****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Do not quote without permission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 23, 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 consulting firm also serves as the company's actuary or provides benefits-administration services, and that CEO 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, 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 information on industry and market pay practices. In addition, consultants are routinely asked to sanctify existing compensation arrangements and to give general guidance on 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 providing other services than they were paid for providing executive

[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."

> 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. 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 higher pay when their consultants also provide actuarial services. In addition, we find some evidence that CEO pay is higher in US firms where the executive compensation consultant provides other uncommon services unrelated to compensation, and find some evidence in Canada that CEO pay is 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 *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 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

[5] This highly significant result, while intriguing, becomes only marginally significant after eliminating one outlier observation.

[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.

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, 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

---

[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).

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 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

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

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.

2. The Structure of the US Compensation Consulting Industry

The Securities and Exchange Commission (SEC) disclosure rules for executive compensation effective for publicly traded corporations with fiscal closings after December 15, 2006 requires corporations to disclose:

> "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."[11]

Taking advantage of this change in disclosure rules, we collected information from the proxy statements of 1341 firms, representing all firms filing under the new rules and included in the October 2007 release of Compustat's ExecuComp Database. These include 408 firms from the S&P 500, 291 firms from the S&P MidCap 400, 382 firms from the S&P SmallCap 600, and 260 additional firms. From the proxy statements, we identified every consultant recommending executive pay in each firm, and coded information regarding the consultant's assignment and whether the consultant was engaged by (or worked for) the compensation committee, management or both.

We find that 78% (1046) of the firms for which we collected information retained a consultant to advise on executive pay in the first year when the disclosure rules were in place, and another 9.2% (123 firms) relied on purchased compensation surveys (often prepared by consulting firms).[12] We focus our analyses on the 1046 firms that established a relationship with a consultant.

Of our 1046 sample firms, 17% (181 firms) used two or more consultants for executive pay issues. The compensation consulting industry is relatively fragmented; our 1046 sample firms reported working with 91 different consulting firms. However, the industry is dominated by six major consulting firms – Towers Perrin, Mercer Human Resource Consulting, Hewitt Associates, Frederic W. Cook & Co., Watson Wyatt Worldwide, and Pearl Meyer & Partners – who collectively serve 801 of the 1046 firms (76%) in our sample

[11] Title 17, Section 229, Item 407(e)(3)(iii). The rules can be found at the following electronic website: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=%2Findex.tpl

[12] In a small number of cases, the company stated that they did not use a consultant in the first year of disclosure but did identify consultants used in earlier years. We recorded information for the consultants used in earlier years, as long as they were hired within the previous three years.

(see Figure 1).[13] Of these six, Towers Perrin, Mercer, Hewitt, and Watson Wyatt are large integrated corporations with offices in most major U.S. and international cities offering a full-range of compensation, benefits, and actuarial services.[14] Pearl Meyer & Partners, located in seven offices in the U.S., offers executive, director and employee pay consulting services,[15] while Frederic W. Cook, located in five offices in the U.S. offers executive and director pay consulting services.[16]

Figure 1 shows the composition and level of pay for the median CEO in our 1046 sample firms, grouped by compensation consultant. The figure shows the median total expected pay associated with each of the six primary consulting firms (along with a seventh category consisting of all other consultants). Total expected compensation (indicated by bar height) is defined as the sum of salaries, non-equity incentives, stock & options and other pay. The non-equity incentives are evaluated at the target level of payout (or, at an estimated target level calculated as the average of the minimum and maximum payout if the target is not reported) and include realized payouts from discretionary bonuses. Stock options and stock awards are evaluated at grant-date using their company-estimated present value (typically Black-Scholes calculations for options and the grant-date market price for stock). Other compensation includes perquisites, signing bonuses, termination payments, and above-market interest paid on deferred compensation.

As evident from Figure 1 the median pay varies substantially by consultant: the median CEO client of Frederic Cook, for example, earned $5.7 million, over 70% more than the pay of the median CEO client of Pearl Meyer. Another feature of Figure 1 is that companies rely more or less on incentive-based pay depending on the consultant they seek advice from. For example, the use of equity-based pay is particularly high among clients of Frederic Cook, where 52% of pay is comprised of restricted stock and options.

One of the best-documented facts about CEO pay is that pay increases with company size. Indeed, the findings in Figure 1 are largely driven by the fact that the choice of consultants varies with company size. Among the primary consulting firms, Frederic Cook

[13] The percentage of our sample that uses at least one of the six major consulting firms is less than the percentage implied by adding up the percentages in Figure 1 because many companies use multiple consultants.

[14] Towers Perrin has 91 offices in 25 countries (including 37 offices in the US); Mercer (which is an operating unit of insurance giant Marsh & McLennan Companies) has 180 offices in 41 countries (including 72 offices in the US); Watson Wyatt has 101 offices in 32 countries (including 34 offices in the US); and Hewitt has 111 offices in 37 countries (including 31 offices in the US).

[15] During 2006, Pearl Meyer & Partners (not to be confused with its founding partner, Pearl Meyer, currently with Steven Hall & Partners) was an operating unit of Clark Consulting, a diversified benefits firm specializing in corporate-owned life-insurance and other benefit programs. In 2007, in connection with Aegon's purchase of most of Clark's assets, Pearl Meyer & Partners became part of Clark & Wamberg, LLC.

[16] Although based only in the US, Frederic Cook & Company was closely affiliated with UK-based New Bridge Street Consultants until Hewitt acquired New Bridge in March 2008.

serves the largest clients (the median revenues for Cook's 143 clients in our sample is $4.03 billion; the median revenues for clients of Hewitt, Mercer, Towers Perrin, Watson Wyatt, and Pearl Meyer are $3.98 billion, $2.95 billion, $2.85 billion, $2.43 billion, and $1.53 billion, respectively).

3. Conflicted Consultants and CEO Pay: Evidence from US Firms

In Section 2 we described the nature of the compensation consulting business and documented that the levels of CEO pay vary for firms using different compensation consultants. In this section we examine whether CEO pay is higher when the consultant engaged by the firm has inherent conflicts of interest. Section 3.1 starts by describing the two primary sources of conflicts of interest to which consultants are exposed: "other services" and "repeat business." In section 3.2 we test the "other services" effect by examining whether CEO pay is higher in firms where the compensation consultant carries out other work for management beyond executive compensation consulting (e.g., actuarial, benefits administration, or rank-and-file employee pay consulting services). In section 3.3 we test the "repeat business" effect (i.e., the consultants' concern with being reappointed) by examining whether CEO pay is lower in companies where the compensation consultant works exclusively for the board rather than for top management.

3.1. Conflicts of Interest among Compensation Consultants

Compensation consultants play a legitimate, and indeed often critical, role in corporate governance. Compensation committees, who are charged with setting pay levels and designing incentive plans for the CEO and other top-level executives, lack the time, expertise, and staff necessary to fulfill their duty without relying on outside help. Compensation committees rely on consultants for recommendations on plans that attract, retain, and motivate managerial talent. Committees rely on consultants to help them understand the value of compensation packages that may include stock options or complex payoff structures. In addition, committees rely on consultant expertise to inform them about changes in the managerial labor market (including pay in similarly situated companies), evolving so-called "best practices" in pay design and an increasingly intricate and frequently changing regulatory environment affecting executive pay, including accounting rules, tax laws and disclosure requirements.

Although most academics and practitioners recognize that consultants can contribute to improving the executive compensation process, perceived abuses in executive pay have

raised suspicions about the role played by executive compensation consultants.[17] These suspicions arise because compensation consultants are unlikely to be truly independent from the CEOs who are the subjects of their pay recommendations since the consultants will naturally seek to provide additional engagements in the form of non-executive-pay services ("other work") or future consulting assignments ("repeat business"). As noted by pay critic Graef Crystal, "this is not to suggest that a firm like Towers Perrin, or indeed any other consulting firm, will make recommendations in which it does not believe simply to keep some additional client business. But, the pressure to do just that is always present."[18]

There are several ways in which consultants can purposely or inadvertently inflate executive pay. For example, consultants can justify high levels of compensation by benchmarking their client companies against groups of "peer firms" that offer generous pay to their CEOs and executives,[19] or by recommending pay levels at or above (but never below) the peer-group median.[20] High pay can also be camouflaged through stock and option awards, low performance hurdles on accounting-based plans, and generous deferred compensation and pension arrangements that are not fully disclosed to (or the cost of which is not fully understood by) shareholders.[21] In addition, senior executives can insist on screening various incentive design alternatives offered by the consultant before presenting a final proposal to the compensation committee, which also biases plans in favor of the executives.

---

[17] Some observers believe an increase in stock option grants during the 1990s provided incentives leading to the accounting scandals in the early 2000s. Consistent with this belief, several studies provide evidence that the use (or misuse) of stock options was linked to earnings management (Bartov and Mohanram 2004; Bergstresser and Philippon 2006) and accounting restatements (Burns and Kedia 2006; Efendi, Srivastava, and Swanson 2007). Outrage over perceived excesses in executive pay intensified after academic research and subsequent *Wall Street Journal* investigations unearthed the practice of "option backdating" in which companies deliberately falsified stock option agreements so that options granted on one date were reported as if granted on an earlier date when the stock price was unusually low (Lie 2005; Heron and Lie 2006; Maremont 2005).

[18] Crystal (1991), p. 219-220. Crystal speaks from experience: before becoming an outspoken critic of executive pay, he spent decades building Tower Perrin's executive pay practice.

[19] Porac, Wade and Pollock (1999) examine how companies define their peer groups and find that firms expand industry boundaries to include companies with high levels of CEO pay. Similarly, Faulkender and Yang (2008) find that firms forego potential peers whenever they provide lower compensation to their CEOs, especially in cases where the firms have weak governance. Practitioners have expressed concerns related to this matter. In its 2006 annual letter to Berkshire Hathaway's shareholders (http://www.berkshirehathaway.com/letters/2006ltr.pdf), Warren Buffett argued that: "Irrational and excessive comp practices will not be materially changed by disclosure or by 'independent' comp committee members (…) The consultants' present drill of deftly selecting 'peer' companies to compare with their clients will only perpetuate present excesses."

[20] Bizjak, Lemmon and Naveen (2007) find that the "vast majority of firms that use peer groups set pay levels at or about the 50th percentile of the peer group, although a number of firms seek pay levels well above the peer-group median."

[21] For arguments Bebchuk, Lucian, Jesse Fried, and David Walker, 2002, "Managerial Power and Rent Extraction in the Design of Executive Compensation," *University of Chicago Law Review* 69, 751-761.

