

# As We See It

July 4, 2009

## Consultant Independence Revisited

The public furor over consultant independence has softened to a dull roar over the past three years. Recent events will again turn up the volume.

Three years ago, in the wake of public outrage over excessive executive pay packages, and on the heels of Sarbanes-Oxley, government turned its attention to governance issues within compensation committees. The SEC's 2006 proxy disclosure changes introduced a requirement for companies to identify the "...role of compensation consultants ...stating whether such consultants are engaged directly by the compensation committee... [and] describing the nature and scope of their assignment..." In late 2007, consultant independence came to a head with Congressional hearings conducted by Rep. Henry Waxman's Committee on Oversight and Government Reform.

In response, we saw compensation committees actively address the issue of consultant independence, and include definitive statements about independence in their proxy statements. At that point, committees and, in large part the public, moved on. Now, consultant independence is again coming into the public eye.

### Recent Events

One of the fallouts of the 2008 financial crisis is renewed attention on executive compensation and the process by which committees make decisions. Much of this

attention is driven by the perception that excessive executive pay levels contributed to undue risk-taking by financial institution executives. This concern has led to increased attention to the role of consultants in both the determination of pay levels and the design of incentive plans.

Just this week, the SEC proposed new proxy disclosure rules that would require companies to include additional information on the committee's compensation consultant if the consulting firm provides any additional services to the company. The additional information would include a description of all services provided to the company and the associated fees.

Add to that, the recent announcement that two of the largest human resources consulting firms plan to merge by the end of the year. To date, there has not been much said about the potential conflicts among their respective executive compensation practices, as they represent a small portion of the client revenues of both firms. However, the merger will undoubtedly resurrect conflict concerns for their executive compensation clients.

In light of this activity, we thought it worthwhile to reiterate our opinion of the issue of consultant independence.

## Our Opinion

**As we see it**, the issue of consultant independence is not unlike the issue of director independence. The most important consideration is that the consultant *think and act independently*. Ensuring this level of independence requires committees to consider both external factors as well as internal factors in assessing consultants.

Many committees have taken pains to ensure that their consultants are “technically” independent. It has become common, especially among the largest public companies, to include statements in the annual CD&A that the committee’s advisor:

- Reports directly to the committee, rather than management;
- May not perform any other work for the company or may only do additional work with the committee’s prior knowledge and approval.

In addition, some companies have adopted a dual-consultant process, whereby management has its own consultant and the committee’s advisor acts in the role of an adjunct committee member, with limited interaction with management.

In this environment of heightened scrutiny and skepticism about all executive compensation processes and decisions, committees should be applauded for avoiding potential questions and accusations by establishing a paper trail and selection process to minimize or eliminate potential and real conflicts of interest.

However, these measures are external in nature and are designed to satisfy regulators, politicians, the media and other pundits on the issue of consultant independence. Such precautions do not guarantee real independence, which demands that the committee’s consultant also:

- Provide unbiased analysis, advice and counsel in the committee meeting room;
- Take a stand on issues when necessary, even if it means engaging in an occasional “vigorous debate” with committee members or management; and
- Assume a responsibility similar to the fiduciary responsibility of committee members to shareholders.

This last role is most important, as a truly independent consultant places shareholder interests above those of the committee and management. For the truly independent consultant, the question is “does this [program/plan/pay level] serve shareholders’ interests”. This role cannot be legislated, regulated or jaw-boned in a public forum. It is particularly difficult to attain in the jumble of competing interests, legal, tax, accounting and regulatory issues, and other influences on executive pay in today’s complex society. But it must be attained if executive pay is to serve its role in the business world – an enabling mechanism designed to serve the interests of all parties, but most particularly those of shareholders.