MEMORANDUM

September 1, 2009

To: File No. S7-13-09

From: Scott H. Kimpel
Office of Commissioner Troy A. Paredes

Re: Proxy Disclosure and Solicitation Enhancements

On September 1, 2009, Commissioner Troy A. Paredes and Scott H. Kimpel, Counsel to the Commissioner, met with representatives of Hewitt Associates LLC; Watson Wyatt & Company; Mercer; Towers Perrin; Marsh & McLennan; and Patton Boggs LLP. The participants discussed the Commission's proposed rule amendments to require disclosure of fees and potential conflicts of interest of compensation consultants. The representatives of the firms also circulated discussion materials (including abstracts and excerpts from several academic papers), copies of which are attached hereto.

Attachments.

Watson Wyatt
Worldwide

Compensation Committee Disclosure: Role of the Compensation Consultant:

1. How We Selected the Consultant

As permitted by the Compensation Committee (the "Committee") charter, the Committee has retained the consultant as its independent executive compensation consultant to assist in the Committee's evaluation of CEO and executive officer compensation levels, severance arrangements and program design. The Committee undertook a rigorous interview process in determining the best compensation consultant to provide this assistance, and personally interviewed three potential candidates before it made its selection. Management recommended these candidates as the result of a competitive Request for Proposal that was sent to each of the major firms that provides compensation consulting services.

In making the decision to select the incumbent, the Committee was impressed with the depth of knowledge of the individual consultant of our specific industry, and by the ability of his firm to recommend solutions for matters of particular importance to the Company's unique business circumstances. The Committee was committed to take a fresh look at the existing compensation structure for our executive cadre, and was particularly impressed by the consultant's understanding of the challenges presented and his perspective on potential solutions we might consider. We gave high marks for the survey capabilities of the consultant's firm and its ability to deliver current and relevant data we might consider in making our compensation design decisions. We were also influenced by the recommendations provided by other clients of the consultant, which noted the consultant was a recognized expert in our industry who had helped solve difficult compensation and business issues with creative and flexible recommendations.

The consultant and his firm has an excellent reputation in advising compensation committees on these matters and is widely quoted on the research the firm performs on compensation issues. Bench strength and the ability to advise on regulatory, tax, accounting and legislative matters also were factors in our decision.

During our interview process, we were made aware of the other consulting services the consultant's firm provides to management. We believe that based on the rigorous processes and procedures the consultant's firm has in place, there exist no conflicts of interest in the recommendations and advice the consultant provide to the Committee. These include:

- The consultant receives no bonus or commission based on the fees charged to the Company for other services;
- The consultant must adhere to a strict Code of Conduct that prohibits consideration of any other relationships his firm may have with the Company in rendering his advice and recommendations; and
- The protocols for the engagement (described below in How We Work With the Consultant) that dictate how and when the consultant may interact with management and the committee.

2. How We Work With the Consultant

The Committee, considering recommendations from management, determines the work to be performed by the consultant. The consultant works with management to gather data required in preparing analyses for Committee review.

The Compensation Committee has the sole authority to retain and terminate the independent executive compensation consultant. In considering the advice provided by an executive compensation consultant, and whether to retain or continue the retention of an executive compensation consultant, the Committee requires that the Company regularly inform the Committee of all work provided or to be provided by the consultant's firm in addition to the executive compensation services provided to the Committee, and the fees charged or to be charged for those services. The Committee reviews and approves all bills rendered by the compensation consulting firm to the Company for services provided to both the Company and the Compensation Committee. Annually, Committee grades the quality of the services provided by the consultant and has the right to terminate those services should performance levels fall below those deemed acceptable to the Committee.

Specifically, the consultant provides the Compensation Committee with market trend information, data and recommendations to enable the Compensation Committee to make informed decisions and to stay abreast of changing market practices. In addition, the consultant provided analysis on the alignment of pay and performance and assisted in the process of preparing this disclosure. While it is necessary for the consultant to interact with management to gather information and obtain recommendations, the Committee has adopted protocols governing if and when the consultant's advice and recommendations can be shared with management. Ultimately, the consultant provides his recommendations and advice to the Compensation Committee in an executive session where company management is not present, which is when critical pay decisions are made. This approach helps to assure the Compensation Committee receives unbiased and objective advice from the consultant so that it may make independent decisions about executive pay at the company.

3. Other Consultant Work With the Company

In addition to the services provided at the request of the Compensation Committee, management has retained a separate division of the consultant to perform process review and implementation assistance related to outsourcing the Company's stock plan administration system, and pays quarterly software usage fees related to a call center tracking system. In addition, management has retained a separate division of the consultant to provide actuarial services, including preparation of the FAS 87 disclosure for the Company's financial statement, and pension plan advisory services. The fees paid by the Company to the consultant's firm for non-Compensation Committee work constitutes less than 1% of firm revenues. The Committee believes that the provision of this work by the consultant does not impair the independence and objectivity of advice provided to the Committee on executive compensation matters.

