

### The Spotlight on the Independence of Compensation Consultants

By *Ning Chiu and Kyoko Takahashi Lin*

Much as the demand for auditor independence followed the wave of accounting scandals several years ago, there has been increasing focus on the “independence” of the compensation consultants hired to advise on executive compensation in light of perceived excessive compensation paid to senior executives. In May 2007, Representative Henry S. Waxman, chair of the US House of Representatives Committee on Oversight and Government Reform, requested data from the major compensation consulting firms on the amount of fees and types of services performed by the consultants for the Fortune 250 companies from 2002 to 2006. The House Committee’s premise was that compensation consultants have an inherent conflict of interest if they provide both executive compensation and other services to the same company.

In December 2007, the House Committee issued a report<sup>1</sup> highlighting several findings that it considered notable:

- Almost half of the companies used consultants to provide both executive compensation advice and other services, such as benefits plan administration, with the fees paid for other services being almost 11 times more than the fees for providing executive compensation advice.
- Over two-thirds of the companies that used consultants for both executive compensation and other services did not disclose this practice in their proxy statements, and 30 of those companies stated that the consultants were “independent.”
- Median CEO salary paid by companies that hired consultants with the “largest conflicts” was 67 percent higher, and the companies that hired consultants with the “largest conflicts” increased CEO pay “twice as fast” as the companies that did not use consultants with conflicts.

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As the Committee Report’s findings are based on nonpublic information, it is difficult to challenge either its methodology or its conclusions. Even the Committee Report notes that the correlation between consultants’ conflicts of interests and levels of CEO pay does not necessarily prove a causal relationship, as the companies that used “conflicted” consultants tended to be larger. However, the statistics cited above as highlighted in the Committee Report have been widely circulated by the press,<sup>2</sup> without any similar caveat.

While the analogy to auditor independence may have some resonance, what has been lost in the rhetoric is the recognition that compensation consultants have a very different role than registered accounting firms that audit public company financial statements. Investors believe that auditors are essential to ensuring that management has produced accurate financial statements that they can rely on to make investment decisions, and, as a result, auditors, sometimes referred to as “public auditors,” and their work are highly regulated by both the Public Company Accounting Oversight Board and the SEC. Auditors must follow detailed and often complex accounting rules, standards and guidance in reviewing a company’s financial statements and conducting their audits, discuss specific matters with audit committees and provide reports in company filings with the SEC on their audits and their assessments of internal controls.

By contrast, compensation consultants are not regulated and do not adhere to any particular set of published rules or guidelines in formulating their advice, nor are they responsible for auditing or attesting to executive compensation. Unlike the existence of the well-established “Big Four” accounting firms, the market structure for compensation consulting services is quite different, with lower barriers to entry. The ratio of revenue generated from executive compensation advice relative to other consulting services for the major benefit firms is much less than the ratio of audit to non-audit fees for the accounting firms. In addition, the role of the consultants and their influence vary

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widely among companies, and it is unlikely that shareholders rely on those consultants to validate the type or amount of executive compensation.

Regardless of the merits of the arguments as to whether conflicts actually exist in the arrangements with compensation consultants, companies need to be aware of these concerns and the interest of both the SEC, with respect to disclosure, and major investor groups, as to possible subjects for shareholder proposals.

*What are the conflicts concerns being raised?* The House Committee appears to believe that there is an inherent conflict if the same compensation consultant provides advice on executive compensation and performs other services, because the compensation consultant could not be expected to give independent, objective advice about the appropriate type and level of compensation to be paid to the same management that may hire them for those other services, which usually generate higher fees. These other services may include employee benefit plan design and administration, human resource management and information and actuarial services.

*What are the opportunities for a company that wants to address these perceived conflict issues?* As the issuance of the Committee Report and the ensuing publicity demonstrate, there is likely to be increased attention on the use of compensation consultants in advising on executive pay. Shareholder groups may also submit proposals seeking reports or other actions by companies related to consultants, and the appropriate response may vary depending on the nature of the request.

To address these perceived conflicts, some compensation committees have adopted policies making clear that the consultant reports directly to the committee and limiting the role of the consultant advising the committee to executive compensation. Some companies have carried this even further and hired a separate consultant to serve only the committee, noting that a different consultant performs other services for the company. Other companies require that the compensation committee pre-approve other services to be performed by the same compensation consultant that advises on executive compensation, a similar approach to audit committees' pre-approving audit-related, tax and other services performed by auditors. Whether these or other

actions are appropriate for any company depends on the circumstances involved.

