

Compensation Consultants And Your Board

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Compensation committees face a new era of disclosure and independence in their work with outside pay consultants. Investors will soon know how much your consultant is paid and whether they were hired by you or management. Now is the moment when your committee should re-examine its relationship with outside consultants, not only to assure that it will meet the new rules, but that it also provides the best pay advice.

Today, almost any discussion of the current financial crisis brings up the topic of executive compensation. Additional legislation and oversight are forthcoming, and government intervention will likely have a lasting impact on how executives are paid.

Board compensation committees must not only deal with the competing demands of regulators and shareholders, but must now operate in an environment where their actions and decisions are highly visible and often criticized. For many boards, hiring an out-side compensation consultant to help them navigate this highly complex environment is a worthwhile and prudent business decision. A consultant can help the committee fulfill its oversight and governance responsibilities while maintaining competitive, compliant, and responsible executive pay.

In this article, we discuss how the compensation committee and the compensation consultant can have an effective relationship. The process begins with the compensation committee defining its objectives and expectations and hiring the consultant. We then discuss procedures that emphasize communication and facilitate productivity.

A mutually beneficial consulting relationship will require considerable dialogue. When the relationship is built on a solid foundation, differing points of view can be addressed without detriment to the ongoing consulting relationship.

An effective consulting relationship begins with the selection process. The human resources department or procurement may begin the process with a “request for proposal.” However, the process should be driven by the compensation committee itself. Selection criteria should be identified as well as any required skills, knowledge, or experience. Often, experience in a particular industry, or experience with a specific transaction, such as an IPO or merger is important. If the company is expanding internationally, global resources and data may be needed.

The full compensation committee should be involved in interviewing the consultant or team, and they should assure that those they are interviewing will be the ones involved in the engagement. The committee must be comfortable with the consultant’s experience on similar issues facing the company, with the consultant’s technical acumen, access to available resources, and ability to present a coherent and well thought-out point of view. The consultant’s references should also be checked.

Each consulting relationship is unique. A start-up company, an IPO, or a newly merged or acquired company may need help with virtually every aspect of employee pay design. Other companies may need an overall review of management’s pay recommendations and expert opinion to the committee at each meeting. Others may need specific technical expertise (a company in Chapter 11; one that has received TARP

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Once the consultant is selected, the committee should define in advance its objectives for the year and its expectations of the consultant. This need not be an involved or lengthy process, but in any working relationship, purpose and context need to be provided.

For example, if the compensation committee needs education and training on executive pay issues and practices, it should inform the consultant. If the committee is not comfortable with the design of the incentive plans that have provided lucrative payouts while stock price remained flat, the consultant should know about it. If there is disagreement over Ike CEO's pay or the pay and performance linkage, the consultant should be alerted.

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Certainly, if the prior consultant did not meet the expectations of the committee, the new consultant should be told why. Where the compensation committee is not experienced in working with outside advisors, the consultant is in an excellent position to help structure objectives and processes that work.

Most of all, the committee relies on the consultant for experience and expertise, to help ensure that the company is not exposed in terms of inappropriate pay practices. Ultimately, the overall goals of the compensation committee and consultant are the same: to help the board perform its governance and oversight role in an informed manner.

Throughout the year, the compensation committee and consultant should adhere to certain practices that will lead to a successful working relationship. There will still be challenges and tough issues to work through together, but these processes will help materially in achieving committee objectives.

- At the beginning of every year, the consultant should develop a "statement of work" that defines the scope of their consulting activities for the coming year, including deliverables, fees, timing, and reporting relationships to the committee. If there is an annual calendar of meeting dates and activities, the statement of work is straightforward. Since the human resource function is typically responsible for the annual calendar, this planning helps to ensure that all parties have a common understanding for the year ahead.
- If the committee has not done so already, its goals and objectives should be articulated to the consultant. This should include objectives for the consultant, but might also include objectives for the committee itself. The committee chairperson should also alert the consultant to any critical issues facing the committee.
- In a new relationship, the committee will often request that the consultant provide a high-level review of the company's executive pay program, highlighting any atypical or uncompetitive pay practices or plan features that should be reviewed in detail. It is incumbent on the consultant to uncover potential problem areas that need to be addressed.
- The committee chairperson and consultant should review meeting materials in advance of each meeting, preferably before the materials are mailed, which allows for revisions. This allows both parties to understand each other's point of view and pose questions that will help in meeting preparation.
- The consultant should assure that the chair understands the key messages to be delivered on a particular topic. The chair, in turn, can use the opportunity to bring the consultant up to speed on any strong committee views or business issues that may be relevant to the subject matter at hand. This could include plan design, competitive analysis, the CEO's contract or pay recommendations. It is surprising how often this dialogue does not happen, or comes at the last minute when it is often too late to resolve an issue or avoid a problem during the meeting.