The inherent biases for consultants to favor executives are undoubtedly mitigated by the consulting firms' concerns about their own reputation. The testimonies of senior consultants in the Waxman Congressional Hearings, coupled with our own interviews described in the introduction, suggest the consulting firms have recently adopted business standards aimed at enhancing the independence of their advice. For example, executive pay consultants are increasingly hired by the board rather than by management; individuals providing executive pay consulting operate in a separate unit and are not compensated for selling other services; independent peer reviews have been implemented; and codes of business conduct have been revised. The fact that companies are now required to disclose the identities of their consultants naturally subjects the consultants to more scrutiny and increases the reputational consequences of bad pay recommendations. We predict that scrutiny on pay consultants and the accompanying reputational consequences will further intensify with the expected passage of proposed legislation giving shareholders a "vote" on executive compensation.[22] In addition, we expect that the new disclosure rules will increase the prevalence of consulting companies being named as defendants in lawsuits over excessive executive pay and identified by the media when discussing perceived abuses in pay for particular executives. For example, consultant Lyons Berenson & Co. was named as a defendant in a recent lawsuit related to option backdating at Cablevision, which included an award of backdated options to its vice chairman after his death in 1999.[23] And, a Towers Perrin consultant hired by management was implicated for recommending a generous compensation contract for Countrywide's CEO, after two other pay consultants hired by the compensation committee (Pearl Meyer & Partners and Exequity) had been fired after recommending pay cuts.[24]

Although most compensation consultants face at least some pressure to favor incumbent executives when making pay recommendations, the inherent conflicts of interest vary across consultants and their clients. Table 1 provides a description of our proxies for

---

[22] The "Shareholder Vote on Executive Compensation Act" (H.R. 1257) was approved by the House of Representatives on April 20, 2007, and is pending the approval of the Senate and the President to take effect in 2009. The bill, introduced in the Senate by then-Senator Obama, proposes that public companies provide shareholders with "an annual nonbinding advisory vote on their company's executive compensation plans," and "an additional nonbinding advisory vote if the company awards a new golden parachute package while simultaneously negotiating the purchase or sale of the company." Although these votes are advisory in nature, negative votes can be relevant to the companies. Recent research has suggested compensation-related advisory votes supported by a majority of shareholders tend to affect financial reporting and compensation decisions made by the companies (e.g. Ferri and Sandino 2009; Ertimur, Ferri and Stubben 2008).

[23] Peter Grant, James Bandler and Charles Forelle. 2006. "Cablevision Gave Backdated Grant To Dead Official," *Wall Street Journal*, Sept. 22, p. A1; and Kaja Whitehouse. 2006. "Pay Advisors Seek Shelter From Suits," *Wall Street Journal*, Dec. 13.

[24] James R. Hagerty and JoAnn Lublin, "House Report Says Countrywide's Mozilo Resisted Pay Cuts," *Wall Street Journal*, March 7, 2008, p. A11..

potential conflicts of interests faced by the consultants working for the 1046 firms that identified at least one compensation consultant that the company retained in the first year when the disclosure of the compensation consultant became mandatory. The statistics in the table are based on 1270 observations (or one observation for each consultant identified by the 1046 firms). A more refined understanding of the sources of conflict allows us to investigate their effect (and the potential effect of these proxies) in greater depth. Consultants face two types of conflicts of interest that may compromise their judgment in recommending executive pay: the consultants' objective to cross-sell "other services" to the firm and their determination to get "repeat business."

Other Services (Actuarial Services)

The first source of conflict arises when the compensation consultants provide services to their client firms in addition to giving advice on executive compensation. These other services, which include actuarial services, management of employee benefits, and rank-and-file employee compensation consulting among others, are provided to the human resources department (a department subordinate to the CEO). The fees generated from these other services are often much larger than the fees for executive compensation consulting. For example, between 1997 and 2006 Verizon paid Hewitt Associates more than $500 million for actuarial services and for running the company's employee benefit plans.[25] Similarly, in 2006 Johnson & Johnson paid Towers Perrin over $11 million for other services compared to only $160,000 for executive compensation advice, and Halliburton paid Hewitt over $11 million for other services, compared to $210,000 for executive compensation advice.[26]

Compensation consultants perceive that recommending a lower-than-expected level of CEO pay can jeopardize the opportunities to cross-sell other more lucrative services to the firm. The conflicts of interest arising from the desire to preserve opportunities to cross-sell other services beyond executive compensation consulting lead to the following prediction:

Hypothesis 1: *CEO pay is higher if the compensation consultant provides services to the firm beyond executive compensation consulting.*

In our statistical tests of Hypothesis 1 we measure "other work" using both company-reported (voluntary) disclosures in proxy statements and externally obtained data extracted from tax filings. Prevalence statistics for our measures are summarized in Panel A of Table 1.

---

[25] Gretchen Morgenson, "Gilded paychecks, Troubling Conflicts: Outside Advice on Boss's Pay May Not Be So Independent," *New York Times* April 10, 2006.

[26] The Waxman Report, p. 4.

Although the new SEC disclosure rules do not explicitly require firms to disclose other services the consultants provided to the firm, several firms voluntarily disclosed this information in their proxy statements. Panel A of Table 1 summarizes these voluntary disclosures, which indicate that 4.6% of the consultants identified by our sample firms provided employee pay services to the firm, 3.8% provided benefits administration services, 2.4% provided actuarial services, and 4.5% provided other uncommon or non-specified services.[27] Voluntary disclosures suggest Watson Wyatt was the consultant that cross-sold other services to the largest share of its executive compensation-consulting clients. The fact that the disclosure of other services is not mandated by the SEC suggests that the percentages above are underestimated.

One major component of "other services" is actuarial service: Towers Perrin, Hewitt, and Watson Wyatt all began as firms providing actuarial services to sponsors of defined-benefit pension plans.[28] Under a defined-benefit pension plan, beneficiaries are promised a pre-specified future sum or annuity (often based on years of service and final salaries) to be paid upon retirement. Companies with defined-benefit pension plans require certified actuaries to determine the extent to which the plans are over funded or under funded (that is, whether the companies have sufficient assets in its pension plans to fund expected liabilities) and to determine the annual cash contribution requirements and the current accounting expense associated with the liabilities. In our sample of 1341 firms, 693 (52%) had defined-benefit plans with total pension plan assets in 2005 of almost $1 trillion.[29]

In contrast with "other services" provided by compensation consultants, information on actuarial services is publicly available. Companies with defined-benefit pension plans must file Form 5500 annually with the IRS and the Department of Labor, and Schedule B of Form 5500 includes information on the plan's actuary. We obtained information from 162,942 Form 5500 filings covering the years 2003 through early 2006 from Pension Planet, an

---

[27] Uncommon services (and prevalence) include tax-related services (0.2%); managing pension-fund assets (0.3%); employee training (0.1%); non-pension actuarial work (0.3%), HR outsourcing (0.3%), and other non-pay consulting (1.4%). Approximately 2.1% of the firms reported that the consultants provided other services to the company but did not specify what those services were. We did not include in our analysis "other services" to the board of directors (specifically we excluded services related to training directors and providing advice on director compensation), since our focus is to report the effects of conflicts of interest between consultants and company executives.

[28] Information based on histories provided on company websites. Hewitt Associates was founded in 1940 as provider of actuarial services. Towers, Perrin, Forster & Crosby opened for business in 1934 with a reinsurance division and life division 20 years after founding partner H. W. Forster developed the first private pension plan. Watson Wyatt was formed from the 1995 merger of the UK actuarial firm R. Watson & Sons (founded in 1878) and the US-based actuarial firm The Wyatt Company (founded in 1946). Mercer began in 1937 as the employee benefits department of Marsh & McLennan, Inc.

[29] Pension plan assets and the existence of a defined-benefit plan are obtained from Compustat using Data item PPLAO.

organization that collects and tabulates these data. We matched the Schedule B data to our sample firms using Employee Identification Numbers (EINs) and hand-matching in some cases,[30] and were ultimately able to match actuaries to 1180 defined-benefit plans in 604 of our sample firms (representing 87% of the 693 sample firms with defined benefit plans).

Table 2 provides summary statistics for the actuaries used by our sample firms. The 604 firms we matched to Form 5500 data used a total of 57 different actuaries. The four largest actuaries – Hewitt, Mercer, Towers Perrin, and Watson Wyatt – collectively provide actuarial services to 426 of our 1341-firm sample (representing 61% of the 693 sample firms with defined-benefit plans). The pension plans associated with these four actuaries have $741 billion in assets and cover 12.4 million beneficiaries (current employees or retirees).

Based on these IRS data we are able to identify firms where the consultant provides both executive compensation consulting and actuarial services. As shown in Panel A of Table 1, 8.7% of the consultants provide actuarial services to the company that employs them. This percentage contrasts with the 2.4% obtained from the firms that voluntarily disclosed that the consultant provided actuarial services in their proxy statements. The three-fold difference between the mandated IRS disclosures and the voluntary proxy disclosures makes us concerned about potentially important underreporting biases inherent in voluntary corporate disclosures, but we report some results below based on the voluntary disclosures so that our results can be compared with those from Cadman, Carter, and Hillegeist (2009).

Table 3 shows the prevalence of providing both executive compensation and actuarial services is higher than the "expected" prevalence if the retention decision were truly independent. For example, the table shows that Towers Perrin serves as the pay consultant for 214 of the 1341 firms for which we hand-collected data, serves as an actuary for 110 firms, and serves as *both* pay consultant and actuary for 41 firms. If the decision to retain pay consultants and actuaries were independent (but the overall prevalence were unchanged), we would expect Towers Perrin to provide both services in only 18 firms, or less than half the number observed.[31] Overall, 110 of our 1046 sample firms that use compensation consultants (10.5%) use the same consulting firm for both executive pay and actuarial services.

[30] Companies with multiple subsidiaries (each its own legal entity) will often have multiple EINs, and matching Form 5500 data to parent companies based on EINs is therefore imperfect.

[31] The "Expected" number for Towers Perrin is computed as the number of consulting clients (n=214) multiplied by the number of actuarial clients (n=110) divided by the number of sample firms (n=1341). Put differently, Towers Perrin is a pay consultant for 16.0% of the firms, and an actuary for 8.2% of the firms, so if the retention decision were independent we would expect Towers Perrin to be both pay consultant and actuary for (16.0%)x(8.2%) = 1.31% of the 1341 sample firms, or about 18.

