

**UNITED STATES HOUSE OF REPRESENTATIVES**

**COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM**

**HEARING**

**“EXECUTIVE PAY: THE ROLE OF COMPENSATION  
CONSULTANTS”**

**TESTIMONY OF**

**DONALD L. LOWMAN**

**MANAGING DIRECTOR  
TOWERS, PERRIN, FORSTER & CROSBY, INC.**

**Washington, DC**

**December 5, 2007**

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Good morning Chairman Waxman, Ranking Minority Member Davis, and Members of the Committee. Thank you for the opportunity to express our views today on executive compensation consulting services, the role of compensation consultants in the determination of the compensation of senior corporate executives, and the question whether potential conflicts of interest might arise when a consulting firm simultaneously provides compensation consulting and other services to a single client.

These are all subjects of great interest to Towers Perrin and our clients. It is our long held belief that executive compensation is a critically important component of good corporate governance.

Today I'd like to provide you with some background about Towers Perrin and describe the nature of our executive compensation consulting practice, including the various forms that executive compensation engagements may take. I also would like to outline for you steps we take to help ensure that our consulting work is not affected by other relationships our firm may have with a given company. Finally, I will address some issues that have been raised regarding the role of executive pay advisors, and will discuss some positive steps that we believe can improve the executive compensation process in various respects.

## **About Towers Perrin**

Towers Perrin is a global consulting firm that was founded in 1934 and has been privately owned by full-time employees since its inception. With our global workforce of approximately 6,000 employees we deliver consulting services in a broad range of disciplines including human resource strategy, design, and management; actuarial and risk management services in the insurance and financial services industries; and reinsurance intermediary services. Our mission is to help improve our clients' business performance through our unique combination of talent, expertise, and commitment, thereby creating value for our stakeholders. In all of the work we do, we adhere to our stated values of integrity, respect, and professionalism.

I am a Managing Director of Towers Perrin's Human Capital Group and a member of our Executive Council and our Board of Directors. Our eight-person Executive Council has overall responsibility for setting Towers Perrin's strategic direction and overseeing the management of the firm's operations. In my 25 years with Towers Perrin, I have had a variety of leadership roles and have managed different parts of our global geographic operations and a number of our lines of business. I remain an active consultant today, and was honored as one of the top 25 consultants in the world by Consulting Magazine in 2003.

## **Towers Perrin's Executive Compensation Consulting Practice**

Towers Perrin began offering compensation consulting services to its clients in 1962. Our firm's compensation consulting services are delivered by a separately identified line of business with its own leadership structure. The services this line of business offers include both executive compensation consulting and consulting relating to rewards for broad-based employee groups. We have provided executive compensation consulting services to

thousands of clients worldwide and have been ranked first in U.S. market share by various analyses of 2007 proxy disclosures.

Towers Perrin's executive compensation practice has specific and clearly articulated policies and procedures that we use to govern the delivery of our services to our executive compensation consulting clients. These policies and procedures build on long-standing policies that govern all of Towers Perrin's consulting work.

It is important to understand how the executive compensation process works in most companies. Generally, executive compensation consultants provide advice and support to a company's board of directors (or one or more of its committees), which ultimately makes the decisions about executive pay for the company. Sometimes, however, the executive compensation consultant is not asked to offer advice at all, but rather is assigned to provide and analyze data. In any event, the key point is that consultants neither displace nor provide a substitute for sound corporate governance and the proper exercise of authority by the company's board of directors and compensation committee. Sound governance, including a compensation committee that exercises its authority with courage, conviction, integrity, and discipline – and with the best interests of shareholders top of mind - is the cornerstone of sound executive compensation decisions.

Towers Perrin fully supports the proposition that shareholders, boards of directors, compensation committees, and company management should receive the information they need to carry out their respective roles in an environment characterized by transparency and objectivity. Executive compensation consultants help to provide that information, but they do not create or control the market for executive talent, nor do they make the ultimate executive compensation decisions.

In contrast to outside auditors, the services of which publicly traded companies are required to retain, no compensation consultant need be hired at all by a corporation or its

compensation committee. In light of the optional nature of company board decisions to secure outside executive compensation advice, such engagements, for Towers Perrin, vary considerably from client to client, in both nature and scope. In some cases – for example, where our consultants are asked simply to supply data about competitive practices or calculate the value or cost of a particular award – we have minimal interaction with the compensation committee. At the other extreme, our consultants may attend compensation committee meetings, develop materials for the committee’s review, serve as a sounding board, technical expert and/or advisor to the committee, and provide other input to the committee’s decision-making process. Thus, our compensation consulting engagements can range from only a few hours per year to hundreds of hours per year.

