What Every Compensation Committee Should Ask Its Consultant

By David N. Swinford

Important questions often go unasked when compensation committees interview a prospective consultant. Members are likely to be attentive to important but routine issues related to a candidate's reputation, capabilities, and expertise. Yet as committees' functions and visibility have expanded as a result of new disclosure requirements, changing governance standards, and intense public attention to executive pay programs, so too should the expectations and standards set for their consultants.

Clearly, the compensation consultant should not overstep what, by its nature, is a purely advisory role. But in guiding directors through the details of complex executive pay packages, the consultant should be willing to take, and be capable of taking, a proactive role in assuring the thoroughness and integrity of the committee's decision-making processes. Fully discussing and reaching a consensus beforehand on both sides' expectations and level of comfort can help ensure that the committee—and ultimately investors—get the most benefit from the relationship.

The following questions can serve as a helpful starting point in assessing the fit between the committee and a prospective consultant.

1. What is the consultant's role in safeguarding the governance process?

In the current business environment, it is increasingly necessary that an advisor accept responsibility for keeping committee members attentive to the effectiveness of their governance processes. That requires that the consultant pursue two seemingly conflicting aims: to be a mediator between management and the committee and, conversely, to move the two sides off common ground if they are overlooking a key factor in their decision making.

2. Will the consultant be accessible?

The committee needs to know its consultant will be available to discuss issues when needed—and the consultant should expect the same of committee members. From the committee's standpoint, the consultant should not be overloaded with other client work and should be reasonably available for in-person, and not just telephonic, meetings with the committee. A senior consultant is usually the lead person on an account, but the committee should be aware of the extent to which assignments will be undertaken by a more junior person. While the latter may be competent to respond to most factual questions, the committee needs assurance that the most experienced consultant will respond when an opinion is needed regarding a particular course of action. In turn, the consultant should explain to members that doing a good job requires candor from, and accessibility to, the committee—not just when the chair requests a meeting, but also when the consultant believes there is an issue that deserves further consideration.

3. How will the consultant react when asked to take a stand?

While compensation consultants are not decision makers, a committee is ill-served if its consultant habitually summarizes the pros and cons of issues without ever taking a stand. A good advisor knows when to step forward and say, "Here's what I would do and why"—even if the committee hasn't asked for an opinion. In certain situations, the consultant may need to risk disagreeing with the committee chair. For example, directors at many companies have a tendency to rely heavily on general practice

Director Summary: Compensation committees increasingly rely on outside advisors to provide effective oversight of pay programs and ensure compliance with new regulatory mandates. For the relationship to work, directors must be confident that consultants will not only provide the committee with the most accurate and meaningful data, but will also take the lead in promoting decisions in the best long-term interests of the organization, its employees, and shareholders.

in making policy—that is, to go along with what peer companies are doing. The consultant should provide information about typical practices, but in some situations may suggest that the committee consider whether those particular practices are germane to their company's situation, or if a less standardized approach might be appropriate.

4. Will the consultant serve as a reality check?

While the compensation consultant is not bound by an official code of professional conduct like an accountant or a lawyer, a high standard of professionalism demands that consultants serve as more than a source of black-and-white answers or even a voice independent of management. Unlike the oversight provided by the audit committee, most decisions made by the compensation committee are not right or wrong, but primarily matters of judgment and degree. When appropriate, the consultant must also function as a brake on the decision-making process.

Committees are well served by a consultant who will take the initiative to say to members, "There are some important issues here that you're overlooking and should be considered before you make a decision." It is the consultant's duty to try to persuade members to factor in new information when needed, even if doing so may end up increasing costs or result in a delay. Consultants should make sure they achieve this without being rigid or demanding. For example, if management and the committee are overly focused on how increased earnings should be reflected in pay levels, the consultant may need to point out that the organization's return on capital employed ranks at the bottom of its industry.

5. Will the consultant be willing to disagree with the chair? With management?

There is a fine line between being a strong advocate for a particular viewpoint and seeking to impose that opinion. But it is no better for the committee to have a consultant who will invariably support its point of view than one who automatically takes the side of management. A good compensation consultant will tread the line but not overstep it, seeking to persuade members of what he or she believes is the right course of action in a way that is respectful of their authority.

