

CHAPTER 15 COMPENSATION CONSULTANTS AND EXECUTIVE PAY

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ABSTRACT

This chapter provides a review of the recent literature on compensation consultants and executive pay. Six major pay consulting firms dominate the market. These firms advise client firms about executive pay and frequently supply other services such as actuarial work. There is some evidence that CEO pay is higher in firms that use compensation consultants. However, the hypothesis that CEO pay is higher in firms whose consultants face potential conflicts of interest, such as cross-selling of other services, is not as empirically robust.

INTRODUCTION

Compensation consultants are firms or individuals who advise client organizations about executive pay practices (Bebchuk and Fried, 2006; Conyon, Peck, and Sadler, 2009a). Critics contend that consultants lead to excessive CEO pay and poorly designed contracts. As Crystal (1991, p. 9) notes, “Executive compensation in the United States did not go out of control simply through some random process; it went out of control because of the actions—or inactions—of a number of parties. The first culprits in what will be a litany of culprits are compensation consultants.” An alternative perspective is that compensation consultants are experts who provide valuable information and data to busy boards of directors. Their presence ameliorates opportunistic behavior by chief executive officers (CEOs) and leads to well-structured optimal compensation contracts (Conyon et al., 2009a). Do pay consultants promote the best interests of the firm’s owners or do they simply enrich entrenched CEOs?

This chapter has two objectives. First, it reviews whether compensation consultants enhance or encumber the effective governance of CEO pay in light of recent studies in the field. Second, the chapter provides new evidence on the association between CEO pay and consultants in a sample of publicly-held firms in the United Kingdom.

CEOs in the United States can earn large sums of money (Canyon, Core, and Guay, 2009; Canyon and Murphy 2000; Fernandes, Ferreira, Matos, and Murphy, 2009). CEO pay in S&P 500 firms has increased substantially from about \$3 million in 1993 to a peak of about \$16 million in 2000. While it has fallen back in recent years, CEO pay in 2006 still stood at more than \$8 million (Kaplan, 2008). Comparisons with other employees are also important to consider. Kaplan documents that American CEOs earn significantly more than the typical American household. As Kaplan notes, average total pay of CEOs in 1993 was just under 100 times greater than median household income; by 2006, it was more than 200 times greater.

This high level of CEO pay is controversial and a common topic of media coverage. This is not surprising when set against the perceived lack of pay-for-performance, growing income disparities, the economic crisis, and putative declining ethical standards in company boardrooms. Some academics have been especially critical of executive pay, questioning whether current arrangements are consistent with shareholder interests (Bebchuk and Fried, 2003, 2004, 2006). Bebchuk and Fried (2004) provide an in-depth review of the problems surrounding CEO pay practices. However, not all academics are so critical of CEO compensation. Kaplan (2008), for example, provides a robust defense of CEO pay practices in the United States. He argues that CEO pay is tied to performance, and that boards are appropriately setting pay, and that CEOs are subject to market forces. Other studies have also examined whether the

market power or efficient contracting approach is a more appropriate explanation for patterns of CEO pay (Core, Guay, and Thomas, 2005; Conyon et al., 2009).

Until recently, the role of executive compensation consultants has been largely unexamined. These consultants often advise busy boards and compensation committees on the design of executive pay packages. As with CEO pay, consultants are controversial (Crystal, 1991; Bebchuk and Fried, 2003, 2006, 2004; Waxman, 2007;). Critics argue that consultants are responsible for high levels of CEO pay and their poorly designed compensation packages that include too many perks, hidden benefits such as golden parachutes or lucrative pension deals, and non-demanding performance criteria. Especially salient is the hypothesis that consultants are not sufficiently independent. Consultants suffer from conflicts of interest because they sell other services to their clients and are thus wary of provoking the CEO for fear of jeopardizing this other business (Bebchuk and Fried, 2004; Waxman, 2007).

This study contributes to a nascent literature on pay consultants. The remainder of the chapter has four sections. The first section discusses compensation consultants including disclosure rules, the role of consultants, and consultant independence. This section is followed by a review of existing studies. New empirical evidence on CEO pay and consultants is then presented. The final section contains a summary and conclusion.

COMPENSATION CONSULTANTS

Disclosure

Disclosure of information about executive compensation consultants is now required in the United States, the United Kingdom, and Canada. Each country stipulating disclosure requires firms to identify the pay consultant by name, but regulations in each dominion are nuanced so that information disclosure is appreciably different. For example, U.K. firms disclose whether the consultant engages in other non-compensation

consulting business activities such as actuarial services with the client firm. This is not mandated in the U.S. but companies may voluntarily reveal this information. In Canada, firms sometimes separately reveal fee income paid to consultants for executive compensation services and non-executive pay business. In the United States and the United Kingdom, this rarely happens, if at all.

