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Will Dodd-Frank Transform Comp Consulting?

By Kristin Gribben February 27, 2012

Board insiders have quipped that the compensation committee is the new audit committee, its members grappling with Dodd-Frank just as their colleagues grappled with Sarbanes-Oxley after 2002. Now, some believe that the compensation consulting industry is going down a path of regulatory oversight that mirrors what happened to the auditing industry after SOX. That legislation completely transformed audit firms. And although comp consulting is quite a different profession from auditing, many critics of executive pay practices think transformation would be an excellent thing.

One is **Richard Leblanc**, professor of law, governance and ethics at **York University** in Toronto and an external board advisor. He says it's problematic that the comp consulting industry does not require adherence to third-party standards. Accountants, lawyers and even management consultants have codes of conduct, he says. "Compensation committees and boards should insist on an industry-wide rigorous code of conduct for compensation consultants that is independently drafted and enforced; that is publicly accessible; and to which all compensation consultants who advise these compensation committees subscribe," Leblanc writes in a blog post.

Comp consultants are already more regulated than they used to be. Just as SOX made clear that an external auditor's client was the audit committee chair, not management, Dodd-Frank requires that the comp committee have sole responsibility for retaining outside consultants when setting executive pay. SEC rules on compensation consultant independence, expected to be finalized between now and June, will take a step toward standards of independence similar to the audit profession's. "We're just now entering a new phase of accountability," Leblanc says.

Not all governance thought leaders think more regulation is desirable. **Jay Lorsch**, a professor at **Harvard** Business School who has served on public boards and is critical of comp consultants in other ways, says drawing similarities between consultants and auditors is an apples-to-oranges comparison. And **Patrice Gélinas**, a part-time comp consultant at **Towers Watson** and also a professor at York University, stresses that the ultimate responsibility for setting pay rests with compensation committees. "Comp committees at the end of the day are seeking advice," he says. Gélinas agrees with Lorsch that it would be hard to regulate consultants the same way auditors, lawyers or other professions are regulated, since the latter assume more legal liability for their advice.

But at least one director who has been on the front lines of setting compensation says a code of conduct for consultants is not only a good idea but probably an inevitability. **C. Warren Neel**, a comp committee member at **Healthways**, director at **Saks** and executive director of the corporate governance center at the **University of Tennessee**, thinks global convergence on other governance issues, like international accounting standards, could lead to a universal code of conduct for comp consultants.

"The standards for a person's certification in this field do need to occur and become a requirement of a corporate board," he writes in an e-mail. "This is going to be a much bigger issue in the near future as we are becoming more global."

Perhaps predictably, **Russell Miller**, managing director of consultancy **ClearBridge Compensation Group**, doesn't think a code of conduct or third-party standards would be as effective as the self-regulation that now occurs through market competition, although he says he supports Dodd-Frank's mandated disclosure of potential conflicts of interest by consultants. Reputation can go a long way toward creating standards for a boutique industry like compensation consulting, he says.

Plus, Dodd-Frank also requires the **SEC** to review boards' use of compensation consultants and how their advice affects executive pay, and to send Congress a report. The agency expects to do so during the second half of the year, according to its latest timetable on Dodd-Frank.

David Lynn, a partner at law firm **Morrison Foerster** and former chief counsel at the SEC, says he doesn't expect the report to be an exposé of the consulting industry. The SEC will take into account the fact that many large consulting firms spun off their comp business over the past several years, eliminating some concerns about conflicts of interest, he says.

Still, behind the debate about compensation consultants' role lies a broad question: How much do boards rely on their advice? One comp committee chair at a Fortune 500 company says his consultant, who has advised the board for at least eight years while working for three different consulting firms, provides only data and analysis without making recommendations on pay. The comp committee meets eight times a year, so members have time to reflect on the data, says the chair, who did not want to be named. The committee also meets in executive session without the consultant.

That type of independence is what Dodd-Frank seems aimed at achieving at all boards. However, independent advice doesn't get to the heart of another problem some governance observers have with the consulting industry. That issue has to do with the type of data consultants provide.

Inadequate Data?

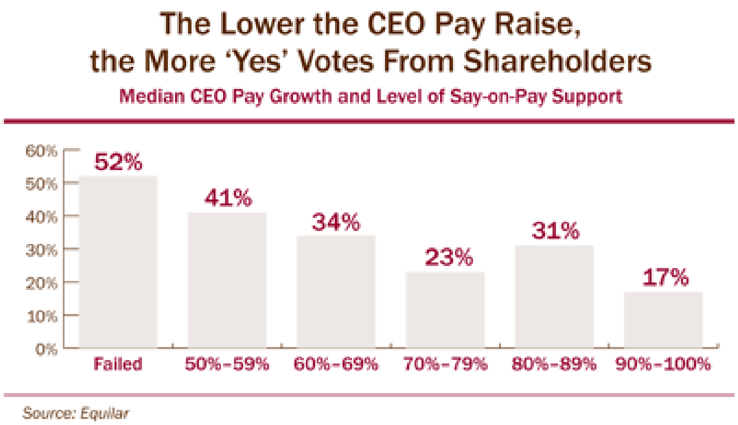
Lorsch says whether or not the consulting industry adheres to a code of conduct, CEO pay won't stop spiraling upward until comp committees begin questioning the data they get from their consultants. Lorsch co-authored a 2010 article in *Harvard Magazine* with fellow business professor **Rakesh Khurana** called "The Pay Problem." In it, the professors argue that consultants use inadequate data when helping boards determine executive pay.

"Compensation consultants have sought a method for making market rates transparent — the much-discussed compensation surveys," they write. "Not only is the validity of such a methodology questionable, but the surveys also have the perverse effect of 'ratcheting' compensation ever upward."

Indeed, a study published in the *Journal of Accounting, Auditing & Finance* in 2010 by two U.K. university professors found that when boards used a consultant to help set CEO and director pay, compensation was higher overall. But it also had a higher ratio of equity incentives to salary. The study examined FTSE 350 firms from 2002 to 2008.

The secret of how CEO pay keeps rising faster than other NEO pay (not to speak of the broader workforce) has been laid bare before. Many boards like to pay their CEOs above the industry average, so when peer surveys are broken into quartiles, most companies choose the upper quartile. The quartiles keep readjusting upward, year after year.

And Equilar data suggest that the bigger the jump in CEO comp, the less support boards can expect from shareholders in say-on-pay votes (see chart).



Lorsch says Dodd-Frank hasn't helped consultants and boards find better metrics for paying executives. Consultants know a lot about taxes and certain forms of compensation, Lorsch says, "but what I think they don't think about as much as they should is how do you really motivate [executives] and what goals you're asking executives to achieve." That would require consultants to better understand corporate strategy, he says.

Leblanc, the York University professor, suggests one way compensation consultants can give boards more valuable data would be to review peer data from similarly performing companies, not those of similar size or in the same industry.

ClearBridge's Miller says that his firm and a few other industry leaders have started to look more closely at business strategy "in the continuing push to get CEO pay right." Miller meets with the comp chair or whole committee, and sometimes with senior management, to discuss the company's long-term business plans. "It's an ongoing effort as strategy changes," he says.

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