Companies may engage more than one executive compensation advisor for different reasons – e.g., for multiple sources of data, specialized expertise, compliance with applicable laws and regulations, additional perspectives, or second opinions. In addition to consultants, companies frequently turn to lawyers for compensation advice or help in crafting public disclosures about particular programs or individual remuneration arrangements.

As a general matter, Towers Perrin’s executive compensation consulting engagements reflect a variety of structures, depending upon four main variables: first, the number of consulting firms employed by the client; second, whether the board compensation committee or management retains the consulting firm; third, the specific terms of the engagement, *i.e.*, whether or not the firm is permitted to provide other services and, if so, any approvals or restrictions that might apply to such other services; and fourth, the nature of the particular assignment that the client expects the consulting firm to execute. While the foregoing four variables could yield any number of possible models, in practice we

find that the following three approaches have proved most prevalent in the executive compensation consulting industry:

1. The compensation committee hires one consulting firm, which works for both the committee and management, at the direction of the committee. In this compensation model, there normally are no restrictions on other work provided by the consulting firm to management, so long as the committee is kept informed of such other work and has an opportunity to disapprove it.
2. Two consulting firms are hired: one by management to do the work involved in designing a particular compensation package, and a second by the compensation committee to review and audit work done by management and management's compensation consulting firm. Under this model, the committee's consulting firm normally performs no other work for the company but management's consulting firm is allowed to do such other work. Usually, the committee employs a firm that specializes exclusively in executive compensation work, while management's consulting firm is a full-service human resources firm.
3. A single consulting firm, hired by the committee, which usually (but not always) is allowed to interact with management on executive compensation matters, at the direction of the committee, but is barred from performing any other (*i.e.*, non-executive compensation) work for the company.

Whatever the nature and scope of Towers Perrin's executive compensation consulting engagement or the roster of professionals advising a particular client, our firm is committed to delivering sound, expert advice, consistent with our high standards of quality work and objectivity, in an environment that is free from conflicts of interest. In our view, this objective can be achieved through hiring talented consultants, training them fully, and operating in a culture of integrity, reinforced and monitored by properly designed policies and procedures, such as those described in detail below, provided those policies and procedures are implemented effectively and applied consistently.

We do not believe that the delivery of sound, objective, and conflict-free advice on executive compensation requires a particular corporate structure or a regulatory limitation on the types of engagement a consulting firm may pursue. Nor do we believe a firm's ability to deliver sound, objective, and conflict-free advice is automatically or necessarily

compromised simply because the same firm also may provide other consulting services to a client.

Indeed, to this point, recent published reports – such as the one released less than two months ago by the Corporate Library – indicate that consulting firms that offer only executive compensation consulting advice and whose revenues derive exclusively from that one line of business are associated with the very highest levels of executive pay. These reports also suggest that such specialized firms may well not be as objective as firms whose revenue sources are more numerous and diverse. For Towers Perrin, the complete loss of a relationship with any single client, while obviously regrettable, typically would have a far less significant impact than such an event would have for a specialized firm with far fewer clients and a far greater percentage share of revenues associated with any particular client relationship. Accordingly, far from presenting an obvious or attractive solution to the perceived problem of conflict of interest in the delivery of executive compensation consulting services, a rule barring firms from accepting both executive compensation and other types of consulting engagements from the same company actually could exacerbate the risk that a company could receive conflict-compromised advice.

All of Towers Perrin's executive compensation consulting engagements share certain features that, we submit, enable us to achieve our goal of providing sound and objective advice to our clients. First, regardless of whether we have been retained by the compensation committee or by management, we invariably consider our client to be the enterprise itself, not a particular individual. Indeed, we do not accept engagements from individual executives to further their personal interests (even where the company would be paying our fee) and we have declined to pursue potentially lucrative business offerings to provide executive search, coaching and outplacement services that might engender a risk of our becoming too closely aligned with individual executives' financial interests.

Second, the fees for Towers Perrin's executive compensation consulting services are calculated by hourly rate or based on a fixed, pre-established amount unrelated to any level of executive pay. Thus, contrary to what some believe, the size of our fee is not a function of the size of any given executive's compensation package.

Third, Towers Perrin's executive compensation consultants receive no direct reward for promoting or selling other services provided by our firm. We do not pay sales commissions, nor do we provide specific financial incentives for our executive compensation consultants to help sell other work to clients for whom we already provide executive compensation services. In fact, as noted below, Towers Perrin executive compensation consultants who serve as advisors to compensation committees are precluded from participating in any significant way in account planning for clients to whom we provide significant other consulting services beyond executive compensation. By the same token, Towers Perrin consultants in other lines of business do not review executive compensation consulting reports and have no input into the content of such reports or the direction of any recommendations they may contain.