Disclosure of compensation consultant information in the United States has been mandated since 2007 (SEC 2007). New rules came into effect for companies filing with the SEC after December 2006. Item 407(e) of the new regulations requires firms both to identify the consultants and to disclose any role of compensation consultants in determining or recommending the amount or form of executive and director compensation. Disclosure happened earlier in the United Kingdom. The Directors' Remuneration Report Regulations of 2002 mandated firms to disclose consultant information in the U.K. for accounting periods after December 2002 (DRR 2002). The firms must name any person who provided material advice or services to the compensation committee and must disclose whether services in addition to compensation advice were given (Bender, 2008; Conyon, Peck, and Sandler, 2009a; Kabir and Minhat, 2009). Disclosure in Canada has been required since 2005. On April 15, 2005, the Canadian Securities Administrators (CSA) issued National Instrument 58-101, which requires corporations to disclose whether a compensation consultant has been used (Canada, 2005). Together, the United States, the United Kingdom, and Canada report sufficient information about compensation consultants to investigate their effect on CEO pay.

The Market for Executive Compensation Consulting Services

The market for executive compensation consulting services is an oligopoly: a few prominent compensation consultants supply a range of services to a large number of

client firms. Panel A of Table 15.1 illustrates the basic market structure for the United States, the United Kingdom, and Canada. The 'big six' consulting firms in the U.S. are Towers Perrin, Mercer Human Resource Consulting, Frederick W. Cook & Co., Hewitt Associates, Watson Wyatt Worldwide, and Pearl Meyer and Partners. Various studies document evidence of the dominance of the big six (Bebchuk and Fried, 2004; Waxman 2007; Armstrong, Ittner, and Larcker, 2008; Cadman, Carter, and Hillegeist 2009; Conyon et al., 2009a; Murphy and Sandino 2009). These major consulting firms are also prevalent in the United Kingdom.(Bender, 2008; Conyon et al., 2009a; Conyon, Peck, and Sadler, 2009b; Kabir and Minhat, 2009; Voulgaris, Stathopoulos, and Walker, 2009) as well as in Canada (Murphy and Sandio, 2009). In addition, New Bridge Street Consultants and Monks Partnership are also important players in the U.K. market.

The following broad features of the market are noteworthy (see Table 15.1). First, there are six main firms consulting on executive compensation. The frequency distribution of client market shares is right skewed such that the big six capture most clients but there is a long tail of other consulting firms. Second, consulting firms are ubiquitous. Most large publicly-traded firms use them and only a few do not. Third, pay consultants often supply additional services other than pay advice to client firms. These other services can include actuarial or benefits advice. These other services have been used to measure whether the consultant has a potential conflict of interest with the client firm.

(Insert Table 15.1 about here)

Why Do Firms Use Pay Consultants?

Compensation consultants are firms or individuals who provide client organizations with advice and information about executive pay. Why do firms use pay consultants? Compensation consultants can form part of an optimal governance

structure by providing information, which can reduce agency costs and help boards arrive at the best compensation contract to offer the CEO on the behalf of shareholders. Consultants provide expert advice, salient information, data and valuable analysis (Baker, Jensen, and Murphy, 1988; Bebchuk and Fried, 2004; Conyon et al., 2009a; Murphy and Sandino, 2009). They are experts in helping boards and compensation committees understand the value of complex pay packages and associated tax, disclosure, and accounting issues. In this scenario, consultants are not controversial. Their use is warranted and defensible because consultants represent a low-cost (economic) solution for generating the optimal compensation contract and reducing moral hazard. Problems arise, as discussed next, if consultants are not independent or suffer from conflicts of interests.

Are Pay Consultants Independent?

Critics often contend that pay consultants face significant conflicts of interests that impede their impartiality and independence (Crystal, 1991; Bebchuk and Fried, 2003, 2006). Critics argue that executive compensation contracts will be sub-optimal and favor the CEOs interests at the expense of the owner/shareholders. Three issues potentially compromise the consultant's independence and create a conflict of interest.

Psychological Bias

In practice, the company and not the shareholders hires the consultant. Consequently, the consultant may psychologically favor managements' interests at the expense of shareholders' interests. This bias might be inadvertent or strategic. A consultant hired by the firm (or CEO) may feel psychologically obligated to the CEO (Bebchuk and Fried, 2004; Core et al., 2005; Murphy and Sandino, 2009). A type of gift exchange has occurred. The consultant having received a lucrative assignment by the client firm may reciprocate by recommending generous pay for the CEO. When

management does the hiring, the consultant's incentives may be skewed in favor of the CEO's interests rather than those of the shareholders.

Repeat Business

The prospect that the consultant's assignment may be terminated or not renewed may also distort incentives (Bebchuk and Fried, 2004; Conyon et al., 2009a). This has been referred to as the 'repeat business' hypothesis (Murphy and Sandino, 2009). If the consultant recommends low CEO pay, then the probability of being terminated increases. In addition, the likelihood of getting business from other clients may also diminish (Bebchuk and Fried, 2004). Consultants who fear being fired and losing repeat business are more likely to recommend pay contracts that favor the CEO at the expense of shareholders.

