

As We See It

Compensation Consultants and Good Governance

Today's governance environment requires that companies be mindful about avoiding any perceived conflicts of interest among Compensation Committees, their pay consultants and executives. Whatever the assignment, unless it is clear to all sides that the outside consultant ultimately reports to the Board – not management – its advice is unlikely to be perceived by shareholders as independent and objective. But there is nothing sinister about consultants and executives working together on the development of corporate pay programs. We explain why and offer some guidance for avoiding real conflict.

There is increasing attention to issues related to Boards' use of outside compensation consultants – particularly the need to ensure that the advice provided to a Compensation Committee is not filtered by the very managers whose interests are at stake.

As a general practice, we believe firms engaged in the review and recommendation of executive compensation should be retained by the Board, which should also authorize and oversee all work performed for itself or for management. We support the SEC's proposal for expanded disclosure, which would mandate that the Compensation Committee disclose "any role of compensation consultants" in developing executive and Board pay programs, as well as state whether the consultant was engaged directly by the Committee and describe the scope of its responsibilities. Such information would be of interest and useful to stakeholders in evaluating a firm's compensation practices.

Sarbanes-Oxley legislation takes a similar, but even stricter, approach toward the use of outside auditing firms. It requires that the Audit Committee be directly responsible for retaining the company's outside auditors and that the auditor report directly to the Committee.

However, the SEC and Congress part ways in their view of the propriety and necessity of an outside Board consultant working with management. SOX treats regular communication between the outside auditor and management as a routine and legitimate part of preparing the auditor's report for the Committee, not a potential conflict of interest in need of regulation.

In contrast, the SEC proposal includes a requirement that companies identify "any executive officer within the company the [compensation] consultants contacted in carrying out their assignment." While we generally favor increased transparency, such a broadly worded mandate might easily give shareholders the impression that communication between pay consultants and management is an inherent conflict of interest that should be kept to a minimum.

In fact, without access to data and insights from management regarding corporate goals, strategies, culture and other considerations, compensation consulting firms would be unable to develop effective corporate pay programs. Such interaction is so routine that a mandatory proxy disclosure of management's contacts with compensation consultants would probably look fairly similar from one company to the next: a listing of executives in those positions typically involved with oversight of corporate pay programs.

We believe the more meaningful governance issue is how companies should handle those frequent situations in which management would like the Committee's consultant to undertake additional consulting work that is unrelated to its work for the Committee. For example, Committee decisions frequently generate a need for additional work to extend programs to lower levels of employees not normally reviewed by the Committee. This is an issue of increasing concern to companies. In a January survey conducted by our firm of 109 public firms, more than half said their Compensation Committee and

management use the same compensation consultant. While 71% of all the companies surveyed said such an arrangement is not or is unlikely to present an actual conflict of interest, 43% said it might create the appearance of a conflict.

Retaining separate compensation consulting firms for the Board and management – “dueling consultants” – would be more costly and might result in contradictory recommendations on pay issues. Moreover, shareholders are unlikely to appreciate footing the bill for management to have an exclusive advocate. Yet expecting the same consultant to regularly switch between reporting directly to the Board or to management, with neither taking overall responsibility for the consulting relationship, creates real potential for conflict.

As we see it, good governance and good business calls for the Compensation Committee to directly retain the best compensation consultant it can find – and then exercise exclusive authority to approve and review any and all services provided by the consultant to the company, whether initiated by itself or requested by management.

That being said, there are specialized consulting scenarios where the use of separate consulting firms may be more appropriate. For example, in the renegotiation of an incumbent CEO’s employment contract, the Committee’s consultant cannot fairly represent both sides of the table. Our policy when asked to advise Compensation Committees on such agreements is to act exclusively as its representative to eliminate any conflict and recommend that the CEO consider retaining his or her own counsel.

When it comes to the question of compensation consulting firms doing additional corporate work, restrictions governing the work of outside auditing firms are a useful model. The Audit Committee is required to pre-approve all audit and non-audit services provided by the outside auditor, as well as all audit engagement fees and terms. Similarly, we believe that in addition to maintaining oversight of any work performed by its compensation consultant, the Compensation Committee should approve or reject any unrelated financial relationship between the consulting firm and the company.

In our recent survey, 24% of the public companies polled thought there was a possible conflict in a compensation consulting firm performing other services, but that figure rose to nearly half of all companies when it came to the potential appearance of a conflict.

Overall, we have found that some organizations prefer their consulting firm to provide integrated services that can offer project efficiencies and leverage, while others would rather maintain consultant independence. Most consulting firms are prepared to work under either arrangement. Regardless of the scenario, we encourage Committees to adopt PM&P’s standard practice: once we are engaged by a Compensation Committee, we require its authorization before undertaking any assignments, whether or not they are connected to our Committee work, including consulting to management.

Better clarification of good governance practices for use of compensation consulting firms should be welcomed by consultants, Committees and shareholders alike. But we would recommend against building walls where gates are more appropriate. Ultimately, as with most aspects of Board oversight, transparency, awareness and good judgment will be the keys to effective and appropriate relationships between Compensation Committees and their consultants.