### **Towers Perrin's Protocols for Ensuring Professionalism, Independence and Objectivity**

Many Towers Perrin clients want to be able to take advantage of the breadth of services and global expertise our firm offers. Mindful of the potential for conflicts of interest, we long ago established formal policies and procedures to help ensure the soundness and objectivity of our consulting advice.



Among the policies and procedures that allow us to deliver such advice are the following:

- Towers Perrin's Code of Business Conduct, which governs the work of every employee of our firm, clearly articulates the firm's commitment to providing clients with services that are impartial and objective.
- Towers Perrin designates senior leaders in each of our consulting practices to serve as Professional Standards Officers ("PSOs"). PSOs have been responsible for many years for ensuring that professional standards are adhered to and that all potential conflicts of interest are considered and resolved before an engagement proceeds.
- In any case where an executive compensation PSO determines that other consulting work is resulting (or potentially could result) in undue influence on the objectivity or independence of our executive compensation advice, the PSO can take steps to impose structural changes to the relationship, including mandating Towers Perrin's withdrawal from the executive compensation or other consulting relationship if he or she makes a judgment that objectivity cannot be preserved.
- Towers Perrin's formalized executive compensation quality assurance protocols mandate that all significant executive compensation recommendations be reviewed by at least one senior practitioner in addition to the consulting team performing the work.
- Towers Perrin's policy is to preclude an individual who serves as a board-appointed executive compensation consultant from also serving as the firm's client relationship manager in any instance where we deliver both executive compensation and other consulting services to the client.
- Towers Perrin's policy is to cooperate with reasonable client requests to implement any other steps that may be designed to address any perceived conflict of interest and to preserve the objectivity and independence of our consulting advice. Several examples of such additional steps have been reported in the press.

We believe that close adherence to these policies and procedures – which apply equally regardless of whether Towers Perrin is the lone consulting firm in a particular engagement or is teamed with another firm – has enabled Towers Perrin to ensure the objectivity and independence of our executive compensation consulting advice over many years. Indeed, we believe that the objectivity and integrity that are the hallmarks of our work are in large measure responsible for the success we have enjoyed.

In sum, we firmly believe that, handled responsibly and professionally, executive compensation consulting engagements will provide clients with the information they need to design and/or modify or approve sound and defensible pay packages. It is neither wise nor appropriate to impose on companies a particular model that would limit their flexibility to adopt the system for setting compensation that best meets their own needs.

### **Towards an Improved Process for Setting Executive Compensation**

As noted earlier, responsibility for executive compensation decisions resides ultimately with each company's compensation committee and board. The quality of such decisions is a function of the collective knowledge and experience of the members of those bodies, the due diligence they follow in reaching decisions, their objectivity, and their individual integrity. They decide whether or not to engage outside advisors to assist them and whether or not to follow any advice they receive. The quality of consulting advice is a function of consulting firm resource depth and individual consultant experience.

The debate around executive compensation – already heated – plainly has intensified, prompted not only by the new SEC disclosure requirements, but also by other emerging developments such as Congressman Barney Frank's "say on pay" bill. And, to be sure, there have been cases of abusive compensation packages that have rightfully raised eyebrows not only in Congress, but in boardrooms and living rooms across the country.

The issues that typically make front page business news and appropriately attract the attention of this Committee include the worst things that have happened in the areas of corporate governance and executive pay. They are not flattering portraits, to be sure, but neither do they represent the overwhelming majority of companies and boards, nor the

professionals who advise them. Moreover, we have also seen significant changes for the better; specifically:

- Improvements in governance resulting from Sarbanes-Oxley (2002) and new stock exchange corporate governance requirements (2003) have improved the way that compensation committees operate.
- Threats of lawsuits and criminal prosecution against directors have provided wake-up calls for any board members in need of one. Directors who participated in or witnessed stock option backdating investigations or observed derivative suits now have a renewed appreciation for the breadth of their fiduciary responsibilities and for the scrutiny accorded senior executive compensation by regulators, shareholders and the general public.
- Shareholder activism, coupled with new proxy disclosure requirements, has caused certain questionable past practices to fall out of favor or nearly vanish (*e.g.*, executive loans, stock option repricing, reload stock options, director retirement plans).
- Stock option expensing requirements put the brakes on the wasteful use of equity compensation. Most investors now believe dilution is at or near acceptable levels.
- Directors have become smarter, more committed, better prepared, and for the most part, unafraid to ask tough questions. Polite and perfunctory “give and take” at compensation committee meetings has been replaced by rigorous discourse and debate.
- Increased use of lead directors or independent board chairs and greater use of executive sessions (without management present) at compensation committees have established a more equal balance of power between management and the independent board members (who comprise compensation committees).
- Statements like “because we’ve always done it that way” are no longer defensible, and “everyone else does it this way” is increasingly being challenged. Committees focus on what’s right for their company today. This is starting to have effects on lower severance multiples, tax gross-ups and so forth.