Cross-selling of Other Services

Compensation consultants often provide services in addition to advice about executive compensation (Armstrong et al., 2008; Cadman, Carter, and Hillegeisst, 2009; Conyon et al., 2009a; Murphy and Sandino, 2009). Such advice may involve actuarial assignments, benefits, accounting, and general management. Selling other services in addition to compensation advice potentially distorts the incentives. These additional services make consultants unwilling to attack a CEO's pay package for fear of putting this other business at risk. The extant literature hypothesizes that CEO pay is higher in client firms if the consultant provides business services other than executive compensation advice (Cadman et al., 2009; Conyon et al., 2009a; Murphy and Sandino, 2009). As noted in Table 15.1, the cross-selling of other services is a relatively common practice in the United States and the United Kingdom.

In summary, compensation consultants may be conflicted for the following reasons: (1) the psychological pressures that bond them more closely to management

(e.g., reciprocation and gift-exchange); (2) the fear of losing future or repeat business; and (3) the presence of other lucrative business opportunities. The result is that potentially conflicted consultants offer advice in favor of management rather than shareholders. One brake on opportunistic consultant behavior is the consultants desire to maintain a high-quality reputation. A consultant exposed for colluding with management or recommending lucrative pay deals for poor performance will suffer a loss of reputation or risk termination by the client firm's board of directors. Maintaining and developing a good market reputation is therefore important for the consultant and ameliorates the tendency for consultants to side with management over shareholders. The effect of maintaining a good reputation works against finding a positive correlation between CEO pay and conflicted consultants.

LITERATURE REVIEW

Several recent research papers on pay consultants have emerged. The broad hypothesis tested in these papers is that compensation consultants are associated with higher CEO pay at client firms. These new studies generally use multivariate regression methods. The overall goal has been to determine whether pay consultants are operating in the best interests of shareholders or err on the side of management. Current evidence comes from three countries where disclosure rules permit data collection: the United States, the United Kingdom, and Canada. These are English Legal Origin countries (La Porta, Lopez-de-Silanes, and Shleifer, 2008).

The emerging literature uses data from different countries. Two studies adopt a comparative methodology: Conyon et al. (2009a) focus on the United States and the United Kingdom while Murphy and Sandino (2009) study the United States and Canada. Other papers focus on single countries such as the United States (Armstrong et al., 2008; Cadman et al., 2009) or the United Kingdom (Bender, 2008; Conyon et al., 2009b;

Kabir and Minhat, 2009; Voulgaris et al., 2009). Still other papers have remarked on compensation consultants, although this has not been the primary focus of the research design (Tosi and Gomez-Mejia, 1989; Wade, Porac, and Pollok, 1997; Bizjak, Lemmon, and Naveen, 2007; Faulkender and Yang, 2008). Central to this new literature is how to measure the variable 'consultant.' Researchers have used many different measures, thus making direct comparisons across studies difficult. For example, studies have used an indicator variable (1 = yes, 0 = no) for the presence of a compensation consultant (Armstrong et al., 2008; Conyon et al., 2009a, 2009b; Kabir and Minhat, 2009; Voulgaris et al., 2009), the market share of the consultants (Kabir and Minhat, 2009), proxies for conflicts of interest in the cross-selling of other services (Cadman et al., 2009; Conyon et al. 2009a, 2009b; Murphy and Sandino, 2009), the ratio of fee income from additional non-compensation services divided by fees from executive pay advice (Murphy and Sandino, 2009), and various indicator variables for individual specific consultants (Armstrong et al., 2008; Kabir and Minhat, 2009).

Multi-country Studies

Conyon et al. (2009a) investigate the relation between CEO pay and compensation consultants in the United States and the United Kingdom. In the research design, they consider the two countries separately rather than pooling them into the same sample. Their econometric models use a sample of 308 U.S. firms from the S&P500 in 2006 and 229 large U.K. firms in 2003. The sample size is small relative to other emerging studies in this field. The authors use ordinary least squares (OLS) methods on cross-section data. They measure CEO pay in a manner consistent with the extant executive compensation literature (Murphy, 1999). The authors broadly calculate CEO compensation as the sum of salary, bonus, benefits, stock options, restricted stock, and other compensation. This measure reflects the expected cost to shareholders of

granting equity and stock options. Granted stock options are valued using the Black Scholes model where the price of a European call option on a dividend paying stock is $C = Se^{-qt}N(d1) - Xe^{-rt}N(d2)$, where $d1 = (\ln(S/X) + (r-q+\sigma^2/2)t) / \sigma\sqrt{t}$, $d2 = d1 - \sigma\sqrt{t}$, and S is the stock price; X the exercise price; t the maturity term; r the risk-free interest rate; q the dividend yield and σ the volatility of returns. $N(.)$ is the cumulative probability distribution function for a standardized normal variable (Black and Scholes, 1973). The source of the U.S. pay data is the ExecuComp database and data for the U.K. firms is hand-collected from annual reports and accounts.

