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EXECUTIVE PAY:
CONFLICTS OF INTEREST AMONG
COMPENSATION CONSULTANTS

PREPARED FOR
CHAIRMAN HENRY A. WAXMAN

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EXECUTIVE SUMMARY

Corporate consultants can have a financial conflict of interest if they provide both executive compensation advice and other services to the same company. According to experts on corporate governance, consultants hired by corporate executives to administer employee benefit plans or to provide other services to a company may not be able to provide objective advice about the compensation of the executives who hire them. These experts have recommended that corporate boards should retain a compensation consultant that performs no other work for the company.

At the request of Rep. Henry A. Waxman, this report examines whether the compensation consultants hired by large publicly traded companies meet this standard of independence. The report is based on nonpublic information provided to the Committee by the leading compensation consultants in the United States. For each consultant, the Committee requested and received data on the value of the executive compensation services and other services provided to the 250 largest publicly traded companies as determined by *Fortune* magazine.

The report finds that compensation consultant conflicts of interest are widespread. Over 100 large publicly traded companies hired compensation consultants with substantial conflicts of interest in 2006. In many cases, the consultants who are advising on executive pay are simultaneously receiving millions of dollars from the corporate executives whose compensation they are supposed to assess.

Key findings in the report are:

- **Compensation consultant conflicts of interest are pervasive.** In 2006, at least 113 of the Fortune 250 companies received executive pay advice from consultants that were providing other services to the company.
- **The fees earned by compensation consultants for providing other services often far exceed those earned for advising on executive compensation.** In 2006, the consultants providing both executive compensation advice and other services to Fortune 250 companies were paid almost 11 times more for providing other services than they were paid for providing executive compensation advice. On average, the companies paid these consultants over \$2.3 million for other services and less than \$220,000 for executive compensation advice.
- **Some compensation consultants received over \$10 million in 2006 to provide other services.** One Fortune 250 company paid a compensation consultant over \$11 million for other services in 2006, over 70 times more than the company paid the consultant for executive compensation services. Another Fortune 250 company also paid a compensation consultant over \$11 million for other services, over 50 times more than it paid the consultant for executive compensation advice.

- **Many Fortune 250 companies do not disclose their compensation consultants' conflicts of interest.** In 2006, 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. In 30 instances, the companies informed shareholders that the compensation consultants were “independent” when in fact they were being paid to provide other services to the company.
- **There appears to be a correlation between the extent of a consultant's conflict of interest and the level of CEO pay.** In 2006, the median CEO salary of the Fortune 250 companies that hired compensation consultants with the largest conflicts of interest was 67% higher than the median CEO salary of the companies that did not use conflicted consultants. Over the period between 2002 and 2006, the Fortune 250 companies that hired compensation consultants with the largest conflicts increased CEO pay over twice as fast as the companies that did not use conflicted consultants.

The investigation also uncovered evidence that some Fortune 250 companies may not be disclosing the identity of all consultants hired to provide executive compensation advice. Securities and Exchange Commission rules require publicly traded companies to disclose “any role of compensation consultants” in determining executive pay and to identify all such consultants, whether they advise management or the board. The information obtained by the Committee from the compensation consultants indicates that in 2006, almost 100 Fortune 250 companies used executive compensation consultants that they did not disclose. In some cases, the companies paid hundreds of thousands of dollars to undisclosed consultants for executive compensation services. One explanation for these discrepancies may be that the compensation consultants used a different definition of executive compensation services in reporting to the Committee than the companies used in their SEC filings.

I. INTRODUCTION AND METHODOLOGY

Executive pay is rising rapidly. The chief executive officers (CEOs) of the 250 largest U.S. companies, as identified by *Fortune* magazine, received an average of \$18.8 million each in 2006, an increase of 38% in just one year.¹ A decade ago, the aggregate pay of the top five executives at large U.S. companies amounted to about 5% of corporate profits. By 2003, the share of corporate earnings paid to top executives had doubled to 10%.² Many experts believe there is a growing disconnect between CEO pay and performance, as increases in executive pay cannot be explained by factors such as changes in firm size, profits, and industry classification.³ Analysts have observed that poorly performing CEOs sometimes receive exceptionally large pay packages.⁴

Dramatic increases in executive compensation have widened the gulf between CEO pay and the pay of the average worker. In 1980, CEOs in the United States were paid 40 times the average worker.⁵ In 2006, the average Fortune 250 CEO was paid over 600 times the average worker.⁶ While CEO pay has soared, employees at the bottom of the pay scale have seen their real wages decline. In real terms, the value of the new federal minimum wage, \$5.85 per hour, is 13% below its value a decade ago.⁷

At the request of Rep. Henry A. Waxman, the Chairman of the Committee on Oversight and Government Reform, this report examines one possible cause of high CEO compensation: the use of compensation consultants with conflicts of interest.