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- The consultant should be available for every meeting and executive session, as requested by the chairperson. Time should be scheduled for debriefing, particularly when follow-up activities are required. When the meeting agenda is full, or when many decisions have been made, follow-up ensures that everyone has similar takeaways.
- The committee's annual calendar typically includes a review of compensation strategy, annual pay benchmarking, assessment of the pay and performance relationship, and risk assessment. At the most basic level, both parties should work to avoid controversial pay practices, ensure that pay programs support company strategy, and establish appropriate performance linkages for incentive plans. These are joint responsibilities. Any review of CEO pay (with recommendations) should go to the chairperson first, without prior review by the CEO.
- The performance of outside advisors should be evaluated as part of the committee's annual self-evaluation. Even if the consultant assists the committee with the evaluation, it is important that the members review the overall relationship each year to determine if the consultant is meeting expectations. Feedback should be provided to the consultant.
- At the end of each year, management (usually human resources) should provide the committee with documentation on the consultant's fees and deliverables for the year. A summary of all services and fees provided by the consultant's firm to the company overall should also be provided.
- As part of the committee's review of the proxy Compensation Discussion and Analysis (CD&A), the required language describing the consultant's involvement in pay decisions should be reviewed, as well as other needed disclosure.
- There should be a clear process for requesting and approving additional work for the consultant during the year. If management has a need for additional work, the committee should approve it. If the amount of work the consultant's company does overall is significant, the committee may want to know about such work in advance.

The processes described above will contribute to a productive relationship between the compensation committee and its consultant. The following success factors can strengthen the relationship even more.

- The chairperson and consultant must have access to one another during the year. They should communicate before and after each meeting, and whenever necessary.
- Both parties must have realistic expectations about the relationship. They may not always agree on every issue, but this is not a signal of failure or dysfunctional relationship. The committee must be open to views and opinions different from its own, and consultants must understand that their responsibility is to voice opinions to the committee, even if it is not what the board (or CEO) wants to hear.
- The committee and consultant should proactively review company pay programs and practices, while anticipating potential issues or necessary changes. In today's environment, the compensation committee cannot be reactive and wait for problems to occur. The consultant must uncover relevant and timely issues.

For example, if the company intends to seek shareholder approval of a new long-term incentive plan share reserve, the committee should research the voting policies of their largest institutional investors before making the request. When advisory groups introduce new policies, companies should review their programs to anticipate any problem areas that could arise. The committee should also involve the board's audit or risk committee in an annual evaluation of pay programs as it relates to risk.

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- Understand that the ultimate decision-making is the responsibility of the compensation committee, not the consultant. The committee needs to exercise its own judgment after getting the best information and advice possible.

In the past year, consultant independence has come to the forefront. Since 2006, if a consultant played a role in determining or recommending executive or director pay, the consultant had to be identified in the company's proxy and the scope of services and reporting relationship had to be noted. SEC rules approved in December 2009 expanded the requirement to include the fee disclosure if a consultant provides additional services to the company beyond \$120,000 in the aggregate. Also in 2009 draft legislation delivered from the Treasury Department to Congress included a provision that any compensation consultant or legal counsel hired by the compensation committee must be "independent" from management.

Most full-service consulting firms have independence standards to manage any potential conflicts, while a boutique firm specializing only in executive compensation is generally structured to reduce the potential for conflict.

