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Alternative Uses of Compensation Consultants

A Discussion on Advocacy, Adversarial, and Judicial

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Introduction & Background

- Now more than ever it is evident to stakeholders of major corporations (Shareholders, Boards of Directors, Executives, Employees, and various Government Agencies, etc.) that the Boards need advice in many forms
- Historically, most Boards gained an understanding of the complexities of Executive and Board Compensation from first-hand experience focusing pay considerations on “How Much”,
 - This “one dimensional” focus on “how much” is typically ineffective
 - By focusing on “How Much”, instead of “How” or “Why,” Boards have created pay structures which promote a “lemming-like” adherence to “safety zone” targeting Board and Executive Compensation at either the median or 75th percentile of market
 - Too little time is spent on review process and advice that could drive a more appropriate set of reward programs
- Grahall believes a more comprehensive approach to rewards design is appropriate and necessary to optimize the effectiveness of the money spent on rewards for Executives and Boards
 - Compensation levels are important, but if organizations don’t use the correct process to determine the level, it is the resulting compensation scheme will not be optimal
- In this paper we have outlined several alternative processes and recommendations to be considered by Compensation Committees and others with responsibility for determining the structure of reward programs for Boards and Executives

The History of the Profession Advising Board of Directors on Director and Executive Compensation

- Historically, much compensation advice to Boards of Directors has been provided by “Strategic and/or Human Resources” Consulting Firms
 - While these firms’ primary focuses were on broad based HR consulting, each had a small contingent of Executive Compensation Consultants
 - This list of these firms is relatively small: McKinsey & Co.; Booz Allen Hamilton ¹, Towers Perrin, Hewitt, Mercer, Hay, Wyatt, Sibson
- Accounting and legal firms also developed fringe practices but have never been particularly successful
 - These firms have tended to provide a tax and legal slant to their advice
- Boutique firms
 - These firms specialize in Board and Executive compensation consulting, and are generally comprised of 10 to 40 individuals
 - Most began as a result of the principals determining that they could provide their services without the large firm structure and most focused almost exclusively on total direct compensation (salary, annual and long-term incentives).
 - Most prominent of these firms include Fred Cook, Pearl Meyer, Longnecker, Compensia, Westward, etc.
- COLI Firms
 - A fourth group of practitioners focuses on selling of company owned life insurance (COLI) but found it more effective to sell under the umbrella of executive compensation consultants. As a result of COLI’s tax advantages, the sales story was compelling and they provided advice to the Boards and Executives regarding non-qualified deferred compensation, SERPs, or other executive benefits
- Sole Practitioners
 - The last group of practitioners of Board and Executive Compensation advice are the single practitioners that represent an entire range of advisors on the issues and provide advice on Board or Executive Compensation in the form of Base Salary, Short and Long term incentives

¹ Booz exited compensation in the 1980’s – believed it represented a conflict of interest

The Present State of Affairs

- Enhanced Scrutiny
 - The compensation consulting industry has seen a significant increase in complexity over the past 3-5 years, primarily due to increased press coverage, legal and regulatory requirements (Sarbanes Oxley)
 - This has increased awareness for the compensation process, but has resulted in little or no real change in the application or result.
- Consultants have typically focused on “how much”
 - This approach tends to limit consideration to total direct compensation and not total rewards.
- Few consultants review an organization’s entire reward architecture and complete rewards programs in the context of the organization’s business and people strategies
- The “headline making” compensation problems reported in the media are egregious but tend to be isolated
- Even with all the media attention, most Boards receive adequate advice regarding the organization’s executive compensation and make decisions that are in the shareholders’ best interests
 - By “adequate advice”, we mean sufficient information to determine the appropriate pay for the executives and directors from external advisors coupled with the experience of the compensation committee and other members of the board.
 - Exceptions, although rare do exist, and typically take place under special circumstances, such as imbedded Boards of Directors, Imperial CEO’s, unique events such as IPOs, Bankruptcies, Mergers & Acquisitions, etc. Most can be explained by a temporary imbalance in the decision process not usually isolated to the compensation programs

A Framework for Thinking About Advisory Services

#1 Level of Advisory Services

- The first aspect of a framework is the level of consulting. Are you looking for information or insight; for data or advice?
 - *Data Provider* – here the company purchases survey results that provides both general and specific data regarding pay levels and pay mix. Survey results require a significant level of interpretation
 - *Information Provider* – here the deliverable is a “customized report” that claims to use comparable companies and comparable positions in comparable industries with comparable strategies, etc. The buyer should be aware that these reports rarely live up to the expectations
 - *Reconnaissance* – a more customized service providing, for a fee, some superficial interpretation of the information regarding pay levels and any variance from norms (attributing variances to higher sales growth rate, a greater EPS, a higher CFROI, etc.)
 - *Reconnaissance with Interpretation/Insights* – data, information, reconnaissance, **and** interpretation of the information on a multifactor basis provided by experienced consultants including insights based on credible research.
 - *Advice* – the most comprehensive level of services (and the highest fees) including data, information, reconnaissance, interpretation/insights and business based advice on how pay for directors and executives can contribute to the success of the enterprise
- This list is not meant to be hierarchical from “poor” to “superior”, but rather this list displays the service levels from least to most sophisticated
 - Companies and boards should be aware of the levels of service offerings and select the approach best suited to its needs taking into account the experience of Compensation Committee and other board members and the business circumstances of the organization.