Large companies routinely retain compensation consultants to provide advice on executive pay, such as developing compensation peer groups, designing equity compensation plans, conducting compensation surveys, and analyzing the tax, accounting, and legal implications of specific pay packages. These consultants can be retained by either the corporate board (typically, the compensation committee of the board) or management, and they may advise the board, management, or both on executive pay issues. Whether retained by the board or management, these consultants can have a major impact on executive pay decisions.

According to experts on executive compensation, compensation consultants can have a conflict of interest if they provide other services to a company at the same

¹ *Big Paychecks*, Forbes (May 3, 2007).

² Lucian Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay," *Oxford Review of Economic Policy*, Vol. 21, pp. 283-303 (2005).

³ *Id.*

⁴ See, e.g., Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004); The Corporate Library, *Pay for Failure: The Compensation Committees Responsible* (2006); The Corporate Library, *Pay for Failure II: The Compensation Committees Responsible* (2007).

⁵ Institute for Policy Studies and United for a Fair Economy, *Executive Excess 2007: The Staggering Social Cost of U.S. Business Leadership* (Aug. 2007).

⁶ In 2006, the average American worker earned \$29,544. *Id.*

⁷ The current minimum wage is \$5.85 — adjusted for inflation, \$4.49 in 1997 dollars. The actual minimum wage in 1997 was \$5.15.

time that they are providing executive compensation advice.⁸ The concern is that the ability of consultants to provide independent, unbiased advice to directors regarding the pay of senior executives can be compromised if the senior executives are at the same time paying the compensation consultants to provide other services to the company. These other services can include a wide range of activities, including employee benefit administration, human resource management, and actuarial services.

Little information is currently available to the investing public to assess compensation consultant conflicts of interest. In August 2006, the Securities and Exchange Commission (SEC) promulgated new rules on the disclosure of executive compensation that for the first time require publicly traded companies to disclose the identity of their compensation consultants and describe the nature of the consultant's assignment.⁹ These rules do not, however, require companies to disclose whether the consultant has other business relationships with the company or the fees received for providing executive pay advice and other services.

To assess the extent of consultant conflicts of interest, Chairman Waxman wrote to request nonpublic information from six leading compensation consultants: Frederick W. Cook & Company, Hewitt Associates, Mercer Human Resources Consulting, Pearl Meyer & Partners, Towers Perrin, and Watson Wyatt. For each consultant, the Committee requested data on the value of the executive compensation consulting services and any other services that the consultant provided to Fortune 250 companies from January 1, 2002, through December 31, 2006.¹⁰ The compensation consultants were asked to report to the Committee as executive compensation consulting fees any revenues earned for work related to the compensation of the most senior executives of the companies, including such services as devising equity compensation plans, designing compensation peer groups, and providing pay survey data. The consultants were asked to report fees earned for services related to compensating employees other than senior executives or for other work unrelated to compensation as "other" revenue.

Four of the consultants (Hewitt, Mercer, Towers Perrin, and Watson Wyatt) reported to the Committee that they are diversified firms offering a variety of services to their corporate clients. The data the Committee received from these four consultants disclosed how much they were paid in each year by each Fortune 250 company to provide executive compensation services and how much they were paid to provide other services for companies for whom the consultants provided both types of services between 2002 and 2006. Because of limitations in how the consultants maintained their records, the data did not indicate the precise nature of the financial arrangements between the

⁸ The Conference Board, *The Evolving Relationship Between Compensation Committees and Consultants*, 6, 15, (Jan. 2006).

⁹ SEC, *Final Rules on Executive Compensation and Related Party Disclosures*, Items 402 (b) and 407 (e) of Regulation S-K (August 29, 2006).

¹⁰ Letters from Chairman Henry A. Waxman to Frederick W. Cook & Company, Hewitt Associates, Mercer Human Resources Consulting, Pearl Meyer & Partners, Towers Perrin, and Watson Wyatt (May 8, 2007) (online at <http://oversight.house.gov/story.asp?ID=1302>).

consultants and the companies, such as who retained the consultants. It also did not indicate the precise services provided by the consultants.

