

Conflict Concerns Benefit Independent Pay Advisers

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Increased concern about conflicts of interest among compensation consultants is spurring a cottage industry of smaller firms that primarily work for boards of directors and decline management assignments at those corporate clients.

Activist shareholders have long complained that large consulting firms often simultaneously advise directors about executives' compensation and provide benefits consulting or other human-resources advice to management. Activists say these consultants have an incentive to please managers, who control those more lucrative contracts.

The issue gained new prominence last week when the House Government Oversight Committee concluded that nearly half of the 250 largest public companies get executive-pay advice from consultants who also provide other services to the company. A committee report found that median CEO pay was 67% higher at companies with the largest conflicts than at those whose consultants had no conflicts. The committee is led by Rep. Henry Waxman (D., Calif.).

The report will persuade more boards to hire consultants that do no other work for the company, predicts John F. Olson, a senior partner at Gibson, Dunn & Crutcher in Washington. "Congressman Waxman has given the executive-compensation business a very nice holiday gift."

The beneficiaries will likely include about 20 small and midsize independent consulting firms that shun management assignments at clients when they are retained by board members. Most are relatively new firms; half didn't exist five years ago. Often run by refugees from bigger rivals, these firms will account for about 20% of the \$750 million spent on executive-compensation advice in the U.S. this year, estimates James F. Reda, founder of one such firm. He thinks their market share could double within five years.

Mr. Reda worked for three major pay consultancies before launching his New York business in 2003. Revenue has grown 60% every year, and the 2008 rate "could be higher," he says. James F. Reda & Associates employs 11 people.

Compensia Inc., a San Jose, Calif., firm specializing in the high-tech industry, counseled 158 board pay panels this year -- up from 29 in 2004, its first full year, says President Timothy J. Sparks.

Exequity, of Libertyville, Ill., needs more pay consultants because "we can't keep up with the pace we have," says Ross Zimmerman, a co-founder of the 10-person firm. He previously spent 17 years at Hewitt Associates, a big human-resources consultancy.

The largest independent firm is Frederic W. Cook & Co., which advises board compensation committees at 54 of the 250 largest U.S. corporations. Founded in 1973, the New York firm has long avoided working simultaneously

for boards and management. With increased concerns about potential conflicts, "this approach has now become a definite plus for us," says Chief Executive George Paulin.

Before the committee's report was issued, the Securities and Exchange Commission began requiring boards this year to reveal their compensation consultant in proxy statements. While the SEC doesn't require disclosure of the consultant's other work for the company, it recently asked several concerns for fuller descriptions of pay advisers' efforts.

Worries about perceived conflicts have prompted some boards to switch consultants. **Johnson & Johnson** is cited in the committee report for paying consultant Towers Perrin more than \$11 million last year for other services, far more than the approximately \$160,000 its compensation committee paid a different arm of Towers Perrin for executive-compensation advice. J&J this year chose a different compensation consultant, which does no other work for the health-care giant.

The large consulting firms defend their work. Donald Lowman, a Towers Perrin managing director, told lawmakers at a hearing last week that his employer's integrity was "not for sale." Towers Perrin has adopted internal practices to help clients deal with perceived conflicts of interest.

In 2002, the board of Methode Electronics Inc. replaced a consultancy that also served management with Donald Delves, an independent consultant who works only for the board.

Mr. Delves, president of Delves Group, "is a very straight shooter," says Warren Batts, a compensation-committee member at the Chicago maker of electronic components. Based on an informal audit by another pay consultant, he says, Methode directors recently concluded that their company's executive-compensation plans "were in the range of what the competition was doing -- and in the range for our performance."

Mr. Delves, who worked at Towers Perrin for 10 years, says his Chicago firm flourished after its 2001 debut before leveling off for several years. But in the past year, he adds, "there has been another wave."