For some companies, these changes represent only minor modifications of past practices, while for others, they have caused a complete overhaul of the past. We have seen more changes in executive compensation program design in the last five years than in the previous 25. Over the last few years, many companies have re-thought, re-mixed and re-designed their executive pay programs. They are getting far better at pay design. They

are using sophisticated tools and approaches to create incentives that contemplate a broad range of business and performance outcomes, from success to failure to change-in-control. Corporate America has never been more conscious of executive pay and the implications for not getting it right.

Still, no ready-made formula exists to satisfy all interested parties. After all, it is difficult, if not impossible, to reconcile the core belief of some that “the company that pays least pays best” with the equally fundamental principle that the market for executive talent should be permitted to function with a minimum of interference. Nevertheless, certain basic, undeniable precepts endure. Long followed by many companies, these principles are receiving increased emphasis in boardrooms across the country:

- **It all starts with good governance.** In today’s environment, the words “duty of loyalty” and “duty of care” are serious and substantial – defining the commitment and responsibility that board members have to the shareholders they serve. The chain of governance is only as strong as its weakest link. Increasingly, companies are taking measures to ensure that each link *is* strong. Good governance is foundational and necessary for sound pay decisions. But governance itself does not guarantee good decisions.
- **More committed and courageous board members make a difference.** These days, compensation committees are taking an increasingly active role. The best directors are better prepared (thanks, in part to their increased reliance on executive compensation consultants) and unafraid to ask the tough questions. Polite and predictable “give and take” has given way to far more searching analysis and negotiation.
- **Testing scenarios helps ensure sound design.** Few would argue that, in the past, a number of U.S. companies have underestimated or not even known the “upside potential” of numerous pay plans. The relatively recent increased use of “tally sheets,” however, helps ensure that virtually all realistic scenarios, from change-in-control to voluntary termination, are explicitly contemplated by the compensation committee. Both upside and downside outcomes need to be balanced. By minimizing the potential for surprises after the fact, committees are reaching decisions less susceptible to the second-guessing of Monday morning quarterbacks.
- **Survey data should inform, but not determine, pay levels.** No doubt, slavish reliance on competitive survey data can cause the “Lake Wobegon” effect that critics rightly condemn as generating widespread, if not universal, “above

average” levels of compensation. But this does not mean we should ignore the wealth of information that describes pay practices and reports pay levels within various sectors of the economy. Rather, pay data should be used judiciously, in conjunction with a host of other factors, in reaching the ultimate determination of how much a particular executive should be paid.

- **Talent management and succession planning make for affordable pay.** Increasingly in the business world, the “whatever it takes” mentality to hire top executives is giving way to thoughtful succession plans and careful talent management. Without a solid succession plan in place, many companies can end up over-paying an under-performing executive for protracted periods. Building a strong internal talent pool can also reduce the need to buy expensive outside talent and eliminate the costs and risks of bringing that talent up to speed.
- **Use of long-term performance plans improves the “pay-for-performance” linkage.** Many companies now realize that cash and stock-based performance plans can provide executives with tangible rewards directly aligned with the overall objective of shareholder value creation. Such plans, of course, require companies to answer three important questions: What’s the measure? What’s the target? And what’s the range of performance around which we will pay? Unlike stock options, which allow companies essentially to outsource performance management to the vagaries of the stock market, performance plans require goal-setting and negotiation.

Rather than resign themselves to an unending stream of criticism about executive pay, companies increasingly are recognizing the value of taking proactive steps, along the lines outlined above, to present their shareholders with sound, well thought out performance-based programs. We respectfully submit that – with the aid of outside professionals demonstrably committed to rendering objective advice – corporate America is fully capable of improving the credibility of the executive compensation process.

Full service executive compensation consulting firms like Towers Perrin clearly have a role to play in helping companies meet this challenge. Indeed, given the increased attention being directed to senior executive pay packages, companies need to have access to our technical expertise and sophisticated analytical skills now more than ever.

As I hope we have succeeded in demonstrating, companies use numerous and different models for engaging consultants, and many variables factor into sound executive

compensation decisions. These many moving parts, combined with the complex policy and business considerations raised by the debate surrounding executive pay, highlight the risk of adopting a solution that, while perhaps simple on its surface, actually may do more harm than good.

Again, thank you for this opportunity to share our views and suggestions. We will continue to follow the Committee's work in this area with great interest and are confident that it will give careful consideration to these important and complex issues.