Conyon et al. (2009a) find the level of CEO pay is positively correlated with the presence of consultants (defined as 0-1 binary variable) in both the United States and the United Kingdom. They also find that the mix of CEO pay, defined as the fraction of equity pay in total CEO compensation, is positively correlated to consultants. The latter suggests that consultants provide client CEOs with greater pay-at-risk, an outcome that is presumably in shareholder interests as it represents greater pay-for-performance. The results have implications for the interpretation of the positive association between the level of CEO pay and consultants. Risk-averse CEOs whose contracts contain more risky pay (for example, more stock options or other equity pay) will need to be compensated with greater expected levels of pay (Conyon et al., 2009; Fernandes et al., 2009). The findings imply that the higher levels of CEO pay associated with the presence of consultants may well be part of an efficient contract and not due to upward pay pressures promulgated by conflicted consultants. Further evidence in favor of this interpretation is the fact that the authors can measure directly conflicted consultants by an indicator variable of whether the consultant also supplies other business to the client firm. The variable is insignificant in their estimated OLS models.

Conyon et al. (2009a) also investigate whether CEO pay is related to potentially conflicted consultants. This is measured as a binary variable ($= 1$) if the consultant

supplies other services to the firm. Firms are mandated to reveal this information in the report and accounts in the United Kingdom but not in the United States. Instead, for the United States, the authors use a dummy variable (= 1) if the firm uses consulting firm Pearl Meyer or Frederick W. Cook. This follows a strategy advocated by Cadman et al. (2009). Pearl Meyer and Frederick C. Cook do not provide other non-compensation services to clients and thus are less prone (relative to other consulting firms) to be potentially conflicted. Conyon et al. find no statistical relation between CEO pay in firms whose clients also supply other business.

Murphy and Sandino (2009) investigate the relation between CEO compensation and consultants in the United States and Canada. They focus explicitly on potentially conflicted consultants, rather than just the presence of a consultant. Murphy and Sandino (p. 30) find “marginally significant evidence in the U.S. that CEO pay is higher in firms where the consultants provide other services and that pay increases with the number of other services provided. Empirical analyses using data from Canada suggest that CEO pay is higher when the consultant provides other services, especially actuarial or benefits-administration services.”

Murphy and Sandino (2009) use a snapshot of U.S. data on 1,341 S&P 500, S&P MidCap 400, and SmallCap 600 firms. The sample is larger than that used by Conyon et al., (2009a) who focus instead on constituents of the S&P 500. Murphy and Sandino measure the potential conflict of interests faced by the compensation consultant in a two ways: whether the consultant offers a defined-benefit (DB) plan; or whether the consultant is also the actuary for the client firm. Using these measures, no statistical evidence exists of a positive correlation between potentially conflicted compensation consultants and CEO pay. Murphy and Sandino (p. 20) also investigate CEO pay in firms “whose compensation consultant provides other services to the company beyond (or in addition to) actuarial services, based on voluntary and self-reported disclosures by

companies.” In the United Kingdom, legal rules mandate this disclosure (DRR, 2002) but in the United States, the information is voluntary. Importantly, the authors find a significantly positive correlation between CEO pay and the variable “consultant provides other services.”

Murphy and Sandino (2009) also test the relation between CEO pay and potentially conflicted compensation consultants using data on 120 Canadian firms. They find that CEO pay is higher in firms whose consultants supply other business to the firm. Especially important is the explanatory variable “fee ratio,” defined as the fees paid for non-executive-compensation services divided by the fees paid for executive compensation services. The fee ratio variable arguably captures the degree of incentive distortion that a consultant faces. If zero, the consultant cares only about compensation consulting fee incomes. The greater the ratio, the more the consultant cares about non-compensation service fees. The coefficient on the “fee ratio” variable is positive and significant in the regression models. However, the authors note that outliers may drive this result because once they remove some extreme observations from their data, the significance of the finding erodes considerably. However, in principle the fee-ratio seems to be a good measure of the temptation faced by consultants to side with management. As yet, this ratio is generally unavailable to researchers in the United States or the United Kingdom.

Single Country Studies

Cadman et al. (2009) investigate whether U.S. compensation consultants’ potential cross-selling incentives are positively correlated with CEO pay in client firms. Specifically, they investigate 755 firms from the U.S. S&P 1500 for 2006. The sampling frame is akin to Murphy and Sandino (2009) and larger than that of Conyon et al. (2009a). Cadman et al. (p. 1) 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, [they] do not find evidence suggesting that potential conflicts of interest between the firm and its consultant are a primary driver of excessive CEO pay.” This finding is in accord with the results contained in Conyon et al. for the United States and the weakly significant U.S. results in Murphy and Sandino.

As with other U.S. studies, Cadman et al. (2009) find that consultants are ubiquitous (only about 14 percent of firms do not retain a consultant). Cadman et al. (p. 2) define potentially conflicted consultants as: “(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.” There is little evidence that CEO pay is correlated with these different measures of conflict of interest. An important feature of the study is the recognition that the selection of the consultant is endogenous. The authors estimated a two-stage least squares (2SLS) regression, but the main results of the effect of consultants on CEO pay remained qualitatively unaltered.