Two of the consultants (Frederic W. Cook and Pearl Meyer) reported to the Committee that they are specialized firms that focus on executive and director compensation. Because they do not provide other services to their corporate clients, the data from these two consultants did not show conflicts of interest.

II. FINDINGS

Academic researchers and investors have raised concerns that the methods used by boards of directors to set CEO pay are flawed. In theory, executive pay should result from an arm's length negotiation in which executives bargain in their own self interest while corporate directors advocate the best interests of the company and its shareholders. In fact, studies suggest that rapidly rising executive pay results in part from management influence over the process by which executive pay is set.¹¹ Corporate directors themselves have recognized that executive compensation practices are problematic. In a recent survey of over 1,000 directors at large U.S. companies, 67% said that they believe boards are having difficulty controlling the size of CEO pay packages.¹²

One area of potential management influence on the executive pay process involves the use of compensation consultants that work for corporate management. Corporate governance experts recommend that corporate directors hire independent executive compensation consultants that are free of conflicts of interest and can provide objective advice regarding executive pay. A 2003 Blue Ribbon Panel of the National Association of Corporate Directors emphasized the importance of an independent compensation consultant and recommended that a truly independent consultant “should be hired by and report directly to the [compensation] committee, and should not be retained by the company in any other capacity.”¹³ In January 2006, the Conference Board, a leading business think tank, advised:

When the compensation committee uses information and services from outside consultants, it must ensure that consultants are independent of management and provide objective, neutral advice to the committee. ... The economics of the consultants' engagement for services is very important as an insight into independence. Any imbalance in fees generated by management versus fees generated on behalf of the committee should receive intense scrutiny.¹⁴

¹¹ Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004).

¹² Corporate Board Member and Pricewaterhouse Coopers, *What Directors Think: Annual Board of Directors Survey* (Oct. 2007).

¹³ National Association of Corporate Directors, *Executive Compensation and the Role of the Compensation Committee* (Dec. 2003).

¹⁴ The Conference Board, *The Evolving Relationship Between Compensation Committees and Consultants*, 6, 15, (Jan. 2006).

Similarly, the Business Roundtable states in its “Executive Compensation Principles” that “the compensation committee should have independent, experienced expertise available to provide advice on executive compensation arrangements and plans. The compensation committee should oversee consultants to ensure that they do not have conflicts that would limit their ability to provide independent advice.”¹⁵

Despite these recommendations, this report finds that large publicly traded companies often retain consultants with significant conflicts of interest. In 2006, over 100 Fortune 250 companies relied on compensation consultants that had been hired by corporate management to provide other services to the company. In most cases, the amount the consultants earned providing executive compensation advice was a fraction of the amount they were paid to provide the other services. Often, the consultants who were advising on executive pay were simultaneously being paid millions of dollars by the corporate executives whose compensation they were supposed to evaluate.

A. Extent of Compensation Consultant Conflicts of Interest

In their SEC filings for 2006, 194 of the Fortune 250 companies disclosed retaining a compensation consultant to help set executive pay. Of these 194 companies, 179 disclosed hiring at least one of the compensation consultants examined in this report.

Among the 179 Fortune 250 companies that disclosed hiring one of the compensation consultants examined in this report, the use of compensation consultants with conflicts of interest was common. In 2006, 113 of these companies (63%) paid the same consultant to provide other services for the company in 2006.¹⁶

The fees these compensation consultants earned providing executive compensation advice were consistently small compared to the fees they received for providing other services. In 2006, the compensation consultants that provided both types of services to Fortune 250 companies received an average of \$220,000 for executive compensation advice and \$2.3 million for other services from each client company. For each dollar these consultants received for executive pay advice, they received almost \$11 in payments for other services. Figure 1.

