FACT SHEET: Administration's Regulatory Reform Agenda Moves Forward
New Independence for Compensation Committees

Today, as part of its push for comprehensive regulatory reform, Treasury delivered draft legislation to Congress that would take steps to ensure that compensation committees are independent in fact, not just in name. Compensation committees are responsible for negotiating executive compensation arrangements that protect long-term shareholder value. Yet some compensation committees may not be fully independent of management—for example, because the directors themselves stand to gain from the decisions of executives. And even where the members of the committee are independent of management, they may lack the tools to bargain effectively with executives over complex compensation decisions or may receive advice from consultants or legal counsel that face conflicts of interest.

The Administration's proposed legislation takes three important steps to ensure that compensation committees have the independence and expert assistance they need to serve their important role:

- First, the legislation requires that members of the compensation committee meet exacting new standards for independence, just as Sarbanes-Oxley did for members of audit committees.
- Second, to ensure that committees are receiving objective advice, the legislation requires that any compensation consultants and legal counsel they hire be independent from management.
- Finally, the legislation requires that compensation committees be given the authority and funding to hire independent compensation consultants, outside counsel, and other advisers who can help ensure that the committee bargains for pay packages in the best interests of shareholders. At the same time, it requires that if the committee decides not to use its own compensation consultant, it explain that decision to shareholders.

I. To ensure that compensation committees setting executive pay are independent from management, the Administration will require that compensation committee members meet stronger standards for independence.

- ***Directors responsible for ensuring that executive pay is in the best interest of shareholders should not have financial conflicts with management.*** Some directors have financial relationships with the company and its executives that may compromise their independence. Studies have linked some of the most controversial pay practices, such as option backdating, with the absence of independent directors on the board. A study by Lucian Bebchuk of Harvard, Yaniv Grinstein of Cornell and Urs Peyer of INSEAD, for example, concluded that backdating is "correlated with . . . CEO influence over internal decision-making processes," such as "the lack of a majority of independent directors on the board."[1] Current law does not prohibit these conflicted directors from sitting on the committees that set executive pay at American companies.

- ***Strict independence standards have curbed abusive accounting practices.*** The Administration's legislation would require that compensation committee members meet strict independence standards—just as Sarbanes-Oxley did for audit committees. The independence of audit committees has been a critical factor in restoring investors' confidence in American companies. For example, academic studies have linked increased audit committee independence with the reduced incidence of the most abusive accounting practices, such as the practice of "managing" the company's earnings in order to satisfy financial analysts' expectations.[2]

- ***While stock exchanges have set independence standards, they may not go far enough to ensure shareholder interests are protected:*** The major stock exchanges now require that compensation committee members meet certain minimum standards for independence, and studies have indicated that

directors who meet these minimum standards may be better guardians of shareholder interests.[3] But under New York Stock Exchange standards, directors can still be considered independent even if they receive up to $100,000 in outside compensation from the company—in addition to directors' fees. And a director who owns or operates a business receiving up to $1 million in revenue from the company is considered independent under these standards.

II. The Administration will give compensation committees the authority and funding to retain their own compensation consultants and counsel to help them set compensation packages that protect shareholder interests.

- ***Compensation committees can be at a disadvantage in setting pay due to a lack of independent expertise.*** Compensation committees may negotiate pay at a significant disadvantage because executives use compensation consultants to advocate for their views — while the committee may not have access to experts of their own. Under those circumstances, it is unsurprising that academic studies have repeatedly established a link between the use of compensation consultants and higher pay. A study by Chris Armstrong and Christopher Ittner of the University of Pennsylvania and David Larcker of Stanford found that the use of consultants was most closely correlated with higherCEO pay most when other shareholder protections are weakest, noting that "compensation consultants provide a mechanism for CEOs of companies with weak governance to extract and justify excess pay."[4]

- ***Providing compensation committees with access to independent consultants can level the playing field in a way that protects shareholder interests.*** Directors themselves have long recognized that management's use of consultants without comparable access on the part of compensation committees may compromise their ability to establish compensation packages that protect shareholder interests. In 2003, a blue-ribbon panel established by the National Association of Corporate Directors recommended that compensation committees be given access to their own consultants.[5] The Business Roundtable's own "Executive Compensation Principles" make clear that "the compensation committee should have independent, experienced expertise available to provide advice on executive compensation arrangements and plans."[6]

