

How to Choose the Right **COMPENSATION CONSULTANT** *in the Post-Dodd-Frank Era*

More than ever, it's important to pick the right compensation consultant using a bullet-proof process.

By Jack Lederer,
JL Board Advisors

Selecting a compensation consultant is never an easy task, as anyone who has been through this knows; and now with say on pay in place, it's become even more challenging. There is more scrutiny, not just on what companies are paying their executives, but also on how those decisions are made and who is making them. It is not just the U.S. Securities and Exchange Commission that's looking at executive compensation decisions; it's employees, customers, stock exchanges, the press and company shareholders. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the compensation committee is now directly responsible for the executive compensation

decisions that are made, so having the right adviser who is chosen through an independent, conflict-free process is critical. In addition to regulatory issues, selection missteps can have a significant impact on a company's market credibility and overall brand reputation.

What is Dodd-Frank and Why Should we Care?

Dodd-Frank, which was passed in June 2010, had a major impact in the executive compensation arena; with the new rules that were released in June 2012 there is more clarity around the actions public companies need to take now to ensure they are compliant.

There is a new level of responsibility placed on the compensation committee, and senior management can provide strategic support in the decision-making process.

The new rules will most likely impact the 2013 proxy season. The most important aspect for public companies is the penalty for noncompliance, which involves exchange delisting. This is a very serious penalty, in terms of capital markets impact and public perception.

Following are a few of the key points of Dodd-Frank:

- Compensation committees now have the direct responsibility to engage, oversee and compensate compensation advisers.
- Compensation committees must consider six factors relating to the independence of external advisers, including compensation consultants, before selecting or obtaining advice from them.
- Each member of the compensation committee must be independent. Actions that public companies should take now to ensure compliance with these rules:
- Educate your board and compensation committee on the law and new rules.
- Review the six independence factors for the external advisers to understand whether your advisers would be deemed independent.
- Review the independence of the members of your compensation committee.

These new rules empower compensation committees as never before.

Case Study

Minneapolis-based Caribou Coffee operates 500 company-owned retail locations in 16 states, Washington, D.C., and several countries.



Caribou Coffee's compensation consultant search, completed in fall 2011, shows how the compensation committee can use a transparent, analytical approach involving a collaborative process between the committee and management. It is a process that yields a lead consultant with the right fit through the quality of the request for proposal (RFP) and interview questions pertaining to the needs of the business situation, as well as the consultant's qualifications, style and presence. But asking the right questions is only half the battle. With the RFP responses, how does someone process and score the answers to determine who should be interviewed? And then how are the results of the interviews analyzed to ultimately make a selection?

Another complication with the executive compensation consultant selection process is resolving differences in preference between the board, the compensation committee members and management. There could be half a dozen or more people involved in the selection process, so there will undoubtedly be differences of opinion during the process and in the final selection. How does one navigate

so that ultimately everyone on the committee endorses the final selection?

Companies should focus on five key areas for a best-practices executive compensation consultant search to yield the right consultant for specific needs, and which will stand up to the Dodd-Frank legislation:

- 1 | Define the qualities and competencies needed from your consultant
- 2 | Understand the current universe of consulting firms
- 3 | Craft an RFP that will deliver tangible insights
- 4 | Outline an effective interview process
- 5 | Conduct effective reference checks with appropriate sources.

By understanding the requirements and style needed in a consultant, companies can select the right adviser for their situation. There is a new level of responsibility placed on the compensation committee, and senior management can provide strategic support in the decision-making process.

Defining the Qualities and Competencies Needed from Your Consultant

Caribou Coffee began its selection process by defining the basic qualities and competencies the company required of its consultant. As a regional, branded retailer, the company needed a seasoned professional with experience in that industry, but it also needed someone

with experience in private equity and with a background in creating plans that provide incentive and retain key executives during transitional periods. Caribou's unique requirements and the working style of the compensation committee, as well as how the company interacts with management, were considered. An inventory of requirements, skills, abilities, competencies and experience was developed, and was used to develop the list of qualified consultants and firms to invite to submit an RFP, and also to then develop the content of the RFP itself and ultimately the interview questions.

These initial inquiries serve as the foundation of the entire process, so the more time that's invested at the beginning of this evaluation stage with the compensation committee and management, the better the outcome.

A few of the key questions discussed with the committee and management in guiding Caribou to define its selection requirements were:

- What is the current business strategy/situation of the company?
- What are the key compensation issues for the committee and senior management?
- What are the specific skills, abilities and experience needed in the lead consultant?

■ Which firms and lead consultants to your knowledge have the most relevant experience to Caribou's needs?

It is very important to understand the qualities required of the lead consultant, support consultant and the consulting firm, since all have an impact on how effective the relationship will become. The compensation committee at Caribou determined that it needed a lead consultant who had experience in strategic growth situations in the retail industry, and a firm that had best in class compliance and data capabilities.

Understanding the Current Universe of Consulting Firms

The current regulatory environment has changed the compensation consulting industry in many significant ways, one of which is the impact that the more stringent definitions of independence has had on consulting firms. In the past several years, a number of the most experienced consultants have resigned from the larger firms to establish their own independent consultancies, many of which are not known to compensation committees. Ironically, all of the larger firms still maintain compensation advisory services. Based on the author's direct knowledge, there are more than 40 executive compensation consulting firms — all with

different strengths and operating styles — that are qualified for consideration by compensation committees. Caribou's compensation committee had only identified three or four firms that were known to them from prior experience.