Economic Characteristics, Corporate Governance, and the Influence of Compensation Consultants on Executive Pay Levels

Christopher S. Armstrong
carms@wharton.upenn.edu

Christopher D. Ittner
Ittner@wharton.upenn.edu

The Wharton School
University of Pennsylvania
1300 Steinberg-Dietrich Hall
Philadelphia, PA 19104-6365

David F. Larcker
Larcker_David@gsb.stanford.edu

Stanford University
Graduate School of Business
Rock Center for Corporate Governance
518 Memorial Way
Stanford, CA 94305-5015

June 12, 2008

Abstract: This study investigates the relation between the use of compensation consultants and CEO pay levels. Using new proxy statement disclosures from 2,116 companies, we examine claims that pay is higher in clients of compensation consultants, and test whether any pay differences in users and non-users of consultants are due to differences in economic or corporate governance characteristics. We find that CEO pay is generally higher in clients of most consulting firms, even after controlling for economic determinants of compensation. However, when users and non-users are matched on both economic and governance characteristics, differences in pay levels are not statistically significant. These results are consistent with claims that compensation consultants provide a mechanism for CEOs of companies with weak governance to extract and justify excess pay. Finally, we find no support for claims that CEO pay is higher in "conflicted" consultants that also offer additional non-compensation related services.

Keywords: equity incentives; corporate governance; executive compensation; compensation consultants

This paper has benefited greatly from many insightful discussions with Paul Rosenbaum. We also thank Bo Lu for making available his code to perform the nonbipartite matching algorithm used in this study. Funding from Ernst & Young (Ittner) and the Bob and Marilyn Jaedicke Faculty Fellow Program (Larcker) is gratefully acknowledged.

These claims have prompted increased compensation disclosure requirements and political investigations. The Security and Exchange Commission now requires proxy statements filed on or after December 15, 2006 to disclose which, if any, consultants provide compensation advice to the company.[1] The U.S. House of Representatives Committee on Oversight and Government Reform, in turn, has held hearings on the link between compensation consultants and executive pay. A study commissioned by the Committee used data from *Fortune* 250 firms to examine whether conflicts of interest among compensation consultants are associated with higher executive pay. The study's authors conclude that executive pay in companies using compensation consultants that provide other advisory services to these clients is higher than pay in companies using specialized compensation consultants without these potential conflicts of interest (U. S. House of Representatives, 2007).

In another study highlighted in the House hearings, the Corporate Library (2007), a compensation research center, conducted pay comparisons across clients of the ten largest compensation consultants (based on market share) relative to median pay in peer groups formed on the basis of ten industry sectors and four market capitalization groups. The Corporate Library report concludes that pay levels, in general, are higher in companies using one of these ten consultants, but that the extent to which "excess" pay exists depends upon the specific consultant. Though generally consistent with claims that compensation consultants facilitate rent extraction by executives, both the U.S. House

[1] Regulation S-X 407(e)(3)(iii) states that companies are required to provide a "narrative description" of "Any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying such consultants, stating whether such consultants are engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person, describing the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement."

Economic Characteristics, Corporate Governance, and the Influence of Compensation Consultants on CEO Pay Levels

1. Introduction

The controversy surrounding CEO compensation increasingly focuses on compensation consultants' influence on executive pay levels. Compensation consultants are generally hired by the company or its Board of Directors to assist in the design of executive compensation packages. Using their experience working with organizations, benchmarking data, and proprietary procedures, consultants can help companies choose economically-appropriate compensation levels and structures that efficiently achieve labor market objectives and provide appropriate incentives to executives. If companies' compensation decisions and compensation consultants' advice reflect underlying economic factors such as firm objectives, performance, and labor markets, any differences in executive pay levels between companies that do and do not use compensation consultants should simply reflect differences in these economic factors and efficient contracting.

In contrast, a wide range of business leaders, academics, and politicians charge that compensation consultants contribute to excessive CEO pay levels that cannot be attributed to differences in economic factors alone (e.g., Crystal, 1992; Bebchuk and Fried, 2004; Buffet, 2007; U. S. House of Representatives, 2007). According to these critics, CEOs of companies with weak governance use compensation consultants, who are beholden to clients for current and future business, to design and justify excessive pay packages.

Committee report and Corporate Library study have been widely criticized for inadequately controlling for the economic determinants of executive pay (Harris, 2007), leaving the relation between compensation consultants and executive pay an open question.

Given the increasing scrutiny of compensation consultants and the limited theoretical and empirical evidence on consultants' role in pay decisions, we conduct an exploratory analysis of the influence of compensation consultants on CEO pay levels using proxy disclosures by a diverse sample of 2,116 companies. Our goal is to contribute to this debate by providing the most extensive, large scale evidence to date on the relation between compensation consultants and CEO pay, and on the influence of economic and governance characteristics on this relationship.