- ***Just as compensation committees need access to their own compensation consultants to protect shareholder interests, committees should have the authority to hire legal counsel and other advisers that report only to the committee.*** For the same reasons that compensation committees need the assistance of their own compensation consultant in order to ensure that executive pay is designed to protect shareholder interests, directors also need help from independent legal counsel when bargaining with executives over compensation. Many companies have already authorized their compensation committees to retain independent counsel as they see fit, and giving the committee this authority has long been considered a best practice among corporate governance experts.[7] In 2003, the well-respected group of top corporate lawyers and academics that comprised the American Bar Association Task Force on Corporate Responsibility concluded that compensation committees should have the authority to hire independent counsel,[8] while two prominent academics found it to be a "necessary conclusion" that "the independent directors of a public company have their own legal counsel."[9]

III. The Administration will ensure that compensation consultants and outside counsel that work for compensation committees are independent from management.

- ***Compensation consultants sometimes also provide non-compensation related services to companies and stand to profit when executives agree to use their firms for those services.*** In 2003, the Conference Board's Commission on Public Trust and Private Enterprise, which included both former CEOs and public officials such as John Snow, concluded that major financial scandals were frequently accompanied by the "excessively close relationship between executives and compensation consultants who recommend to the board appropriate levels of executive compensation."[10] In December 2007, the House Committee on Oversight and Government Reform conducted a comprehensive survey of

conflicts among compensation consultants, noting further that there appears to be a correlation between the retention of compensation consultants with significant conflicts of interest and levels of CEO pay. The report's key findings indicated that:

- Compensation consultant conflicts of interests are "pervasive," affecting at least 113 of the Fortune 250 companies;
- The fees "earned by compensation consultants for providing other services often far exceed those earned for advising on executive compensation;"
- Some compensation consultants received "over $10 million" in 2006 to provide non-compensation related services; according to the committee, "[o]ne Fortune 250 company paid a compensation consultant over $11 million for other services in 2006, over 70 times more" than for compensation services; and
- Over two-thirds of the Fortune 250 companies that hired compensation consultants with conflicts of interest did not disclose the conflicts in their SEC filings.[11]

- ***This legislation recognizes that compensation consultants provide valuable services to companies***, ***while ensuring that advice given directly to compensation committees is independent.*** While consulting firms offer expertise to companies on emerging best practices across a wide range of business contexts, an independent review of management's proposals is also needed to ensure that compensation is structured in order to maximize long-term shareholder value. As a result, this legislation allows the SEC to strike the appropriate balance between the need for companies to have the benefit of expertise and for compensation committee members to receive independent advice.

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[1] *See, e.g.*, Lucian Bebchuk, Yaniv Grinstein, and Urs Peyer, *Lucky CEOs and Lucky Directors* (June 2009), at 3.

[2] April Klein, *Audit Committees, Board of Director Characteristics, and Earnings Management* (October 2006).

[3] Sanjai Bhagat & Brian J. Bolton, *Sarbanes-Oxley, Governance and Performance* (March 2009).

[4] Chris Armstrong et al., *Economic Characteristics, Corporate Governance, and the Influence of Compensation Consultants on Executive Pay Levels* (June 2008).

[5] NACD Blue Ribbon Commission, *Report on Executive Compensation and the Role of the Compensation Committee* (2003).

[6] The Business Roundtable, *Executive Compensation Principles* (2007).

[8] Report of the American Bar Association Task Force on Corporate Responsibility (March 2003).

[9] Geoffrey C. Hazard, Jr. & Edward B. Rock, *A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel*, 59 BUS. LAW. 1389 (August 2004).

[10] James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles* 83 OR. L. REV. 435 (2004) (quoting The Conference Board, Commission on Public Trust and Private Enterprise 2 (January 2003)).

[11] Majority Staff of the United States House of Representatives Committee on Oversight and Government Reform, *Executive Pay: Conflicts of Interest Among Compensation Consultants* (December 2007).