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The right moves for the new realities

Alert to compensation committees: Do the procedures you use to select and manage your outside pay experts stand up to scrutiny? Here is how two comp committees 'owned the process.'

By Jack L. Lederer

After what seemed to be an eternity of political back-and-forth, the Dodd-Frank Wall Street Reform and Consumer Protection Act is the law of the land. It calls for a litany of significant changes to corporate governance and executive compensation, including say on pay, proxy access, compensation clawbacks, and restrictions on broker discretionary voting.

The law will require public company compensation committees to be much more independent in their membership and transparent in their dealings with pay experts and in delineating their executive pay rationales in proxies.

Robert J. Jackson Jr., a former Treasury official in the office for TARP executive compensation, recently told a high-level audience at a compensation symposium that he wouldn't be surprised if, in the next few years, public company boards will be required to have an outside director experienced in executive pay issues on the compensation committee, similar to the Sarbanes-Oxley requirement of a financial expert on audit. At this point, some boards are proactively searching for HR executives to fulfill this qualification.

Yet even in the face of this white-hot scrutiny, many compensation committees continue to do things the old way, drawing on well-established rituals when they should be adopting new, independent procedures. To recruit an outside pay consultant, for instance, they call friends on other boards for suggestions. Or, they ask the company's human resources department for a few finalists.

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A conflicted position

Let's illustrate this with an example. A major Midwest public company board was recently in the final stages of selecting a compensation consultant. A human resources officer called us to say he'd been asked to give the compensation committee a list of finalists. But, by definition, it was a conflict-of-interest situation. He was one of the top five paid officers listed in the proxy, yet he was expected to recommend an independent pay consultant who would advise on his remuneration.

Because he recognized his conflicted position, the officer contacted us. Curcio Webb offered to act as an independent resource and was retained to assist in the process. We met with the head of the compensation committee, who took the additional step of excluding management from the interview and selection process.

Management reviewed the 10 submitted requests for proposals with the committee's blessing and selected six. The chairman of the committee thanked them for their input but noted that, from that point on, the committee would meet with vendors and make its own selection. We worked with the directors to prepare a detailed and structured procedure for interviewing the six firms and then selecting a new consultant from the three finalists (see sidebar).

From a governance standpoint, this is exactly what a compensation committee should be doing to ensure a truly independent process, free from management influence. What began as a conflict of interest turned into a best-practice, state-of-the-art model by the comp committee.

A new mentality

Clearly, in these times of dramatic change, it's tough to be on a compensation committee. For the foreseeable future, directors on compensation committees must disclose their background, qualifications, and potential or existing conflict-of-interest relationships, including interlocking directorships that may have an impact on compensation policies for several companies on whose boards they serve.

Compensation committees operating in today's environment must regard themselves as operating business units and must quickly adopt this mentality. They need defined budgets and access to independent resources that are not those of the company. They also require full information and cooperation from management. They must be truly independent — in committee composition and in the experts they hire — and they must structure their own processes that are conflict-free and marked by due diligence.

The trend today is for compensation committees to look for multiple advisors proficient in particular pay areas — executive pensions, stock programs, and the like. But boards must be smart about what they need. Boards must find the best people in performance metrics, long-term incentive designs, comparator data, and compensation risk analysis, to cite four areas of expertise. They may decide to interview several law firms to select the best experts to prepare the compensation discussion and analysis for the proxy.

'Nimbleness of service'

In the executive compensation marketplace, there are several truly independent advisory firms, qualified and possessing deep backgrounds. There are also several new and large compensation advisory firms, many of which have been formed out of recent mergers and acquisitions or spun out of larger HR consultancies. These firms have excellent support capabilities they bring to the compensation table — research, database management, numbers of support staff. But some of these firms may also have potential conflicts or be looking in their rear-view mirrors, relying on old formulas and benchmarks. They are doing their clients a disservice because the clients themselves can't be expected to be up-do-date on changes in the comp marketplace.

The new realities can result in a grueling search for a suitable expert.

Many comp committees still tend to regard pay experts from an historical perspective. They know of experts who are well-established names in the field. But I'm seeing a new breed of specialists who are no longer with big compensation and benefits

What to ask a compensation consultant candidate

To help the candidate interview process, the compensation committee should prepare a structured guide with the help of an outside, impartial advisor. Committee members should be able to score candidates' responses simply — a grading mechanism of 1 to 5, for example. Such factors might include:

• The consultant's presence and style, as well as experience and understanding of the company's business situation.

