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COMMENTARY ON COMPENSATION COMMITTEE INDEPENDENCE

May 19, 2011

United States Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C. 20549-1090
Attention: Ms. Elizabeth M. Murphy, Secretary

Dear Ms. Murphy:

We are submitting this letter in response to the Commission's invitation for comments on its proposed rules under Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), addressing compensation committee independence. As researchers whose recent work includes analysis of compensation committees, compensation consultants, and legal advisors specializing in executive pay, we write to comment on these proposed rules.[1]

We have limited our comments to three issues raised by Section 952. In sum, we suggest that the Commission's rules:

- As proposed, ***permit directors affiliated with significant shareholders, such as private equity owners, to serve on compensation committees***;
- Require ***disclosure of any financial relationship between a compensation consultant and her former employer*** where the consultancy has been "spun off" from a larger firm that continues to work for the company and its executives; and
- Require ***disclosure of potential conflicts of interest for the lawyers who help compensation committees set executive pay***.

Significant Shareholders and Director Independence

Section 952 adds Section 10C(a) to the Securities Exchange Act of 1934, requiring the Commission to direct the national securities exchanges to adopt rules relating to the independence of the directors who serve on the compensation committees of listed firms. The proposed rules generally allow the exchanges to establish their own criteria for determining whether a director is sufficiently independent from management to serve on the committee.

In light of similar statutes addressing audit committees, however, commentators have expressed the concern that the exchange rules will prohibit directors affiliated with large shareholders from serving on compensation committees. To address this concern, the

[1] We conducted this work as faculty and students at the Columbia Law School during the Fall of 2010. We conducted confidential interviews with more than a dozen consultants and legal counsel specializing in executive compensation matters, including professionals at both large and small firms. We write solely in our individual capacities; our institutional affiliations are given for identification purposes only. Although Professor Jackson served as an advisor to senior officials at the Department of the Treasury on matters related to executive compensation during 2009 and 2010, the views reflected in this letter are solely our own.

Commission's proposed rules expressly permit the exchanges to "determine that, even though affiliated directors are not allowed to serve on audit committees . . . [directors who are] representatives of significant shareholders" are allowed to serve on compensation committees.

We agree that directors affiliated with significant shareholders—for example, directors affiliated with private equity owners—should be allowed to serve on compensation committees. Empirical study has shown that these directors are highly effective advocates for shareholder interests in bargains over executive pay.

For example, previous work conducted by one of us shows that companies owned by private equity investors link CEO pay far more closely to performance than similar firms without private equity owners.[2] At the time these owners make their investment, they frequently bargain for contractual rights to appoint directors, and the directors they appoint typically own large amounts of the company's stock. These directors pursue the pay-performance deal closer to shareholder interests because they often *are* significant shareholders themselves.[3]

Section 10C requires the exchanges to ensure that directors are sufficiently independent from management to drive a hard bargain over executive pay. Because the evidence shows that directors affiliated with significant shareholders do exactly that, the Commission's rules should, as proposed, ***permit the exchanges to determine that directors affiliated with significant shareholders may serve on compensation committees.***

Disclosure on Compensation Consultants' Financial Ties to Former Employers

Section 952 also adds Section 10C(c) to the Securities Exchange Act of 1934, requiring the Commission to adopt rules requiring public companies to disclose potential conflicts of interest raised by the work of compensation consultants. Like Section 952 itself, the proposed rules do not provide a precise definition of a conflict of interest, leaving necessary flexibility for case-by-case determinations with respect to whether a conflict of interest exists.

In 2009, the Commission adopted important new rules requiring public companies to disclose the role of consultants in setting executive pay. These rules require companies to disclose fees paid to compensation consultants in cases where the consultant's firm provided additional services to the company in an amount in excess of $120,000. Thus, compensation committees have increasingly sought executive-pay advice from consultants at smaller, "boutique" firms that are less likely than larger, "multi-service" firms to provide additional services to the company that would trigger this disclosure.[4]

Multi-service firms responded, in turn, by spinning off executive pay consultants into new boutique firms. This market shift has been the subject of considerable attention from other

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[2] Robert J. Jackson, Jr., *Private Equity and Executive Compensation* (unpublished manuscript, on file with authors) (finding that the link between CEO pay and performance, as traditionally measured by financial economists, is more than twice as strong in firms with private equity owners as it is in firms without such owners).