Armstrong et al. (2008) investigate the relation between CEO pay and the use of compensation consultants in a sample of 2,116 U.S. firms in fiscal year 2006. The firms are effectively the constituents of the Russell 3000 and this sample is substantially larger than other U.S. studies. The authors define a binary variable (1 = yes, 0 = no) where the firm uses a compensation consultant for strategic compensation advice as opposed to no consultant or simple pay benchmarking.

Armstrong et al. (2008, p.1) find that “CEO pay is generally higher in clients of most consulting firms, even after controlling for economic determinants of

compensation.” About 87 percent of participants in their sample uses pay-consultants. An important feature of their analysis is the propensity score matching methodology. This permits the authors to create statistically equivalent distributions for the users of consultants (the treatment group) and non-users of consultants (the control group) based on a broad set of covariates (except CEO pay). This approach is compelling because it helps correct for the endogenous nature of the treatment variable in non-random data. In the empirical results, Armstrong et al. (p.1) find that 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.” The authors investigate CEO pay in client firms across the different consultants. As with Cadman et al. (2009), Armstrong et al. find little support for the hypothesis that CEO pay is higher in firms using “conflicted” consultants who also offer additional non-compensation related services (i.e., are not Pearl Meyer or Frederick W. Cook).

For U.K. firms, Kabir and Minhat (2009) and Minhat (2009) investigate the effect of pay consultants on executive pay using a sample of 175 companies for the period 2003-2006 (700 firm-year observations). Kabir and Minhat (p. 1) find “no support for the hypothesis that CEO pay is higher when firms employ multiple compensation consultants. Instead, [their] results show that the market share of compensation consultants is significantly related to CEO compensation.” The authors interpret their finding as consistent with the idea that consultants do not want to lose business with client firms.

In Kabir and Minhat (2009), the primary measure of compensation consultant influence is the count of the number of consultants used by a firm. They measure executive compensation as total pay. Using OLS and panel data (random effects)

methods, the authors find no statistical relation between CEO pay and the number of consultants used. On the other hand, a statistically positive correlation exists between CEO pay and the firm's market share. The panel data methodology used in the study is attractive because such data methods attenuate persistent firm effects, capturing them in the error structure of the estimating equation. However, the study does not attempt to control for potentially conflicted consultants by investigating whether the CEO hired them or if the consultants provide any other non-compensation services.

Voulgaris et al. (2009) investigate the relation between CEO pay and compensation consultants in a cross section of 2006 data. The sample consists of 500 U.K. firms from the FTSE 100, 250, and Small Cap indices. Similar to other studies, the authors measure CEO pay as the sum of salaries, bonuses, long-term incentives, and stock option grants, where stock options are valued using the Black-Scholes method. Overall, they find that 134 firms (about 27 percent) do not have consultants, but larger and more complex firms are more likely to use consultants than smaller ones. Conyon et al. (2009b) also find a positive correlation between use of consultants and firm size in a regression model.

Voulgaris et al. (2009) find a positive correlation between CEO pay and the presence of a compensation consultant, which is consistent with the hypothesis that consultants raise pay. However, they also find that the ratio of equity pay to total pay is higher in firms using consultants and the ratio of salary to total pay is lower. This finding suggests that consultants not only raise the level of pay but also design contracts that contain more risk (equity pay) and less insurance (salary pay), consistent with shareholder goals. This result is consistent with Conyon et al. (2009a) who find a positive correlation between the equity pay mix and consultants in U.S. and U.K. firms. Another attractive feature of the Voulgaris et al. study is that it controls for the endogenous nature of the pay consultants. They re-estimate their CEO pay models

using 2SLS where the first stage is a probit selection model on the use of consultants. Importantly, they find that CEO pay is still greater, the salary pay mix is lower, and the equity pay mix higher in firms using a consultant. .

Conyon et al. (2009b) investigate the relation between CEO pay and consultants in a set of 232 large U.K. firms in 2003. The authors discover a positive correlation between CEO pay and conflicted compensation consultants, measured as the consulting firm selling other business to the client firm. The result is marginally significant. In addition, they find that CEO pay is positively correlated with CEO pay in peer firms who used the same consultant as the focal firm. They also find the level of CEO compensation in the focal firm is positively related to the number of board interlocks created by both a shared director and a shared compensation consultant. As with Voulgaris et al. (2009) in the United Kingdom and Cadman et al. (2009) in the United States, Conyon et al. also model the selection of the compensation consultant. They find that firm size is a significant predictor variable of using a compensation consultant.