Repeat Business

The second source of conflict derives from the compensation consultant's desire to be rehired by the firm. Consultants have a conflict of interest whenever they design the pay packages of the same executives that have the power to reappoint them. Traditionally, most compensation consultants were retained by and worked for the firm's CEO and/or the human resources department. Such consultants have clear incentives to please the firm's CEO and top executives by recommending generous pay packages. According to Warren Buffett, excessive compensation packages in the 1990s were promulgated by consultants "which had no trouble perceiving who buttered their bread."[32]

The potential for conflicts of interest related to repeat-business concerns has arguably decreased in recent years. Historically, consultants were rarely retained by the compensation committee but were rather retained by company management, and worked directly for and with the head of human resources, the chief financial officer, and/or the CEO, creating obvious conflicts of interest for consultants concerned about generating repeat business. However, in recent years, compensation committees have increasingly retained their own compensation consultants, partly due to general governance concerns resulting from Sarbanes Oxley Act (and the scandals that precipitated the Act) but also in response to listing requirements from the New York Stock Exchange, which adopted a rule (Rule 303A) in November 2003, stipulating that "if a compensation consultant is to assist in the evaluation of director, CEO or senior executive compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms."[33]

The shift towards giving the compensation committee authority over hiring consultants has decreased but not eliminated the repeat-business conflicts of interest. First, while complying with the NYSE listing requirement implies that the compensation committee has the sole authority to hire and fire the consultant, the requirement does not imply that the compensation committees in fact exercise that authority. The rule does not, for example, preclude the CEO or other executives from making recommendations regarding the appointment or reappointment of the compensation consultant. Second (and as we discuss in more detail in Section 4 below), management routinely hires its own consultant in addition to the consultant retained by the compensation committee, and management's consultants remain conflicted. Third, even when retained by the compensation committee, consultants often work directly for top managers.

[32] 2003 Annual letter from Warren Buffett to Berkshire Hathaway's shareholders. (http://www.berkshirehathaway.com/letters/2003ltr.pdf)
[33] A copy of these rules can be found at http://www.nyse.com/pdfs/finalcorpgovrules.pdf .

The conflicts of interest associated with generating repeat business lead to the following hypothesis:

Hypothesis 2: *CEO pay is higher in firms where the CEO influences the decision to appoint (or reappoint) the compensation consultants.*

In our statistical tests of Hypothesis 2, we measure managerial influence over consultant appointments using a proxy that indicates whether the consultant works exclusively for the board or also works for management.

Panel B of Table 1 provides prevalence statistics for our measure of managerial influence over consultant appointments. In spite of the NYSE listing rules, we find that only 40.9% of the consultants identified in our sample work exclusively for the compensation committee or board, rather than for management. This measure is correlated (ρ=0.24, p-value<0.001) with a dummy indicating whether or not the consultant is referred to as "independent" in the proxy statement prepared by the firm. Presumably, this qualification also captures the level of managerial influence over retaining the consultant, however the definition of "independence" is unspecified in most firms and in many cases is unrelated to obvious conflicts of interest between the consultant and the firm.[34]

In the remaining two sub-sections of Section 3, we examine the effect of conflicts of interest on CEO pay. Specifically, we test our two hypotheses.

3.2. Relation between CEO Pay and Compensation Consultants Providing Other Services to the Firm

Research Design

Our first set of analyses tests whether CEO pay is higher in firms where compensation consultants provide other services to the firm (i.e., Hypothesis 1). We restrict our sample to the 1046 firms using compensation consultants, and exclude firms hiring a new CEO during fiscal year 2006 to avoid the effect of one-time compensation choices (e.g., severance payments to outgoing CEOs, signing bonuses or mega-grants to incoming CEOs). We conduct our tests at the firm level by employing the following OLS regression:

[34] We note that 8.8% of the consultants associated with our 1,046 sample firms were described as "independent" in the same proxy statements that described how those consultants had been hired by management. The fact that we find such inconsistencies using data that are voluntarily disclosed by the companies suggests that firms may use the word "independent" to refer broadly to outside advice regardless of whether that advice is free of conflicts of interest. Similarly, the Waxman Report indicates that 26.6% of 113 companies paying other service fees to their compensation consultants described their consultants as "independent" in their proxy statements.

$$Ln\ (Expected\ CEO\ Pay_i) = \mu_0 + \mu_1 * Other\ Services_i + \alpha_n * Controls_i + \varepsilon_i \quad (1)$$

Our dependent variable is the natural logarithm of the expected CEO pay, defined as the sum of salaries, discretionary bonuses, the target value for non-equity incentives, the grant-date value of restricted stock and stock options and other compensation (including perquisites, signing bonuses, termination payments, above-market interest paid on deferred compensation). Our primary explanatory variable ("other services") varies across regressions, but includes (for example) a dummy variable indicating whether the consultant provides any other services, a count of how many other services are provided, and separate dummy variables for four specific categories of services (actuarial services, employee-pay services, benefits-administration services, and any other services).

Our controls include many standard (and some not-so-standard) determinants of CEO pay. We account for size using the logarithm of prior-year firm sales, as it is well established that firm size is strongly associated with higher pay, presumably due to the fact that large firms have higher monitoring costs and demand highly skilled executives to operate (Rosen 1982). We also include two performance measures that are often linked to compensation contracts (Lambert and Larcker 1987; Murphy 1999): stock returns and return on assets (measured as net income before extraordinary items and discontinued operations divided by total assets), both averaged over the prior three years.

In addition, we control for differences in the composition of the pay package. Our measure of compensation is meant to approximate the expected *opportunity cost* to shareholders of the executive's pay package. However, our measure does not approximate the *value* of the package from the perspective of a risk-averse and undiversified executive who presumably does not hedge the risk of the package.[35] Thus, for example, while the opportunity cost to shareholders of giving an additional $100 in base salary is the same as the opportunity cost of giving $100 in restricted stock, a risk-averse and undiversified executive will prefer certain salary to risky stock, and will predictably discount the value of the stock. Put differently, all else equal, we expect that executives at companies with riskier pay will receive higher expected levels of pay to compensate for the increased risk. To control for differences in the riskiness of pay, we include as control variables the fraction of expected pay from non-equity incentives and from equity-based incentives. We expect that expected pay will be positively related to both of these variables, and expect a higher coefficient on the

[35] For examinations of the distinction between the company's cost and the executive's value of equity-based compensation, see Hall and Murphy (2002), Meulbroek (2001), and Lambert, Larcker and Verrecchia (1991).

equity-pay variable since equity pay is traditionally riskier than bonuses based on accounting returns.[36]

We control for industry-effects by including nine industry dummies based on the Fama-French classification[37] plus an additional dummy variable for the financial services sector (SIC codes 6000 to 6999). Finally, we control for "consultant effects" by including individual dummy variables for the six largest consulting firms (Towers Perrin, Mercer, Hewitt, Cook, Watson Wyatt, and Pearl Meyer). Since some firms use more than one consultant, we define our consultant dummy variables as a fraction (e.g., if Mercer is one of three consultants used by the firm, the Mercer dummy variable is set to one-third). By defining these dummy variables as a fraction we implicitly give equal weight to each consultant in influencing CEO pay.

Empirical Results

We initiate our analyses by focusing on actuarial services (our externally measured proxy for other services). Since actuarial services can only be provided to a client firm that demands such services (i.e, the client firm maintains a defined-benefit pension plan), we estimate the following modified version of equation (1):

$$\begin{aligned} Ln\ (Expected\ CEO\ Pay_i) = {} & \beta_0 + \beta_1 * Firm\ offers\ defined\text{-}benefit\ plan \\ & + \beta_2 * (Dummy\ Variable\ indicating\ that\ the\ firm\ has\ a \\ & compensation\ consultant\ that\ is\ also\ an\ actuary\ for\ the\ firm) \\ & + \alpha_n * Controls_i + \varepsilon_i \end{aligned} \quad (2)$$

Our primary coefficient of interest in equation (2) is β_2, which indicates whether CEO pay is increased when at least one compensation consultant also serves as an actuary for the firm, and our conflict-of-interest hypothesis predicts that $\beta_2 > 0$. The coefficient β_1 controls for factors that affect pay that are common across firms with defined-benefit plans (these firms tend to be more-established firms with old workforces and large retiree populations).

Table 4 column (1) reports regression coefficients from equation (2). Our primary coefficient of interest, β_2, is statistically insignificant, inconsistent with the hypothesis that CEO pay is higher when the consulting firm provides actuarial services to the CEO's firm.

---

[36] We also recognize that the coefficients on equity pay in our regression may reflect a systematic over-granting of stock and options by compensation committees who do not understand the full opportunity cost of granting stock and options.

[37] Specifically, we employ the 10 Industry Portfolios Fama/French classification described at: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/changes_ind.html. The "omitted" category in our regressions includes mines, construction, transportation, hotels, entertainment, and services.

The remaining columns in Table 4 report results from estimating a simplified version of equation (2) separately for each of the four largest actuarial firms – Towers Perrin, Mercer, Hewitt, and Watson Wyatt.

$$\begin{aligned} Ln\ (Expected\ CEO\ Pay_i) = {} & \beta_0 + \beta_1 * Firm\ offers\ defined\text{-}benefit\ plan \\ & + \beta_2 * Consultant\ is\ the\ actuary \\ & + \alpha_n * Controls_i + \varepsilon_i \end{aligned} \quad (3)$$

The estimated β_2 coefficients for the four large consultant-actuaries are insignificant. Thus, the results of Table 4 provide no evidence for our "other services" hypothesis (i.e., hypothesis 1).

Table 5 examines whether CEO pay is higher 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. The explanatory variable of interest in column (1) is a dummy variable equal to one if the firm purchases any other services beyond executive-pay compensation services from its consultant, while the variable of interest in column (2) is the number of services provided (ranging in our data from 0 to 4). The coefficients on these variables are positive and marginally significant based on a one-tailed t-test (t-statistic=1.61 in both cases).

Our finding of a (marginally) significant relation between pay and other services is at odds with Conyon, Peck and Sadler's (2006) UK results and Cadman, Carter and Hillegeist's (2009) US results, which provide no evidence of an association between CEO pay and the consultant's provision of other services. In particular, Conyon, Peck and Sadler estimate a regression similar to our regression in Column (1) of Table 5 for a sample of 229 UK firms, and obtain the same coefficient we do (0.07) with a higher standard error. We therefore suspect the differences in our results reflect their relatively small sample size (since we analyze 966 firms, more than four times the number of companies in their sample). Cadman, Carter and Hillegeist analyze a smaller sample of US firms and estimate a different specification that includes an interaction of "Other Services" and prior-year ROA. Nonetheless, although we have been unable to replicate their results for our larger sample, the differences seem mostly attributable to three factors. First, our definition of "Other Services" includes externally obtained actuarial data, while their definition is based on voluntary disclosures. Second, Cadman, Carter and Hillegeist do not specify what types of services are included in their definition of other services; our percentage of other services

appears to differ substantially from theirs. Third (and perhaps most importantly), our regressions include fixed effects for the six largest consulting companies.[38]

In column (3) of Table 5, we include separate dummy variables for four categories of other services, and find no evidence that CEO pay is higher in firms where the executive compensation consultant provides actuarial, rank-and-file employee pay, or benefits administration services to the firm. However, our results suggest a significant relation between CEO pay and the percentage of consultants that provide other uncommon or non-specified services to management.[39] The positive coefficient +.223 in column (3) suggests that firms using consultants that provide other non-compensation consulting services to management are likely to pay 25% more to their CEOs.[40]

Armstrong, Ittner and Larcker (2008) examine differences in CEO pay between firms that use and firms that do not use compensation consultants, and find evidence suggesting that the use of consultants leads to higher pay only in firms that have weak governance. By the same token, it is likely that the provision of "other services" by consulting firms will be associated with higher increases in CEO pay whenever the firm has weak governance (i.e., when the independence between the board members and the CEO is compromised). In Table 6, we analyze interactions between governance and the relation between CEO pay and other services using three proxies to capture the CEO's influence over the board: a dummy variable indicating whether or not the CEO is also the chairman of the board; the percentage of directors appointed after the CEO was appointed; and the percentage of non-independent directors.[41] As predicted, the measures capturing the degree of influence of the CEO over the board are linked to higher CEO pay.[42] However, we find no evidence that "other services"

---

[38] To see how these fixed effects matter, consider that Fred Cook and Company provides no other services, and yet is associated with the highest pay levels. Regressions that fail to control for the "Fred Cook effect" will therefore result in a lower coefficient for Other Services. Indeed, the results in Table 1 are much weaker after omitting the controls for consulting company.

