HUGESSEN CONSULTING

Board-Side Advice on Executive Compensation – the Effective Role of the Truly Independent Advisor to the Board

By Ken Hugessen and Christine Vinette

For some time now observers have recognized that executive compensation consultants can have a significant influence on the level of executive pay. As a result, the role and impact of these consultants has come under heightened scrutiny. Questions raised by stakeholders include: what is the nature of consultant influence, does consultant "independence" make a difference, and does it matter who hires the consultant – management or the board?

In North America, the executive compensation consulting industry has changed significantly over the past decade. Consultants from large, multi-service firms have split off to form "independent" single-service firms that provide advice on only executive compensation. This separation stemmed from concerns about real or perceived conflicts of interest tainting the credibility of executive pay advice provided by firms that are also engaged by management to provide other services (e.g., pension and benefits consulting, broad-based employee compensation advice). Recently, this concern has increased as boards, in part responding to shareholders and proxy advisors applying pay-for-performance tests, began seeking advice and support from their consultant on selecting appropriate comparators and assessing relative pay-for-performance. As a result, independent compensation consultants are now commonplace and provide the majority of executive compensation and related performance advice to large issuers in North America.

However, there is some evidence that independence, which must be reviewed annually by compensation committees, is only part of the story. Who hires the consultant appears to be equally important because independence, on its own, does not address the conflicts of interest that arise from executives receiving advice on their own pay and performance from consultants that they hire. Shareholders, it would seem, are best served when the board, rather than management, has control over the consultant selection process and retains and instructs the consultant directly.

Two recent academic studies that examine the role of executive compensation consultants support these observations. The Economist[1] published an article, *If You Hire Them, Pay Will Come,* which summarized the findings of a Judge Business School (Cambridge University) study[2] on the influence of advisor independence on executive pay levels. While the title of the Economist article suggests that compensation consultants influence CEO pay upward, the article goes on to say that, importantly, this depends on who hires the consultant. According to the study, independent advisors hired by management were associated with 10% higher pay (compared to similar issuers that retained their multi-service firm consultants for executive pay advice). Conversely, advisors hired by the board are associated with lower levels of pay; median CEO pay was found to be 13% *lower* amongst those issuers where only the board retained the compensation advisor.

A second study offers further evidence on the importance of who retains the consultant. The study, *Does Independent Advice to the Board Affect CEO Compensation*?[3], examines the impact of the board hiring an independent consultant on CEO pay and pay-for-performance. This study found that hiring a compensation consultant (whether by management or the board) is associated with an increase in pay-for-performance sensitivity, and increased use of relative performance measures. The study also found that these findings are magnified when the consultant is hired by and reports directly to the board and does not provide other services to management, suggesting that consultants hired directly by the board enhance the board's ability to align CEO incentives with performance.

Both studies link the hiring of a compensation consultant by the board with lower absolute levels of CEO pay. Our own experience would suggest that this result is typically the consequence of lower pay to the CEOs of weaker performing companies, rather than a reduction across the performance spectrum. Increased pay-for-performance sensitivity and relative performance evaluation increases CEO pay amongst high performing issuers and, conversely, reduces CEO pay amongst issuers with below

[1] Nov 22, 2014 (from the print edition)
[2] Do compensation consultants enable higher CEO pay? New evidence from recent disclosure rule changes. Jenny Chu, Jonathan Faasse, and P. Raghavendra Rau. Judge Business School, University of Cambridge. September, 2014.
[3] Does Independent Advice to the Board Affect CEO Compensation. Hamed Mahmudi. Price College of Business, University of Oklahoma. January, 2013

median performance. The decrease more than offsets (on an average or median basis) the increase in pay at better performing issuers.

These studies suggest that consultant independence, while essential, is not necessarily sufficient to ensure effective executive compensation design, decision-making and outcomes. For these to occur the board should hire and instruct the advisor. Advisors supporting boards directly can help companies "get it right" by guiding the selection of performance metrics and supporting the board in setting stringent performance standards. This support is followed, at year end, with outside performance analysis and context, enabling the Board to complete a rigorous performance assessment that does not rely exclusively on performance analysis prepared (or approved) by management.

> *"I chair several compensation committees; we believe it is essential to have a direct, ongoing relationship with an independent compensation advisor who is able to provide an unfiltered, independent perspective on the company's pay and performance"*
>
> -John Cassaday, Compensation Committee Chair, Sysco Systems; Management Resources & Compensation Committee Chair, Manulife Financial Corporation

While most advisors proclaim they provide "independent advice" to the Board, we believe that the reality of the relationship is often not so clear. When independent consultants are pre-screened by management prior to hiring, these consultants are "independent" in name only, and are expected to seek management's approval before any materials are provided to the directors. Truly independent advice to boards requires the following:

- **A hiring process, including development of selection criteria and identification of candidate firms, carefully overseen by the compensation committee chair.** Management should provide input and support, but not screen or lead the selection process. If the consultant needs management's approval to be included on the committee shortlist, the consultant is by definition beholden to management.
- **An open, unfettered, and on-going line of communication between the consultant and the compensation committee chair, together with a predefined working relationship with management.** The consultant should, of course, seek to maintain a constructive working relationship with management and seek management's input in the normal course, but should always be at liberty to

contact the committee chair as the consultant sees fit without notice to or consent from management.

- **Executive session or "in camera" review and discussion with the compensation committee of all sensitive and potentially prejudicial materials (for example, those related to the CEO's pay and performance) prior to their distribution to management.** Less sensitive materials (e.g., those related to market trends) may be reviewed and discussed with management, but only with prior committee chair consent.
- **The committee chair, not management, should review and approve scope of the mandate and billings, and lead the assessment of the consultant's performance.**

Board-side advisors on executive compensation provide directors with the support they need to set rigorous performance goals, independently assess performance, and determine commensurate pay outcomes. When reviewing the independence of compensation consultants, boards (and shareholders, proxy advisors, and other stakeholders) will want to ensure that, in addition to eliminating the possibility of cross-selling, other potential conflicts are also reduced by having consultant accountability to and a direct working relationship with the board – otherwise, as the studies suggest, shareholders may pay the price.

Author Bios:
Ken Hugessen is a recognized leader in executive compensation, performance and related corporate governance. He founded Hugessen Consulting in 2006 to offer boards and compensation committees independent advice on these issues. Previously, he was a worldwide partner with Mercer, working in Canada, the U.S. and the UK.

Christine Vinette is a Manager at Hugessen Consulting, and has extensive experience consulting to boards and compensation committees of large and mid-sized public and private companies across a variety of industries on a broad range of executive compensation, performance and related corporate governance issues.

Additional Information:
Please note that Hugessen Consulting serves as the Management Resources & Compensation Committee advisor to Manulife Financial Corporation