A Framework for Thinking About Advisory Services

#2 Scope Provided

- The second framework is the Scope of Consulting provided, or how many variables or situations are considered as part of the analysis. Here we look at 8 alternatives:
 - *Competitive Analysis (Money)* – here analysis the focus on on “how much” money the executive is paid, with data provided in the form of survey results
 - *Component Balance (Mix)* – this analysis provides a determination of how much compensation should come in the from of salary, annual incentive, long-term incentive, benefits, perquisites
 - *Delivery or Provisions (Messages)* – each aspect of the reward program sends a message to the individuals receiving the reward and to all employees aware of the reward structure
 - *Reconnaissance with Interpretation/Insights* - data, information, reconnaissance, and interpretation of the information on a multifactor basis provided by experienced consultants including insights based on credible research.
 - *Best Practice* – these are “safe harbor” lists of considerations outlining “do’s and don’ts” that reflect the way current “best practice” companies in a particular industry reward their employees. A “halo effect” can help under achieving companies gain credibility when they use the “best practices” of better performing companies.
 - *Best Fit* – these are simple formulaic approaches that presume that companies a certain stages of maturity and/or in a certain industries should have a certain rewards programs.
 - *Best Alignment* – At this level, the advice includes details on how to best spend the reward resources to enable the company to execute its business and people strategies.
 - *Impact Analysis* – An impact analysis can provide a company with a thorough appreciation of the entire range of operational inputs and reward program outputs over an extended period of time. This advanced modeling uses Black Sholes, Monte-Carlo simulation, discounted present value, economic impact and/or a fact-based estimates of the organizational impact of the program(s). Impact analysis is critical to providing comprehensive compensation design consulting services

A Framework for Thinking About Advisory Services

#3 The Type of Consultant

- There are many potential models for consulting relationships. An organization must consider its needs and its budget when selecting an advisor
 - Somewhat misunderstood historically, this has become a real issue garnering the attention of the SEC and is creeping into the consciousness of the Boards of Directors and Executives
- An important point of clarification is to establish who the advisor work for?
 - Does the Advisor work for the shareholders, the directors, the executives, or the general public?
 - A professional works to the best of his ability as an advocate for his client while maintaining confidentiality.
 - The client that is the person paying the bill
- In some cases there has been confusion over who the consultant works for and what they have been hired to do. Boards, executives, shareholder, and sometimes the consultants themselves misunderstood this relationship and the expectations. The confusion can and has led to situations where conflicts of interest have occurred.
- Conflicts of interest are essentially misunderstandings (on the part of Boards, management, executives, shareholder, stakeholder and the advisors themselves) of the type of assistance purchased and the actual assistance delivered
 - For example: if the shareholders believed they were getting unbiased information, advice, etc. but the financial arrangement had the appearance or reality of tilting that advice in favor of one party at the other party's expense, then the provider would be in a conflict of interest and their objectivity would be compromised
- There are several studies which have attempted to define and isolate the impact of real or apparent conflicts of interest, however:
 - The existence of conflicts of interest is impossible to determine empirically
 - Various commentators have drawn conclusions from little or no data to support their findings

Grahall LLC's Alternatives

- Having assessed the history and the current practice of compensation consulting, Grahall has developed several “model relationships” to govern its client relationships
- Grahall serves its clients in the following capacity:
 - Individual employee or executive advisor or advocate
 - Management teams’ advocate
 - Board of Directors advisor
 - Shareholders’ representative
 - Act in the organization’s best interests

Individual Employee/Executive Advisor or Advocate

- We often represent individual employees in their desire to optimize their income or severance payments from an organization
 - In this form we work to acquire advantage for the individual whom we are advising.
- We typically provide information that strengthens our client's position and work to discount information provided by the opposing team and its advisors
- Strengths:
 - *No Conflict of Interest*. Similar to the legal model, we are hired and paid by the individual/executive and as such have virtually no possible apparent or perceived conflict of interest
 - Client receives the “best possible deal” we can negotiate for them individually, with little regard for the impact on the organization
 - Occasionally we will negotiate that our fees be paid by the organization, but we do not believe this is a conflict since it is a clear we work for the individual/executive
 - *Note also that under the SEC's proposed disclosure rules, these arrangements may become disclosable*
- Challenges:
 - Individual focus can result in “counter cultural” result
 - For example, a favorable contract provision for one executive, such as a special bonus arrangement or severance provision, can create a disconnect with other executives in the same company
 - Focusing on individual can be shortsighted, and/or result in lost opportunity to create “win-win” synergies between company and management team

