



Working with the Board's Compensation Advisor

Introduction

The last ten years have seen a broad trend towards Compensation Committees of Boards engaging their own independent executive compensation consultants. This trend is in response to the expanding role and visibility of Compensation Committees, as they work to address shareholder and regulatory demands for Boards to provide more effective and transparent oversight of executive compensation.

For many years, virtually all support work for Compensation Committees was done by management (or consultants retained by management), so, not surprisingly, the arrival of consultants working directly for Compensation Committees has given rise to some legitimate questions as to who does what. This Briefing sets out some practical suggestions on how to allocate and facilitate the flow of work between the Committee, its advisor, and management, so as to ensure effectiveness and to minimize friction and/or duplication of effort.

Background

In 2000, the Enron debacle drew attention to the conflicts of interest existing in the professional services industry, and the need for Boards and their committees to have access to truly independent advice. Within a few years, attention to potential conflicts - which had begun with auditors - turned to those of compensation consultants. In response, the Boards of many large issuers took measures to ensure that consultants serving the Compensation Committees met increasingly stringent tests of independence. This trend has accelerated in the last few years, as demonstrated by evolving best practices and regulatory changes (e.g., December 2009 SEC changes¹, and proposed regulation in Canada²). Among the largest public companies in Canada and the US, recent proxy disclosures reveal that approximately 70% now use an independent Board consultant³. Today, a Board advisor is

¹ The rules require, among other things, the disclosure of potential conflicts of interests of compensation consultants.

² Proposed amendments to Executive Compensation disclosure rules (Form 51-102F6)

³ 2009 Canadian Spencer Stuart Board Index, Dow Jones Industrial Average company proxies, Hugessen Consulting analysis.

considered to be independent when the advisor does not provide any services directly to the management of the issuer, and does not operate in other business lines, thus eliminating *potential* conflict (e.g., the risk of a Board advisory mandate being used as a platform from which to sell other services to management). Over the last couple of years, this has led several of the traditional broad-based benefit firms to spin off the Board advisory division of their executive compensation practices.

With the growth in both the number and use of independent Board advisors, it is helpful to have a roadmap to assist in planning and managing the relationship. What follows are some practices to promote a productive and constructive working relationship between management (and their consultant and/or data provider where they choose to hire one), the Compensation Committee Chair, and the Compensation Committee's independent advisor. For many issuers, these practices are already in place, with positive results for the company in the overall decision-making process. We hope the framework and suggestions in this Briefing will help those companies considering a move to the use of an independent Board consultant, as well as those trying to optimize the process where an independent consultant is already engaged.

Working with the Board Advisor: Keys to a Productive Relationship

In our experience, there are three elements to a productive relationship between management, the Chair of the Compensation Committee, and the Committee's advisor: (i) acknowledging a common objective and need to work well together, (ii) agreeing on a delineation of roles and responsibilities, and (iii) establishing protocols for working together.

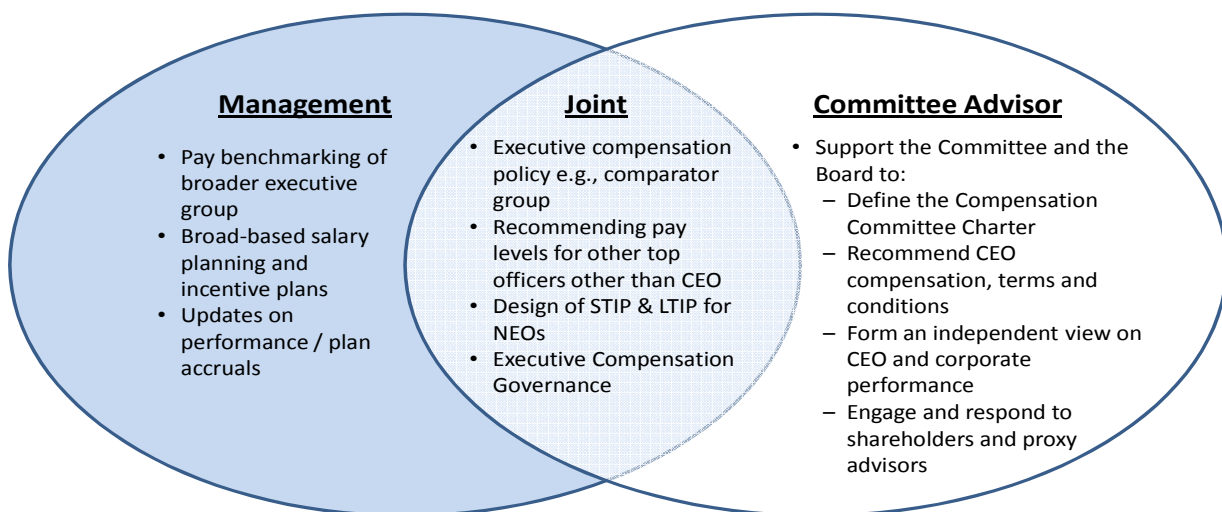
Each of these ideas is discussed below:

1. Acknowledging the need to work together towards a **common objective**
 - Management and the Committee's advisor have a mutual interest in maintaining a constructive working relationship. By working closely together to generate workable alternatives and to identify and resolve minor issues before they get to the Committee, the Committee can focus its attention on the substantive issues requiring its direct attention (e.g. attracting and retaining the right management team) Effective oversight by a Board of directors necessarily involves an element of "healthy tension" as it exercises its responsibilities for setting pay opportunities and performance goals and for assessing business and individual (CEO) performance, but this in no way requires an adversarial or hostile working relationship. The need for a healthy tension between partners is not a new concept in business, but it is relatively new to the governance of executive pay and performance. Effectively managed, it results in a better outcome for all.

2. Agreeing on a **clear delineation of roles and responsibilities between the advisor and Human Resources leadership**

- In every situation, there will be areas of equally shared responsibility as well as areas of primary responsibility – to work effectively, it is important to clearly delineate and agree the areas of responsibility between the Board’s advisor and management
- The guiding principles for deciding upon this delineation are contained in the Compensation Committee Charter. The charter details the areas over which the Committee has direct oversight and so suggests those areas where the Committee and/or its advisor should take the lead

Example of partial delineation of roles and responsibilities



- Particularly sensitive issues, such as CEO pay, and developing an independent view on CEO and corporate performance, will almost always be led by the Committee and/or Board Chair who will often engage the Committee’s advisor to research and develop analysis and a preliminary view. Important but somewhat less sensitive issues (e.g., gathering pay data for executives below the five Named Executive Officers (“NEOs”)) will often be led by management.
- The most challenging areas will be those that require joint responsibility – those areas where the CEO and management must have ownership of the outcome, while the Board has direct accountability to shareholders. For

Protocols for maintaining an advisor’s independence:

1. The Compensation Committee Chair leads the process for selecting the consultant
2. The Compensation Committee Chair provides instruction directly to the consultant
3. The consultant reports directly to, fees are set by, and performance assessment is conducted and communicated by the Compensation Committee Chair
4. Fees are paid from a separate, Committee approved budget to eliminate any conflict with HR

these issues, an open back and forth dialogue early in the process is essential.

- Regardless of who takes a leadership role in any particular piece of work, continuous communication between the parties, to keep each other apprised, is key.

3. Establishing **protocols for working together on Areas of Joint Responsibility**

- The Committee’s advisor and management will want to agree on a number of working protocols, including (but not limited to):
 - The frequency and objective of touch-points so that each party is aware of and can review the work being done by the other. This will provide an opportunity to express views, explore, and (ideally) reconcile differences of opinion early in the process
 - The process for resolving, or outlining differences of opinion, prior to the finalization of materials for the Committee/Board
 - Agreement that each party will provide the other with a “head’s up” when new information becomes available, so as to avoid potentially surprising the other at, or immediately before, a Compensation Committee meeting
 - The process for ensuring the Committee advisor has reasonable time to review and question proxy and/or survey data prepared by management (or third party data provider)