6. Under what circumstances would the consultant sever the relationship?

Good consultants make their services and their standards clear to clients from the start. The committee's compensation consultant should be willing to resign in situations that involve unchecked greed, dishonesty, or unethical behavior, because it jeopardizes the consultant's own credibility. If a consultant perceives that management and the committee have lost confidence in his or her judgment, that advisor has lost any effectiveness and should step down. Similarly, if over an extended period the consultant is unable to persuade the committee to take a course of action, or is convinced members are consistently going in the wrong direction in spite of his or her recommendations, it is probably time to end the relationship.

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7. When was the last time the consultant was fired by a client—and why?

As part of their duty to help safeguard the integrity of the committee's processes, compensation consultants may raise issues that directors and managers either have not thought about or prefer not to address. An experienced consultant who has never been fired has never taken a risk or made a mistake. Given the rarity of perfection, members should understand how mistakes are handled and what the consultant has learned from negative experiences.

In the event a mistake of fact or judgment is made, the committee has a right to expect that the advisor will not only take full responsibility, but that he or she will be proactive about explaining what went wrong and what follow-up steps will be taken to keep it from happening again.

8. Is the committee comfortable with the consultant's ability to appear before the full board? Or in front of shareholders?

Compensation committees increasingly are being asked to explain and justify the decisions they make about pay programs to the full board and, under new SEC disclosure rules, to shareholders. Particularly at highly visible companies, the committee must be confident that its consultant has the experience, independence, candor, confidence, and credibility to provide technical support and advice outside the committee room.

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9. Who else does the consultant work for?

The committee should insist upon full disclosure and carefully consider any conflict of interest or perception of conflict on the part of the consultant. Such a relationship would not automatically disqualify a consultant from consideration, but should be weighed in the context of its effect on the consultant's ability to advise them independently and on the committee's willingness to share confidential information. Among the issues: whether the consultant does other work for the company or for other companies that are associated with board members; whether the consultant works for another company where the CEO serves on the board; and whether the consultant advises other companies in the same industry. The last question is particularly important when the committee will need to disclose highly confidential information regarding the company's business plans and financial information, especially in a very competitive industry.

10. How does the consultant do the job differently today compared to five years ago?

That answer will shed light on consultants' awareness of and approach to changes in both their own role and the committee's function. An advisor should be sensitive to the need to assist the committee in developing new approaches and strategies in response to major changes in the governance and regulatory arena, including: increased shareholder activism; institutional shareholder voting guidelines; evolving best practices; and the challenge of discussing and resolving disagreements within the board and with management with both candor and discretion.

Conclusion

In a challenging governance environment, compensation committees increasingly will rely on their outside advisors to help them provide the most thorough and effective oversight of corporate pay programs, as well as to ensure compliance with new regulatory mandates. For the relationship to work, directors must be confident that consultants not only will provide the committee with the most accurate and meaningful data, but also will take the lead in promoting decisions in the best long-term interests of the organization, its employees, and shareholders. ■

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Ratings Agency Now Ranks Corporate Pay Alignment

GovernanceMetrics International (GMI), a corporate governance research and ratings agency, recently announced the introduction of its Pay Alignment Ranking[SM] system. The information is now included in GMI Rating Reports for U.S. companies.

GMI's Pay Alignment Ranking (PAR) is a number between 0% and 100% and is based on a sector by sector comparison of alignment between compensation and corporate performance. It indicates where a company sits in relation to a peer group of companies in achieving this alignment. For example, if a hypothetical company, ABC Inc., has a PAR of 23%, it means GMI considers that 77% of companies in the sector have a better pay alignment than ABC Inc. The PAR is calculated by determining the company's ranking within its market sector for three measures: ranking of total shareholder returns, ranking of change in total direct compensation expense for the CEO, and actual total direct compensation expense. The PAR is based on a relative assessment within each company's sector for each of these measures over a three-year period in order to provide a meaningful look at pay v. performance and its trend line. GMI will be issuing a red flag when a company receives a PAR between 0% and 9.99%.

The Pay Alignment Ranking will be included in a new Summary Compensation Report inside each GMI Rating Report and will graphically display CEO pay relative to firm performance. The report will also include the fees paid to management's compensation consultant and to the consultant retained by the compensation committee of the board, if any.

A sample report is available on GMI's home page at www.gmiratings.com.