Bender (2008) provides a qualitative account of compensation consultants in the United Kingdom rather than using quantitative methods. She analyzes 12 (anonymous) companies from the U.K. FTSE 350 covering 40 individual and group interviews between 2001 and 2003. The author interviews CEOs, remuneration committee chairs, and five consultants advising those companies. Although firms choose consultants for their expertise, Bender (p.11) finds that “There was no common thread to how the consultants had been engaged, other than the fact that the consultants’ reputation was very important, and personal recommendations, for example from a board member who had worked with them before, were an advantage.” Bender (p. 23) also reports that pay consultants themselves do recognize the potential for conflicts of interest: “... yes you [the consultants] do come across difficulties between the execs who have appointed you or the remuneration committee who have appointed you. And that’s when you’ve got to

know who appointed you. Because at the end of the day if there is a conflict, you've got to go back to the people who appointed you and say look I cannot advise both of you." However, it seems apparent that all parties (i.e. consultants and firms) tend to recognize this conflict and take steps to ameliorate it so as not to harm owner interests. In a similar vein, Murphy and Sandino (2009) report that pay consulting firms address their internal governance structures to avoid conflicts of interest by building formal divisions between different parts of the overall business.

Related Studies

Related studies have also remarked on the importance compensation consultants (Baker et al., 1988). An early study by Tosi and Gomez-Mejia (1989) find that consultants are important for determining CEO pay. They base their analysis on survey data. Wade et al. (1997) theorize that companies use consultants to justify and legitimize executive pay practices. They find that firms who pay their CEOs high salaries are more likely to explain this by reference to a compensation consultant in proxy statements. Faulkender and Yang (2008) study how peer group comparisons affect CEO pay. They find evidence that consultants can influence the choice of peer firms used in the benchmarking of CEO pay.

CONSULTANTS AND CEO PAY: U.K. EVIDENCE

This section provides new evidence on the relation between CEO pay and compensation consultants using U.K. data found in (Canyon et al., (2009a). The main results are based on OLS estimates. Using insights from the prior literature, the author estimates the relation between CEO pay and the compensation consultant by estimating a fairly standard CEO pay equation. Table 15.2 contains the results. Columns 1 to 3 are based on measuring consultant use (1 = yes, 0 = no). Columns 3 to 6 are conditional on the firm using at least one consultant. These columns measure 'conflicted' compensation

consultants as either the consultant supplying other business to the client firm (1 = yes, 0 = no) or whether the compensation committee appoints the compensation consultant (1 = yes, 0 = no. This an inverse measure of conflict).

CEO compensation is calculated as the sum of salary, bonus, benefits, stock options (using the Black-Scholes formula), restricted stock, and other compensation. The regression models contain economic and human capital control variables including the size of the firm (the log of firm sales), reflecting the returns to organizational complexity (Core, Holthausen, and Larcker, 1999; Murphy, 1985, 1999). The model includes company performance, reflecting the potential alignment of owner and manager interests (Core et al., 1999; Murphy, 1985, 1999) measured as total returns to shareholders (share price appreciation plus dividends). The book-to-market ratio is included as an (inverse) measure of growth opportunities within the firm (Core et al., 1999). The model contains a measure of stock volatility, measured as the standard deviation of annualized monthly stock returns over the prior calendar year to capture the idea that risk-averse executives require greater compensation in more risky corporate environments. The model includes human capital variables CEO tenure and CEO age to reflect the CEO's skill and experience. Finally, a set of industry indicator variables is included as controls for inter-industry variation in the demand for executive talent (Core et al., 1999).

Columns 1 to 3 demonstrate a positive correlation between CEO total pay (including bonuses and options) and the use of consultants. CEO salary is also positively correlated with the presence of a consultant. In addition, CEO equity pay mix (the amount of options and other equity expressed as a fraction of total pay) is greater in firms that use consultants. These results control for other economic determinants such as growth opportunities (book-to-market ratio), firm performance (shareholder returns), firm risk (stock price volatility), and demographic characteristics (CEO job tenure and

age), and are in agreement with other work (Canyon et al., 2009a; Voulgaris et al., 2009). The coefficient estimates are all significant. Adjusted standard errors are reported based on clustering on the consulting firm because different consulting firms may offer different pay strategies and advice. For example, column 1 suggests that total CEO pay is approximately 26 percent higher in firms using consultants (calculated as $e^{0.23} - 1$). Similarly, CEO equity pay mix is about 14 percent higher in such firms. In columns 3 to 6, there is marginal evidence that CEO pay is higher in firms whose consultants supply other business. CEO salary is estimated to be about 7 percent higher in such firms (conditional on having hired a consultant). Although the coefficient estimates of the consultant effect on total CEO pay and the equity pay mix are positive, they are not significant. However, the insignificance may be due to the small sample size so the sign of the coefficient is of interest.

(Insert Table 15.2 about here)

One issue to note when interpreting such results is how the disclosure of information about consultants affected the dynamic estimation between CEO pay and measures of (conflicted) consultants. Typically, researchers estimate reduced form econometric models using observed data rather than the underlying (true) parameters from a theoretical or structural equation. These estimates of the CEO pay and consultant relation could possibly have changed when the disclosure policy changed. For example, in the pre-disclosure period, there might have been a positive correlation between CEO pay and consultants but the data was not publicly observable to the econometrician. However, when the policy changed, so that more information was disclosed, this may have modified agent behavior. For example, the previously conflicted pay consultants decided no longer to recommend lavish CEO pay. In consequence, the relation between CEO pay and consultant altered. This suggests that policy decisions based on reduced-

form models could be misleading. These type of policy issues are discussed by Lucas (1976).