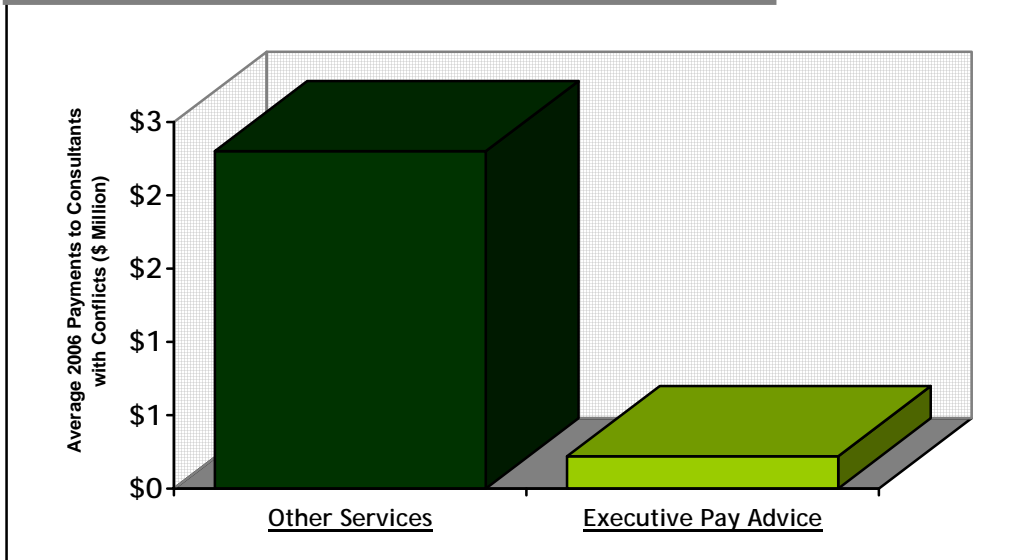
A compensation consultant’s “fee ratio” is the ratio of the consultant’s fees for other services to the consultant’s fees for executive compensation advice. In 27 cases, these fee ratios exceeded 20 to 1 in 2006. In some cases, they were over 100 to 1.

One company, Johnson and Johnson, paid its compensation consultant over \$11 million for other services in 2006 compared to approximately \$160,000 for executive compensation advice, producing a fee ratio of over 70 to 1. Another company, Halliburton, also paid its compensation consultant over \$11 million compared to approximately \$210,000 for executive compensation advice, a fee ratio of over 50 to 1.

¹⁵ The Business Roundtable, *Executive Compensation Principles* (2007).

¹⁶ Companies that paid consultants a minimal fee — less than \$10,000 for either executive compensation or other services — were not considered to have hired a conflicted consultant for purposes of this report.

FIGURE 1: Fees for Other Services Are Much Larger Than Fees for Executive Pay Consulting Services



Twenty-five of the 113 Fortune 250 companies disclosed hiring multiple compensation consultants in 2006. In at least nine of these cases, the additional compensation consultant did not provide other services to the company. The retention of an independent compensation consultant in these cases could mitigate the influence of the conflicted consultant. In at least five cases, the additional compensation consultant also had a conflict of interest. The retention of a second consultant with a conflict of interest would not mitigate the conflict concern.¹⁷

B. Disclosure of Compensation Consultant Conflicts of Interest

Most of the 113 Fortune 250 companies that hired compensation consultants with conflicts of interest did not disclose these conflicts to public investors. The existence of multiple business relationships with the compensation consultants was revealed in the SEC filings of only 33 of the 113 companies. The remaining 80 companies did not disclose to investors that the executive pay advisor mentioned in its proxy statement did other work for the company.

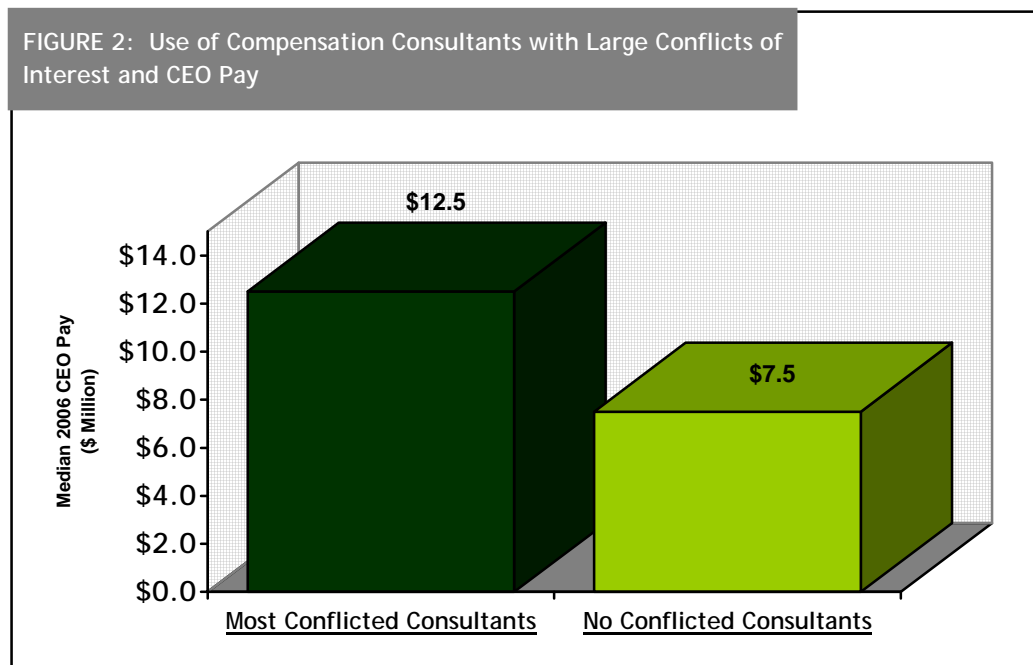
In fact, 30 of the 113 companies identified their compensation consultant as “independent” in their proxy statements even though the information provided to the Committee showed that the consultant had been hired by the company to provide other services. One company, Metlife, described its compensation consultant as “independent” in its SEC filings even though Metlife paid the consultant more than \$7 million to