[39] Most of these other services were left unspecified, yet, those specified included non-compensation consulting services, employee training, outsourcing of human resources functions, tax services, investment services for pension funds and actuarial services unrelated to pension plans.

[40] Calculated as $e^{.223} - 1 = .250$.

[41] The percentage of directors appointed by the CEO is estimated as the percentage of directors joining the board after the CEO took office. The percentage of non-independent directors is the percentage of board members that are either employees of the firm and/or are affiliated with the firm in at least one of the following ways: they were former employees of the firm; they (or their employers) are major clients or provide services to the firm; they are recipients of charitable funds from the firm; they have interlocks; or they are family members of one or more directors or executives.

[42] For example, the positive coefficient +0.104 in columns (1) and (2) of Table 6 suggests that CEO pay is 11% higher when the CEO is also the chairman of the board (but when the consultant provides no other services). However, we note that there are reasons beyond "influence" why CEOs who are also chairs receive higher pay, including: expanded responsibilities, tenure and experience, and unobservable characteristics correlated with why the board appointed the CEO as chair.

(measured by either the other services dummy or the number of services variable) are associated with higher CEO pay in firms with less-independent boards.[43]

Robustness Checks

We conduct several (untabulated) tests to verify the robustness of our results.

First, it is unclear whether controlling for the mix of pay and/or including compensation consultant-effects may have driven away some of the effects that conflicts of interest have on Expected CEO pay (e.g., firms where the consultant was providing other services may have paid more to the CEO but may also have suggested to "camouflage" this pay by granting additional equity instead of cash to the CEO (Bebchuk and Fried, 2004)). We replicate the regressions in Tables 4 and Table 5 without including the incentive measures (target non-equity incentives as a fraction of expected pay, and grant-date values of stock and options as a fraction of expected pay) and without including consultant controls. As in Table 5, we find a positive and marginally significant association between CEO pay and our "consultant provides other services" and "number of services" variables. These associations are significant at a 10% level based on a one-tailed test when the consultant-effects are dropped and based on a two-tailed test when the incentive measures are eliminated. Consistent with Tables 4 and 5, we continue to find an insignificant association between CEO pay and the consultant's provision of actuarial, employee pay, and benefits administration services. The "other services" results thus, seem to be driven by the positive association between the "other uncommon or non-specified services" provided by the consultant and CEO pay (Table 5), which remains robust to these alternative specifications.

Second, a potential concern is that our findings (or lack of findings) are driven by a few outliers or are affected by significant noise on the CEO pay variable. We address these concerns by conducting two additional tests: (a) we replicate all of our results in Tables 4 and 5 after excluding the bottom and top one percentiles of the CEO pay observations. (b) we construct a measure of average pay across the top five executives of the firm (including the CEO and the "next" highest paid four executives) to mitigate the noise embedded in a single-year observation of CEO pay, and then replicate our models using this new measure as the dependent variable. These additional tests yield essentially the same results that we found in

[43] We also investigate whether any of the four categories of "other services" provided by the consulting firms are associated with higher increases in CEO pay whenever the firm has weak governance (i.e., when the independence between the board members and the CEO is compromised). However, untabulated results show no evidence that any of the four categories of "other services" is associated with higher CEO pay in firms with less-independent boards. Indeed, we find in that the pay premium for CEOs purchasing "uncommon or non-specified services" is lower for CEOs who also serve as Chair; none of the other governance interactions are significant.

Tables 4 and 5, except that the positive coefficient on "consultants provide other services" (Table 5, column 1) becomes insignificant in one of the tests and the coefficient on "number of services" (Table 5, column 2) becomes insignificant in both tests.

Third, we consider two alternative specifications for our models to address the fact that 181 of our 1046 sample firms (17%) use more than one consultant: (a) we constrained our analyses to the subsample of firms that use only one compensation consultant; and (b) we defined our proxies for "other services" as the "fraction of consultants" providing other services to the company rather than dummies indicating one or more consultants provided other services to the firm. Our replication of Tables 4 and 5 under both of these specifications yields similar results to those reported in the empirical results section, except that the coefficients of the "consultants provide other services" and "number of services" (Table 5, columns 1 and 2) variables become insignificant if we constrain our sample to firms using only one consultant.

Finally, since not all firms specify the time when they hired their consultants, we consider the possibility that the consultants influenced CEO compensation not on the year when they were mentioned in the proxy statement, but instead the following year. We rerun our analyses in Tables 4 and 5, substituting CEO pay on the first year of the new SEC disclosures rules, for CEO pay on the second year of disclosure. Our results remain the same as those reported in Tables 4 and 5.

3.3. Relation between CEO Pay and Compensation Consultants' Independence and Repeat-Business Concerns

Research Design

Our next analyses examine Hypothesis 2, which predicts higher CEO pay whenever the CEO is more likely to influence the decision to appoint (or reappoint) the compensation consultant. Our sample includes all firms that use compensation consultants, excluding firms where the CEO has been employed for less than a full fiscal year. We conduct our tests at the firm level by employing the following OLS regression:

$$Ln\ (Expected\ CEO\ Pay_i) = \alpha_0 + \alpha_1 * (Consultants\ work\ exclusively\ for\ the\ board_i) + \alpha_n * Controls_i + \varepsilon_i \quad (4)$$

The main explanatory variable in equation (4) is a dummy variable equal to one if the company has a consultant who works exclusively for the board rather than for management. According to Hypothesis 2, the predicted coefficient for this variable is expected to be

negative. As in equation (1), we control for size, stock returns, return on assets, the equity and non-equity incentive components of expected CEO pay, compensation consultant-effects for the six primary consulting firms, and ten industry dummy variables.

Empirical Results

Table 7 column (1) reports the association between consultants working exclusively for the board and CEO pay. The estimate for α_1 ("Consultants work exclusively for the board") is positive (α_1=0.069) and significant (t-statistic=2.0) – rather than negative as predicted – and suggests that CEO pay is 7.1% higher in companies where the board retains its own compensation consultant.

Columns (2) through (4) examine whether the reason for this positive (rather than negative) coefficient is due to lack of independence of the board. To evaluate this possibility we interact the fraction of consultants working exclusively for the board with each of the three "weak governance" proxies that capture the CEO's influence over the board (i.e., the dummy indicating whether the CEO is the chairman of the board, the percentage of directors appointed after the CEO was appointed, and the percentage of non-independent directors). We expect the coefficient for "consultants working exclusively for the board" to be negative and the coefficients for the interactions of this variable with the weak governance proxies to be positive. The results are consistent with this prediction (albeit insignificantly) only in column (4). The results in columns (2) and (3) are insignificant and the signs of the coefficients are inconsistent with expectations.

The general insignificance of the dummy variable indicating that the "consultants work exclusively for the board" is directly inconsistent with Hypothesis 2. In other words, our results provide no evidence for our "repeat business" hypothesis.

Robustness Checks

As in Section 3.2, we rerun column (1) in Table 7 by (a) excluding the incentive components of pay, (b) excluding compensation consultant-effects, (c) excluding the bottom and top one percentile of the CEO pay observations, and (d) substituting the dependent variable for the average pay across the CEO and the top four executives of the firm. Our results confirm a positive coefficient for the "consultants work exclusively for the board" variable when we run these robustness checks.

We also consider a specification where we constrain our analyses to the subsample of firms that use only one compensation consultant. The positive coefficient for the "consultants

work exclusively for the board" variable remains significant but only on a one-tailed test (t-statistic=1.4). Alternatively, we examine the full sample of firms using consultants by redefining our dummy variable indicating that "at least one consultant works exclusively for the board" to "fraction of consultants that work exclusively for the board" In this case our "works exclusively for the board" variable becomes insignificantly positive (t-statistic=1.3).

Finally, we replicate Table 7 after substituting CEO pay on the first year of the new SEC disclosures rules for CEO pay on the second year of disclosure. Firms using consultants working exclusively for the board are found to pay significantly more to their CEOs (t-statistic=2.4) the year after the consultants' names are disclosed in their proxy statements. Overall these robustness checks are inconsistent with Hypothesis 2 and suggest that firms where the compensation consultant works exclusively for the board are likely to pay more (rather than less) to their CEOs than other firms using consultants. We recognize this result is difficult to interpret since committees may retain their own consultant (rather than a consultant that also works for management) precisely in cases where pay is expected to be too high. Disentangling the simultaneity of this result, however, is difficult and beyond our capabilities, since the reasons that would lead the board to suspect CEO pay is high are likely to be the same reasons that would predict the level of CEO compensation.

4. Conflicted Consultants and CEO Pay: Evidence from Canadian Firms[44]

In addition to identifying their consultants and describing the nature of their compensation-related work, Canadian firms are also required to disclose whether the consultant provides any additional services for the company beyond those related to executive compensation. In particular, on April 15, 2005, the Canadian Securities Administrators (CSA) issued National Instrument 58-101, which requires corporations to disclose:

> "If a compensation consultant or advisor has, at any time since the beginning of the issuer's most recently completed financial year, been retained to assist in determining compensation for any of the issuer's directors and officers, disclose the identity of the consultant or advisor and briefly summarize the mandate for which they have been retained. If the consultant or advisor has been retained to perform any other work for the issuer, state that fact and briefly describe the nature of the work."[45]

[44] We are grateful to David Maber for inspiring this section; see Maber (2008) for more details on Canadian disclosure regulations.

[45] National Instrument 58-101, Disclosure of Corporate Governance Practices, Section 7(d), April 15, 2005.

