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BOARD ADVISORY LLC

Compensation Advisor Independence

The SEC recently published new rules on Compensation Committee Independence and Outside Advisers (17 CFR Parts 229 and 240), including specific factors to be used by the national exchanges in determining compensation advisor independence. The intent of this evolving regulation is to establish standards for compensation committees and their advisors that are comparable to the standards established over a decade ago for the audit committees and external auditors. However, after three years in the making, the resulting rules fail to establish any real test for independence. Worse, the resulting "factors" are inconsistent with existing audit committee standards and compensation committee member (director) independence standards. Regrettably, the resulting rules are more the inevitable outcome of successful lobbying efforts on the part of the compensation consulting industry than reflective of any rising standard for conduct by compensation committees and their advisors.

The Act and the subsequent SEC rules ignore the most likely conflict of interest facing compensation committees; that firms will derive the lion's share revenue from any single client engagement serving management, and therefore be hesitant to upset management when completing an assignment with the compensation committee or the board. This is perfectly analogous to the situation in the 1990's with audit firms conducting large-scale consulting assignments for management in the same firms they were supposedly auditing. We get it -- independence means you can serve only one party.

The legislature erred in establishing two of the factors in their drafting of 10C (b)(2).

- First, the rules establish as a factor the "provision of other services to the issuer" by the consulting firm, and do not consider the magnitude of the total fees attributable to the "other services" provided. This fails to differentiate minor services that may be provided to management by a board consultant that do not pose a threat to advisor independence. Using the audit analogy, it is not uncommon for external auditors to still provide services to management; it simply requires advance approval by the audit committee and disclosure to investors.
- Second, the rules establish as a factor fees paid by the issuer as a percent of total consulting firm revenue, without considering the nature of the fees (i.e., management vs. board services). Clearly, if 100% of the fees are derived from the board relationship, interests are aligned and there is no conflict, independent of any concentration of consulting firm revenue derived from the relationship. In auditing, we find no consideration of audit income as a percent of firm income

being relevant to the independence standard (nor is director concentration of income from the issuer a factor in establishing director independence). This factor is at best a red herring, at worst, a triumph of lobbying over shareholder interests.

It is our opinion the only amount of fees that are relevant are the fees earned for advising the Board versus the fees earned by advising management. When proxies report fees of $200,000 for advising the Compensation Committee and $2,000,000 for advising management on pension and welfare matters, it is difficult to see any independence.

Clearly the legislative staff was concerned about disrupting this industry. The Dodd-Frank legislative process considered input from a number of sources, including several of the large multi-service consulting firms, and includes a preamble to specifically establish that the independence factors be "competitively neutral among categories of consultants…". Unlike auditor independence, where Sarbanes-Oxley created a bright line that clearly disadvantaged firms with conflicts of interest, this Act attempts to protect even those situations where a conflict exists, to "preserve the ability of compensation committees to retain…" advisors even when obvious conflicts exist.

Fortunately, we do believe that in spite of Dodd-Frank, boards are migrating to conflict-free committee members and conflict-free committee advisors. As a result, we find multi-service consulting firms continuing to spin off their executive pay consulting units. Market share for the multi-service firms has continued to erode since the late 90's, indicating that most boards – independent of regulation – are mindful of both the potential for conflict of interest and the appearance of conflict of interest, and choose firms specializing in board-level consulting services. We clearly are on a trajectory to end up with the same model as with audit firms, albeit at a more confused pace.