Consistent with claims that executive pay levels in clients of compensation consultants are higher than justified by *economic* characteristics, ordinary least squares (OLS) regressions that control for a wide variety of economic determinants of compensation indicate that total pay is higher for clients of most (but not all) of the consulting firms relative to companies without consultants. The OLS results also suggest that pay levels of clients of the larger, most frequently used compensation consultants are higher than those of firms using other consulting firms (most of which are smaller, boutique compensation consultants) in some model specifications. However, when more sophisticated propensity score matched pair analyses are used to relax the stringent functional form assumptions imposed by OLS models and to assess correlated omitted variables problems, most differences between the individual consulting firms disappear, though the statistically higher levels of total pay at companies using compensation consultants persist.[2]

Our finding that CEO pay levels are higher in consulting clients, even after controlling for economic characteristics, is consistent with related studies by Conyon et al. (2006), Cadman et al. (2008), and Murphy and Sandino (2008). However, these studies provide little or no analysis of claims that companies with weak governance use compensation consultants to facilitate or justify excess pay. When we add *governance* variables to examine these claims, we continue to find higher pay in clients of most consulting firms in OLS regressions. In contrast, we find no significant differences in total pay levels between users and non-users of consultants or among the various consulting firms when propensity score matched pair analyses are used. This evidence indicates that once companies with similar economic and governance characteristics are compared and OLS's strict functional form is relaxed, pay levels are not significantly different, suggesting that governance differences account for much of the unexplained pay differences between consultant users and non-users.

Further analysis indicates that these results are due (at least partially) to pay levels for clients of individual consulting firms varying with governance strength, with weaker governance *within* clients of a given consultant associated with higher total pay. Similar statistical associations between governance characteristics and pay levels are *not* found in

[2] As we discuss more fully in Section 4.2, OLS may not be the preferred econometric approach because it relies on the assumption that a strict linear relation exists between CEO compensation and the selected determinants. Moreover, this relation must be the same for each consultant. In contrast, propensity score matching is robust to misspecification of the functional form linking CEO compensation to selected determinants and allows us to assess the impact of the endogenous choice of compensation consultants on the results. See Rosenbaum (2002) and Rosenbaum and Rubin (1983) for theoretical background and Armstrong et al. (2008) for a detailed explanation of propensity score matching in compensation research and an application examining whether equity incentives motivate managers to engage in accounting manipulations.

companies that do not use compensation consultants. While these results do not provide direct evidence that consulting firms play an *active* role in allowing CEOs of companies with weak governance to extract excess pay, they do suggest that the higher pay found in consulting clients is at least partially explained by the link between weaker governance and higher pay in companies using consultants. This evidence is consistent with the rent extraction view of the association between compensation consultant use and CEO pay, which argues that companies with weak governance use consultants to extract excess pay. Finally, consistent with Conyon et al. (2006), Cadman et al. (2008), and Murphy and Sandino (2008), we find no support for claims that CEO pay is higher for clients of potentially "conflicted" consultants that offer a broad range of advisory services relative to clients of specialized, "non-conflicted" compensation consulting firms.

The remainder of the paper is organized as follows. Section 2 reviews the prior literature on economic and governance arguments for differences in total CEO pay levels in companies using or not using compensation consultants, and between companies using different types of consultants. Section 3 discusses our sample and variables. Results are provided in Section 4. Section 5 offers our conclusions.

2. Literature Review

The majority of large companies engage compensation consultants to provide assistance in the design of executive compensation contracts. This assistance can range from the simple provision of benchmarking data on pay practices in other companies to advice on the structure and level of executive compensation and the tax, legal, and accounting implications of pay packages. Although some consultants focus solely on the

The Incentives of Compensation Consultants and CEO Pay

Brian Cadman*
David Eccles School of Business
University of Utah
brian.cadman@business.utah.edu

Mary Ellen Carter
Carroll School of Management
Boston College
maryellen.carter@bc.edu

Stephen Hillegeist
INSEAD
Stephen.Hillegeist@INSEAD.edu

First draft: October 2007

Current draft: February 2009

ABSTRACT

We examine whether compensation consultants' potential cross-selling incentives explain more lucrative CEO pay packages using 755 firms from the S&P 1500 for 2006. Critics allege that these incentives lead consultants to bias their advice to secure greater revenues from their clients (Waxman, 2007). Among firms that retain consultants, we are unable to find widespread evidence of higher levels of pay or lower pay-performance sensitivities for clients of consultants with potentially greater conflicts of interest. Overall, we do not find evidence suggesting that potential conflicts of interest between the firm and its consultant are a primary driver of excessive CEO pay.