Information on compensation for Canadian executives is available in Management Information Circulars issued in connection with the annual shareholder meeting. These Information Circulars are roughly the equivalent to proxy statements in the US (indeed, the compensation disclosures are explicitly patterned off of the SEC's 1992 proxy disclosure rules), and we will therefore use the term "proxy" to describe this data source. We identified the largest 200 Canadian companies ranked by market capitalization as of December 31, 2005, and were able to locate proxy statements with usable compensation data for 180 of these 200 firms in Canada's System for Electronic Document Analysis and Retrieval ("SEDAR" – the Canadian counterpart to the SEC's EDGAR database).[46] We excluded from our analysis 41 companies not using consultants, and another 14 companies using consultants only for surveys. Our final analysis of Canadian data therefore focuses on 125 firms engaging consultants for advice on executive compensation.

Panel A of Table 8 compares the frequency of other services provided by compensation consultants as disclosed in Canadian firms (where disclosure is mandatory) to the frequency as disclosed in US firms (where disclosure is voluntary). The statistics in the table are based on 156 Canadian observations (or one observation for each consultant identified by the 125 Canadian firms that use consultants) and on 1270 US observations (or one observation for each consultant identified by the 1046 US firms that use consultants). As shown in the table, the reported use of consultants for other services is much higher in Canada than in the US. For example, while 46.2% of consultants to Canadian firms are reported to provide other services to their client firms, only 11.7% of consultants in US firms are reported to provide other services.

In Section 3.1 above, we showed that only 2.4% of consultants were identified in proxy statements as providing actuarial services to their US-client firms, while mandatory IRS filings indicated that nearly 9% of the consultants also provided actuarial services to their firms. We interpreted this difference as indicating that voluntary disclosures in US proxy statements substantially under-report the prevalence of actuarial services provided by consultants. Similarly, assuming that the prevalence in other services is similar in the US and Canada, the results in Panel A of Table 1 are consistent with substantial under-reporting in the US data. This suggests that US tests based on voluntary disclosures (e.g. our analyses of employee pay, benefits management and other uncommon or unspecified services in Table 5, and Cadman, Carter and Hillegeist's (2009) "non-executive-compensation services" analyses) are likely to suffer from severe under reporting, biasing the results against finding a

[46] We are grateful to Fernandes, et. al. (2009) for providing our initial list of Canadian firms and for much of the Canadian compensation data used in our analysis.

relationship between other services and CEO pay.[47] By relying on mandatory disclosures of other services, our Canadian analyses mitigate these concerns.

Panel B of Table 8 shows the frequency of consultants used by the 125 Canadian firms that used consultants. The market leader in Canada is Mercer (42% of our sample firms), followed by Towers Perrin (36%), Hay (9%), and Hewitt (7%); overall, the 125 firms retained 16 different consulting firms. These market leaders typically provide other services to half or more of their clients (51% for Mercer, 62% for Towers Perrin, and 55% and 56% for Hay and Hewitt, respectively).

In addition to describing the other services provided by consultants, Canadian corporations are strongly encouraged to report the fees paid to consultants for their compensation-consulting advice and the fees paid for any other services provided. This encouragement comes in the form of "Best Practice Guidelines" issued by the influential Canadian Coalition on Good Governance, an industry advocacy group composed of the largest institutional investors in Canada. Our 125 sample companies provided compensation-consulting fees for 83 of the 156 identified consultants; the average fee was C$98,000 (where "C$" indicates results in Canadian dollars). Similarly, non-compensation fees were reported for 37 of the 72 consultants providing other services; the average fee was C$1,061,400. The average ratio of non-compensation fees to compensation-consulting fees for these consultants providing non-compensation consulting fees was 13.4.

Table 9 presents tests of our other-services hypothesis based on the mandatory disclosures for Canadian corporations. The dependent variable for all regressions in Table 9 is the logarithm of expected CEO compensation, defined as the sum of base salary, bonus, LTIP payments, and the target values for performance shares and the grant-date values of restricted shares and options.[48] Our controls are the same as those used in US analyses. Because of the smaller sample size, we control for industry effects using the Fama-French five-industry classification (rather than the ten-industry classification used for US data) and we control for incentive pay using total incentive pay as a fraction of expected pay (rather than separately controlling for the equity and non-equity incentive components of pay).

---

[47] The lack of mandatory disclosure and consequent underreporting in the US leads us to misclassify firms purchasing but not reporting other non-executive pay services from their consultants as firms that *do not* purchase such services. If a positive association between CEO pay and the firm's purchase of non-executive pay services indeed exists, this misclassification might prevent us from finding it.

[48] In computing Black-Scholes (1973) option values, we assumed a term equal to 70% of the full term. Volatilities were estimated using 60 months of data (or as many months as available if the company had not traded for 60 months); volatilities above or below the 95th and 5th percentile were set equal to the 95th and 5th percentile, respectively. Dividend yields were based on average yields over the prior three years; yields above the 95th percentile were set equal to the 95th percentile.

The independent variable of interest in Column (1) of Table 9 is a dummy variable equal to one if the any of the compensation consultants provide other services to the firm. The coefficient of .334 is positive and statistically significant (t-statistic=2.7), and indicates that CEO pay is 40% higher in Canadian companies where the consultant(s) provide services in addition to compensation consulting. The independent variable of interest in Column (2) of Table 9 is the total number of other services provided by consultants; this variable is based on the four categories of services in Panel A of Table 8 and therefore ranges from zero to four. The coefficient of .254 is positive and highly significant (t-statistic=4.3), indicating that each additional service corresponds to a 29% increase in total compensation. Thus, in contrast to the US data based on voluntary disclosures (where the effect was only marginally significant), we find evidence that CEO pay in Canada is positively associated with the number of services offered by the compensation consultant.

Column (3) of Table 9 decomposes other services into separate components based on the four categories of services in Panel A of Table 8. The coefficient on actuarial services of .549 is positive and significant, and indicates that CEO pay is 73% higher in firms where the consultant also serves as the firm's actuary, after controlling for size, industry, and performance characteristics. Similarly, the coefficient on benefits-administration services is positive and marginally significant (t-statistic=1.7), and indicates that CEO pay is 26% higher in firms where the consultant also provides benefits administration. These results are consistent with our other-services hypothesis but are in stark contrast to our result for US data in Table 4 (where actuaries were identified using IRS filings) and Table 5 (where benefits administration is identified through voluntary disclosures).

We explored the robustness of the results in columns (1) through (3) of Table 9 by eliminating outliers; increasing the number of industry controls; excluding the incentives variable; excluding firms that used more than one consultant; substituting our dummy variables for "other non-executive pay services" in columns (1) and (3) for the "fraction of consultants" providing those services to the company, and by including an additional explanatory variable (as in Table 4) indicating that the firm offers a defined-benefit plan. In each of these tests, the coefficients on our "compensation consultants provide other services" and our "number of services" variables continue to be positive and significant. Similarly, the coefficient on actuarial services remains positive and significant and the coefficient on benefits administration remains positive and marginally significant.

Finally, Column (4) of Table 9 includes as an explanatory variable "Fee Ratio," defined as the fees paid to executive compensation consultants for non-compensation-related services divided by the fees paid for compensation consulting. The regression is based on the 54 firms

that either reported fees for other services or where we could infer that these fees were zero because the consultant did not offer other services. The coefficient on Fee Ratio is positive and significant, indicating that CEO pay is higher in firms where most of the fees earned by the compensation consultants come from other services provided. However, subsequent analysis shows that this result is largely driven by a single outlier: Canadian National Railway Company, who paid Mercer Human Resource consultants C$47,000 for compensation-related services and "C$7,800,000 for non-compensation consulting and administrative work related to actuarial, compliance and design activities for the Company's pension and benefit plans, unrelated to the compensation of the Company's executives."[49] In particular, after excluding this observation, the coefficient on the Fee Ratio increases from .010 to .019, while the t-statistic falls from t=3.1 to t=1.4 (still significant in a one-tailed test).[50]

Overall, our results from the Canadian data strengthen our suspicions that the prevalence of other services is substantially under-reported in the voluntary disclosures in US proxy statements. Similarly, the results are consistent with the small-sample findings in the Waxman Report that the fees paid to compensation consultants for other services are often orders of magnitude higher than fees paid for compensation-related consulting. After omitting an outlier, we find little evidence that the difference in fees explains cross-sectional differences in CEO pay. However, and in contrast to our US results, we do find evidence that compensation for Canadian CEOs is higher when the consultant also serves as the company's actuary or when it offers benefits-administration services.

5. Conclusions

This study examines the influence that compensation consultants have on executive pay. We focus on testing whether the inherent conflicts of interest faced by compensation consultants lead to higher observed levels of CEO pay. We find marginally significant evidence in the US 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. In addition, we find differences in fees paid to consultants providing non-executive pay services are

[49] Canadian National Railway Company Management Information Circular, March 6, 2007, p. 36.

[50] In additional robustness tests we exclude cases where the Fee Ratio equaled zero. The coefficient on Fee Ratio remains positive and significant (t-statistic=3.0) but becomes insignificant when we exclude the Canadian National Railway Company observation (t-statistic=0.4).

associated with higher levels of CEO pay, but this result seems largely driven by an outlier observation.

Our US analyses are based on the first fiscal year of sweeping new disclosure rules, including the disclosure of compensation consultants. We view the fact that we analyze a transition year as a potential advantage, since the firms have not yet fully reacted to the new disclosure rules and the associated narratives in the proxy statement have not yet "matured" into legal boilerplate. However, our cross-sectional analysis of a single-years' data limits our ability to analyze several hypotheses related to consultant conflicts of interest. For example, with a time-series of consultant data, we could analyze whether consultant-turnover is related to decreases in CEO pay, or whether increases in CEO pay are indeed followed by increased purchases of other services from the consulting firm. Finally, a time-series of data would allow us to analyze how companies respond to the increased scrutiny associated with increased disclosure.

As suggested in the introduction, our analysis of the conflicts of interest among compensation consultants and their client firms closely parallels the literature on "auditor independence." Concerns regarding conflicts when accounting firms offered services beyond auditing led not only to the Sarbanes-Oxley Act and to detailed disclosures of fees charged for auditing and non-auditing businesses, but also to the practice of companies avoiding using their auditors for other services. This practice has defined the industry, in spite of the fact that the auditors (with their vast firm-specific knowledge) might be the efficient provider of such services, and notwithstanding the fact that there is no direct evidence that these undeniable potential conflicts actually translated into misleading auditing decisions.

The findings of our study are particularly relevant in view of the current debate in the US where some legislators and activists have demanded that executive compensation consultants disclose information regarding other non-executive-pay related services provided to the firms. Indeed, concerns about the independence of compensation consultants have attracted the attention of regulators, resulting in Congressional hearings in December 2007 and the production of the Waxman Report (2007).

