

### Compensation

# Where Common Sense Rules

Your consultant should push for healthy debate.

By Yvonne Chen

Successfully managing the relationship with an independent compensation consultant is as much rooted in common sense as good governance. In recent years, expanded proxy disclosure and economic woes in certain industries have focused attention on shortcomings in the compensation committee's oversight of executive pay and performance.

Audit members faced similar scrutiny in the wake of the Enron debacle and passage of Sarbanes-Oxley, but compensation committees and their consultants do not have the benefit of a clear regulatory framework or definitive policies in regard to executive pay. While every advisory engagement is unique, we've identified some sensible guidelines to steer the relationship between committees and their consultants in the right direction:

- A "best practice" may not be best for your company.

When it comes to compensation, committees often take comfort in what their peers are doing. Governance best practices and prevalence data provide useful parameters for figuring out the most effective programs and pay levels for top executives. The real test, however, is whether the compensation program addresses the specific needs of your organization and will drive meaningful shareholder value. Comp committees that overemphasize peer-company practices or median-pay levels may sacrifice the advantages that may be offered by customized, flexible, and more practical solutions. Consultants should be encouraged to provide a broad independent perspective of the extent to which a standard solution will address the company's needs, or whether alternative approaches should be considered beyond the scope of market data.

- Accept the challenge of having to make difficult decisions.

A committee that is conflict-averse may seek a negative opinion from an outside consultant as ammunition to oppose management's pay demands. Alternatively, a committee that acquiesces easily to aggressive pay demands from management may want an independent seal of approval as cover. It's the consultant's role to facilitate healthy debate and provide an independent evaluation, not to automatically act in concert with the committee's wishes.

- Listen if your outside consultant is pushing back.

When appropriate, a good compensation consultant will offer an alternative opinion or approach without waiting to be asked, or may respectfully disagree with the committee's direction. In extreme cases, a consultant who believes the committee is moving in a highly problematic direction may choose to terminate the engagement. While the committee has full responsibility for making compensation decisions, it's generally an important warning sign if your expert doesn't agree.

- Take a reasoned approach to consultant independence.

Consultant independence is now a critical governance issue, based on concerns that recommendations related to executive compensation could be influenced by more lucrative services being provided to management. While the committee and the consultant should safeguard their status as independent, prohibiting communication with management is both impractical and unnecessary. The right balance allows consultants to work with management as needed, but discourages such extensive col-

laboration that the consultant's judgment may be called into question.

- Schedule regular executive sessions.

Executive pay is obviously a sensitive issue. It is essential that the committee and the chairperson make formal arrangements to meet regularly with the consultant without management present to candidly discuss pay and performance issues. This avoids the possibility of an awkward situation where the consultant is requesting a special executive session in front of management.

- Conduct an annual review of the consultant's work.

A formal schedule for review and direct feedback from the committee to the consultant, particularly at the end of a major project or the beginning of a new budget year, is good practice. Candid appraisals allow both sides to clarify how engagements are being conducted, provide a window for airing any areas of concern, and promote ongoing discussion of the committee's objectives, priorities, and expectations.

Today, independent compensation consultants are increasingly working directly with compensation committees, rather than senior management, in the determination and oversight of corporate pay programs. Sensible guidelines, combined with thoughtful practices, can best assure good governance, but also promote the candor and flexibility needed to get the most out of the consulting relationship.



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