

How “Independent” Is Your Compensation Advisor?

by James Reda

With shareholder (and election year) outrage over top executive pay at a new peak, board compensation committees must put increasing faith in the numbers and advice they receive from executive pay consultants. Yet research finds that many of the big compensation consulting firms suffer from the same independence and conflict of interest issues that roiled major auditing firms earlier in this decade.

Shareholder confidence and public patience continue to erode over the situation with CEO and top executive pay. In the past few years, headlines were made by executives who walked away with hundreds of millions of dollars in severance pay despite dramatic stock losses and poor performance overall. This begs the question of how these pay-for-failure arrangements were initially conceived or approved by the compensation committee of the board of directors.

Of course, concern over executive pay is hardly a new phenomenon. These days, however, the outrage has reached levels no director can afford to ignore. Compensation committee members must take a hard look at pay levels and continually reassess their processes and operations from start to finish.

Though there are evolving best practices, including pay-for-performance, the difficulty of board members' work is that there is not one “right” compensation level or philosophy that works for all companies at all times. Therefore, committee members seek outside expertise from consultants to provide them with a view of competitive market levels of executive pay, and to review all aspects of executive compensation. These include base salaries, annual cash incentives or bonuses, long-term incentives, and stock awards.

From a shareholder's point of view, the question remains, “Despite this additional expertise, are

executive pay decisions being made within a truly independent process?” The choice of consultant for a compensation committee is an important one in the eyes of shareholders.

Compensation consultants who are retained to provide unbiased advice on executive pay offer a variety of services to the committee, such as:

- Benchmarking total compensation (salary, bonus, long-term incentives, perquisites and benefits).
- Designing employment agreements.
- Assisting with tax, accounting, and SEC implications of incentive plan design.
- Evaluating the CEO, other senior executives and the board.
- Designing deferred compensation, supplemental executive retirement programs (SERPs), and other executive perquisite and benefit programs.
- Designing change-in-control and severance programs.
- Providing corporate governance advice on executive and board pay.
- Advising on all other executive compensation matters.

The board's compensation consultants may have conflicting economic interests if they provide advice detrimental to management's payday.

Although compensation consultants are hired as independent advisors, it has been suggested by many (myself included) that the traditional providers of pay consulting services are influenced too heavily by management. This can lead to a situation where

James Reda is founder and managing director of James F. Reda & Associates compensation consultants.
[www.jfreda.com]

the compensation committee may have little to no control over the negotiations that they are responsible for overseeing.

These consultants may have conflicting economic interests if they provide advice that is detrimental to management's payday, which may result in adverse economic consequences to the consultant or the consultant's firm.

Like the audit firms before Sarbanes-Oxley, traditional providers of compensation advice, referred to as "diversified human resources consulting firms," have significant economic incentives to provide additional services. These added services are oftentimes more lucrative, and include business process outsourcing, information technology consulting, risk and insurance underwriting, and actuarial consulting.

Consider for a moment, if the firm providing advice to the board on CEO and HR director pay also provides other services to the CEO and HR. How can the board ensure the firm's recommendations are independent and objective?

Even if a consultant is not providing other services to management—but has the potential to do so—the public still perceives a conflict.

According to the 2003 Blue Ribbon Panel of the National Association of Corporate Directors, in order for a consultant to be truly independent, that consultant "should be hired by and report directly to the [compensation] committee, and should not be retained by the company in any other capacity."

This advice has also been repeated by the Business Roundtable, Conference Board, New York Stock Exchange, prominent legal experts (practicing attorneys as well as academics), Chancery Court of Delaware, institutional investors and institutional investor advisory firms.

Even if the consultant is not providing other services to management but has the potential to do so, the public still perceives a direct conflict-of-interest and lack of independence. Public policy makers, public and private oversight bodies, and shareholder

groups continue to focus on enhancing the ability of corporate boards to ensure the businesses operate ethically and effectively. Best practices have been encouraged by professional associates and new rules have been developed.

As of August 2006, publicly traded companies must disclose the identity and the nature of the assignment of their compensation consultants to the Securities and Exchange Commission. In a letter to the SEC in April of 2006, during the discussion of proposed regulation changes, I recommended that the SEC require further disclosure on compensation advisor independence. However, the final requirement stopped short of disclosing what (if any) other services the consultants provide to the company and also the fees charged for the executive pay consulting or fees charged for other services.