An objective and plausible outcome of the current debate is to require additional disclosure on other services provided by the consultants and even (following the auditing-independence analogy) to require companies to report the consulting fees associated with the various services. Our analyses have led us to mixed views on this "plausible outcome" of additional disclosure requirements. On one hand, our analyses – especially of the Canadian data – provide support for the Congressional investigation: we find evidence that conflicts of interest among compensation consultants lead to higher CEO pay. In addition, and again

following the auditor-independence literature, we predict that required disclosure will lead firms to avoid using their executive-pay consulting firms for other services, even when such consultant firms have acquired valuable client-specific knowledge that would benefit these other services.

REFERENCES

Agrawal, Anup and Mark Chen. 2008. "Do analysts conflicts matter? Evidence from stock recommendations," *Journal of Law & Economics,* 51:503–37.

Armstrong, Christopher S., Christopher D. Ittner, and David F. Larcker. 2008. "Economic Characteristics, Corporate Governance, and the Influence of Compensation Consultants on Executive Pay Levels." Wharton School working paper.

Barber, Brad M., Reuven Lehavy, Maureen McNichols and Brett Trueman. 2006. "Buys, holds, and sells: The distribution of investment banks' stock ratings and the implications for the profitability of analysts' recommendations," *Journal of Accounting and Economics* 41: 86-117.

Bartov, Eli, and Partha Mohanram. 2004. "Private information, earnings manipulations and executive stock option exercises," *The Accounting Review* 79(4): 889-920.

Bebchuk, Lucian Arye and Jesse M. Fried. 2004. *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, Harvard University Press.

Bergstresser, Daniel and Thomas Philippon. 2006. "CEO Incentives and Earnings Management," *Journal of Financial Economics*, 80 (3): 511-529

Bizjak, John M., Michael L. Lemmon and Lalitha Naveen. 2007. "Has the Use of Peer Groups Contributed to Higher Pay and Less Efficient Compensation?" Working paper (March).

Burns, Natasha and Simi Kedia. 2006. "The Impact of Performance-Based Compensation on Misreporting," *Journal of Financial Economics* 79 (1): 35-67.

Cadman, Brian, Mary Ellen Carter, and Stephen Hillegeist. 2009. "The Incentives of Compensation Consultants on CEO Pay," Working Paper (February).

Cohen, Lauren , Andrea Frazzini and Christopher Malloy. 2008. "Hiring Cheerleaders: Board Appointments of "Independent" Directors", NBER Working Paper 14232.

Conyon, Martin C. 2008. "Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom," ESSEC Business School working paper.

Conyon, Martin C., Simon I. Peck and Graham V. Sadler. 2009. "Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom." Academy of Management Perspectives (forthcoming).

Crystal, Graef. 1991. *In Search of Excess: The Overcompensation of American Executives.* New York: W.W. Norton & Company.

DeAngelo, Linda E. 1981. "Auditor Size and Audit Quality," *Journal of Accounting and Economics* 3: 183-199.

Dopuch, Nicholas, Ronald R. King and Rachel Schwartz. 2003. "Independence: Appearance vs. Fact: An Experimental Investigation," *Contemporary Accounting Research* 20(1): 79-114.

Dopuch, Nicholas, Ronald R. King and Rachel Schwartz. 2004. "Contingent Rents and Auditors' Independence: Appearance vs. Fact," *Asia-Pacific Journal of Accounting and Economics* 11(1): 45-68.

Efendi, Jap, Anup Srivastava and Edward P. Swanson. 2007. "Why do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors," *Journal of Financial Economics* 85 (3): 667-708.

Ertimur, Yonca, Fabrizio Ferri, and Stephen Stubben. 2008. "Board of directors' responsiveness to shareholders: Evidence from majority-approved shareholder proposals," Working paper, Harvard University.

Faulkender, Michael and Jun Yang. 2008. "Inside the Black Box: The Role and Composition of Compensation Peer Groups," Working paper, Northwestern University and Washington University in St. Louis.

Fernandes, Nuno, Miguel Ferreira, Pedro Matos, and Kevin J. Murphy. 2009. "The Pay Divide: (Why) Are U.S. Top Executives Paid More?" Working paper, University of Southern California (http://ssrn.com/abstract=1361365).

Ferri, Fabrizio and Tatiana Sandino. 2009. "The Impact of Shareholder Activism on Financial Reporting and Compensation: The Case of Employee Stock Options Expensing," *The Accounting Review* (forthcoming).

Hall, Brian J. and Kevin J. Murphy, 2002. Stock Options for Undiversified Executives, *Journal of Accounting and Economics*, 33(1), 3-42.

Heron, Randall A. and Erik Lie. 2006. "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?" *Journal of Financial Economics*.

Higgins, Alexandra. 2007. "The Effect of Compensation Consultants: A Study of Market Share and Compensation Policy Advice," The Corporate Library (October)

Jensen, Michael C., Kevin J. Murphy, and Eric G. Wruck. 2008. *CEO Pay and What to Do About It: Restoring Integrity to Both Executive Compensation and Capital-Market Relations*. Harvard Business School Press (forthcoming).

Kadan, Ohad, Leonardo Madureira, Rong Wang and Tzachi Zach. 2009. "Conflicts of Interest and Stock Recommendations: The Effects of the Global Settlement and Related Regulations," *Review of Financial Studies*, forthcoming.

Kinney, William R., Zoe-Vonna Palmrose and Susan Schloz. 2004. "Auditor Independence, Non-Audit Services, and Restatements: Was the U.S. Government Right?" *Journal of Accounting Research* 42 (3): 561-588.

Lambert, R., and D. Larcker. 1987. An analysis of the use of accounting and market measures of performance in executive compensation contracts. *Journal of Accounting Research* 25: 95–125.

Lambert, Richard A., David F. Larcker and Robert E. Verrecchia, 1991. Portfolio Considerations in Valuing Executive Compensation, Journal of Accounting Research, 29(1), 129-49.

Libby, Robert, James E. Hunton, Hun-Tong Tan and Nicholas Seybert. 2008. "Relationship Incentives and the Optimistic/Pessimistic Pattern in Analysts' Forecasts," *Journal of Accounting Research* 46(1):173-198.

Lie, Erik. 2005. "On the Timing of CEO Stock Options Awards." *Management Science*, V. 51, No. 5: May, pp. 802-812.

Lin, Hsiou-wei and Maureen McNichols. 1998. "Underwriting relationships, analysts' earnings forecasts, and investment recommendations," *Journal of Accounting & Economics* 25, 101-127.

Maber, David. 2006. "The Role of Compensation Consultants in Executive Compensation and Corporate Governance: Best Practices and Evidence from Canadian Proxy Filings." Harvard Business School.

Maremont, Mark. 2005. "Authorities probe improper backdating of options: Practice allows executives to bolster their stock gains; a highly beneficial pattern." *Wall Street Journal*, Nov. 11.

Meulbroek, Lisa, 2001. The Efficiency of Equity-Linked Compensation: Understanding the full cost of awarding executive stock options, Financial Management, 30(2), 5-44.

Murphy, Kevin J. 1999. "Executive compensation." *Handbook of Labor Economics*, Orley Ashenfelter and David Card (Eds.), Vol.3. North Holland.

Nanda, Ashish. 2003. "The Essence of Professionalism: Managing Conflict of Interest," Technical-Note 9-903-120, Harvard Business School.

Porac, Joseph F., James B. Wade and Timothy G. Pollock. 1999. "Industry Categories and the Politics of the Comparable Firm in CEO Compensation." *Administrative Science Quarterly* 44 (1): 112-144.

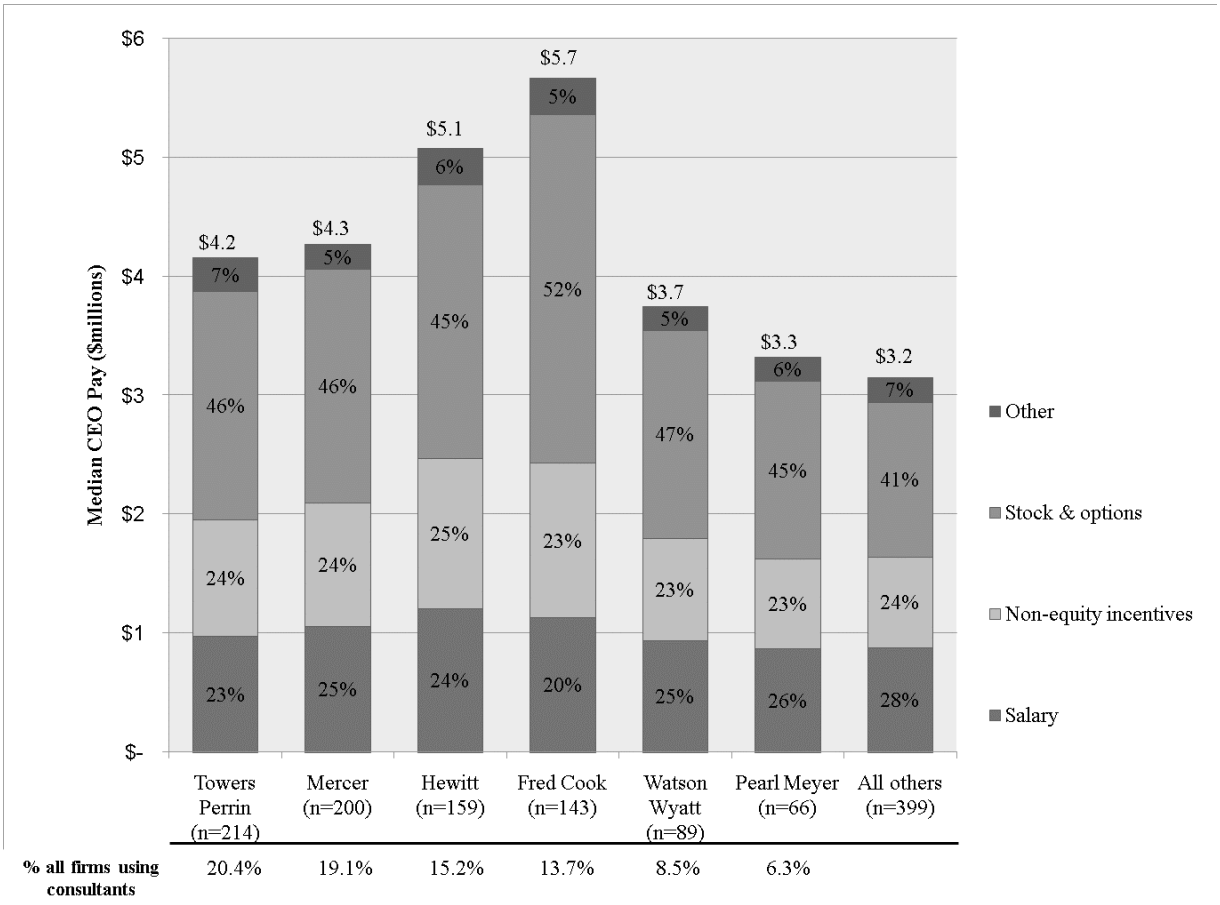
Rosen, Sherwin. 1982. "Authority, Control, and the Distribution of Earnings." *The Bell Journal of Economics*, 13(2), 311-323.