¹⁷ In 11 cases, it could not be determined whether the additional consultant was independent or conflicted because the consultant was not one of the six consultants surveyed by the Committee.

provide other services to the company, according to the information received by the Committee. Another company, Pepsico described its consultant as “independent” in its SEC filings even though it paid the consultant over \$6 million to provide other services to the company, according to the information received by the Committee.

C. Relationship Between Compensation Consultant Conflicts of Interest and Levels of CEO Pay

There appears to be a correlation between the retention of compensation consultants with significant conflicts of interest and levels of CEO pay. The 25 Fortune 250 companies that used compensation consultants with the largest conflicts (as measured by fee ratios) paid their CEOs a median salary of \$12.5 million in 2006. This was 67% higher than the median salary of \$7.5 million paid by Fortune 250 companies that did not report using consultants with conflicts of interest.¹⁸ Figure 2.



A similar but less pronounced trend is observed when the CEO salaries of all Fortune 250 companies that used compensation consultants with conflicts of interest are compared to the CEO salaries of Fortune 250 companies that did not use compensation consultants with conflicts of interest. In 2006, the median CEO salary of the companies with conflicted consultants (\$8.7 million) was higher than the median CEO salary of the companies that did not use conflicted consultants (\$7.5 million).

¹⁸ CEO salary data was obtained from the Forbes magazine annual CEO compensation report. See, Forbes, *supra* note 1. Companies that did not use one of the six compensation consultants surveyed by the Committee, companies for which CEO salary data was unavailable for 2006, or companies that did not file a proxy statement in 2006 were not included in this analysis.

The Committee obtained information on fee ratios from the surveyed compensation consultants for a five-year period from January 1, 2002, through December 31, 2006. Over this period, the median CEO salary increase of the 25 Fortune 250 companies that used compensation consultants with the largest conflicts of interest was 226%. In comparison, the median CEO salary increase was less than half as much (105%) at the Fortune 250 companies that did not use conflicted compensation consultants.

These correlations between consultant conflicts of interest and levels of CEO pay suggest, but do not prove, a possible causal relationship. Numerous factors beyond the use of compensation consultants with conflicts may affect CEO pay at Fortune 250 companies. Among the companies included in this analysis, the companies that used compensation consultants with the highest fee ratios tended to be larger than the companies that did not use conflicted consultants, possibly explaining some of the pay differences. More investigation is needed to confirm whether the correlations are significant and to assess whether an unrelated factor could be responsible for the relationships observed in the data.

D. Compliance with SEC Disclosure Rules

The regulations promulgated by the SEC in 2006 require that companies disclose “any role of compensation consultants in determining or recommending the amount or form of executive and director compensation” and identify such consultants.¹⁹ According to SEC guidance, companies must disclose all consultants that played a role in determining executive pay, not just the consultant advising the board or its compensation committee.²⁰

The information the Committee received raises a question about whether the Fortune 250 companies are complying fully with this disclosure requirement. In their SEC filings, 194 of the Fortune 250 companies disclosed retaining executive compensation consultants in 2006. According to the information that the Committee received from the leading compensation consultants, however, an additional 13 Fortune 250 companies retained executive compensation consultants in 2006 but did not identify these consultants in their SEC filings. Moreover, among the 194 Fortune 250 companies that reported retaining an executive compensation consultant in 2006, not all of the retained consultants may have been disclosed. According to the information that the Committee received, almost 100 of the 194 companies failed to disclose a compensation consultant retained by the company.

