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Consultants In Organization Design, Leadership & Stakeholder Value

June 7, 2004

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, N.W, Washington, D.C. 20549
by Fax

Re: Corporate Governance – Fixing Director Nomination and Executive Pay-for-Performance in America

Dear Chairman Donaldson,

I understand that the SEC is now under intense lobbying by various stakeholder groups regarding the adoption of new rules to include shareholder nominated director candidates in the company proxy statement and proxy card.

While there is much debate about process and rules regarding Director nomination, there is little discussion about the corporate performance that should result from good governance and effective Directors. I am writing to share our recent research results that may better put the debate in context and help the SEC in making the right decision for all stakeholders.

The following material facts do not appear in the published comments and highlight current problems in the capitalist system that require remedy:

- Our recently completed financial analysis of the top 700 publicly traded corporations representing over 80 % of U.S. market capitalization has identified that over 5 years ending in 2002, 464 companies or 59 % failed to provide a Net Operating Profit After Tax (NOPAT) greater than their cost of capital.

The resulting poor return on invested capital over 5 years or more raises the question of how viable are the business strategies of many of these companies and what are the respective Board Directors holding their CEO's accountable for.

Moreover, the boards and CEOs of these poorly performing companies are apparently not using adequate metrics to assess enterprise/CEO performance, or the link between business performance and executive compensation.

- Of the 500 companies that made up the S&P 500 in 1957, only 74 remained on the list through 1997. Only 12 outperformed the S&P 500 index in Total Shareholder Return over the same period (McKinsey & Co.). Based on this track record, the longer-term sustainability of many corporations is in question.

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- Ninety-five percent of the S&P 500 companies have failed to disclose any non-financial criteria they use to measure corporate and social responsibility (MVC)
- Over a ten-year period, 61 percent of mergers and acquisitions failed to create shareholder value (McKinsey & Co.)
- A review of compensation policies disclosed in proxy statements indicates that 89 percent of the S&P 500 CEOs and their executive teams are *not* held accountable, or paid, for business (as opposed to stock market) performance beyond 2 years (MVC)

Yet many shareholders including the State Treasurers and pension trustees are accountable for 5 to 30 year pension liabilities. Thus there is a serious mismatch in time-scales for accountability among the stakeholders. Unless this mismatch is fixed companies will not be run in the long-term interests of shareholders and stakeholders.

- According to Business Week's 54th Annual Executive Compensation Survey published recently, the average large company CEO received compensation totaling \$8.1 million in 2003, up 9.1% from the previous year. Business Week's survey covers the 365 largest companies that have reported their executive pay to date.
- From 1990 to 2003:
 - ◆ CEO pay rose 313%
(CEO to average worker pay in 2003 300:1 versus 42:1 in 1982)
 - ◆ The S&P 500 rose 242%
 - ◆ Corporate profits rose 128%
 - ◆ Average worker pay rose 49%
 - ◆ Inflation rose 41%

Our recently published research has identified that not all CEOs and Boards are created equal and there are actually 5 levels of required CEO and Board accountability / capability, depending on the level of complexity of the enterprise. These 5 levels each have a different contribution to customers and society, different time-scales for planning and results, and different pay commensurate with the overall Level of Work accountability (see attached).

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This has implications for Director Nomination. Many of the recent business failures have demonstrated there is a significantly higher risk of a write-down of shareholder equity when:

- Board/CEO level of work are not aligned with each other and the external business environment.

(as an example, the increased globalization of business, outsourcing and costs pressures require that many U.S. companies transform their business models to survive. Yet few CEO's are clearly held accountable for this level of innovation.)
- Board/CEO level of work is defined at too low a level of innovation and at an inadequate 1-2 year time-span for planning and results.

The failure to understand the differences in the business models (e.g. Quaker Oats understanding the differences in Gatorade's and Snapple's distribution channels) when considering acquisitions has led to multi-billion dollar shareholder write-downs (Mattel / Learning Company, Eli Lilly / PCS Health Systems, etc). In these cases where the enterprise is looking to grow through acquisition and the Board is not seen as having the right level of strategic capability, shareholders cannot just depend on the CEO / Board and may have to become actively engaged to protect shareholder interests. The current system does not allow for shareholder involvement.

The time and skilled knowledge required for a Level 1 Board providing oversight to a Level 1 process innovator CEO is exponentially less complex than a Level 5 Board providing oversight to Level 5 global business/societal innovator CEO. This suggests that a Director could effectively sit on 12 to 16 level 1 Boards but only 1 or 2 level 5 boards. Jack Welch when he was CEO at GE recognized this and never accepted an outside directorship. Again this has implications for Director Nomination. (see our recent article "Are Boards and CEO's Accountable for the Right Level of Work?" at www.mvcinternational.com)

Board Directors who would like to bring about change have been very candid and commented to us in recent discussions:

- It appears that many Directors are NOT prepared to clarify and bring to closure what they are holding the CEO accountable for, given the fear of seeming confrontational. This makes it difficult for those Directors attempting to provide Board leadership and true independence.
- Until key shareholders at an Annual General Meeting are permitted to bring up the disclosure issues of what the CEO is truly being held accountable for and the lack of linkage to pay for performance in many companies, truly independent Directors will have trouble convincing peer Directors to take action on these deficiencies. The type of probing questions they suggest shareholders ask Directors include:

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- What are the 3 to 5 year key performance metrics and targets that the CEO and executive team are being held accountable for?
 - What is the Board's process for evaluating management and how do you tie compensation into these metrics to make pay for longer-term performance a reality for shareholders?
 - Is there any discrepancy between what is disclosed in the proxy statement and how executive compensation decisions are actually made by the Board?
- Executive Pay for Performance can't become a reality until Boards address the CEO accountability and tenure gap. It is not that Pay for Performance is broken, as much as it never existed in most companies.

Our research has identified that too many CEO's are accountable for too low a Level of Work resulting in compensation that is more inappropriate for their current Level of Work rather than just excessive (see pay multiplier and compensation bands by Level of Work attached).

These leading Directors also disclosed that few Boards have asked the right questions including calculating the 3 to 5 year total cost of the compensation policies and programs they have approved.

- Too many Directors are "Old Guard", uncomfortable in challenging the CEO, and conflicted by their relationship with the CEO and Directors fees.
- It will take a new set of rules and a new generation of Directors before we see any real change in boardroom behavior that impacts corporate performance. Some Directors suggested we can't wait for a new generation of Directors and need to immediately start now the transformation of Boards and Board/ CEO accountability.

Ultimately, the shareholders must decide if the level of corporate performance outlined above and current board behavior are acceptable to them and broader society. If not, then what actions and new rules for Director nomination as well as CEO / executive accountability and executive compensation disclosure is the SEC prepared to mandate to protect shareholders and contribute to improved corporate performance?

Corporate democracy is missing in much of corporate America. Also missing is the transparency of multi-year metrics and CEO / executive accountabilities required to make effective investment decisions.

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If the purpose of good governance is to provide a check and balance on management for shareholders and improve **sustained** corporate performance for all stakeholders, then the principles, process and rules must be designed to fix the current systemic flaws outlined by many who provided formal comment to the SEC regarding Proxy Access S7-10-03.

If we can be of any further assistance regarding our recently published research about levels of CEO and Board accountability please visit our website at www.mvcinternational.com or feel free to contact me at (813)-920-9123.

Respectfully submitted

Mark Van Cleef
Managing Director

CC: Hon. Paul Atkins, Commissioner, SEC
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Hon. Cynthia Glassman, Commissioner, SEC
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