial and Capital Market Short Termism”, 2020).\(^7\) Even CEOs with the highest integrity might be tempted to build a spreadsheet to see how they might maximize short-term pay formulas. These short-term payouts not only pad the CEO-to-average-worker gap, but they also distract the senior executive from doing what’s best for the business over a longer time horizon. In its March 2021 report, “The Risk of Rewards: Tailoring Executive Pay for Long-term Success,” FCLTGlobal identifies pay components that can drive short-term behavior including significant near-term point-in-time bonus payouts — and the acceleration of future stock award vesting upon executive departure.

\(^5\) Specifically, Sarbanes Oxley, Dodd-Frank, NYSE, and NASDAQ – as well as the SEC’s 2011 requirement for shareholders to cast advisory votes on executive pay.


Complexity in executive pay formulas.

Like other trends in CEO pay structures, the push for performance-driven pay formulas has good intentions. Boards and their compensation committees have largely traded the qualitative judgments of the past for formula-driven bonus totals and stock award amounts. And the performance-driven pay approach has much to support it, including clearer links to company performance as well as better transparency and predictability in total executive compensation — *in theory*. Evidence is emerging, however, to suggest boards (and their consultants) might be producing too much of a good thing — i.e., with formulations factoring in more and more variables driving increased complexity and working against the transparency it strives to achieve. For example, in its 2019 Directors’ Remuneration Report (published in 2020), the BP board remuneration committee needed 28 pages to explain how they determined compensation for BP’s CEO, CFO and board members (with a page or two dedicated to the broader organization). This complexity not only compromises the transparency objective, but it also works against the executives it claims to support; CEOs and their lieutenants either must invest extra hours to understand and track the nuances of the schemes or push forward knowing they aren’t 100% sure how they’re being compensated.

Mistaking pay for the end-all, be-all.

Boards are wise to pay close attention to CEO pay levels, no doubt, but they should not make the mistake of making a good thing into an ultimate thing. FCLTGlobal’s report reminds boards that “...To achieve a desired outcome, it is important not only that the right incentives are implemented, but they are incentivizing the right person. The most thoughtful remuneration will not drive its desired outcome if it is [attempting to motivate] an executive who cannot do the job.” In addition, the report cautions that even for executives who can do the job, they should not be looking to compensation as their sole motivation. As an extrinsic motivator, pay formations should be synergistic, but not supersede, intrinsic motivations including, above all, finding meaning in the work and a passion for the company’s purpose, its culture, and its long-term financial health.
Important questions that are often overlooked

In addition to legitimate concerns over present-day CEO pay design and levels, we believe that related, equally important questions are often overlooked. Commonly overlooked questions include: Why is CEO tenure relatively short?, Is CEO compensation correlated to total shareholder returns?, and Why is pay for the average worker growing so slowly?

Why is CEO tenure relatively short?

A 2019 survey by Harvard Business Review (“HBR”) points out that average tenure for an S&P 500 CEO is about 7 years.\(^8\) If companies are focused on creating value over long-term, how do they rationalize shorter tenures? The same HBR study asserts that the best-performing CEOs hold the post for 15 years on average.\(^9\) Boards appear to be inclined to dismiss CEOs who get off to a slow start or stumble early on in their tenures, but how can boards know if they are dismissing a strong CEO too soon or tolerating a mediocre CEO for too long?\(^10\) Though this is a really difficult question to answer, HBR suggests that boards need to at least recognize the potential hazards — since data suggests the higher risk is dismissing a CEO with strong potential too early.

Is CEO compensation correlated to total shareholder returns?

Work done by MCSI ESG Research contends that over the ten-year period they studied (2007-2016), the realized compensation of CEOs demonstrates an R-squared of 0.009 to total shareholder returns.\(^11,12\) So are we to believe that CEO

\(^9\) Ibid.
\(^12\) R-squared measures correlation between two variables on a scale of 0 to 1 with R-squared = 1 being perfect correlation.
compensation has no impact on shareholder returns? Other studies that incorporate additional factors claim higher correlations, but the lack of consensus begs the question: are companies spending too much time engineering CEO pay formulas?

**Why is pay for the average worker growing so slowly?**

CEO pay levels make for better headlines, but the numerator of the ratio shouldn’t get all the attention. Politicians and journalists are highlighting this question more and more, but boards spend relatively little time on how the rank and file are paid. Corporate boards rightly focus on their key hire (the CEO) and the senior executive team, but that doesn’t mean they shouldn’t spend any time thinking about the broader pay philosophy. Requiring the CEO to outline and justify the overall organizational pay approach and assessing the health of the corporate culture (including pay satisfaction) could combine as a good first step.

**Looking ahead**

The ratio of CEO pay to that of the average worker is not an easy problem to solve, so our aim is to highlight a few problems, and more importantly, recommend often overlooked questions that corporate boards should also be asking. Even if boards can’t make everyone happy with CEO pay overnight, they can at a minimum, demonstrate that their CEO pay formulations exclude components that could motivate short-term, harmful behavior; that they recognize the bias in many cases is to cut high potential leaders loose too soon; and most of all, that CEO pay is not the “end all, be all” in CEO or company performance. Groupthink can infect even the best companies, and it’s time for boards and senior management teams to question the status quo. It will take creativity and courage in equal measure, but there’s no time like the present to address CEO pay formulations and the stagnation of worker pay.