We gratefully acknowledge the financial support of the Alliance Center for Global Research and Development at INSEAD, Boston College, University of Utah, and The Wharton School. We appreciate helpful comments from Ross Watts (the editor), and Jennifer Gaver (the referee), Tim Gray, Sue Haka, Steve Matsunaga, Karen Nelson, Katerina Semida, and seminar participants at Chinese University of Hong Kong, Dartmouth College, George Washington University, INSEAD, Hong Kong University of Science and Technology, Northwestern University, Southern Methodist University, University of California at Davis, University of Texas at Dallas, University of Utah, University of Washington, Washington University of St. Louis, and participants at the 2008 European Accounting Association Annual meeting and 2008 London Business School Accounting Symposium. This project involved extensive hand collection of data. We thank Nichole Kim, Cheng Li, Christine Roh, Katerina Semida, Shari Singh and YinYin Yu for their help with this effort. Some of the data has been supplied by The Corporate Library.
*Corresponding Author

1. Introduction

Compensation consultants are frequently hired by board compensation committees to assist them in designing pay packages for the Chief Executive Officer (CEO) and other top executives. Despite their widespread use at public firms, little is known about how consultants influence executive pay packages. This study examines whether potential conflicts of interest of compensation consultants influence CEO pay for a large sample of S&P 1500 firms. Compensation consultants are often subject to conflicts of interest in that they can sell additional services to the firm. In theory, that might lead them to recommend overly generous compensation for client CEOs. We thus examine their effect on the level of pay and pay-performance sensitivity (PPS).

Compensation consultants assist compensation committees in two primary ways. First, they provide expertise on compensation-related issues. This expertise includes knowledge of relevant laws and an understanding of executive compensation practices in general and for organizational changes such as mergers, acquisitions, spinoffs, and restructurings. Consultants' extensive knowledge about different forms of compensation allows them to help boards tailor executive pay packages (Brancato, 2002). Second, compensation consultants typically have access to detailed, proprietary information about pay practices. If consultants do not respond to conflicting incentives and, instead, act in the interests of shareholders, then they can advocate for efficient levels of compensation and for packages that effectively link pay to firm performance compared with compensation schemes that committees acting alone would have devised.

Many executive compensation (EC) consultants also provide non-executive compensation (non-EC) consulting services to the firm (as opposed to the board of directors), such as advice on pension plans, outsourcing of employee benefits plans, and compensation advice for mid-level managers. Providing non-EC services creates an economic dependence on revenues that are ultimately under the control of the CEO. Critics allege that these cross-selling interests induce compensation consultants to provide biased advice in order to secure additional revenues from non-EC services (Bebchuk and Fried, 2006; Morgenson, 2006; Waxman, 2007). Beyond simply recommending higher levels of compensation, consultants can also design compensation schemes that provide greater pay without requiring greater performance. According to this view, consultants with conflicts of interest ("conflicted consultants") help executives extract wealth from shareholders through higher compensation and/or lower PPS.

To examine the effect of cross-selling incentives, we take advantage of new SEC rules requiring companies to disclose the use of compensation consultants in proxy statements. We hand collect data on which, if any, compensation consultant the compensation committee retains to advise it on executive pay and whether the firm discloses its consultant provides additional services to the firm. Our primary sample consists of 755 firms in the S&P 1500 index with December 2006 fiscal-year ends that retain a compensation consultant.[1]

We examine whether the level of pay (salary, bonus, equity and total) is higher and whether the degree of pay-performance sensitivity is lower in firms where consultants have greater potential cross-selling incentives. Data on actual EC and non-EC services are not available so we consider three proxies for conflicts of interest: (1) client firms who affirmatively disclose that their compensation consultant provides non-EC services; (2) firms that are not clients of Frederic W. Cook or Pearl Meyer, large consultants that focus exclusively on executive compensation services and thus do not have cross-selling incentives; and (3) firms that hire their auditor for significant non-audit services, indicating a willingness to allow possible conflicts of interest among their professional service providers.[2]

Contrary to recent reports (Waxman, 2007), we find no consistent evidence that firms whose consultants have greater cross-selling conflicts of interest compensate their CEOs more highly or have lower PPS than the clients of consultants that are less likely to be conflicted. Our

[1] Our sample consists of firms with December 2006 fiscal year-ends since the Securities and Exchange Commission (SEC) first mandated firms disclose their use of compensation consultants for fiscal years ending on or after December 15, 2006.
[2] In Section 3, we discuss the correlation of our proxies with actual EC and non-EC revenues.

results are robust to several alternative measures of performance and remain when we control for the decision to retain a consultant. Further, our findings do not result from our sample being biased toward larger firms nor do we find effects of conflicts in firms with weaker corporate governance structures. Finally, we explore, but find little support for, the possibility that the decision to hire a consultant overshadows any effect that potential conflicts of interest might have. While we find some evidence that firms hiring a consultant in 2006 compensate their CEOs more than firms that do not, this result is not robust when we examine changes in pay as a function of changes in the use of consultants in 2007. Specifically, firms that add or continue to use a consultant do not have greater increases in pay, and firms that drop consultants do not have smaller increases in pay compared to firms that do not use a consultant in either year. Those analyses do not provide consistent evidence that compensation consultants are associated with more lucrative pay packages.

Overall, we do not find evidence suggesting that potential conflicts of interest associated with cross-selling incentives are a primary driver of excessive CEO pay. Reputation and credibility incentives can limit consultants' desires to act on cross-selling incentives. Similarly, safeguards put in place by compensation committees, such as requiring prior approval of or prohibiting the provision of non-EC services by the consultant, can limit the consultants' ability to act on their incentives. Taken together, our findings suggest that concerns about compensation consultant independence are overstated.