• Relevant experience linking pay and performance with concrete examples and results.

• A clear understanding from the consultant as to a conflict-free and independent relationship with the CEO and top management. Does the company have prior or current business dealings with this consultant?

• Attention to the consultant's and consulting firm's recent client experiences, including positive and negative results. Have they been asked to leave any engagements and why?

• A focus on the consultant's and consulting firm's related client experiences regarding development and use of comparator groups.

• A discussion of current clients with "say on pay" votes and results.

• Capabilities for evaluating company compensation risk factors.

• Perspective on proxy advisory firms, regulators, and institutional investors in designing compensation programs.

• The number of companies where the candidate currently works *directly with the board* and the candidate's calendar of engagements for the coming year. Is the candidate overextended? Will the board be dealing with the expert, or someone he or she delegates? Will the board have unimpeded access to the expert?

• A thorough background and reference check involving more than one person at the company.

— Jack L. Lederer

consulting firms. They have the benefit of great technical training and client experience early in their careers. They know how to work with large companies. They have what we call "a nimbleness of service." Their mindset is less institutional, less focused on rigid processes.

We are not suggesting that these experts are more qualified than seasoned veterans. But their approach may be different; they may be better equipped to deal with new executive pay realities. They are more apt to solve problems, rather than to bring a predetermined set of solutions to an engagement. And, they're more apt to look for unique solutions.

There is a new breed of specialists who are no longer with the big consulting firms.

The new realities can result in a grueling search for a suitable expert. But oftentimes old realities persist, and the compensation committee feels it must involve the CEO and the top team in the process but not in the final decision.

Here is a conflict-free approach

The compensation committee of a multinational company based in New York City was searching recently for a new independent consultant. Whoever was chosen had to work effectively with the CEO and his team. The board had to gauge the level of cooperation with the new consultant.

The compensation committee set out a series of important criteria regarding the company's business situation and executive pay requirements. Then the committee asked the company's HR group to prepare a request for proposal and construct a process for recommending two or three compensation consulting firms for the committee to consider in final interviews.

The RFPs were developed and sent out. When they came back to the company, the senior HR officers felt they should have an independent advisor review them, and they called us.

Curcio Webb reviewed and scored the RFPs independently of the HR executives. We arranged in-person interviews and sat in on two-hour interviews per candidate with the HR team. We ended up meeting with 12 firms and narrowing the field to six. Ultimately, after thorough reference and background checks, there were four candidates. (We provided additional background on three of these candidates because they were not well known to the compensation committee and management.)

We made a point to talk with the heads of HR, and we put together a letter recommending the four finalists for the compensation committee.

This was a huge undertaking because the committee set up criteria that required the newly hired expert to deal with many aspects of pay throughout the company — not just compensation for the top five officers. The board was looking at the impact of cash incentives and long-term stock grant levels at all echelons of the enterprise.

The rigorous process boiled down to two finalists, both little known to the HR team, the compensation committee, and the CEO. Down to the wire, there were some nervous moments at the company: Had they really chosen someone who could do all this?

Own the process

Well, within the first several months after taking on the assignment, the new consultant successfully helped the compensation committee complete year-end pay actions and negotiate a new contract for the CEO.

The big headline here is that compensation committees must own the process of consultant performance and selection to a greater extent than ever before. Moreover, the compensation committee will look like the audit committee in the next two years, even if this is not legislated. It's just good practice, a new game in a complicated world. ■

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Executive Compensation Advisory Services

Curcio Webb acts as a senior advisor, consulting with boards of directors on executive compensation practices, guiding the board process in evaluating current resources and selecting the best compensation expertise. We advise committees on specific company needs and compensation consultant capabilities and performance. We counsel boards on the best way to choose independent pay experts who have no conflict-of-interest issues and who most closely meet the client's executive compensation requirements.

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Curcio Webb, LLC is an independent human resources advisory consulting firm. We provide analyses and recommendations that allow our clients to focus on the best possible outcomes for both their people and companies. Since 1997, we have counseled both public and private companies on HR and benefits administration, executive compensation consultant evaluation and selection, actuary selection, and investment services. We have structured Curcio Webb to be totally independent and objective. Our only allegiance is to our clients – who provide 100% of our firm's revenue.

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