MVC Associates International

Consultants In Organization Design, Leadership & Stakeholder Value

Sept 4, 2003

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W, Washington, D.C. 20549

Submitted electronically - rule-comments@sec.gov.

Re: Proposed Amendments to NYSE Rules Relating to Corporate Governance (File No. SR-NYSE-2002-33) – including the Role of the Compensation Committee

I am writing to express our strong concerns regarding the proposed changes to compensation committee responsibilities in Amendment No 1 to the NYSE's Corporate Governance Rules Proposal (Amendment No. 1).

The SEC and the NYSE have made progress to improve corporate governance.

However, our emerging research regarding problems with CEO Pay for Performance, compels us to share recent findings. Our credentials include numerous appointments and publications on organization and executive work design, executive search, leadership assessment, performance management and shareholder value. [1] Our research identifies **a crisis in *competence* related to executive compensation and pay for performance.**

I will specifically address the responsibilities of the compensation committee and the required skills and knowledge to effectively carry out its charter, and add value to the governance process.

Our recent research has identified that:

- Many listed companies are using inadequate metrics and time duration for measurement to link CEO accountability and compensation to sustainable value creation for shareholders. Current U.S. GAAP is also not working as an effective input to executive pay for performance.

MVC Associates International
2001 North Rocky Point Dr E, Suite 200, PMB 2034
Tampa, Florida, 33607
813-920-9123 / fax 813-926-2487
www.mvcinternational.com

We have offered our expertise in performance management to the PCAOB advisory group. A third party expert in accounting advised us that using **financial information** as an input into CEO compensation is outside the mandate of the PCAOB. If this is accurate, we believe the mandate is too narrow. Current approaches to calculate earnings, which are then used to determine CEO compensation, treat equity capital as if it had no cost. Thus some CEOs are being overpaid while destroying shareholder value.

- A number of executive compensation consultants hired by both management and Boards, whom we have recently contacted, stated they are experts in compensation and **not measurement.**

  This would be the measurement of both:
  a) levels of executive work complexity used to compare executive roles [ii] (internally and or externally), and then the development of comparable compensation benchmarks;

  b) business performance used to create alignment between compensation with overall enterprise performance that creates value, short and long term.

- Many compensation committee members, advisors in executive compensation and executive search are not ensuring a rigorous executive job analysis as the input to establish equitable and legally defensible compensation and hiring practices. Even if a job analysis is undertaken, the current factors used such as size of business, budget or team are not appropriate at the executive level to truly determine the Level of CEO Work Complexity. This results in excessive compensation increases for certain CEO roles as they are benchmarked against the wrong peer group of CEO jobs.

- The Compensation Policy disclosed in the proxy statement does not reflect the basis on which many / some Boards are actually making CEO compensation decisions. Anecdotal feedback to us from governance experts and CFOs has highlighted this.

  Three years ago we analyzed the metrics disclosed in the compensation policy section of the proxy statements of the complete S&P 500. Updating this research would add no value if what is disclosed does not reflect how Boards make compensation decisions.

MVC Associates International
2001 North Rocky Point Dr E, Suite 200, PMB 2034
Tampa, Florida, 33607
813-920-9123 / fax 813-926-2487
www.mvcinternational.com

The Role of the Compensation Committee & Proxy Statement Disclosure

Too many Compensation Committees are asking the wrong question. They have been asking "**How Much**" and have not been asking " **For What**". Thus Pay for Performance is not working.

The *proposed* NYSE amendment to subsection 5 of new section 303A of the Listed Company Manual mandates that the board's compensation committee:

3 Review and approve corporate goals and objectives relevant to CEO compensation,
4 Evaluate the CEO's performance in light of those goals and objectives,
5 Have sole authority to determine the CEO's compensation level based on this evaluation.

This is a good start, but does not go far enough.

Missing First Step

Forty years of research on organization design and accountability [iii], as well as current statutes and legal case precedent show a first and required process step has been omitted by the NYSE.

Employment laws and case precedents established by the EEOC and Equal Pay Act define that, to effectively address employment issues related to selection or pay, a rigorous job analysis is required to define and clarify **what is the work. Should not the principles and spirit of these laws apply equally in the boardroom to the benefit of shareholders?**

The Level of Complexity of the CEO role at Johnson and Johnson versus at El Lilly, is exponentially more complex, as it is at Procter and Gamble versus Kimberly Clark. Yet Eli Lilly and Kimberly Clark have chosen these peer group companies and CEO roles to benchmark against that are far more complex than their own CEO roles. J&J and P&G due to the higher complexity of their CEO roles should have a CEO compensation band exponentially higher than Eli Lilly and Kimberly Clark. [iv] However, faulty benchmarking is contributing to excessive executive compensation for the less complex CEO roles. This example represents much of current practice.

