



# Compensation Insight

## **The Importance of Independent Advisors on Executive Compensation Issues**

In today's highly publicized and scrutinized executive compensation environment, the importance of independent board advisors on executive compensation issues has taken center stage.

Most recently, on May 8, 2007, U.S. Rep. Henry Waxman, chairman of the House Committee on Oversight and Government Reform, sent a letter to six consulting firms requesting information on the consulting services provided to the largest 250 U.S. publicly traded companies. The letter asked the firms to describe executive compensation and other types of consulting services provided to these companies between Jan. 1, 2002 and Dec. 31, 2006. It also requested that the firms provide the total revenue they received from each of these companies, segmented by executive compensation consulting and other consulting services revenue.

The committee's letter to the consulting firms stated, "Shareholders and investors have expressed concerns that a compensation consultant's ongoing business relationship with a company could compromise the independence of the advice the consultants provide to the company's board about executive compensation." The letter indicated that little is known about the extent of executive compensation consultants' relationships with publicly traded companies since the SEC does not require disclosure in this area.

The committee's investigation implies that firms with major consulting relationships or product-related revenue—in addition to executive compensation consulting services—may have conflicts of interest, and that firms with these additional relationships may not be able to render independent

executive compensation advice. For example, a firm's provision of significant employee-benefit outsourcing and/or actuarial services may "conflict" with the consultant's ability (whether intentionally or unintentionally) to provide independent advice on executive compensation to the board.

Not-for-profit organizations are not immune to the standards and regulations that apply to for-profit organizations. This is evidenced by the implementation by some not-for-profits of Sarbanes-Oxley-type rules, as well as the adoption of for-profit best corporate governance practices. In addition, not-for-profit organizations have a special legal obligation to ensure that the net income of the organization does not inure to the benefit of any person having a position of influence in the organization (such as an officer), and that executive total compensation is reasonable and representative of what is "ordinarily provided by similarly situated organizations, under like circumstances."<sup>1</sup>

In recent years, the IRS has emphasized the need for effective governance in executive compensation. From 2004-2006, the *IRS Executive Compensation Compliance Initiative* reviewed the executive compensation practices of more than 1,800 not-for-profit organizations. Following this initiative, the IRS released a long-awaited report that provided important information for not-for-profit boards to consider in their efforts to ensure effective governance of executive compensation.

Organizations should assess whether their executive compensation consultants are independent and conflict-free, to protect and validate executive compensation decisions. Independence—whether of the board members approving executive compensation or the executive compensation consultants providing advice to the board—is of paramount importance for demonstrating best corporate governance of executive compensation decision-making.

So how should your organization determine whether your executive compensation advisor is truly independent?

## **What To Do**

Not-for-profit organizations should consider establishing guidelines for engaging consultants who provide their boards with executive compensation services. The guidelines should cover the nature and length of the executive

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1. As defined by Treasury Regulations Section 4958, commonly referred to as Intermediate Sanctions Regulations

compensation assignment(s), the expected fees, the contact people within the organization with whom the consultant will interact, the method for reporting findings and recommendations, and other process-related aspects of the assignment.

Not-for-profit organizations should also request that any outside consultants who are retained to provide executive compensation advisory services disclose all of their company's business dealings with the organization's designated approval body. This includes any relationship that an executive or the organization has with the consultant or the consultant's firm. This should also include any services provided by the firm's parent or subsidiary corporations (e.g., a consulting firm owned by an insurance broker; a subsidiary providing consulting services or benefits products). The organization should also require the consultant to report any potential conflicts that arise during the course of its assignment.

Another area of concern is the potential conflict caused when a consultant sells "products" or other services to the organization and/or its executives (e.g., life insurance or other benefits products). Disclosure of these services should include all costs and fees, to avoid "buried" costs in premiums or administrative fees, which are not readily visible to the oversight body.

The board should assess the consultant's relationships within the organization and determine whether a material conflict of interest exists, or whether an exception should be made based on the degree to which the consultant demonstrates independence. The board may find that when conflicts of interest exist, it can be difficult for the consultant to serve or be perceived as an independent advisor in executive compensation. The board should also assess the organization's ability to withstand public, regulatory or stakeholder scrutiny if any conflicts exist with the executive compensation consultant's firm.

Further, organizations may request that consultants sign a "conflict-of-interest" statement. This statement should disclose all potential conflicts of interest to the board and reaffirm that the work performed by the consultant is on behalf of the organization's board, rather than for the benefit of the executives who receive the compensation.

In closing, the board is in the best position to evaluate consulting relationships, determine whether any conflicts of interest exist and take appropriate action.

For further assistance, contact your SullivanCotter consultant today.

## **About Sullivan, Cotter and Associates, Inc.**

Since 1992, SullivanCotter's innovative yet practical compensation solutions have created tremendous value for the healthcare organizations it serves. In this capacity, SullivanCotter specializes in the development and implementation of strategic compensation and reward programs for its healthcare clients.

As a leader in healthcare executive, physician and employee compensation consulting, SullivanCotter has served many of the nation's leading and largest health systems, academic medical centers and community healthcare organizations and has developed some of the top healthcare compensation surveys in the United States.

SullivanCotter strives to help our healthcare clients develop and implement creative, comprehensive and compliant compensation programs that bridge the needs of organizational stakeholders.

SullivanCotter has offices in Atlanta, Boston, Chicago, Dallas, Denver, Detroit, New York, Parsippany, San Francisco and Westport.

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