This study contributes to the compensation and corporate governance literatures on how potential conflicts of interest affect the services provided by advisors to the firm. Our setting examines one important advisor, the compensation consultant, and its role in achieving efficient contracts. Because of prior limited disclosure, ours is among the first to study the role of compensation consultants and the effect they have on executive pay using a broad sample of firms in the U.S. Our study also provides additional evidence on the more general debate regarding executive compensation practices, which remains an important issue, not least because the controversy has moved to a global forum with non-U.S. executive pay packages coming to resemble their U.S. counterparts (Fabrikant, 2006; Grant et al., 2006).

Our paper continues as follows. In Section 2, we discuss background information and provide our research question. Section 3 discusses data sources and our research design. Section 4 presents the results of our empirical tests examining the influence of cross-selling conflicts on CEO pay. Section 5 provides additional analyses examining alternative explanations for our findings in Section 4. We provide concluding remarks in Section 6.

2. Background and Research Question

2.1 Background and related studies

Compensation consultants are frequently employed to help boards of directors design executive compensation plans for U.S. firms. However, the role that consultants play in determining pay for top executives has long been controversial (Crystal, 1991). While consultants can use their expertise to assist the compensation committee in designing compensation packages that maximize shareholder value, critics accuse them of aiding executives at the expense of shareholders (Morgenson, 2006). Critics focus on cross-selling conflicts of interest that arise when the consultant provides potentially more profitable non-EC services to the client firm beyond advice on executive pay. While the compensation committee almost always has the sole authority to hire a compensation consultant, the hiring decisions for non-EC services are ultimately under the CEO's control.[3] Thus, compensation consultants can curry the CEO's favor by recommending excessive pay packages in order to secure or protect these other assignments (Crystal, 1991; Morgenson, 2007).

[3] Since the Sarbanes-Oxley Act, compensation committees have generally retained their own consultants, while previously the consultant was often hired directly by management. In addition, listing requirements adopted in 2003 by the New York Stock Exchange (Rule 303A) require that the compensation committee retain sole authority over the compensation consultant. In 247 firms randomly selected from our sample, 95% indicate the compensation committee hired the consultant in 2006.

****Comments Welcome*
Do not quote without permission

Executive Pay and "Independent" Compensation Consultants*

Kevin J. Murphy
Marshall School of Business
University of Southern California
Los Angeles, CA 90089-0804
E-mail: kjmurphy@usc.edu
Phone: (213) 740-6553

Tatiana Sandino
Leventhal School of Accounting
Marshall School of Business
University of Southern California
Los Angeles, CA 90089-0804
E-mail: sandino@marshall.usc.edu
Phone: (213) 740-4842

April 28, 2009

Abstract

Executive compensation consultants face potential conflicts of interest that can lead to higher recommended levels of CEO pay, including the desires to secure repeat business and "cross-sell" additional services. We find mixed US and stronger Canadian evidence that executive pay is higher in companies where the consulting firm also provides other services. We find evidence in Canada (but not in the US) that pay is higher when the consultant also serves as the company's actuary or provides benefits-administration services, and that pay is positively related to the fees charged for non-compensation services relative to the fees for executive-compensation services.

* We thank Harry DeAngelo, Linda DeAngelo, Fabrizio Ferri, Alan Jagolinzer, Nicole Johnson, David Larcker, David Maber, Simon Peck, Karen Sedatole, Jerold Zimmerman, and an anonymous referee, as well as seminar participants at Case Western Reserve University, Harvard Business School, Michigan State University, Penn State University, Stanford University and University of Notre Dame for their comments. We also thank Matthew Carter-Tracy, Caroline Fung, Ryan Helfant, Kuo-Feng Huang, David Huelsbeck, Jamie Kwak, Darline Llamas, Michael Madigan, Kinga Marciszewska, Kara Murphy, Amanda Nakamatsu, Ayrin Santoso, Kunfan Wu and Chao Zhuang for research assistance. All errors remain our own.

Executive Pay and "Independent" Compensation Consultants

by Kevin J. Murphy and Tatiana Sandino

1. Introduction

Most large companies rely on executive compensation consultants to make recommendations on appropriate pay levels, to design and implement short-term and long-term incentive arrangements, and to provide survey and competitive-benchmarking information on industry and market pay practices. In addition, consultants are routinely asked to sanctify existing compensation arrangements and to give general guidance on change-in-control and employment agreements, as well as complex and evolving accounting, tax, and regulatory issues related to executive pay. Finally, while some consultants are "boutique" firms focused exclusively on executive compensation, many are integrated corporations offering a full-range of compensation, benefits, actuarial and other human resources consulting services.