Boards appear to function as if all CEO jobs are created fairly equal. This is far from reality. Key factors used to evaluate executive work and the link to comparable compensation seem either to be missing or based on job evaluation factors that are not applicable at the executive level

MVC Associates International
2001 North Rocky Point Dr E, Suite 200, PMB 2034
Tampa, Florida, 33607
813-920-9123 / fax 813-926-2487
www.mvcinternational.com

nor legally defensible. This same 40 years of research [v], has determined that titles (CEO, President, EVP), thumb nail job descriptions, layers / reporting lines, or size of business are inadequate indicators of comparable jobs at the same Level of Work Complexity. Yet this is accepted as common practice for CEO compensation benchmarking and succession planning. [vi]

Too many CEOs are being overpaid for the Level of Work and unique contribution they are being held accountable for by their Boards. This is based on the fact that 32 % of the S&P 500 had failed over 5 years, ending in 2000, to provide a Return on Invested Capital (ROIC) great than their Weighted Average Cost of Capital (WACC). If we recalculated these numbers for the 5 years ending in 2002, the number of companies not returning back their cost of capital could easily exceed 50 % of the S&P 500 [vii]. Thus the business model and strategies of these poorly performing companies, based on Economic Profit and ROIC as measures, are not working. Nor is CEO Pay for Performance and related board governance.

The courts have established that without a clear and defensible understanding about the true nature of the work, identified through a rigorous job analysis, there is no basis to defend decisions related to pay or selection (please interpret as CEO compensation, selection and succession).

Thus we recommend that the NYSE incorporate a requirement for:

> **A rigorous executive job analysis to effectively define the true level of work complexity of the CEO / key executive roles to establish a defensible job design and compensation framework for job comparison, both internally and externally.**
>
> **Job evaluation factors must *truly capture* the differences in executive work design, accountability and skills that defines the unique contribution that adds value for customers and shareholders versus other roles in the managerial hierarchy.**
>
> **If the compensation committee cannot answer the fundamental question of what are the significant difference in work design between the CEO and direct reports, then they have no defensible basis to determine equitable compensation of the CEO role relative to other roles in the organization structure or externally.**

MVC Associates International
2001 North Rocky Point Dr E, Suite 200, PMB 2034
Tampa, Florida, 33607
813-920-9123 / fax 813-926-2487
www.mvcinternational.com

We will now address the three mandates proposed by the NYSE regarding the compensation committee and CEO compensation.

NYSE mandate 1.) "Review and approve corporate goals and objectives relevant to CEO compensation"

We agree with the NYSE that the compensation committee should review the proposed corporate goals and CEO compensation to ensure alignment with pay for performance. This is ***operating performance*** that creates shareholder value, not just stock market performance. The Compensation Committee should establish the ***Compensation Policy & Pay for Performance Principles*** for the enterprise to define stakeholder value and how this will be measured.

Our review of S&P 500 proxy statements shows that 55 % of these companies are not establishing goals nor measuring business performance for the CEO beyond 1 year. If the top three levels of the enterprise have the same short-term metrics and the same short-term time horizon for planning and decision making, then what is the unique contribution of the CEO role that is different from their direct reports?

This furthers the view that too many CEOs are being held accountable for the wrong work and wrong metrics relative to those roles reporting directly to them.

Thus we recommend that goals at the CEO level, approved by the compensation committee, must be measured over at least a rolling 3 to 5 year time duration. These goals must also include measures of true value creation such as ROIC relative to WACC over a multiple year time period.

Currently only 5 % of the S&P 500 use any type of broader non-financial performance measures. To create a more balanced scorecard, measures related to customers, employees, the organization, environment and society should also be included. For Best Practice see the 2002 Corporate and Social Responsibility Report from Unilever. **We thus recommend that performance metrics used by NYSE listed companies should also include these non-financial measures.**

NYSE mandate 2.) "Evaluate the CEO's performance in light of those goals and objectives"

The effective evaluation of CEO performance can ONLY be carried out if 3 questions have been dealt with in advance by the compensation committee:

1) What is the correct level of executive work complexity and unique contribution of the CEO role?

2) What is the optimum time frame over which planning, innovation, leadership are expected to achieve results for all stakeholders at this differentiated level of work? (depends on the level of complexity of the CEO role.)

3) What are the appropriate metrics to evaluate CEO leadership performance and value creation over this time period and at this level? (depends on the level of complexity of the CEO role.)

To provide a level of consistent quality control to the CEO performance evaluation process for NYSE listed companies, we recommend that compensation committees incorporate the answering of the above 3 questions into their responsibilities.