[3] The exact definition of a significant shareholder is beyond the scope of these preliminary comments. We note only that directors affiliated with large shareholders are often effective advocates of shareholder interests.

[4] *See, e.g.*, EQUILAR, CONSULTANT MARKET SHARE OF FORTUNE 1000 COMPANIES 2006-2009 (indicating that the market share of boutique consultancies rose from 21.5% to 31.7% between 2006 and 2009, while the market share of multi-service firms fell from 72.3% to 56.8%).

commentators. We focus on an issue not previously addressed by other commentators: the financial ties between these new boutique consultancies and their former multi-service parents.

Our research suggests that boutiques spun off from multi-service firms often receive financial support from their former parents, for example in the form of start-up capital. Some boutiques are allowed to use proprietary data owned by their former parent on a discounted basis. And in some cases, in exchange for the waiver of contractual arrangements limiting consultants' freedom to compete with the parent, boutique firms have agreed to make payments to the parent equal to a fixed percentage of the boutique's revenue over a specified period of time. The Commission's 2009 rules, like Section 952, were motivated by the "potential conflict of interest" present where a consultant's employer relies on the firm, and its executives, for fees for other services. We do not see why these concerns should not apply with equal force to situations where the consultant has financial ties to a former employer that provides these services.

Suppose that a consultant's multi-service employer earns $1 million annually by providing payroll services to the company. Because executives control whether the consultant's employer will continue to be chosen to provide those services, the consultant suffers from a potential conflict of interest, and the Commission's 2009 rules would require disclosure of these circumstances. Now suppose that the consultant's *former* multi-service employer earns $1 million annually by providing payroll services to the company. If this second consultant relies on her former firm for capital, data, and client referrals, she faces a conflict of interest at least as acute as the conflict facing the consultant who remains employed by the multi-service firm. But the Commission's existing rules would not require disclosure in this second situation.

Recognizing this problem, other commentators have suggested that the Commission adopt a bright-line rule requiring the compensation committee to consider, as a factor bearing on a consultant's independence, whether the consultant was has been "employed by a consulting firm providing services to the management within . . . a specified period of time (e.g., the past three years)."[5] The proposed rules do not adopt that approach, and we think for good reason. That view is overinclusive, suggesting that there is a conflict of interest even where there is no relationship between the boutique and its former parent. And that approach could constrain the supply of consultants available to advise compensation committees—a paradoxical result for a statute, like Section 952, intended to expand the set of choices available to these committees.

Nevertheless, the potential conflicts of interest raised by financial ties between boutique spinoffs and their former parents are likely to be relevant to shareholders' views on the independence of compensation consultants. Accordingly, we suggest that the Commission's final rules under Section 952 ***require disclosure of any financial relationship between a compensation consultant and a recent former employer that provides services to the company.***

Disclosure on Conflicts of Interest for the Lawyers Who Help Set Executive Pay

As noted above, both the Commission's 2009 rules and Section 952 require extensive disclosure of conflicts of interest arising from compensation consultants' role in setting executive pay. Yet the Commission's rules require no disclosure of any kind with respect to conflicts of interest related to the legal counsel that guide compensation committees at public companies.

[5] Letter from Frederic W. Cook to Elizabeth M. Murphy, Sec'y, SEC (Aug. 13, 2010), at 2.

We do not see a meaningful difference between consultants and legal counsel with respect to the potential conflicts of interest that arise in bargains over executive pay, and we therefore suggest that the Commission close this gap in the disclosure rules.[6]

The structure of executive pay arrangements, including for example terms that govern whether the company will pay income taxes on the executive's behalf, are typically set forth in agreements negotiated between counsel for the compensation committee and the executive's lawyer. The executive's lawyer bargains over these details with a single objective: to pursue the best deal for the executive. But the incentives of the committee's lawyers are often less clear.