Critics of perceived abuses in executive pay have increasingly accused the consultants as being complicit in the alleged excesses in compensation.[1] The accusations have typically focused on conflicts of interests faced by consultants that could lead them to favor incumbent managers when making pay recommendations. For example, a December 2007 report from the US House of Representatives Committee on Oversight and Government Reform, "Executive Pay: Conflicts of Interest Among Compensation Consultants" (the "Waxman Report"), warned about conflicts of interest arising when the "consultants who are advising on executive pay are simultaneously receiving millions of dollars from the corporate executives whose companies they are supposed to assess." Specifically, the Waxman Report (p. i) found that:

> "In 2006, the consultants providing both executive compensation advice and other services to Fortune 250 companies were paid almost 11 times more for

[1] For example, in his 2005 letter to shareholders, Berkshire Hathaway's Warren Buffett asserted that "a mediocre-or-worse CEO – aided by his handpicked VP of human relations and a consultant from the ever-accommodating firm of Ratchet, Ratchet and Bingo – all too often receives gobs of money from an ill-designed compensation arrangement." Similarly, an October 2007 report issued by the Corporate Library, "The Effect of Compensation Consultants" (Higgins 2007), concluded that companies using consultants offer significantly higher pay than companies not using consultants and that "engaging the services of a compensation consultant does not appear to increase the effectiveness of incentive plans."

> providing other services than they were paid for providing executive compensation advice. On average, the companies paid these consultants over $2.3 million for other services and less than $220,000 for executive compensation advice."

Underlying the suspicions in the Waxman Report is the assumption that providing services beyond executive pay inherently creates conflicts of interest leading to higher CEO pay. However, consultants are aware that acting on the types of conflicts highlighted by their critics would damage their credibility and result in losing clients who value the consultants' reputation for independence. Furthermore, the reputational consequences of sacrificing independence by recommending high levels of pay will arguably be highest in consulting companies offering multiple services, since these companies have the "most to lose" by violating the trust of boards and shareholders.

In this paper we investigate whether conflicts of interest between the compensation consultants and their client firms lead to higher levels of executive pay. There are two primary sources of conflicts of interest (which we call "other services" and "repeat business," respectively) between consultants and their client firms that could lead to biased pay recommendations. First, as documented by the Waxman Report, the large integrated consulting firms routinely receive fees from "other services," including actuarial, benefits, rank-and-file employee pay, and other human resources consulting practices that are orders of magnitude larger than the fees earned by their executive pay practices. Decisions to engage the consulting firm in these more lucrative corporate-wide consulting areas are often made or influenced by the same top executives who are benefited or harmed by the consultant's executive pay recommendations. Such prospects for cross-selling other consulting, benefits management, or actuarial services can potentially pressure the consultants into making pay recommendations that favor management.

Second, compensation consultants historically have been retained not by the compensation committee but rather by company management, and work directly for and with the head of human resources, the chief financial officer, and/or the CEO. This situation creates an obvious conflict of interest, since the consultants make recommendations on the pay of the individuals who hire them. Consultants can increase the probability of "repeat business" by recommending generous pay levels and by aligning the recommended composition of pay with the preferences of the CEO and other top managers.[2]

---

[2] Put more bluntly, Bebchuk and Fried (2004, p. 38) offer the following quote from a director interviewed by *Fortune*: "I would say that it is unusual to find a consultant who does not end up, at the least, being a prostitute. The consultants are hired by management. They're going to be rehired by management."

In 2006, the Securities and Exchange Commission (SEC) introduced a set of new disclosure rules for executive compensation that for the first time required publicly traded US corporations to identify and describe the role of all consultants who provided advice on executive compensation. In this paper we code the newly disclosed executive compensation consulting data from proxy statements for 1341 firms and show that 78% (1046) of these firms retained one or more compensation consultant during the 2006 fiscal year.[3] We examine data from the 1046 companies using compensation consultants to investigate whether conflicts of interest between consultants and their client firms lead to higher pay for CEOs and other top executives.

While the US disclosure rules require companies to disclose whether the consultants are engaged directly by the compensation committee rather than by management (useful in testing our "repeat business hypothesis"), the rules stop short of requiring companies to disclose non-compensation-related services provided by the compensation consultants or to disclose the fees charged for compensation-related and non-compensation-related services (useful in testing our "other services hypothesis"). We address these shortcomings in US disclosure rules in two ways. First, our analysis of other services focuses primarily on whether the compensation consultant also serves as the company's actuary as identified from IRS and Department of Labor filings; using these external data allow us to avoid potentially important underreporting biases inherent in voluntary corporate disclosures. Second, we supplement our analysis of US companies with a parallel analysis of approximately 200 Canadian companies. Under Canadian disclosure rules in effect since early 2005, companies are required to not only identify their compensation consultants but also describe the nature of any other services the consultant provides. In addition, following "best practice" guidelines issued by the influential Canadian Coalition for Good Governance, many large Canadian companies disclose the fees paid to consultants for both executive compensation services and other work provided. Finally, while our US analysis is focused on the first year that firms were required to identify their consultants, our Canadian analysis focuses on firms in their second or third year of full disclosure, which mitigates potential transition-year effects inherent in the US data.[4]

---

[3] Our full sample includes 1,341 S&P 500, S&P MidCap 400, and S&P SmallCap 600 companies with fiscal closings between December 15, 2006 (the effective date for the new disclosure rules) and May 31, 2007 (the last fiscal-closing day of the 2006 using ExecuComp and Compustat conventions). Our analyses exclude 295 firms that did not report using a consultant during fiscal 2006.