Simunic, Dan A. 1984. "Auditing, Consulting, and Auditor Independence." *Journal of Accounting Research*, 22(2) (Autumn), 679-702.

Wade, James B., Joseph F. Porac and Timothy G. Pollock. 1997. "Worth, Words, and the Justification of Executive Pay." *Journal of Organizational Behavior* 18: 641-664.

Waxman, Henry A. (et al.). 2007. "Executive Pay: Conflicts of Interest Among Compensation Consultants," United States House of Representatives Committee on Oversight and Government Reform (December).

Figure 1 Median Expected Levels of CEO pay, by Consultant



Note: Median pay levels based on ExecuComp data for CEOs in 1046 firms using consulting services reporting under the SEC's 2006 reporting rules and included in the October 2007 ExecuComp release. Total compensation (indicated by bar height) defined as the sum of salaries, non-equity incentives (including discretionary bonuses and target levels for formula-based plans), stock & options (evaluated at grant date using company-estimated present values) and other pay (including perquisites, signing bonuses, termination payments, and above-market interest paid on deferred compensation.) The numbers in parentheses refer to the number of client firms in the sample; the total number of observations sums to more than 1046 because many firms use multiple consultants.

Table 1 Potential Conflicts of Interest among Compensation Consultants

Proxy Variable for Conflicts of Interest	All consultants in all firms (n=1270)	Major Compensation Consultant					
		Towers (n=214)	Mercer (n=200)	Hewitt (n=159)	Cook (n=143)	Watson (n=89)	Meyer (n=66)
PANEL A. Consultant Other Work							
Other (non-Exec Pay) Work as reported in Proxy Statement:							
Consultant provides actuarial services	2.4%	5.1%	3.5%	3.8%	0.0%	4.5%	0.0%
Consultant provides employee pay services	4.6%	6.1%	7.0%	6.3%	2.1%	6.7%	0.0%
Consultant provides benefits-administration services	3.8%	3.7%	7.0%	8.2%	0.0%	9.0%	0.0%
Consultant provides other uncommon or non-specified services[a]	4.5%	4.7%	9.0%	3.8%	0.7%	10.1%	3.0%
Other Work determined by external sources							
Consultant identified as actuary in Form 5500 filings	8.7%	19.2%	13.0%	18.2%	0.0%	6.7%	0.0%
PANEL B. Consultant Retention							
Consultant works exclusively for board or committee	40.9%	35.0%	30.5%	34.6%	60.8%	42.7%	48.5%
Consultant called "Independent" in proxy statement	45.3%	45.8%	33.5%	45.3%	64.3%	42.7%	45.5%

Note: Consulting based on disclosures from 1341 firms in the S&P 500, S&P MidCap 400, and S&P SmallCap 600 reporting under the SEC's new reporting rules and included in the October 2007 ExecuComp release. Actuarial data from 2003-2006 Form 5500 filings.

[a] Most services under this category were not specified. Other uncommon services include non-pay consulting, employee training, outsourcing of human resources functions, tax services, investment services for pension funds, and actuarial services unrelated to pension plans.

Table 2 Actuaries used by Sample Firms

Actuary Firm	All Sample Firms (n=1341)	Firms with Pension-Plan Assets (n=693)	Total Plan Assets ($billions)	Total Plan Participants
Hewitt Associates	8.9%	17.2%	$165.5	3,128,367
Mercer Human Resource Consultants	8.4%	16.3%	$99.6	2,332,451
Towers Perrin	8.4%	16.2%	$200.5	3,634,967
Watson Wyatt Worldwide	7.2%	14.0%	$275.3	3,259,294
Buck Consultants	4.8%	9.2%	$116.8	1,625,032
AON Corp	2.2%	4.2%	$20.2	407,631
Milliman, Inc	1.7%	3.3%	$10.1	170,372
Prudential (PRIAC)	0.7%	1.4%	$23.0	349,538
PriceWaterhouseCoopers	0.6%	1.2%	$4.0	66,488
Fidelity Investments	0.5%	1.0%	$0.3	58,355
Mellon Consultants	0.5%	1.0%	$3.9	33,575
All other actuaries (n=46)	*5.7%*	*11.0%*	*$48.7*	*917.689*

Note: Actuarial data (including total plan assets and total plan participants) from 2003-2006 Form 5500 Schedule B filings, using only the most recent filing for each defined-benefit plan. Firms with Pension-Plan Assets identified from Compustat (Data Item PPLAO).

Table 3 Consultants who are also Actuaries for 1341 "Client" Firms

Consulting/Actuary Firm	Number of Consulting Clients	Number of Actuary Clients	Number of Firms where the Consultant *is* the Actuary	
			Actual Matches	# Expected if Independent
Towers Perrin	214	110	41	18
Mercer HR Consultants	200	111	26	17
Hewitt Associates	159	118	29	14
Watson Wyatt Worldwide	89	94	6	6
All other consultants who are also actuaries (n=8)	*67*	*133*	*8*	*7*

Note: Actual matches represents number of corporations where the consultant provides both executive compensation consulting and actuarial services. The "# Expected if Independent" is calculated as the number of consulting clients multiplied by the number of actuary clients divided by the total number of clients (1341). The eight other consultant/actuaries are Buck Consulting, AON, Milliman, PriceWaterhouseCoopers, CCA Strategies, Deloitte, Ernst & Young, and The Ross Companies.

Table 4 Coefficients of OLS Regressions showing the relation between Expected CEO Compensation and "actuarial services" provided by the compensation consultants

	Dependent Variable: Ln(Expected CEO Compensation)				
	All Firms	Towers Clients	Mercer Clients	Hewitt Clients	Watson Clients
	(1)	(2)	(3)	(4)	(5)
Intercept	4.335 (40.1)	4.317 (18.0)	4.298 (19.7)	4.789 (14.3)	4.394 (10.9)
Firm offers defined-benefit (DB) plan	0.051 (1.2)	-0.095 (-1.0)	0.102 (1.2)	-0.158 (-1.2)	0.123 (0.8)
Consultant is the actuary[a]	-0.001 (-0.0)	0.062 (0.7)	-0.090 (-0.9)	0.006 (0.0)	-0.223 (-1.0)
Ln(2005 Revenues)	0.303 (22.5)	0.393 (14.6)	0.231 (8.3)	0.344 (9.2)	0.385 (7.7)
Return on Assets (average percentage over previous 3 years)	-0.008 (-4.7)	-0.009 (-1.6)	-0.002 (-0.3)	-0.015 (-2.1)	-0.005 (-0.4)
Stock Returns (percentage returns over previous 3 years)	0.001 (1.8)	0.000 (0.2)	0.003 (2.2)	0.000 (-0.2)	0.003 (1.3)
Target Non-Equity Incentives as a fraction of Expected Pay	1.858 (16.0)	0.784 (2.5)	2.503 (9.4)	1.671 (5.4)	0.837 (1.7)
Grant-date values of stock and options as a fraction of Expected Pay	2.459 (32.2)	1.800 (9.2)	3.052 (17.5)	2.141 (9.2)	1.900 (6.5)
Controls for six primary consulting firms	Yes	No	No	No	No
Industry Controls?	Yes	Yes	Yes	Yes	Yes
R^2	0.738	0.744	0.792	0.665	0.735
N	966	201	185	153	83

Note: t-statistics in parentheses. All regressions include only firms that use consultants. Expected compensation defined as the sum of salaries, discretionary bonuses, the target value for non-equity incentives, the grant-date value of restricted stock and stock options and other compensation (including perquisites, signing bonuses, termination payments, above-market interest paid on deferred compensation). Industry controls include dummy variables for Consumer Durables, Consumer Non-durables, Energy, Financial Services, Health Care, Hi-Tech, Manufacturing, Non-durables, Retail, Telecommunication, and Utilities. Controls are based on Fama-French definitions to which we have added Financial Services (SIC 6000-6999). The consultant dummy variables are defined as 1/n if the consultant provides executive compensation consulting services to the firm (where n equals the number of all consultants providing services to the firm) and 0 otherwise.

[a]Our definitions of the dummy variable "Consultant is the actuary" in the column "All firms" is adjusted to "one or more consultants provide actuarial services."

Table 5 Coefficients of OLS regressions showing the relation between Expected CEO Compensation and "other services" provided by the compensation consultants

	Dependent Variable: Ln(Expected CEO Compensation)		
	(1)	(2)	(3)
Intercept	4.327	4.330	4.336
	(40.5)	(40.5)	(40.6)
Consultants provide other services to the firm	0.070	-	-
	(1.6)		
Number of other services provided by compensation consultants	-	0.049	-
		(1.6)	
Consultants provide:			
Actuarial services to the firm	-	-	-0.006
			(-0.1)
Employee pay consulting services	-	-	-0.087
			(-1.1)
Benefits administration services	-	-	0.090
			(1.0)
Other uncommon or non-specified services	-	-	0.223
			(2.9)
Ln(2005 Revenues)	0.305	0.305	0.303
	(24.0)	(23.9)	(23.8)
Return on Assets	-0.008	-0.008	-0.008
(average percentage over previous 3 years)	(-4.7)	(-4.7)	(-4.8)
Stock Returns	0.001	0.001	0.001
(percentage returns over previous 3 years)	(1.7)	(1.7)	(1.8)
Target Non-Equity Incentives as a fraction of Expected Pay	1.865	1.866	1.879
	(16.1)	(16.1)	(16.2)
Grant-date values of stock and options as a fraction of Expected Pay	2.459	2.458	2.454
	(32.2)	(32.2)	(32.2)
Controls for six primary consulting firms	Yes	Yes	Yes
Industry Controls?	Yes	Yes	Yes
R^2	0.745	0.745	0.747
N	966	966	966

Note: t-statistics in parentheses. All regressions include only firms that use consultants. Expected compensation defined as the sum of salaries, discretionary bonuses, the target value for non-equity incentives, the grant-date value of restricted stock and stock options and other compensation (including perquisites, signing bonuses, termination payments, above-market interest paid on deferred compensation). Other uncommon services include non-pay consulting, employee training, outsourcing HR functions, tax services, investment services for pension funds, and actuarial services unrelated to pension plans. Industry controls include dummies for Consumer Durables, Consumer Non-durables, Energy, Financial Services, Health Care, Hi-Tech, Manufacturing, Non-durables, Retail, Telecommunication, and Utilities. Controls are based on Fama-French definitions to which we have added Financial Services (SIC 6000-6999). The consultant dummies are defined as 1/n if the consultant provides executive compensation consulting services to the firm (where n is the number of all consultants providing services to the firm) and 0 otherwise.