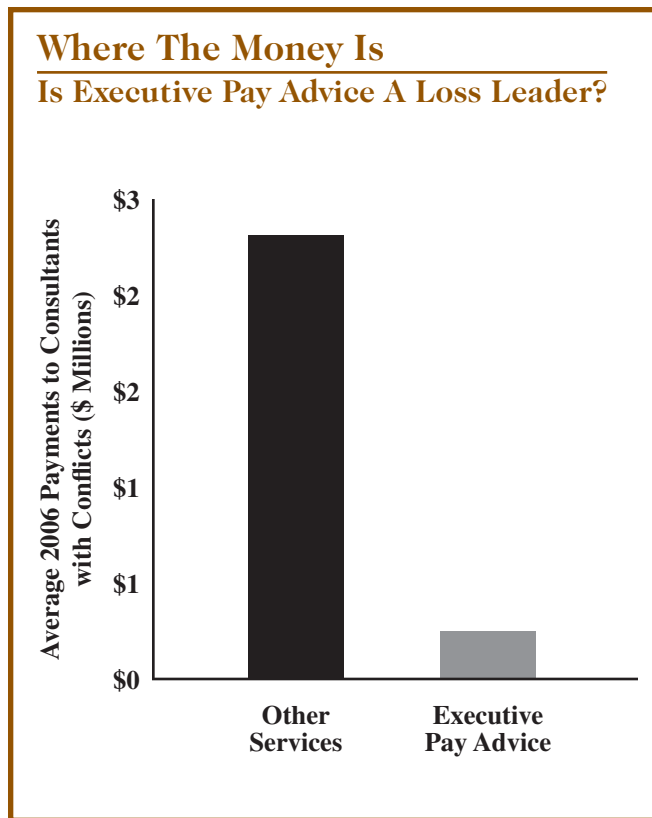
In October 2006, the Connecticut State Treasurer and the AFL-CIO joined 11 other institutional investors in writing letters to the 25 largest U.S. companies, requesting that they exceed the SEC's disclosure requirement on compensation consultant independence.

Also in 2006, Representative Henry A. Waxman, as Chair of the Congressional House Oversight Committee, ordered an examination of whether the compensation consultants hired by large publicly traded companies act independently. In 2007, the Oversight Committee requested that each consulting firm report fees paid for consulting services and for all other services.

This examination collected information from the six top consulting firms about their work for the 250 largest publicly traded companies over the five-year period of 2002 through 2006. For the first time, a review of the fees paid and a study on the impact of such fees on executive pay levels was done.

A hearing of the House Committee on Oversight and Government Reform was called in December 2007, and the report, *Executive Pay: Conflicts of Interest Among Compensation Consultants*, was released. The report found that:

- Compensation consultant conflicts of interest are pervasive.
- The fees earned by compensation consultants



for providing other services often far exceed those earned for advising on executive pay.

□ Some of the consultants received over \$10 million in 2006 to provide other services.

In 2006, over two-thirds of the Fortune 250 companies that hired “conflicted” compensation consultants did not disclose the conflict in their SEC filings.

Many Fortune 250 companies do not disclose their compensation consultants’ conflicts of interest. In 2006, over two-thirds of the Fortune 250 companies that hired “conflicted” consultants did not disclose the conflicts in their SEC filings. In 30 instances, the companies informed shareholders that the compensation consultants were “independent,” when in fact they were being paid to provide other services to the company.

There appears to be a correlation between the extent of a consultant’s conflict of interest and the level of CEO pay. According to the report, the fees

that consulting companies earned for services other than providing advice on executive pay far exceed the fees earned for compensation consulting.

Specifically, the report stated that in 2006, consultants who provided both compensation consulting services and other services to Fortune 250 companies received an average of \$220,000 for executive pay advice and \$2.3 million for other services from each client company.

Furthermore, the report found an apparent correlation between CEO pay and hiring compensation consultants with significant conflicts of interest. According to the report, CEOs were paid a median salary of \$12.5 million in 2006 at the major companies using compensation consultants with the largest conflicts (as measured by fee ratios). This was 67 percent higher than the median salary of \$7.5 million paid by companies that did not report using consultants with conflicts of interest.

The report admits that the correlations only suggest a possible relationship between CEO pay and conflicts of interest. Many other factors may contribute to the salaries paid to CEOs at Fortune 250 companies.

The four diversified human resources consulting firms surveyed maintain that “a consulting firm’s ability to provide objective, independent advice regarding executive pay is not compromised simply because it provides other services to the company.” These firms described policies and practices that are followed to make sure that compensation committees receive unbiased advice.

One such practice that large diversified HR consulting firms talk about is the creation of “walls” that they say ensure independence of consulting advice. However, the economic interest that ties consultants together is difficult to overcome. These include ownership interests in the common firm, overhead expense (rent, administrative support, etc.) and, most importantly, cash pay.

It only makes sense that the more a consulting firm earns, the more valuable it will be for their owners and the more it can pay its senior members. A compensation consultant will always consider their overall economic interests. Consultants that do no

other business with the company will have no concern about management's attitude towards their company with regard to other types of business.

Compensation committees should file disclosures similar to those that have proven crucial in making the audit process independent of management.

As part of my testimony to the House Committee on Oversight and Government Reform, I urged disclosure to verify the independence of the compensation advice boards receive from consulting firms. This disclosure would be similar to that found in the audit committee report, so crucial in making the audit process independent of senior management. Such an added disclosure could help remedy the negative perception executive compensation holds with shareholder groups, the public and the media.

Recommended disclosures would include:

The procedure the compensation committee follows in choosing a compensation consultant and a declaration by the committee identifying its position on the degree of independence of its executive pay consultant.

