The Governance Institute's E-Briefings

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Welcome to The Governance Institute's E-Briefings!

This newsletter is designed to inform you about new research and expert opinions in the area of hospital and health system governance, as well as to update you on services and events at The Governance Institute. Please note that you are receiving this newsletter because you are a Governance Institute member or expressed interest at one of our conferences.

News, Articles, and Updates

Assessing Compensation Advisor Independence

By Timothy Cotter, Sullivan, Cotter and Associates, Inc.

The Securities and Exchange Commission (SEC) recently adopted a final rule to implement a section of the Dodd-Frank Wall Street Reform and Consumer Protection Act to address potential conflicts of interest for individuals involved in establishing executive compensation arrangements at publicly held companies, including the independence of advisors to the compensation committee. Although the rule does not apply to non-profit healthcare and was not written with this sector in mind, it provides helpful guideposts for such organizations given the potential for governance-related "spillover" from the public company sector. Compensation committees in the non-profit healthcare sector would be well-advised to consider the extent to which applying the prescribed compensation advisor independence factors would strengthen their decision-making process, as conflicts of interest (real or perceived) can compromise an effective executive compensation governance process.

What Is a Conflict of Interest?

A conflict of interest arises when an advisor has a personal interest to a degree that appears to influence objectivity in the advisor's professional role. A conflict is not only financial; it is any factor that a reasonable person may perceive to bias an advisor's judgment. A potential conflict does not imply a lack of integrity or that the advisor is actually conflicted. It is a situation that must be addressed to remove doubt surrounding the objectivity of a decision-making process.

Independence factors to consider in identifying potential conflicts of interest involving the compensation advisor are presented below. They are based on the factors presented in the new SEC rule.

Independence Factors to Consider

Other advisory services. One factor to consider is the extent to which the compensation advisor is providing other services to the organization. Optimally, the advisor's work would be limited to services authorized by the compensation committee and related to executive or key employee compensation. Other advisory activities with significant fees (e.g., actuarial services, outsourcing, auditing, general management consulting) require assessment, as they may create real or perceived conflicts. However, a compensation committee may find it appropriate to permit its executive compensation advisor to perform other activities, provided the scope and cost of these services are limited and are fully disclosed to the committee.

Advisor revenue. A second factor to consider is the percentage of the advisory firm's revenue paid by the organization. The committee should determine whether an advisor's independence is compromised if the engagement represents a significant portion of the advisory firm's revenue.

Business and personal relationships. A third factor to consider is the advisor's business and personal relationships with committee members, the CEO, and other senior executives. Such relationships (if any) need to be disclosed and evaluated in the same way as other potential conflict issues. A casual relationship or a mutual social club membership is quite different from being engaged in a business venture with significant financial returns.

Conflict policies. A fourth factor to consider is the advisory firm's conflict-of-interest policies. The committee would be well served to review and assess the firm's standards and policies in addressing conflicts of interest.

Other factors. While the factor in the final rule related to the advisor's stock ownership in the company is generally not relevant in the non-profit health sector, other factors for consideration more common to this sector include the following:

- Does the advisor or firm accept payments from vendors of related products (e.g., life insurance) for which the advisor may be providing recommendations to the committee?
- Does the advisor or firm have a financial interest in organizations that provide services or products in areas in which the advisor may be providing recommendations to the committee?
- Does the advisor or firm have a financial interest in a company where the healthcare organization also has a financial interest?
- Is the firm offering health insurance products and creating provider networks, which may be at odds with the interests of the health system or hospital?
- Does the firm provide employment to client executives at retirement?
- Does the firm provide paid speaking engagements to senior executives or provide travel or entertainment expenses on their behalf that are beyond a nominal amount?

Potential Action Steps

Major themes of this new SEC rule are likely to have a "spillover" effect on non-profit healthcare governance. In our opinion, the compensation committees of hospitals and health systems should ask their compensation advisors to provide information regarding these types of potential conflict factors. Of course, the committee should also directly retain the compensation advisor(s) and have appropriate funding to support their activities on behalf of the committee.

The compensation committee should evaluate the advisor's responses and determine whether a conflict of interest exists. The compensation committee is in the best position to evaluate advisory relationships, determine whether any conflicts exist, and take appropriate action. This new SEC rule provides an excellent road map in this regard.

The Governance Institute thanks Timothy Cotter, managing director at Sullivan, Cotter and Associates, Inc., for contributing this article. He can be reached at timcotter@sullivancotter.com.