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The Investor View on Executive Compensation in 2018

In the first few months of 2018, significant media attention has been focused on new pay-ratio disclosures and how the repeal of the Section 162(m) performance-based compensation tax deductions will impact executive-compensation decisions. But behind the headlines, top of mind for investors voting proxies are perennial and emerging topics such as the alignment of metrics with company strategy, rigor of goal setting, pay magnitude and the responsiveness of compensation committees to low say-on-pay votes. This proxy season, companies should be prepared to engage with investors on their evolving view of compensation as a window into long-term value creation.

New policies, more scrutiny

State Street Global Advisors' decision to introduce an 'abstain' option for its say-on-pay vote may prove to be the most impactful executive compensation policy change for companies in 2018. State Street has said that it intends to use abstain votes when a pay program is not fully in line with its expectations but does not justify an 'against' vote. It is too early to tell how frequently this option will be used and whether it will result in a meaningful shift in overall vote outcomes, but this new policy will only heighten the need to engage with investors to bring them along, particularly with unique or complicated compensation plans.

Proxy advisors have also added new dimensions to the compensation mix for 2018. ISS has added enhanced responsiveness screens to assess how companies respond to low say-on-pay votes (below 70 percent support), which has the potential to result in recommendations against say on pay for failure to properly respond through enhanced disclosure, heightened shareholder engagement or program changes. Glass Lewis also tightened its responsiveness threshold for say-on-pay votes from below 75 percent of votes cast to below 80 percent, raising the bar for companies to avoid further scrutiny from investors. The addition of four non-TSR metrics to ISS's new financial performance assessment in its quantitative pay-for-performance screen is encouraging investors to take a closer look at the alignment of pay with performance. All of these new policies are arming investors with incremental analysis and reasons to ask challenging questions in engagement that companies should be prepared to address in conversations and in their proxies.

Metric selection and goal setting

Metric selection for incentive compensation has become a common topic in engagement as investors seek to understand how incentives link to strategy, culture and risk management. For many investors, executive compensation has become the primary avenue to understand the connection between what they view as long-term value drivers and company actions. For example, with shareholder support for climate risk resolutions at record levels, some investors are looking for companies to be responsive more broadly by incorporating sustainability and qualitative metrics related to those topics. A recent report by Ceres noted that in 2017, 8 percent of companies directly linked executive compensation to sustainability issues such as diversity, greenhouse gas emissions and water management, up from 3 percent in 2014.

The rigor of goal setting is also a key element of executive compensation analysis in the context of say-on-pay votes. Both ISS and Glass Lewis regularly comment on the levels at which performance targets are set relative to prior years' performance, and are willing to make a negative recommendation based in part on targets they perceive to be too easy to attain. However, setting targets below prior-year achievement can be a red flag for proxy advisors and investors, which makes it incumbent on companies to ensure their CD&A and related disclosures are thorough and their engagement teams are well prepared to discuss the context for performance targets and the process the compensation committee uses to set targets.

Section 162(m) and the start of pay-ratio disclosure

The Tax Cuts and Jobs Act, which was signed into law this past December, made significant changes to the tax deductibility of performance-based compensation. Although the original intent of exempting performance-based pay over $1 million under Section 162(m) was to give companies a tax incentive to tie pay and performance, the tax implications of compensation programs have always been less important to investors than the performance incentive. A well-designed and transparent compensation program that demonstrates clear alignment of pay and performance remains key to winning investor support regardless of any tax consideration.

While the loss of tax deductibility of performance-based pay is expected to have a limited effect on how boards and investors consider pay and performance, it may give compensation committees more flexibility in structuring compensation programs, including setting reasonable targets beyond the beginning of a company's fiscal year. However, boards should be aware that this discretion will not alter investor expectations for structural rigor within pay programs. If companies meaningfully deviate from past practice, it's safe to assume that investors will expect clear rationale for how adjustments will create tighter alignment of metrics, goals and payouts with strategic priorities and performance.

It will likely take time for investors to incorporate most pay-ratio disclosures into their evaluation of compensation plans but the impact of the new disclosure is already being felt in the broader marketplace. With roughly 500 pay ratios reported as of the end of March, there has been significant media attention that has brought greater scrutiny of pay practices. In the short term, companies should expect that outlier pay ratios could result in a closer review of the overall compensation program and may be considered alongside other factors when investors vote on the board, say-on-pay and equity plan approval.

Takeaways for issuers

Executive compensation is a prism through which investors evaluate the independence and effectiveness of the board. As engagement with investors becomes more comprehensive, traditional investment stewardship teams are expanding their own mandate by incorporating fundamental-oriented analysis to help drill down on the alignment of pay with performance and evaluate whether compensation plans are or will lead to the sort of outcomes investors seek. Compensation is also a prime focus of many activism campaigns, particularly in instances where pay quantum is part of the broader narrative about the need for change at the top. Expect 2018 to bring renewed focus to the central role that executive compensation plays in investors' evaluation of all aspects of corporate alignment with their long-term interests.

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