A table presenting fees paid to compensation consultants for pay consulting services and all other fees paid to the consultants' firm or affiliated firms for other services.

The type of work performed by the consultant.

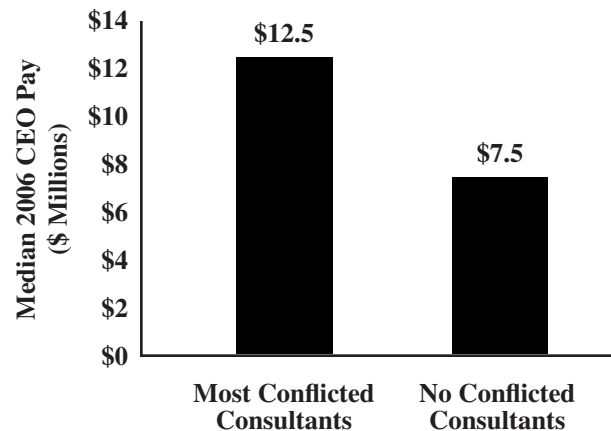
The relative fee structure for work performed for the compensation committee and for management, if applicable.

Additionally, the committee should provide a description of the type of work performed when the consultant works with management.

Having identified this potential for a conflict-of-interest and the demand for objective, independent compensation advice, there are a growing number of *independent* firms made up of experts that formerly worked at large diversified HR firms. These independent experts continue to offer pay advice, but without any potential or perception for conflict

Paying For Results?

Consultant Conflicts Lead To Big CEO Paydays



of interest.

Independent consultants provide about 20 percent of the executive compensation consulting performed in the U.S. This percentage is expected to increase as boards decide on the independence of their executive compensation consulting.

One argument against using an independent is that they are not "full-service" consultants in that they do not provide actuarial, communications, health and welfare, and tax and legal advice. The compensation consultant need not have offices in multiples countries, or offer other services. These may be provided by either the company or other consulting, legal or accounting firms. In most cases, the compensation committees of large companies oversee U.S.-based executives that do not require other country knowledge.

Major companies, including Wachovia, Pfizer and Verizon, now have written policies that prevent pay consultants from doing any other work for the company.

Some companies are starting to take action by moving to independent compensation advisors. For example, Wachovia, Procter & Gamble, Pfizer,

Verizon and others have written policies that prevent pay consultants from performing any other type of work for the company.

In my view, boards need to consider the following criteria when seeking outside advice for executive compensation:

□ *Independence from management.* Advisors engaged solely by the board are more likely to provide objective advice consistent with the board's responsibility to shareholders.

□ *Industry expertise.* This expertise should include a solid understanding of the overall industry in which the company is engaged, its competitive market forces, key dynamics that influence individual company and overall industry performance, and the competitive talent pools.

□ *Direct and relevant experience.* Advisors should be highly experienced and have successful track records in assisting similar companies. Generally speaking, the prospective consultant should have several years of executive compensation consulting experience.

□ *Executive compensation resources.* The firm should have an extensive survey library, data resources, and secondary consulting resources in the event that the lead consultant is not available.

□ *Visibility and good reputation.* Particularly for large companies, the consulting firm and its lead consultants should be nationally recognized and well regarded.

□ *Seamless integration of resources.* The lead consultant and consulting firm should be able to deliver, or arrange for, accounting, tax, actuarial, pension, and financial advice in a seamless manner.

□ *Nationwide and worldwide coverage.* A company with internationally based executive officers should also look for international consulting capabilities

□ *Proficiency with all pay elements.* The consulting firm and its consultants should have knowledge of salary; short-term and long-term incentives; and pension-benefit, welfare-benefit, employment, severance and change-in-control agreements and executive perquisite programs. A consultant who is not personally proficient in all elements should be able to recognize issues and access expertise in all such areas.

□ *Business goals and executive pay strategy alignment.* The philosophy of the consulting firm should be compatible with the company's philosophy. Some consultants have a specific philosophy and approach and may be reluctant to or unable to acknowledge the merits of a different but legitimate approach favored by the compensation committee. This would be a poor fit.

□ *Performance measurement expertise.* The consultant must be expert at interpreting financial statements and correctly applying financial ratios and measures in light of the company's industry, business plan, and other pertinent facts and circumstances.

□ *Creativity and capability to create custom designs.* The consulting firm should be able to provide creative solutions in the context of shifting economic trends and business models.

It is crucial for public U.S. corporations to implement executive compensation programs that truly pay for performance. Such programs will help improve our companies' credibility at home and abroad, and can help quiet the critics of executive pay, provide additional transparency to shareholders, and benefit American business.

Let the shareholders, compensation committee members and others that have an interest in the allocation of corporate resources be aware of potential conflicts associated with executive compensation consulting. ■

Reprinted by THE CORPORATE BOARD
4440 Hagadorn Road
Okemos, MI 48864-2414, (517) 336-1700
www.corporateboard.com
© 2008 by Vanguard Publications, Inc.