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COMP DIRECTORS FACE HEIGHTENED INVESTOR SCRUTINY

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One hundred percent of investors polled in a recent global survey said they would consider voting against compensation committee chairs or members at companies that have exhibited chronically poor pay packages.

This suggests that investors will pay more attention to how compensation committee members undertake their duties in 2017, according to consultancy **Morrow Sodali**, the firm behind the study. Issues related to performance are of particular importance to investors, who are taking a more customized approach in assessing pay plans, Morrow Sodali says. Experts also say that investors are demanding greater rigor and simplification in pay structures.

Investors Focus Primarily on Performance

Three quarters (75%) of the investors said pay for performance was a "must have" component in a pay plan, according to the poll. More than 60% also said the choice of performance measures was very important when assessing pay plans. Respondents to the survey represented a total of $24 trillion in assets under management.

"Not surprisingly, the key thing really for investors is the fact that [investors] want to make sure that the pay practices reward good performance rather than any performance. They want to make sure that the incentive plans have stringent performance measures attached and promote the right behavior," says **Ali Saribas**, director at Morrow Sodali.

In assessing performance, investors are taking a more customized and less benchmarked approach in looking at companies, says **John Wilcox**, chairman of Morrow Sodali. Since individual companies are facing different competitive or internal operating challenges, investors are recognizing that "they may have very good business reasons for rewarding a particular accomplishment by a senior executive or incentivizing executives to push in a certain performance area," says Wilcox.

As investors become more customized in their approach, peer practices and benchmarking have become less important to them. In fact, only 23% of investors said pay benchmarking and peer selection were most important when examining pay plans.

This more individual approach being taken by investors does have some benefits for boards. "This creates an opportunity for companies to really explain very clearly what their business objectives are and how their pay programs are designed to achieve strategic goals, and to incentivize executives to perform well in ways that are defined by the company," Wilcox says. "This is a much more flexible approach than we've seen traditionally, where proxy advisory firms use total shareholder return as their uniform criterion for companies."

in fact, three quarters (75%) of those polled said it is very important for compensation committees to disclose their decision-making process when defining executive pay, including the rationale for deciding on the structure and magnitude of overall executive pay.

Shareholders will generally accept a long-term business rationale for companies' actions relating to pay or governance, Wilcox says. "But companies need to explain what they're doing in terms that make it clear to the shareholder," he says.

Rigor of Performance Targets

Even so, investors believe some boards can do a better job at explaining their performance targets. "Investors are constantly complaining that the performance targets are not rigorous enough or they are not clear. So they are constantly demanding greater clarity from companies and more justification," says Wilcox.

However, companies are often reluctant to share this information for fear it could be used by competitors to understand their strategy or hire away valuable senior executives. "There is this tension between the amount that the shareholders want to know and the amount that the companies are willing to disclose. And that's an ongoing tension and always will be," says Wilcox.

This tension primarily relates to annual targets, says Saribas. "It becomes an issue with the bonus plans, where companies tend not to disclose performance targets for the one-year plan due to the commercially sensitive nature of those. And investors have kind of accepted that explanation, to a greater extent, that companies cannot actually disclose their real targets. They do, however, expect to see retrospective disclosure linking the bonuses paid to the actual performance delivered," he says.

That said, investors are still looking at ways to assess the rigor of these performance targets. Nearly two thirds (61%) of investors polled said "rigor of performance targets" was the most important issue when assessing pay.

"For long-term incentive plans, in addition to looking at analyst estimates to determine the rigor of absolute performance targets, investors will look at the historical level of vesting of these long-term incentive awards. If they've always been vesting at the maximum, it does bring into question whether the compensation committee is setting appropriately stretching performance targets," says Saribas.

The rigor of performance goals contributed to failed pay votes at 50% of the firms that experienced such votes in 2016, versus only 33% in 2015, says data from Semler Brossy.

Investors Want Greater Simplicity in LTI Plans

Meanwhile, investors are seeking greater simplicity in the structure of pay plans, particularly long-term incentive (LTI) plans.

Norway's oil fund, which has $910 billion in assets, plans to begin requesting that companies end long-term incentive schemes, and instead focus on CEO stock ownership levels and holding periods, according to the FT.

"Long-term incentive plans tend to have complex and opaque metrics that are open to discretion, and boards often adjust, supplement or rebalance metrics during the measure period," according to the fund's recently released position paper. The paper also said that a "simplified compensation structure ensures that the CEO, board and shareholders can focus on the company's strategic aims."

Investors are requesting the simplification of incentive plans in order to help better align senior management's interests with those of shareholders, according to Morrow Sodali.

"There seems to be a general feeling that many of these schemes are so complicated that it's difficult for anyone to understand them. If that is the case, it can hardly be motivating for executives if they don't understand incentive plans because of their complexity," says Wilcox.

Goldman Sachs recently announced that it streamlined its long-term compensation structure and eliminated overlapping performance metrics. The company also said that future long-term incentive plan (LTIP) grants would be discontinued. The moves were made by Goldman's board as shareholders said its compensation program for senior executives was "overly complex," according to the 2017 proxy. Incidentally, Norway's oil fund rejected some of Goldman's pay policies in the past year, says the *FT*.

Following, these recent changes by Goldman, proxy advisor **ISS** said it plans to support the executive pay plan this year, after rejecting it in 2016.