Suppose that, as is often the case, the committee chooses to rely on the company's in-house counsel in negotiations over executive pay. Certainly these lawyers will bargain forcefully on behalf of the committee. But they will be bargaining against an executive to whom they report. Thus, in-house counsel have incentives to favor executives in bargains over pay. Similarly, suppose that the committee is advised by the company's corporate counsel, such as an outside law firm. Lawyers at these firms know that the executives they are bargaining with today will decide which lawyers will be retained by the company for lucrative legal assignments tomorrow.[7] These lawyers, too, have incentives to favor executives in bargains over pay.

Thus, with respect to potential conflicts of interest, we see no meaningful difference between compensation consultants and lawyers, both of whom help set pay for the executives who control the advisor's access to lucrative engagements with the company. That is why Section 952 expressly mandates that compensation committees consider the same independence factors before selecting both compensation consultants and legal counsel. And that is why the Commission's rules should mandate disclosure of any conflicts of interest raised by the work of legal counsel, just as they do for consultants. While the exact design of the disclosure is beyond the scope of these preliminary comments, companies should at least be required to disclose which attorneys advised the compensation committee on executive pay—and any potential conflict of interest these lawyers may face.

Previous commentators have offered two arguments against requiring such disclosure. First, they note that the text of Section 10C(c)(2) mentions only consultants, arguing that, by exclusion, Congress has precluded the Commission from requiring disclosure of conflicts raised by the work of legal advisors. But the Commission's authority in this area is well-established. After all, the Commission adopted rules requiring disclosure on compensation consultants before Congress enacted Section 952. Given that the Commission had the authority to address consultants' conflicts of interest even before the passage of Section 952, we think it is clear that the Commission has authority to require disclosure of conflicts of interest for lawyers today.

[6] We offer these views in response to the Commission's request for comment with respect to whether the Commission should require disclosure with respect to conflicts of interest related to "other types of advisers to the compensation committee, such as legal counsel." Securities and Exchange Commission, Listing Standards for Compensation Consultants, 76 Fed. Reg. 18,966, 18,981 (April 6, 2011).

[7] This is particularly true of assignments related to mergers and acquisitions. Thus, law firms with leading mergers and acquisitions practices have developed large departments of attorneys expert in executive compensation. All of the law firms among the top ten mergers and acquisitions advisors in 2010 have such departments; together, these firms alone now employ approximately 200 attorneys who focus principally on executive pay.

Second, some commentators have argued that lawyers' influence on executive pay is limited to minor contractual details that are of little relevance to shareholders. Although empirical evidence on these questions is limited, we think this argument inconsistent with recent developments in the area of executive compensation. Legal advice frequently guides important executive-pay decisions, for example whether the company will pay taxes on an executive's behalf. These decisions have recently been the subject of considerable shareholder scrutiny.[8] These developments suggest that conflicts of interest related to the legal advice that helps determine executive pay arrangements are likely to be highly relevant to shareholders.

In sum, compensation consultants and legal counsel face similar potential conflicts of interest; Section 952 applies the same standards for independence both to consultants and to legal counsel; and legal advice is an important factor in determining executive pay arrangements. Thus, we do not see why shareholders should receive significant disclosure on compensation consultants' conflicts of interest but none on the conflicts faced by the lawyers who help set executive pay. We therefore suggest that the Commission's rules ***require disclosure of conflicts of interest for lawyers who advise the compensation committee*** so that shareholders can determine whether these committees have the benefit of independent legal advice.

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We appreciate the opportunity to provide comments on the Commission's proposed rules on compensation committee independence under Section 952 of the Act. If further discussion of these comments would be helpful to the Commission or the Staff, we would be pleased to be of assistance. Please do not hesitate to contact us at your convenience at (212) 854-0409 or via electronic mail at robert.jackson@law.columbia.edu.

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[8] For example, Institutional Shareholder Services, which advises institutional investors on how to vote on matters related to executive pay, has urged public companies to eliminate contractual provisions requiring the firm to pay taxes on executives' behalf, *see* INSTITUTIONAL SHAREHOLDER SERVICES, 2011 U.S. COMPENSATION POLICY.