

## Independence Standards for Compensation Consultants

■ By **Margaret Engel**

To enhance corporate governance standards, legislators and regulators are calling for Compensation Committees to use independent consultants as advisers on executive compensation matters. Since June, 2009, two bills addressing consultant independence have been proposed in the House. In addition, the Treasury has proposed a bill that would require the SEC to set standards for independence. Finally, the SEC proposed rules requiring enhanced disclosure, including compensation consultant fee disclosure.

Below we review the recent legislative and regulatory activity, culminating in passage of the Corporate and Financial Institution Compensation Fairness Act of 2009 by the House on July 30, 2009.

### Shareholder Empowerment Act

Representative Gary Peters proposed an amendment to the Securities and Exchange Act of 1934 that would require a number of reforms, including enhanced proxy access, independent chairman for corporate boards and say on pay. The Act would require boards retaining advisers in connection with negotiating employment contracts or compensation agreements with executives to retain only independent advisers that report solely to the board of directors or the committee responsible for executive compensation. The Act also requires that companies not agree to indemnify or limit the liability of compensation advisers or advisory firms.

Examples of criteria Boards should consider in determining whether an adviser is independent suggested by Peters include:

- The extent (as measured by annual fees and other relevant metrics) to which the individual adviser or advisory firm provides other services to the Company or its executives;
- Whether individual advisers are permitted to hold equity and do hold equity in the Company; and
- Whether an advisory firm's incentive compensation plan links the compensation of individual advisers to the advisory firm's provision of other services to the issuer.

### Corporate and Financial Institution Compensation Fairness Act of 2009

Representative Barney Frank, Chairman of the House Financial Services Committee, submitted H.R. 3269 a few weeks later. The primary purpose of this Act is to amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation and to prevent perverse incentives in the compensation practices of financial institutions. But independence standards for both Compensation.

Committee members and outside compensation consultants are also addressed. H. R. 3269 was passed by the House on July 30, 2009.

H.R. 3269 requires that Compensation Committee advisers for all public companies – including compensation consultants, legal counsel, or other advisers -- meet new standards for independence to be established by the SEC within nine months of the Act's enactment. While the bill will not become law unless the Senate acts, many feel that independence will almost certainly become an absolute requirement for Compensation Committees.

The bill was amended to provide that the SEC's regulations for independence and disclosure are competitively neutral among categories of consultants. The intent here is to preserve the ability of Compensation Committees to retain either boutique consulting firms that only provide compensation consulting advice or multi-service consulting firms that provide other services, such as actuarial services or outsourcing. Nevertheless, we predict that it will be difficult for multi-service firms to compete effectively if they provide substantial other services to corporate clients.

The Compensation Committee would have the authority, in its sole discretion, to retain an independent compensation

consultant and would be directly responsible for the appointment, compensation, and oversight of the work of the consultant. Committees would not be required to follow the adviser's recommendations and would continue to be expected to exercise its own judgment, but they would own the process.

Frank's Act also requires disclosure in the proxy whether or not the adviser met the standards for independence that the SEC will establish. Finally, appropriate funding of payments to independent advisers, as determined by the Compensation Committee, will be required, assuring Committees' access to appropriate advisers.

### **Treasury's Proposed Investor Protection Act of 2009**

On July 16, 2009, Treasury submitted draft legislation to congress that would ensure the independence of Compensation Committees. Treasury noted that Compensation Committees without access to independent compensation consultants may be at a significant disadvantage when negotiating pay plans with management. Treasury sought to level the playing field by providing Committees with access to compensation consultants, legal counsel, and other advisers.

Treasury noted that conflicts of compensation consultants are pervasive since advisory firms often provide other, non-compensation related services to companies. In addition the fees earned for other services often dwarf the fees earned from compensation consulting.

Treasury outlined several new requirements applicable to all public companies within nine months of the bill's enactment. First, the SEC would be empowered to set standards for consultant independence. Each Compensation Committee would be authorized to retain an independent compensation consultant and would be directly responsible for the appointment, compensation, and oversight of the work of the independent consultant.

The Committee's choices would be subject to proxy disclosure. The company would be required to disclose whether or not the Compensation Committee retained an independent compensation consultant. If the Committee did not retain an independent consultant, the rationale not to do so would need to be explained.

### **SEC Proposed Rules on Proxy Disclosure and Solicitation Enhancements**

The SEC also weighed in on the compensation consultant independence issues. Currently companies are required to disclose the role of compensation consultants in determining executive and director compensation, including whether they are engaged directly by the Compensation Committee. The SEC noted that many compensation consultants provide a broad range of additional services to companies, and fees for other services may be larger than fees earned by consultants for executive compensation. The SEC noted that "provision of such additional service by compensation consultants or their affiliates may create the appearance, or risk, or a conflict of interest that may call into question the objectivity of the consultants' executive pay recommendations."

Under the SEC's proposed rules, if a consultant played a role in determining or recommending the amount or form of executive or director compensation and also provided additional services, the Company would be required to disclose:

A description of all additional services provided during the prior fiscal year;

- Aggregate fees for all additional services, as well as aggregate fees related to executive and director compensation consulting;
- Management's role in the decision to engage the consultant for additional services;
- Whether the Board or Compensation Committee approved all of these additional services.

We expect the SEC to modify these disclosure rules to respond to the requirement for "competitively neutral" regulations embedded in H.R. 3269. The SEC's proposed rules are not competitively neutral since fee disclosure would apply only if additional services were provided. This confers a major advantage on boutique firms that do not provide additional services, since they would be exempt from the disclosure requirements. The attention of regulatory and legislative bodies on this issue will certainly continue. As we point out below ("How Companies Handle Independence Issues") some companies are already initiating their own independence standards for compensation consultants.

***Please contact us at (212)-921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at [www.capartners.com](http://www.capartners.com) for more information on executive compensation.***