In addition to the OLS results contained in Table 15.2, the author also carried out some sensitivity analysis using propensity score matching methods to investigate the relation between CEO pay and consultants (as in Armstrong et al., 2008). In principle, propensity score matching can alleviate selection biases arising from the non-random assignment of data (Rosenbaum and Rubin 1983; Heckman, Ichimura, and Todd, 1997, 1998; Rubin 2006). Propensity score does so by optimally matching firms that use consultants (the treatment condition) to firms that do not use consultants (the control condition). Using a nearest neighbor algorithm (Leuven and Sianesi 2003), a matched sample of firms was constructed between firms that use consultants (treatment) and those firms not using consultants (control). The results indicated that CEO pay in firms using consultants is no different from firms not using consultants. In addition, CEO pay was not higher in firms using potentially conflicted consultants (i.e., those firms where the consultant supplied other business) compared to client firms using independent consultants. This illustrates that studies based on OLS methods alone might result in false inference if the characteristics of the two distributions (consultant versus no-consultant) are different. Propensity score methods can help considerably when using such non-experimental data (Armstrong et al., 2008).

SUMMARY AND CONCLUSIONS

Changes in disclosure rules in the United States, the United Kingdom, and Canada have led to more available information about pay consultants for investors and researchers (Waxnan, 2007; Armstrong et al., 2008; Cadman et al., 2009; Conyon et al. 2009a; Murphy and Sandino, 2009). However, nuances exist in the information reported across countries. For example, in the U.S., firms reveal the name of the consultant. In

the U.K., firms are also mandated to reveal whether the consultant supplies any other business. In Canada, although not mandated, firms may reveal fee incomes from non-compensation services as well as fees received from executive pay advice. Such enhanced disclosure provides traction on whether the consultant is subject to a potential conflict of interest. Overall, there is much more available information about pay consultants today than ten years ago, but more low-cost transparency might be welcome.

A review of the existing evidence shows mixed findings of the effects of consultants on CEO pay. In general, there is a positive correlation between the level of CEO pay and the presence of consultants: firms that use consultants pay their CEOs more. Interpreting this result is problematic not least because CEOs of firms using consultants may have more pay at risk in the form of options or restricted stock. If so, higher levels of CEO pay in firms using consultants might simply reflect a risk-premium rather than a failure of compensation consultants to recommend contracts that are in the best interests of shareholders. It is therefore difficult to interpret a positive correlation between CEO pay and the presence of a consultant as being necessarily bad for owners' interests.

A better approach is to measure directly whether the consultant has a potential conflict of interest, for example by selling other services to the client firm or receiving high level of fees for such services relative to income from executive pay advice. Many studies use this strategy including Cadman et al. (2009), Conyon et al. (2009a, 2009b), and Murphy and Sandino (2009). The current evidence has produced mixed evidence in support of the hypothesis that conflicted consultants lead to higher CEO pay. Murphy and Sandino find some evidence that conflicted consultants are associated with higher CEO pay in client firms in the U.S. For Canada, they find stronger evidence that CEO compensation is higher in firms with conflicted consultants, especially for actuarial and

benefits administration services. Conyon et al. (2009a) and Cadman et al. find little evidence of a relation between CEO pay and conflicted consultants measured inversely by whether the firm uses Frederick W. Cook or Pearl Meyer. In U.K. firms, studies find that CEO pay is greater in firms with consultants but weaker evidence that CEO pay is higher in firms with conflicted consultants such as cross selling other services (Conyon et al., 2009a, 2009b; Kabir and Minhat, 2009; Voulgaris et al., 2009). The existing empirical evidence, then, does not universally support the hypothesis that conflicted consultants lead to higher CEO pay.

In summary, CEO pay is an important tool for aligning management and shareholder interests (Murphy, 1999). Recently, researchers have hypothesized that pay consultants face conflicts of interest that lead to excessive CEO pay and poorly structured pay contracts. Studies are emerging to test this claim, but the available empirical evidence is not wholly supportive. An expanded set of studies is warranted to further test how pay consultants influence executive compensation.

DISCUSSION QUESTIONS

1. Why do firms use compensation consultants?
2. What are the main characteristics of the market for executive compensation consulting services?
3. Are compensation consultants sufficiently independent?
4. Does the current empirical evidence show that consultants lead to excess CEO pay and/or poorly designed pay packages?
5. How should governments and policy makers respond to the fact that compensation consultants have potential conflicts of interest?

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Table 15.1 Executive Compensation Consultants

This table shows the major compensation consultants used by firms in the United States, United Kingdom, and Canada. The analysis is based on data from previous studies.