Differences in definitions may be an explanation for discrepancies between the executive pay services reported to the SEC and those reported to the Committee. The executive compensation services reflected in the consultants’ submissions to the Committee could include a broader range of activities than those required by the SEC to be disclosed to shareholders. If a company hired a consultant only to provide survey data on executive pay, for example, this work could have been reported by the consultant to the Committee

¹⁹ SEC, Final Rules on Executive Compensation and Related Party Disclosures, Items 402 (b) and 407 (e) of Regulation S-K (August 29, 2006).

²⁰ *Id.*, see also, SEC, Staff Interpretation: Item 407 of Regulation S-K – Corporate Governance (March 13, 2007).

as executive compensation services, but the company may not have considered the consultant's work to involve "determining or recommending" the amount of executive pay under the SEC disclosure rules. Alternatively, although it appears inconsistent with the SEC guidance, a company may have disclosed in its SEC filings only the compensation consultants that provided services to the company board.

In some cases the compensation consultants that were not disclosed in SEC filings were paid large amounts for executive compensation services, according to the information reported to the Committee. In dozens of cases, compensation consultants reported to the Committee that they were paid over \$100,000 in 2006 for executive compensation services that were not disclosed in SEC filings.

E. The Position of the Compensation Consultants

The four diversified compensation consultants surveyed by the Committee maintain that a consulting firm's ability to provide objective, independent advice regarding executive pay is not compromised simply because it provides other services to the company. The consultants have described a variety of policies and practices they have instituted to ensure that executive compensation consultants deliver unbiased advice.

Towers Perrin, in a letter to Chairman Waxman, listed several policies and procedures for ensuring the soundness and objectivity of its consulting advice. These include: (a) a code of conduct that articulates a commitment to providing impartial and objective services; (b) the designation of a senior consultant to review and resolve all potential conflicts of interest before an engagement proceeds; (c) review of significant executive pay recommendations by a senior consultant not on the consulting team performing the work; and (d) a policy precluding an individual who advises a company's board on executive pay from serving as the firm's relationship manager with the company, where the firm provides other services to the same company.²¹

Similarly, Hewitt stated:

In the area of executive compensation counseling, Hewitt employs a number of safeguards and procedures to ensure independence. Over the last several years we have increasingly separated our executive compensation engagements from the engagements for our other services. These safeguards have evolved over time, and we adopt new ones as corporate governance and regulatory standards continue to change.²²

The Committee did not investigate the internal practices in place within compensation consulting firms, such as efforts to separate executive pay consultants from the firm's other engagements with a client company. However, there is evidence to suggest that the lines between those providing executive compensation advice and those providing other services may not be as bright as the consultants described. Employment advertisements

²¹ Letter from Mark V. Mactas, Towers Perrin, to Chairman Henry A. Waxman (June 26, 2007).

²² Letter from Ilene S. Grant, Hewitt Associates, LLC, to Chairman Henry A. Waxman (May 25, 2007).

posted by some of the compensation consultants indicate that one responsibility of individuals hired to perform executive compensation services is “cross selling” other services to client companies.

For example, Towers Perrin, in a recent job posting for an executive compensation consultant, listed the following as job responsibilities:

- Cross selling consulting and other Towers Perrin services to existing and new clients
- Minimum revenue generation from all sources (i.e., not just executive compensation services) goal of \$750 thousand in the first 12 months would be expected²³

Similarly, a recent Mercer job posting for a senior executive compensation consultant identified the following as a job responsibility: “generating revenue through development of new client relationships, cross-selling to current clients and extension of current client engagements.”²⁴

CONCLUSION

The information provided to the Committee represents the best — and only — comprehensive information currently available on the extent of conflicts of interest among executive compensation consultants. An analysis of this information shows that in 2006, over 100 Fortune 250 companies used compensation consultants that provided both executive compensation advice and other services to the company at the same. In many cases, the consultants hired to provide executive compensation advice were paid millions of dollars by the executives whose pay they were supposed to assess. The information provided to the Committee also shows that many of these conflicts of interest were not disclosed to the investing public in company SEC filings.

²³ Towers Perrin, Job Description for Executive Compensation Consultant, accessed from Towers Perrin web site on October 31, 2007 (available at http://careers.towersperrin.com/towers_career/).

²⁴ Mercer Human Resources Consulting, Job Description for Senior Executive Compensation Consultant, accessed from Mercer web site on October 30, 2007 (available at <http://www.mercer.com/joiningmercercareer/home.jhtml?rl=&geographyid=-1>).