*Why does the Committee Report indicate that companies did not provide adequate proxy disclosure?* The SEC's executive compensation rules require that companies (1) describe any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, (2) identify such consultants and (3) state whether such consultants are engaged directly by the compensation committee. The disclosure must include the nature and scope of the consultant's assignment and material elements of the instructions or directions given to the consultant.<sup>3</sup>

The Committee Report indicates that it "uncovered evidence" that nearly half of the Fortune 250 companies examined did not disclose the identity of all consultants hired to provide executive compensation advice. It appears that more compensation consultants reported amounts spent by companies on executive compensation services to the House Committee than were identified by those same companies in their proxy statements. This distinction is likely, as the Committee Report notes, because companies used a different definition of "executive compensation services" for their proxy disclosure. The House Committee had asked the consultants to provide information on revenues earned for work related to the compensation of senior executives, including devising equity compensation plans, designing compensation peer groups and providing pay survey data. "Other services" were identified as fees earned for services related to compensating employees other than senior executives, and work unrelated to compensation. Companies may not have been aware that "executive compensation services" could then capture any benefit plans that involve the senior executives, even if otherwise generally available to a broader group of employees, such as work involving a broad-based equity compensation plan.

*Are the disclosure practices changing in this area?* Given the timing of proxy season, we do not yet know whether companies are being more expansive in their disclosure in response to the Committee Report. In fact, even the Committee Report acknowledges that it is unclear whether the scope of the disclosure required by the SEC disclosure rules ("determining or recommending the amount or form of" executive compensation) is the same as the request made by the House Committee to the

consultants in gathering its data. However, at least the Fortune 250 companies that were the subject of the Committee Report should be aware of the specific data that was provided by the consultants in case the House Committee, or the SEC, decides to pursue this further. We understand that the compensation consultants generally informed those companies prior to providing the information to the House Committee, and in-house counsel who do not already possess this information may be able to ask their human resources department, or the consultants directly.

It would also be useful to be aware of not only the company's primary consultant that advises on executive compensation, but also any additional consultants that may have provided services involving, for example, the design of new equity compensation plans in which the senior executives participate. This may be particularly true for those companies that usually engage specialized firms as their executive compensation consultants, given that those consultants do not perform such services related to plans.

In addition, some active investor groups recommend that companies also disclose the compensation committee's assessment of the consultant's independence and a description of any other services performed for the company. This disclosure is not required by the SEC rules, but companies may wish to disclose the basis of their consultant's objectivity, including explaining the nature and extent of any other services provided by the consultant.

*How are compensation consultants responding to these concerns?* Compensation consultants have also responded to the perceived conflict issue by establishing internal "walls" to separate the consultants involved in advising on executive compensation, and a number of boutique firms focus only on executive compensation.

In late January 2008, the House Committee followed up this review with a letter to the chairs of the compensation committees of the Fortune 250 companies seeking information about the use of compensation consultants. The January 2008 letter asks a series of questions, including whether:

- The compensation consultant was retained directly by the compensation committee or management;
- The compensation consultant reports directly to the committee;
- The compensation consultant performs other services unrelated to executive compensation;
- The company discloses the compensation consultant's involvement in providing other services to the company; and
- The company has a policy regarding whether the consultants can perform those other services.

There has not been any indication of how the House Committee will analyze the responses it received from these letters. The Committee appears to have a continuing interest in the role of compensation consultants in establishing executive compensation, as evidenced by the focus on the use of different compensation consultants and their advice during the Committee's recent hearing about the pay package of the chief executive officer of Countrywide Financial Corporation.

It is unclear at the moment whether Congressional, SEC or shareholder interests in these matters will be appeased by the actions already taken by consultants or companies. We may not know for at least another proxy season whether this issue is eventually superseded or continues to be the focus of scrutiny. In any case, awareness and preparation are always useful defenses.

## Notes

1. *Executive Pay: Conflicts of Interest Among Compensation Consultants*, United States House of Representatives Committee on Oversight and Government Reform, Majority Staff, December 2007. For a copy of the report: <http://oversight.house.gov/documents/20071205100928.pdf>
2. *E.g.*, House Panel Finds Conflicts in Executive Pay Consulting, *New York Times*, December 6, 2007; Conflict Concerns Benefit Independent Pay Advisers, *The Wall Street Journal*, December 10, 2007.
3. Item 407(e)(3)(iii) of Regulation S-K.