Table 6 Coefficients of OLS regressions showing whether weak governance affects the relation between Expected CEO Pay and "Other Services" provided by the compensation consultants

	Dependent Variable: Ln(Expected CEO Compensation)					
Weak governance measure >	CEO is chair		% directors appointed after CEO		% non-independent directors	
	(1)	(2)	(3)	(4)	(5)	(6)
Intercept	4.327	4.332	4.275	4.273	4.101	4.106
	(40.3)	(40.4)	(39.2)	(39.2)	(30.8)	(30.8)
Weak governance measure (CEO is chair, % directors appointed after CEO, or % non-independent directors)	0.104	0.104	0.189	0.203	0.234	0.229
	(2.7)	(2.7)	(2.8)	(3.1)	(1.6)	(1.6)
Consultants provide other services to the firm	0.092	-	0.093	-	0.134	-
	(1.3)		(1.5)		(1.5)	
Consultants provide other services to the firm × Weak governance measure	-0.040	-	-0.107	-	-0.298	-
	(-0.5)		(-0.6)		(-1.0)	
Number of other services provided by compensation consultants	-	0.064	-	0.091	-	0.095
		(1.4)		(2.0)		(1.6)
Number of other services provided by comp. consultants × Weak governance measure	-	-0.025	-	-0.159	-	-0.207
		(-0.4)		(-1.3)		(-1.0)
Ln(2005 Revenues)	0.299	0.299	0.306	0.306	0.302	0.302
	(23.1)	(23.1)	(23.9)	(23.9)	(21.0)	(21.0)
Return on Assets (average percentage over previous 3 years)	-0.007	-0.008	-0.008	-0.009	-0.002	-0.002
	(-4.6)	(-4.7)	(-5.1)	(-5.2)	(-0.6)	(-0.6)
Stock Returns (percentage returns over previous 3 years)	0.001	0.001	0.001	0.001	0.001	0.001
	(1.7)	(1.7)	(1.6)	(1.6)	(1.7)	(1.7)
Target Non-Equity Incentives as a fraction of Expected Pay	1.847	1.850	1.871	1.871	1.977	1.978
	(15.9)	(16.0)	(15.9)	(15.9)	(15.3)	(15.3)
Grant-date values of stock and options as a fraction of Expected Pay	2.453	2.452	2.463	2.462	2.563	2.562
	(32.2)	(32.2)	(31.8)	(31.9)	(30.0)	(30.0)
Controls for six primary consulting firms	Yes	Yes	Yes	Yes	Yes	Yes
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
R^2	0.747	0.747	0.744	0.745	0.748	0.748
N	966	966	952	952	817	817

Note: t-statistics in parentheses. All regressions include only firms that use consultants. Expected compensation defined as the sum of salaries, discretionary bonuses, the target value for non-equity incentives, the grant-date value of restricted stock and stock options and other compensation (including perquisites, signing bonuses, termination payments, above-market interest paid on deferred compensation). Industry controls include dummies for Consumer Durables, Consumer Non-durables, Energy, Financial Services, Health Care, Hi-Tech, Manufacturing, Non-durables, Retail, Telecommunication, and Utilities. Controls are based on Fama-French definitions to which we have added Financial Services (SIC 6000-6999). The consultant dummies are defined as 1/n if the consultant provides executive compensation consulting services to the firm (where n is the number of all consultants providing services to the firm) and 0 otherwise.

Table 7 Coefficients of OLS Regressions showing the relation between Expected CEO Pay and the "repeat business" concern of compensation consultants

	Dependent Variable: Ln(Expected CEO Compensation)			
Weak governance measure >	None	CEO is chair	% directors appointed after CEO	% non-independent directors
	(1)	(2)	(3)	(4)
Intercept	4.271	4.278	4.228	4.117
	(39.4)	(38.8)	(37.6)	(29.7)
Weak governance measure (CEO is chair, % directors appointed after CEO, or % non-independent directors)	-	0.097	0.188	0.009
		(2.1)	(2.1)	(0.0)
Consultants work exclusively for the board	0.069	0.069	0.073	-0.029
	(2.0)	(1.3)	(1.5)	(-0.4)
Consultants work exclusively for the board × Weak governance measure	-	0.004	-0.042	0.314
		(0.0)	(-0.3)	(1.2)
Ln(2005 Revenues)	0.309	0.302	0.309	0.307
	(24.5)	(23.6)	(24.4)	(21.6)
Return on Assets (average percentage over previous 3 years)	-0.008	-0.008	-0.009	-0.002
	(-5.0)	(-4.9)	(-5.4)	(-0.6)
Stock Returns (percentage returns over previous 3 years)	0.001	0.001	0.001	0.001
	(1.8)	(1.8)	(1.6)	(1.6)
Target Non-Equity Incentives as a fraction of Expected Pay	1.862	1.846	1.870	1.970
	(16.0)	(16.0)	(15.9)	(15.3)
Grant-date values of stock and options as a fraction of Expected Pay	2.456	2.449	2.461	2.545
	(32.2)	(32.1)	(31.8)	(29.7)
Controls for six primary consulting firms	Yes	Yes	Yes	Yes
Industry Controls?	Yes	Yes	Yes	Yes
R^2	0.745	0.748	0.745	0.749
N	966	966	952	817

Note: t-statistics in parentheses. All regressions include only firms that use consultants. Expected compensation defined as the sum of salaries, discretionary bonuses, the target value for non-equity incentives, the grant-date value of restricted stock and stock options and other compensation (including perquisites, signing bonuses, termination payments, above-market interest paid on deferred compensation). Industry controls include dummy variables for Consumer Durables, Consumer Non-durables, Energy, Financial Services, Health Care, Hi-Tech, Manufacturing, Non-durables, Retail, Telecommunication, and Utilities. Controls are based on Fama-French definitions to which we have added Financial Services (SIC 6000-6999). The consultant dummy variables are defined as 1/n if the consultant provides executive compensation consulting services to the firm (where n equals the number of all consultants providing services to the firm) and 0 otherwise.

Table 8 Descriptive Statistics on other non-executive compensation consulting services in Canada

PANEL A: Other work reported in proxy statements in the United States versus in proxy statements in Canada

Other work reported in Proxy Statement	All consultants in all firms in Canada (N=156)	All consultants in all firms in the United States (N=1270)
Consultant provides *any* other service	46.2%	11.7%
Consultant provides employee pay services	22.4%	4.6%
Consultant provides benefits-administration services	20.5%	3.8%
Consultant provides actuarial services	11.5%	2.4%
Consultant provides other uncommon or non-specified services[a]	15.4%	4.5%

PANEL B: Other work and fees reported in proxy statements in Canada by compensation consultant

Consultant	Number (% market share) of firms using consultants	Number (%) firms where consultant provides other services	Number (%) firms reporting exec-pay consulting fees	Average exec-pay consulting fees ($000s)	Number (%) firms reporting other services that also report other service fees	Average other-services fees (C$000s)	Fee ratio[b]
Mercer HR Consultants	53 (42%)	27 (51%)	29 (55%)	$97.2	17 (65%)	$1,482.1	19.0
Towers Perrin	45 (36%)	28 (62%)	25 (56%)	$119.0	11 (39%)	$1,022.4	10.6
Hay Group	11 (9%)	6 (55%)	4 (36%)	$50.3	2 (33%)	$227.8	2.8
Hewitt Associates	9 (7%)	5 (56%)	7 (78%)	$114.9	4 (80%)	$425.9	10.6
Hugessen Consulting	6 (5%)	0 (0%)	5 (83%)	$106.8	-	-	-
Watson Wyatt Worldwide	6 (5%)	3 (50%)	4 (67%)	$69.1	1 (33%)	$605.0	5.8
Frederick Cook and Co.	5 (4%)	0 (0%)	1 (20%)	$39.3	-	-	-
Others	21 (16.8%)	4 (19%)	8 (38%)	$60.2	2 (50%)	$32.7	0.6

[a] Other uncommon services include non-pay consulting, employee training, outsourcing HR functions, tax services, investment services for pension funds, and actuarial services unrelated to pension plans.

[b] The fee ratio is equal to the average of the ratio of other services fees to executive pay consulting fees for each of the firms reporting these fees in their proxy statements.

Table 9 Coefficients of OLS Regressions showing the relation between Expected CEO pay and "other services" (or other service fees) provided by the compensation consultants in Canada

	Dependent Variable: Ln(Expected CEO Compensation)			
	(1)	(2)	(3)	(4)
Intercept	4.236	4.426	4.578	5.311
	(12.5)	(13.5)	(13.6)	(10.3)
Consultants provide other services to the firm	0.334	-	-	-
	(2.7)			
Number of other services provided by compensation consultants	-	0.254	-	-
		(4.3)		
Consultants provide:				
Actuarial services to the firm	-	-	0.549	-
			(3.2)	
Employee pay consulting services	-	-	0.122	-
			(1.0)	
Benefits administration services	-	-	0.234	-
			(1.7)	
Other uncommon or non-specified services	-	-	0.179	-
			(1.2)	
Fee Ratio	-	-	-	0.010
				(3.1)
Ln(2005 Revenues)	0.255	0.219	0.200	0.141
	(6.0)	(5.2)	(4.6)	(2.4)
Return on Assets	-2.292	-2.081	-2.300	-7.094
(average percentage over previous 3 years)	(-2.3)	(-2.2)	(-2.5)	(-3.9)
Stock Returns	0.003	0.003	0.003	0.138
(percentage returns over previous 3 years)	(0.8)	(0.8)	(0.9)	(1.6)
Equity and Non-Equity Incentives as a	2.604	2.658	2.651	2.455
fraction of Expected Pay	(10.2)	(10.9)	(10.8)	(6.0)
Industry Controls?	Yes	Yes	Yes	Yes
R^2	0.663	0.691	0.704	0.716
N	120	120	120	54

Note: t-statistics in parentheses. All regressions include only firms that use consultants. Expected compensation defined as the sum of salary, bonus, restricted and performance shares, and options valued on the grant date. Other uncommon services include non-pay consulting, employee training, outsourcing HR functions, tax services, investment services for pension funds, and actuarial services unrelated to pension plans. The Fee Ratio is equal to other services fees divided by executive pay consulting fees for each of the firms reporting these fees in their proxy statements. Industry controls include dummy variables for 5 Fama-French categories + to which we have added Financial Services (SIC 6000-6999).