Management Teams Advocate

- Grahall represents the management team even where the Board of Directors has their own retained advisor
 - This process is often called “dueling consultants,” where each constituency has their own advisor, and a consensus result is often arrived at through duel advocacy
 - This approach is similar to a legal/courtroom model, except that the Board has the dual responsibility of arguing its position, and making a final decision with respect to the shareholders’ best interest
- **Strengths:**
 - An excellent model for fleshing out pros and cons of all issues
 - In many ways, through this process we provide a balance and insights to the various stakeholders in the process to ensure that the results benefit from the additional multiple viewpoints.
 - Properly done, allows management to retain a constructive relationship with the Board while satisfying their need for personal advocacy
- **Challenges:**
 - Improperly carried out, can lead to disharmony and/or damage the ongoing relationship between the Board and management
 - Not the best model to achieve “holistic approach” as negotiated settlements are often ad hoc, without the best integration amongst their individual elements
- **Additional comment:**
 - We believe that this advocacy is best accomplished when we are selected by the management team but paid based upon a Board of Directors approved “not to exceed” budget.

Advise the Board of Directors

- Grahall assumes the traditional role of compensation consulting advisors and provides advice and counsel exclusively to the Board of Directors
 - Under this model, Grahall is selected by and paid by the Directors (fees for services provided are handled directly with the Board and not subject to management approval)
 - This has evolved during the past decade, as the relationship between management and compensation consultants (without the Board having its own advisor) came under additional scrutiny
- **Strengths:**
 - The Board receives independent advice typically based on an evaluation of market data, with little or no pressure on the consultant from management to inflate compensation
 - While we may interact, interview and explore the concepts and methodologies suggested or recommended by the management team, we are not constrained by their ideas or recommendations.
- **Challenges:**
 - To the extent that management does not participate in the process, Board decisions regarding pay level, mix and administration can become more arbitrary, potentially resulting in efficiency loss

Representative of the Shareholders

- Grahall evaluates compensation programs from the viewpoint of the shareholder
 - For some compensation advisors this is the predominant model for compensation design
- Strengths:
 - Compensation programs are seen as “shareholder friendly” potentially attracting more capital to the company and/or creating a harmonious relationship between the company, its shareholders, and the public
 - May also be a forerunner of future model to address “say-on-pay” type concerns
 - May be particularly well-suited for in certain industries (environmental, etc) where shareholder relations are a premium concern, or in industries in which there is significant public focus (such as bailed out financials, automakers, etc..)
- Weaknesses:
 - If overly deferential to shareholder concerns, this approach could result in programs that aren’t warmly embraced by management or the Board
 - Some feel this model is at odds with the “limited liability” paradigm that characterizes US corporate law
- Additional comment: This position or review point requires that a consultant be empowered to inject their judgment and advice from the shareholders’ viewpoint, thereby passing the Board advocate and the Executive advocate and putting the good of the owners as the primary consideration for the review and opinion of fitness, fairness, etc. of the reward program for the Directors or Executives

Act in the Best Interests of the Organization

- This approach considers all “stakeholders” in the organization, including employees, internal and external business relationships, and potential environmental impacts
 - While this may seem like a fine distinction from the previous “shareholder model”, it is actually a “distinction with a difference”
 - This difference is better understood outside the United States. In Europe and Canada for instance, the designation of stakeholders is well understood and accepted as critical for the success of any enterprise and organization.
- Strengths:
 - If the consultant operates with the entire **stakeholder** population in mind, there is a much larger obligation to review the risk profile of the executive incentive program so that financial systems are not put in jeopardy, the incentives associated with sales of product and services to customers are balanced with the good achieved for both the organization and its customers, etc.
 - As such, this model actually may be a cutting edge model applicable to industries with significant potential external risks, such as financial services
 - Encourages longer term view
- Challenges:
 - May put companies at a relative disadvantage against competitors who are operating solely on a short term profit model
- Additional Comment: In the majority of situations it could be safely stated that the outcome (when compared to the shareholder model) might not be significantly different, but that does not invalidate the precept since in a few specific instances the outcome would be significantly different for a large portion of the stakeholder group

Criteria for Selection of Advisor

- **Degree of independence**
 - Financial independence—measured by dollar volume of other business conducted with the Company
 - Independent thinking—subjectively assessed by their known work as well as information gathered in the screening interviews
- **Familiarity with the business environment**
 - Knowledge of the industry
 - Specific knowledge of the Company, its senior management, and Board of Directors
 - Broad knowledge of general industry current practices and emerging trends
- **Particular strengths and/or distinguishing characteristics including, but not limited to:**
 - Creative thinking
 - Strong sense of corporate governance
 - Special areas of expertise
 - Ability to establish rapport or dynamic presence with groups
- **References from current clients where the consultant acts in a similar advisory role**
- **Potential issues**
 - Conflict of interest as a result of other work performed for the client or with with other clients in the same industry
 - Degree of availability/accessibility