Illustrative "Protocol" for Working Together on NEOs Compensation Structure

Step	Responsibility	Description
1. Establish objectives and process	Shared ⁴	Management, Compensation Committee (“CC”) and its advisor exchange ideas to define/establish objectives and clear process for completing the work (e.g. annual compensation review)
2. Confirm or develop compensation policy	Shared ⁴	Management, CC and its advisor to confirm/develop compensation policy, including: <ul style="list-style-type: none"> • Pay and performance comparator group and positioning • Pay mix • Performance measures and benchmarks • Link of pay to performance • Share ownership policies
3. Develop preliminary recommendations	Allocated	Allocate responsibilities between management and CC advisor and complete plan design and/or pay and performance benchmarking
4. Continued dialogue	Exchange	Management, CC and its advisor exchange, compare, and reconcile work
5. Document and organize recommendations and approvals (including pro-forma disclosure)	Allocated	<ul style="list-style-type: none"> • Management recommends to the CC compensation structure for non-CEO officers for approval • CC recommends to the Board compensation structure for CEO and direct reports for approval • Management and Board consider shareholder engagement regarding compensation

⁴ Where there is shared responsibility, the decision as to who should lead the work is often a practical issue around who has the resources to get the necessary work done in the targeted timeframe

- The approach, or some variation, described in the chart above is now common among larger issuers and easy to work with once in place – we expect this process will become standard practice among enterprises seeking to maintain strong governance protocols .

Working with a Board Compensation Advisor: Key Benefits

The suggestions outlined above can result in a win/win for everyone involved – in particular:

1. **A trusted, independent advisor can facilitate the Committee and Board making informed decisions** on issues of CEO/NEO compensation and performance
 - With an independent view of CEO pay and practices, and of corporate performance together with current and relevant information on shareholders views, interactions between the Board and management can be more efficient and Boards will be more confident that they are making appropriate (and defensible) decisions
2. Access to a **current source of information** on shareholder and proxy advisory' thinking
 - An experienced board compensation advisor will have extensive relationships among the board and shareholder communities and an up-to-date understanding of the issues being discussed and addressed by these communities. Management as well as the Board can benefit from these insights and relationships in order to better understand the context for some issues being raised amongst their own Board / Committee members. Furthermore, an independent advisor can test ideas on a “no name” basis prior to Board / Committee consideration
3. A more accessible **opportunity to test ideas and proposals**
 - The Board’s advisor may be more accessible than the Compensation Committee Chair to discuss ideas and proposals outside of formal meetings.
4. An enhanced ability to **resolve potentially contentious issues** with the Board
 - A Board advisor can help diffuse potentially tense situations by:
 - i. Identifying and resolving minor issues;
 - ii. Clearly identifying and delineating those issues that merit the attention of the Board and management; and

Constructive Interchange - Allowing the other party to review and comment “early and often” helps maintain a good working relationship

Part of the role of the Board advisor is to review and comment on management’s recommendations as they are being developed, particularly on any work which the Board will be asked to approve. The Board, its advisor and management, typically play distinct yet complementary roles. Input, “**early and often**”, from both parties greatly facilitates an effective process.

- iii. Moderating the role of influencers both within management and the Board and facilitating discussions so that all views are heard and all perspectives considered

Conclusion

The use of an independent advisor on executive pay and performance issues by Compensation Committees and Boards is increasingly common. As mandates for the Compensation Committee have broadened and become more clearly defined, so too have the required capabilities and role of its advisor. While these changes are significant, in our experience, management often has something to gain and little to lose, when the Board hires an independent advisor. The key to developing a good working relationship between the Compensation Committee Chair, management, and the independent advisor is to acknowledge a common objective, clearly delineate their respective roles, establish effective working protocols, and most importantly, communication on an “early and often” basis.

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Hugessen Consulting is an independent consulting firm dedicated to meeting the executive compensation consulting requirements of boards and their compensation committees. With offices in Toronto and Calgary, the firm's mission is to be the leading provider of advice on executive compensation, performance measurement and assessment, and related governance to the compensation committees of medium and large companies in Canada, the U.S., and the U.K.

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