[4] By focusing on the first year of available US data, our results will not capture the long-run effects of disclosure. We believe such long-run effects will include both (1) firms choosing not to retain consultants for other services, and (2) consulting companies instituting safeguards to retain independence in both appearance and fact. We therefore view this "shortcoming" in the US data as a potential advantage, since the transition year might be our best opportunity to identify a relationship between conflicts of interest and executive pay if indeed one exists.

We find mixed evidence in the US, and stronger evidence in Canada, that higher levels of executive pay are related to the potential conflicts of interest faced by the consultants. In particular, we test the hypothesis that CEO pay is higher when the consultant provides services beyond executive compensation advice. We measure "other services" in Canada through mandated disclosures and in the US by whether the compensation consultant also serves as the company's actuary (as identified from IRS and Department of Labor filings) and by whether the company voluntarily discloses in its proxy statement that it uses the consultant for services beyond providing advice on executive pay. We find evidence (statistically significant in Canada but only marginally significant in the US) that CEO pay is higher in companies where the compensation consultants offer other services, and that CEO pay increases with the count of other services provided by the consultants. In particular, US CEOs receive about 7% more total compensation, and Canadian CEOs receive about 40% more, when their executive compensation consultant also provides other services to the firm.

We find no significant evidence that pay for US CEOs is higher in companies where the consultant serves as the actuary; we do, however, find evidence that Canadian CEOs receive approximately 73% higher pay when their consultants also provide actuarial services. In addition, we find evidence that CEO pay is approximately 25% higher in US firms where the executive compensation consultant provides other uncommon services unrelated to compensation, and find evidence in Canada that CEO pay is 26% higher where the consultant provides benefits-administration services. Finally, based on analysis of Canadian data, we find evidence that CEO pay varies with the fees charged by consultants for other services (measured relative to the fees charged for compensation-consulting services).[5]

We also test the "repeat business" effect (i.e., the consultants' concern with being reappointed) by examining whether CEO pay is related to a proxy for managerial influence over the decision to appoint (or reappoint) consultants, i.e. an indicator of whether the consultant works exclusively for the committee or also works for management. Inconsistent with this hypothesis, we find evidence that CEO pay is actually about 7% *higher* in US companies where the consultant works exclusively for the compensation committee rather than for management.

Our research contributes to the literature related to executive compensation in general, and more specifically to the emerging literature on the role of compensation consultants in

[5] Increasing the ratio of non-executive-pay fees to executive-pay fees from 0 to 10 (approximately the average in our sample) corresponds to approximately a 10% increase in pay for Canadian CEOs. This highly significant result, while intriguing, becomes only marginally significant (but with a larger coefficient) after eliminating one outlier observation.

influencing pay.[6] The closest analyses to ours are Conyon, Peck, and Sadler (2009) and Cadman, Carter, and Hillegeist (2009). Conyon, Peck and Sandler (2009) examine the role of compensation consultants in a sample of 231 UK corporations and find no evidence that CEO compensation is higher in UK firms whose compensation consultants provide other services to the client firms.[7] Cadman, Carter, and Hillegeist (2009) also find no evidence that conflicts of interest lead to high pay in a sample similar to our US sample, using three proxies for potential conflicts of interest: voluntary disclosures that the consultant provides other services to the firm; whether the consultant is integrated (that is, whether the consultant offers any services beyond executive compensation advice); and the ratio of auditing fees to non-auditing fees paid to auditors (based on the idea that firms hiring their auditors for other services are more likely to hire their compensation consultant for other services).

In contrast to Conyon, Peck, and Sadler (2009), we analyze the effect of conflicted consultants in a broad sample of US companies.[8] In contrast to Cadman, Carter, and Hillegeist (2009), we use direct measures of cross-selling (rather than voluntary disclosures and imperfect proxies). In contrast to both of these studies, we examine the ratio of non-compensation to compensation consulting fees in our Canadian sample, and we examine the "repeat business hypothesis" by analyzing whether the consultant works directly and exclusively for the compensation committee or also for management. In addition – and also in contrast to both studies – we find evidence (modest in the US, but stronger in Canada) that higher levels of executive pay are related to the potential conflicts of interest faced by the consultants. Our study is particularly relevant in view of the current debate in the US where several legislators and activists have demanded that executive compensation consultants disclose information regarding other non-executive-pay related services provided to their client firms.[9]

More broadly, our research is closely related to the accounting literature on "auditor independence." Concerns regarding conflicts when accounting firms offered services beyond auditing led to both the 2002 Sarbanes-Oxley Act and to detailed disclosures of fees charged for auditing and non-auditing businesses. Subsequent to the Act and these disclosures,

---

6 For example, Armstrong, Ittner and Larcker (2008), Conyon (2008) and Higgins (2007) analyze CEO pay differences between companies using consultants and not using consultants.