Using the required competencies, qualities and experience that Caribou identified, and based on the author's database and knowledge of compensation consulting firms, a broader list of firms was developed. Eight firms were recommended. Only one of those firms was previously known to the committee members. These firms were selected based not only on the firm qualifications but also on the knowledge of the qualifications, experience and style of the proposed lead consultant from each firm.

Crafting the Right RFP

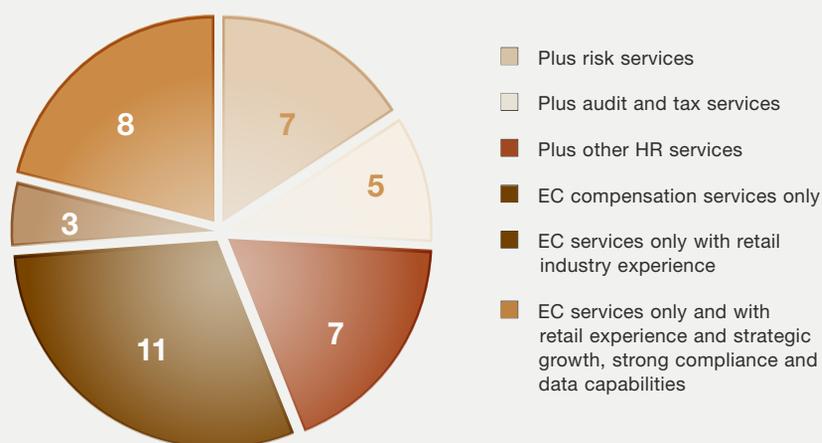
In crafting an effective RFP, there is always a balance between making sure the right questions are asked and keeping the responses to a reasonable length. It is best to limit responses to 20 pages, which helps the consultant be more focused and produces a more manageable document for the company to review. This page limitation should also include exhibits and appendices, as consultants often like to include additional data and information in their responses. Use the information from the initial work with the compensation committee and management to tailor questions that will yield the most meaningful insights for the committee regarding the capabilities of the lead consultant and the firm.

The Caribou RFP included questions in two sections — one focused on the firm and the other on the lead and support consultants. Each of these sections included questions specific to Caribou's needs.

Conducting an Effective Interview Process

There are three factors that are critical to creating an effective and

Figure 1 | Number and Types of Existing Executive Compensation Consulting Firms



After a selection is made, companies are well served to contact the references provided by the selected firm ...

efficient interview and selection process. Companies should have:

- 1 | A clear interview agenda with structured time limits
- 2 | Prescribed questions and specific roles for the committee
- 3 | A consistent, objective scoring methodology to rate the responses of each consultant.

In collaboration with Caribou's compensation committee, an agenda was created for each interview that provided time guidelines for each section. For example: 10 minutes for the consultant to introduce him/herself to the committee; 20 minutes for committee questions to the consultant; and 10 minutes for the consultant to ask questions of the committee. This structure provides an effective format for interaction, and at the same time serves as an efficient process.

This process provides the opportunity to ask consultants questions that were not included in the RFP and that they have not prepared for. This demonstrates their ability to think on their feet, as well as their level of preparation for the interview. Having the same list of questions asked of each consultant also provides for a

consistent review process once all the interviews have been completed.

For Caribou, the scoring methodology applied a 1-5 scale to rank the consultants' response to each question during the interview. This provided an objective way to rate each of the consultants and facilitated the decision-making process. It also provided iron-clad documentation on how the decision was made, which is one of the most critical aspects of the entire selection process. Having a scoring and ranking of each consultant's answers created an efficient process for making the final selection. Within an hour after the final interview, the

committee was able to make its final decision. This was accomplished by each committee member sharing his/her interview scores, which eliminated two of the finalists. The committee then discussed the pros and cons of the two remaining finalists and unanimously selected one consultant.

Conducting Effective Reference Checks

After a selection is made, companies are well served to contact the references provided by the selected firm because the most valuable references come from the compensation committees, not just management. Because the committee is directly responsible for engaging the consultant, it is important that the committee understands the consultant's relationship with other committees. Companies may be hesitant to contact a compensation committee chair with requests for references because there is a perception that the individual will be too busy to respond. In the author's experience, however, the best consultants have strong relationships with compensation committee chairs. A 15-minute conversation with

them can provide a great deal of valuable insight, and most committee chairs are more than willing to share their experiences.

Benefits and Value Added to Caribou

"We had several take-aways from this process," said Karen McBride, senior vice president of human resources for Caribou Coffee. "First, the committee was able to find the best lead consultant for our circumstance even though it didn't know that consultant before the search. Also, the committee fulfilled its direct responsibility of selecting the consultant without putting us [human resources] in a conflicting position or requiring a great deal of our time to manage the process. By having an outside party facilitate the process and involve all the stakeholders, there was a commitment by the committee to the process and buy-in on the final selection.

"Additionally, the compensation committee of Caribou Coffee has complete and transparent documentation of the executive compensation consultant selection process for board compliance. By articulating the competencies, experience and qualities needed; understanding the universe of consultants and firms; crafting the right RFP; having an effective and efficient interview and selection process; and getting in-depth, relevant references, Caribou Coffee was able to select the right executive compensation consultant for its situation, while achieving governance best practices." 

Jack Lederer is CEO of JL Board Advisors in Connecticut. He can be reached at jack@jlboardadvisors.com.

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