COMPLIANCE WEEK

Compensation Committees Hiring Their Own Consultants

By Susan Schott Karr — April 5, 2005

At a February 2005 conference hosted by the Investor Responsibility Research Center, Charles Elson—director of the University of Delaware's Center for Corporate Governance—stressed the idea that boards should engage their own executive compensation consultant who does nothing but work with the board itself. In other words, the consultant doesn't work for management.

The move, seen as critical in creating pay-for-performance packages for CEOs and other top executives, had also been urged by regulators in recent months. "I also hope compensation committees have begun to take to heart suggestions that they reexamine their relationships with compensation consultants to insure that the consultants' work for the committee—not the executives whose pay is being considered," asserted Alan Beller, SEC Division of Corporation Finance director, in an October 2004 speech.

Veasey

The subject of hiring consultants to work with the board's compensation committee has been bandied about since 2002, when E. Norman Veasey, the chief justice of Delaware's Supreme Court, mentioned the topic in a *Harvard Business Review* interview authored by Elson. "Compensation committees should have their own advisers and lawyers," said Veasey. "Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently."

After Veasey spoke, the idea of hiring a consultant "made its way into the lore," says Elson, and has gained prominence among directors following the Disney case and the reality of executive liability (see related story in box at right). "Now, at least anecdotally, you're seeing a movement in that direction," says Elson.

Determining how much the CEO and top executives earn is extraordinarily complex, and there is a renewed interest in ensuring it's done in a proper fashion. "There is a move to get the process right," says Elson. And, to those ends, a compensation consultant can "represent the interests of the committee and the shareholders."

Elson

Strengthened Committees

In November 2003, the SEC approved new rules that changed the membership, roles, responsibilities, and compensation of boards of directors for companies listed on the New York Stock Exchange and quoted on the Nasdaq Stock Market. For directors, these rules honed the definition of "independence."

The NYSE rules require an all-independent compensation committee, which must have a written charter of the company's purposes and responsibilities. The charter is supposed to lay out the committee's relationship to compensation experts; according to the SEC, "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."

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Koppes

The result as has been a more powerful compensation committee; according to Richard Koppes, an attorney with Jones Day in San Francisco and a former general counsel for institutional investor CalPERS, the compensation committee "has been strengthened by all the scandals and all the reforms."

Some say that a conflict of interest here is inevitable, as board-hired consultants still want to remain in favor with management, who in turn want to be compensated well. But Koppes believes the compensation committee can provide cover and support for the consultant, which can help to reduce any conflict. In addition, the role of compensation committee chairman is one that will face additional scrutiny over time, which can help ensure consulting relationships are managed appropriately. "I think the [position of] chair of the compensation committee will be a lot more work and a very unpopular position in the next few years," says Koppes. "In general, as boards become more independent, the rest of the board is expecting the compensation committee to say 'no' and to negotiate."

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Hyper-Exclusion

The result, some say, may be an increased distancing between executives and the compensation committees that set their pay. Elson even suggest we may begin to see compensation committees that are "hyper-excluded" from management. In this scenario, the compensation committees would become like audit committees, in that they would be comprised of independent directors and independent consultants, thereby offering "squeaky independence."

Although not all agree. "I'm not sure I would agree 100 percent with the idea of "hyper-exclusion," Koppes recently told Compliance Week. "It almost sounds as if they'll be dealing with these issues on their own. It doesn't mean that management won't have any say."

Former Delaware Supreme Court Chief Justice Veasey notes that one size does not fit all, and that committees should employ consultants as they deem appropriate. "Some compensation committees do have a compensation consultant separate from the consultant hired by the corporation through management; other boards rely on the consultant hired by management," says Veasey.

Whichever model is selected, Veasey notes that the board should make a "reasoned and deliberate decision"—preferably during executive session, or in sessions on this subject—and review it from time to time. "That decision may be to hire its own independent expert or expressly to approve the consultant hired by the corporation, which may be perfectly acceptable if the compensation committee is satisfied that the expert will give independent advice," adds Veasey. "This would be a matter of business judgment if the compensation committee's decision-making process is credible."

Again, one size does not fit all. "The decision is an individual one for each board to decide based on the corporation's size, cost, culture, etc.," says Veasey. He does acknowledge, however, that boards often feel more comfortable hiring their own independent consultants, and, "in my opinion, that should tend to be the better model."

Part Of The Strategy

Brancato

According to Carolyn Brancato, director of the Global Corporate Governance Research Center at the Conference Board, more and more compensation committees are hiring compensation committee consultants. "The practice is becoming a standard now," she says. And while exact figures are unknown, Brancato adds that, "There are very few companies now who don't have an independent compensation consultant."

And that independent consultant can prove extraordinarily useful when countering the recommendations of managements' consultants. For example, Brancato notes that consultants hired by management consistently advise compensation committees that management should be in the top 75 percent of pay. "But it's a mathematical impossibility," she says, likening the scenario to a "Lake Wobegon effect," in which all executives are perceived to be above average.

That created a situation in which compensation committees needed to push back, and began relying on board-hired experts to help them. "I don't think that boards were visceral or evil" in getting tougher on pay, notes Brancato, "they simply needed to have some greater freedom over the situation." And, considering their fiduciary responsibilities, bringing in unbiased third parties is certainly reasonable. "They have to hire the best top management, but also protect the shareholders," Brancato adds, "and do so within the companies' budgets."

And many saw that rigor is long overdue. According to a recent report by TCB, at many companies the compensation committee "has not played as central and vigorous a role as necessary to assure the public that executive compensation policy is determined independently from management or from compensation consultants hired by management."

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