	United States		United Kingdom		Canada	
	#	%	#	%	#	%
Panel A. Major consultants						
Towers Perrin	95	23.8	68	29.4	45	36
Mercer Consulting	84	21.0	26	11.3	53	42
Frederic W. Cook & Co.	77	19.3	n/a	n/a	5	4
Hewitt Associates	66	16.5	13	5.6	9	7
Watson Wyatt Worldwide	31	7.8	30	13.0	6	5
Pearl Meyer	22	5.5	n/a	n/a	n/a	n/a
PricewaterhouseCoopers Monks	n/a	n/a	37	16.0	n/a	n/a
New Bridge Street Consultants	n/a	n/a	62	26.8	n/a	n/a
Panel B. Consultant use						
No consultant used	125	14.2 ^c	26	11.2 ^e	41	20.5 ^f
Two or more consultants used	181	17.0 ^d	95	40.9 ^e	n/a	n/a
Panel C. Potential conflicts						
Consultant supplies other business to client firm	113	63.1 ^g	106	45.9 ^h	156	46.2 ⁱ
Compensation committee retains consultant ^j	n/a	n/a	125	54.2	n/a	n/a
Ratio of fees for other services to fees for executive pay advice	n/a	11 ^g	n/a	n/a ^h	n/a	13.4 ⁱ

Notes: # = number; % = percentage.

a Based on Conyon et al. (2009a, p. 49, Table 1) using a sample of 400 U.S. firms and 231 U.K. firms.

b Based on Murphy and Sandino (2009, p. 42, Table 8, Panel B) using a sample of 200 Canadian firms.

c Based on Cadman et al. (2009, p. 29, Table 1) using a sample of 880 U.S. firms..

d Based on Murphy and Sandino (2009, p. 8) using a sample of 1046 U.S. firms.

e Based on Conyon et al. (2009c, p. 36) using a sample of 232 U.K. firms.

f Based on Murphy and Sandino (2009, p. 26) using a sample of 200 Canadian firms.

g Based on Waxman (2007) using 2006 data on 179 firms from the Fortune 250 (information not available publicly). Murphy and Sandino (p. 27) report 11.7 percent.

h Based on Conyon et al. (2009b) using 231 U.K. firms.

i Based on Murphy and Sandino (2009, p. 27-28).

j This is an inverse measure of potential conflict.

Table 15.2 Consultants and CEO Pay: U.K. Regression Results

This table provides OLS estimates of the relation between CEO pay and compensation consultants in the United Kingdom. The analysis uses data from large publicly-traded firms in the United Kingdom in 2003.

Variables	(1) Log CEO Total Pay	(2) Log CEO Salary	(3) Equity Pay mix	(4) Log CEO Total Pay	(5) Log CEO Salary	(6) Equity Pay mix
Consultant	0.23** (0.07)	0.08** (0.03)	0.13*** (0.02)			
Consultant supplies other business				0.10 (0.09)	0.07* (0.03)	0.01 (0.03)
Compensation committee appoints consultant				0.08 (0.10)	0.05 (0.05)	0.04 (0.02)
Log sales	0.26*** (0.04)	0.18*** (0.01)	0.02 (0.01)	0.24*** (0.04)	0.18*** (0.02)	0.02 (0.01)
Book to market	-0.45** (0.13)	-0.27* (0.11)	-0.04 (0.05)	-0.45** (0.13)	-0.30** (0.12)	-0.04 (0.06)
Shareholder returns	0.00 (0.00)	0.00 (0.00)	-0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	-0.00 (0.00)
Volatility	0.10 (0.18)	-0.09 (0.13)	0.08 (0.07)	-0.04 (0.08)	-0.15 (0.11)	0.02 (0.06)
Job tenure	-0.00** (0.00)	0.01* (0.00)	-0.01*** (0.00)	-0.00 (0.00)	0.00 (0.00)	-0.01** (0.00)
CEO age	0.00 (0.01)	0.01* (0.00)	-0.00 (0.00)	0.01 (0.00)	0.01** (0.00)	-0.00 (0.00)
Constant	5.15*** (0.22)	4.31*** (0.26)	0.30** (0.10)	5.25*** (0.19)	4.28*** (0.28)	0.44*** (0.09)
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes
Observations	229	229	229	209	209	209
R-squared	0.325	0.501	0.138	0.318	0.520	0.088

Notes: The sample consists of 229 U.K. firms in 2003. CEO pay is the sum of salary, bonus, Black-Scholes value of stock option grants, restricted stock grants, and other pay. Equity pay mix is equity pay (the value of options and restricted stock) divided by CEO pay. Consultant is an indicator variable equal to 1 if the firm has a consultant and 0 otherwise. *Consultant supplies other business*, and *compensation committee appoints the consultant* are also indicator variables. *Consultant supplies other business* is an indicator variable equal to 1 if consultant provides services other than remuneration advice to the focal firm. *Log sales* is the log of firm sales revenues. *Book to market* is the book value of assets divided by the market value of the company. *Shareholder returns* are stock price appreciation plus dividends over three years. *Volatility* is the annualized

standard deviation in stock prices. *Job tenure* is executive time in office (years). *CEO age* is the executives' age (years). Robust standard errors in parentheses: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.