7 Since 2002, firms in the UK have been required to identify their compensation consultants and to note whether the consultant provided any other services provided to the firm.

8 Conyon, Peck and Sadler (2009) analyze whether CEO pay is higher in US firms that retain consultants, but only analyze conflicts of interest for their UK sample.

9 For examples, see Congressional hearings in December 2007 (http://oversight.house/gov/story.asp?ID=1643) and the comment letters to the SEC's proposed rule on "Executive compensation and related-party disclosure" related to compensation consultant disclosures (http://www.sec.gov/rules/proposed/s70306.shtml).

companies have largely abandoned the practice of using the same accounting firm for both auditing and other services, avoiding perceived conflicts of interest but at the cost of losing the auditing firm's extensive knowledge of the client firm and industry (which could presumably be leveraged in other services).[10] And yet, there is little direct evidence that these potential conflicts actually translated into misleading auditing decisions. For example, DeAngelo (1981) (two decades before Sarbanes-Oxley) concluded that auditors with a greater number of clients have "more to lose" if they fail to disclose any problems encountered during their audit; these incentives lead larger auditor firms to increase the quality of their audits. More recently, Kinney, Palmrose and Scholz (2004) documented that the Sarbanes-Oxley auditing rules were approved despite an extensive number of academic studies were unable to find the existence of a positive association between non-audit services fees and surrogates for financial reporting quality. In addition, Dopuch, King and Schwartz (2003, 2004) present theoretical and experimental results suggesting that mandated disclosure of non-audit services may cause investors to *perceive* audit quality to be compromised even in cases when the auditors faithfully detect and report all material misstatements.

Our study is also related to research on the "independence" of stock price analysts, who faced conflicts of interest when the analysts making forecasts and recommendations were employed by investment banking firms that provided underwriting and other services to the firm being analyzed (Lin and McNichols, 1998; Agrawal and Chen, 2008). In 2002, following the stock market collapse, the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) introduced new regulations aimed at separating investment banking units from research units and at disclosing increased information on analysts' recommendations and potential conflicts of interest. These regulations were followed by the "Global Research Analyst Settlement" which penalized and imposed additional regulations on ten investment banks that had allegedly misled investors through biased analyst recommendations (Barber, Lehavy, McNichols and Trueman, 2006; Kadan, Madureira, Wang and Zach, 2009). Analysts have also been alleged to offer favorable forecasts and recommendations when their client companies reward them through increased access to information (Libby, Hunton, Tan and Seybert, 2007) or through subsequent board appointments (Cohen, Frazzini and Malloy, 2008).

In the process of generating the hypotheses tested in this study, we conducted interviews with senior consultants from several major compensation-consulting firms. We

---

[10] Simunic (1984) for example, discusses the "knowledge externalities" and lower transaction costs in having the auditor provide non-auditing services.

were told that the phenomenon we were investigating – whether consultant conflicts of interest lead to higher pay – was a legitimate concern in past years but that policies and processes have changed dramatically in recent years. For example, while consultants in the past were routinely hired by and worked exclusively for management, they are now routinely retained by the compensation committee and (as we document) often work exclusively for the committee. Another example, one major consulting firm facilitated cross-selling by designating a single consultant as the key liaison for each client firm to coordinate the various services provided to the firm. In the past, this "client relationship manager" was often from the executive-pay practice, since consultants in the executive-pay area routinely had higher-level access to the client executives. Following Sarbanes-Oxley (which did not directly address executive compensation but nonetheless had a general effect on corporate governance), this consulting company forbid executive-pay consultants from serving as client managers, and built more formal "Chinese Walls" between the consulting and other practices. Finally, one senior consultant told us that being publicly identified as a "high payer" would have generated substantial business in past decades, but would now be considered a "kiss of death."

Although our results support that conflicts of interest among consultants and their client firms are associated with higher levels of CEO pay, we also recognize increasing efforts from consultants to self-police in order to protect their reputations (as suggested by the anecdotes in the prior paragraph). The incentives to self-police have undoubtedly increased following the 2006 SEC disclosure requirement that firms identify their executive compensation consultants. Thus, we present a cautionary tale for current demands by some legislators and activists requesting that firms disclose fees paid for non-executive-pay related services provided by the compensation consultant, or further demanding that executive compensation consultants refrain from providing any non-executive-pay services to their client firms. Following the auditing-independence analogy, we suspect that such requirements would lead companies to avoid using the same consultants for executive pay advice and other services, in spite of the fact that some compensation consultants (with their substantial firm-specific knowledge) might be the efficient provider of such services.

We begin in Section 2 with a summary of our US data and an institutional description of the compensation consulting industry. Section 3 examines the effect of the two sources of conflicts of interests ("other services" and "repeat business") based on US data. Our supplementary analysis based on Canadian data is presented in Section 4. Section 5 summarizes our results.