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Executive Pay: The Role of Compensation Consultants Hearing
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The problem of executive over-compensation is quite simple in its origins and solution. Pay unrelated to performance is the result of the failure of effective bargaining between the corporate board and management. The elements leading to this failure are: 1. overreaching management; and 2. passive, management-dominated directors often advised by sometimes compromised compensation consultants. The key to the solution is to stimulate better bargaining between the board and management. This can be accomplished by insisting that the board, and particularly the members of the board's compensation committee who negotiate with executives on pay, be comprised of individuals who are completely independent of management and hold personally meaningful equity stakes in the organization. This will ensure that they have the objectivity and incentive to effectively negotiate pay. Additionally important to the solution, and the subject of this hearing, are reforms in the ways in which compensation consultants aid in the pay negotiation process.

Traditionally, the consultant was hired by management to aid in the design and review of the executive pay package. Often the consultant's firm was also engaged to do a significant amount of other work for the company. Additionally, it was believed that the presence of a consultant provided some legal protection to the board who ultimately approved the compensation agreement. As a third party, non-company employee, the consultant was supposed to add some objectivity to the process that could be effectively relied upon by the board in the review of the compensation package. However, because the consultants were hired by management and often did other highly compensated work for the company, their objectivity as to their review for the board of the executive compensation agreement was either factually or certainly optically compromised. This is why corporate governance advocates have long suggested that the best practice in this case would be that the consultant who advises the compensation committee be hired exclusively by the committee and perform no other tasks for the company or its management. The idea was that the directors who negotiate pay must receive completely unfettered and objective advice from outsiders solely responsible to the committee and full board, un-compromised by managerial relationships. This advice presented to independent and motivated directors would ultimately result in the most effective incentive pay for the company's executives.

At minimum, certainly the optics of such a process would be much more appealing to the shareholders, aiding in the restoration of public confidence in the integrity of our business institutions. This approach, similar to that taken with regard to outside company auditors under the Sarbanes-Oxley Act, has been endorsed by numerous business and investor organizations, including the National Association of Corporate Directors, and is supported by many in the financial community. In fact, Chief Justice E. Norman Veasey of the Delaware Supreme Court, the nations leading appellate business court, in widely quoted remarks made at the University of Delaware in 2002 stated, "Compensation committees should have their own advisers and lawyers. Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently" [1] – suggesting judicial support for the theory.

Given the obvious logical appeal to this approach and widespread shareholder support, the trend

[1] "What's Wrong with Executive Compensation? A roundtable moderated by Charles Elson," HARVARD BUSINESS REVIEW, January 2003, Volume 81, Number 1, p. 68

of which I have been familiar as a director and academic specializing in the area, has clearly been for board compensation committees to engage their own compensation consultants who provide no other services for the enterprise. From a federal regulatory standpoint, to further board adherence to this best practice, better disclosure on compensation consultant conflicts of interest needs to be provided to shareholders. While at present the Securities and Exchange Commission mandates disclosure to investors of the identity of a company's compensation consultant and certain other retention details, there must also be disclosure of any other services the consultant provides to the organization as well as the amount of fees paid to that consultant, similar to the required disclosure regarding the company's outside auditors. This disclosure, combined with public pressure and the resulting trend toward the use of non-conflicted consultants, should lead to improved pay practices and greater confidence by the investing public in the integrity of our public corporations.