# Extreme CEO Payoffs: When Shareholders Lose

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Consulting firms that advise corporate boards about pay packages for chief executives have been squirming a bit lately.

A new study from Congress cites "widespread" conflicts of interest among such firms, which could be driving up CEO pay at the expense of investors. Growing evidence shows that lavish CEO salaries and bonuses just don't translate into greater profits for shareholders.

In fact, boards that rely on compensation consultants tend to pay their CEOs above the median level of their peer groups. Yet no significant relationship exists between the use of such consultants and stock performance, says a recent study by the Corporate Library.

"In fact, we found an inverse relationship in which companies that did not use compensation consultants actually performed better than those that did," said Alexandra Higgins, who wrote the study.

The Corporate Library is an independent governance research firm. For the study, it reviewed annual financial filings for nearly half of the Russell 3000 stock index from last year. The Securities and Exchange Commission required boards to disclose their use of compensation consultants in late 2006.

Some of the top compensation consultants include Towers Perrin, Hewitt Associates (NYSE:HEW) and Mercer Human Resource Consulting.

A congressional panel is mulling new rules that would force public companies to disclose all of the HR services they buy from such firms. Those disclosures would make investors aware of possible conflicts in extravagant CEO pay, says Meredith Miller, an assistant treasurer for the state of Connecticut.

Miller testified before a hearing of the House Committee on Oversight and Government Reform on Dec. 5.

Lighting Dark Corners

Nearly half of the 250 largest U.S. companies rely on compensation consultants that also provide other services to those same companies, according to a study issued by the oversight committee, chaired by Rep. Henry Waxman, D-Calif. At the very least, such relationships cast an appearance of undue back-scratching, Miller says.

"The basic conflict involves the compensation consultant doing work for both the compensation committee and the management of the company," she said. "This conflict is important, because the compensation committee should be getting unbiased, independent advice."

In her testimony on Capitol Hill, Miller urged the SEC to require in-depth disclosures of all the business relationships that companies have with outside advisers. Some observers expect the House panel to push the SEC for such a disclosure rule.

"Without this information," said Miller, "investors cannot hold compensation committees accountable for the management of potential conflicts of interest, regardless of whether those conflicts are actual or perceived."

Some HR consulting firms promote hefty salaries to lure top CEOs. Others base their pay packages on fat bonuses and lucrative stock options. Yet, in both cases, data show that costly consulting advice doesn't yield any payoff for shareholders.

"Our analysis showed no correlation between the use of compensation consultants and total shareholder return," said Higgins, the author of the Corporate Library study.

Actually, companies that used compensation consultants had an average one-year return of 20.9%, vs. 22.9% for those without consultants. A review of the stock performance over a longer stretch of time -- three years or more -- would be "highly unlikely" to change the outcome, says Higgins.

The best HR consulting firms have taken internal steps to address any conflicts without the need for a government mandate, says Donald Lowman, a managing director for Towers Perrin. Lowman defended his industry before the House panel:

"We do not believe that the delivery of sound, objective and conflict-free advice on executive compensation requires a particular corporate structure or a regulatory limitation on the types of engagement a consulting firm may pursue."

In an interview, Lowman said that HR consultants help boards understand CEO pay scales and other relevant trends in their markets. He says that forcing the disclosure of fees for other services wouldn't give investors any context about the actual work.

"My point 19 we've got protocols in place that enable us and our partners to handle those conflicts," he said.

Stealth Alliance?

Still, compensation consultants have "strong incentives to use their discretion to benefit the CEO," according to a 2003 study by Lucian Bebchuk of Harvard University and Jesse Fried of the University of California at Berkeley.

"Providing advice that hurts the CEO's pocketbook is hardly a way to enhance the consultant's chances of being hired in the future," wrote the professors. "Moreover, consulting firms often have other, larger assignments with the hiring company, which further increases their incentive to please the CEO."

For this reason, the Conference Board has found that compensation committees which use outside consultants can best meet their fiduciary duties by insisting that salary consultants do no other work for the management team.

Mercer addresses this concern by regularly updating its business standards to manage potential conflicts of interest, says Charlie Scott, president of Mercer's human capital consulting business.

But if such standards were so foolproof, there would be no harm in disclosing the related consulting fees, says Charles Elson, head of the Weinberg Center for Corporate Governance at the University of Delaware.

The only real way to solve excess compensation is to make boards operate independent of management, especially when negotiating CEO pay, says Elson.

If outside advisers are consulted about compensation, they should not be allowed to serve the management team, Elson told the House members.

"Directors who negotiate pay," said Elson, "must receive completely unfettered and objective advice from outsiders solely responsible to the committee and full board, uncompromised by managerial relationships."

Even the appearance of wrongdoing can harm investor confidence. That, in turn, may lower a stock's value, Elson said in an interview.

"There is a valid concern that payment for other work can compromise the objectivity of a consultant's advice on CEO compensation," he said.