The compensation committee should also have procedures in place regarding the consultant relationship (hiring and firing authority, direct access to the committee, performance evaluation, executive sessions, etc.) that help ensure objective advice, as well as a protocol on mitigating conflicts. Absent a mandated definition of consultant independence, what is important is that the committee be satisfied with the relationship and that there are procedures to avoid conflict.

The consultant should not play both sides of an issue, and has a responsibility to express an opinion even if it is not one shared with the chair, the committee or the CEO.

A related issue which has attracted increased attention is the use of more than one compensation consultant. If two consultants are used (one reporting to the compensation committee, the other to management) the roles should be clearly defined and agreed to in advance. The predominant view is that one consultant reporting to the committee is a more effective arrangement, but the dual consultant model is certainly workable.

To have an effective working relationship, both the compensation committee and the consultant have specific roles to play.

Treasury Department Fact Sheet

Providing Compensation Committees With New Independence

Draft legislation was delivered by the Treasury Department to Congress in 2009 to promote the independence of compensation committees. Key elements would include:

- Compensation committee members will be required to meet stronger standards for independence that are to be issued by the SEC.
- To ensure that compensation committees receive objective advice, any compensation consultants and legal counsel hired by the committee must be independent from management.
- Committees must be given the authority and funding to hire independent consultants, outside counsel, and other advisors who can help ensure that the committee bargains for pay packages in the best interests of shareholders.

Outside compensation consultant. It is expected that the consultant know the company and industry and stay current on all regulatory issues, as well as best practices in plan design, performance measurement, and pay practices. The consultant should not play both sides of an issue, and has a responsibility to express an opinion even if it is not one shared with the chairperson, the committee, or the CEO. Above all else, the consultant needs to be a "trusted advisor" helping the committee think strategically, raising questions and issues the committee should be thinking about.

Compensation committee. Many committee activities are dictated by various regulatory bodies (stock exchanges, the SEC, FASB, etc.), or specific legislation, such as Sarbanes-Oxley. At a tactical level, each committee must follow its charter to ensure members are fulfilling their responsibilities.

The committee also needs to work with other committees of the board (audit, nominating/governance, risk, etc.) and keep the full board informed of decisions, particularly on CEO compensation.

The compensation committee chairperson should develop a healthy working relationship with the CEO.

The committee itself should maintain adequate skills among its members. Diverse areas of expertise and complementary skills are a plus, and basic financial acumen a necessity. Most importantly, the committee must represent the shareholders.

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While the formal reporting relationship of the consultant must be to the committee, a good working relationship between the consultant and management can have an extremely positive impact. Management provides necessary compensation data and financial or legal information. Management can also confirm data accuracy and timeliness, and provide a historical perspective or rationale for unusual pay practices. It can explain how certain programs are implemented (such as company specific definitions for metrics used in incentive plans.)

A good relationship with management can also help provide information on the various viewpoints held on pertinent issues, and offer insights on culture and business strategy. In many cases, pre-committee meeting conference calls and preparation may involve the consultant, the compensation committee chair, and human resources. When all three parties are involved, productivity in the committee meetings can be greatly enhanced. Open communication, where appropriate, contributes to better working relationships overall.

A good working relationship between the consultant and management is a positive. Management provides necessary pay and financial information, plus insights on culture and business strategy.

Executive compensation is a sensitive area. Such factors as company performance, personal views on pay, or a shareholder vote against committee members can temporarily change committee dynamics. Additionally, problem areas can arise: a mistake may be made as a result of not having current data; meeting participants may not be fully prepared when a specific issue arises that was not on the agenda; a committee member may question a methodology used by the consultant; or the consultant may be caught in the middle of two disparate views. Most issues can be worked out. The important thing is for the chairperson and consultant to acknowledge a problem when it occurs, accept responsibility for their role in the misunderstanding, and focus on action to correct the problem.

In the future, the need for compensation committees to work effectively with consultants will increase as new regulations take effect and companies work their way out of the current recession. The committee's role and potential impact - as well as its exposure to public scrutiny - will not diminish.

Nonetheless, along with greater demands and challenges comes the opportunity to make meaningful decisions in shaping pay programs. In many companies, this will ultimately result in pay strategies and programs that are tightly aligned with the competitive market and meaningful returns to shareholders

Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.