The compensation policy and related metrics disclosed in the proxy statement to shareholders should be consistent with the basis upon which CEO performance is actually evaluated. Some CFOs and other experts in governance suggested recently this is not the case. These CFOs of NYSE listed companies recently commented:

- "the information provided in the proxy is boiler plate and everyone knows that"
- "the information is there to meet the requirements of IRS (162m) related to performance based compensation"
- "the basis upon which compensation decisions are really made versus what is disclosed are not the same"

E. Norman Veasey, Chief Justice of Delaware's Supreme Court, has all but issued an invitation to plaintiffs to file a lawsuit on this point. In a recent panel discussion for Harvard Business Review he said, "If directors claim to be independent by saying for example that they base decisions on some performance measure, and don't do so—or if they are disingenuous or dishonest about it—it seems to me that the courts in some circumstances could treat their behavior as a breach of fiduciary duty of good faith."

We recommend for listed companies the compensation committee decisions on evaluating performance and board minutes should reflect the compensation policy and related metrics disclosed in the proxy statement for shareholders. If the compensation policy is not followed then a disclosure to shareholders explaining the difference should be provided.

NYSE mandate 3.) "Have sole authority to determine the CEO's compensation level based on this evaluation"

This mandate is meaningless unless the compensation committee has effectively established defensible benchmark comparisons for the Level of Work Complexity in the enterprise. Without a clear framework to define the Level of CEO Work, the board has NO basis to calibrate equitable compensation, either internally or externally, or to make defensible compensation decisions.

Principles versus Process, Rules and Competence

Jamie Heard, CEO of Institutional Shareholder Services stated " the system of checks and balances that we depend on to make sure we have good governance has broken down…… we have had a very sad and expensive lesson ….. we never dreamed we would see the megagrant options and dilution levels….wholesale repricing of underwater options…. and had a naive faith that the compensation committee would and could police these practices". Thus a principles approach to governance does not seem to be working.

Just as financial literacy is a must for the audit committee, we recommend that there is a minimum literacy for the Compensation Committee in:
• organization and executive work design, including designing managerial accountability structure
• employment law, including job analysis
• business performance measurement (financial and non-financial)
• leadership assessment and
• compensation practices
Only then can we ensure a minimum level of competence to make CEO pay for performance a reality.

MVC Associates International
2001 North Rocky Point Dr E, Suite 200, PMB 2034
Tampa, Florida, 33607
813-920-9123 / fax 813-926-2487
www.mvcinternational.com

While this letter seems specific about process, roles, disclosures rules, and skilled knowledge, based on the performance of too many boards, too few Compensation Committees have asked the right questions, or shown the competence to effectively carry out their charter. Without the process, disclosure rules, and competence we have outlined, CEO compensation and Pay for Performance will remain disconnected from enterprise performance and sustainable value creation for shareholders and society.

I appreciate the opportunity to share with you our recommendations based on recent research, and would be pleased to be of assistance.

Yours very truly

Mark Van Clieaf
Managing Director

CC: Hon. William Donaldson, Chairman, SEC
Hon. Paul Atkins, Commissioner, SEC
Hon. Roel Campos, Commissioner, SEC
Hon. Cynthia Glassman, Commissioner, SEC
Hon. Harvey Goldschmid, Commissioner, SEC
Annette Nazareth, Director, Division Market Regulation, SEC
Giovanni Prezioso, General Counsel, SEC
Richard Grasso, Chairman & CEO, NYSE
Richard Bernhard, EVP & General Counsel, NYSE
Janice O'Neill, VP Corporate Governance, NYSE
Eliot Spitzer, Attorney General, New York State
Norman Veasey, Chief Justice, Delaware Supreme Court
Jamie Heard, CEO, Institutional Investors Services
Sarah Teslik, Executive Director, Council of Institutional Investors
Anne Ruddy, Executive Director, WorldatWork (American Compensation Association)
Dr. Carolyn Kay Brancato, Director Corporate Governance Center, The Conference Board
John Castellani, President, The Business Roundtable

MVC Associates International
2001 North Rocky Point Dr E, Suite 200, PMB 2034
Tampa, Florida, 33607
813-920-9123 / fax 813-926-2487
www.mvcinternational.com

i

My background includes:

- Member of the NACD Blue Ribbon Commission on CEO Succession Planning
- Special guest lecturer – Ivey Business School – Corporate Governance and Pay for Performance
- Founding Member, Executive Selection Research Advisory Board, Center for Creative Leadership
- Past Special Guest Editor and member Editorial Advisory Board, Human Resource Planning
- Led North American Best Practices Benchmarking Study in Performance Management
- Formerly in executive search and business strategy consulting with Price Waterhouse
- 10 + years of research on executive work design and leadership assessment to create shareholder value
- Numerous published articles and presentations on organization design and leadership.
  See attached in press "The Board's Due Diligence - Raising the Bar on Executive Accountability to Restore Investor Confidence", also available in draft on our website.

ii

Extensive research has identified that such job evaluation factors as the size of business, budget and team are not appropriate job factors at the executive level to determined the value or complexity of a role.

Newly identified and applied factors such as the complexity of innovation, complexity of planning / decision making, complexity of resource management, the complexity of stakeholder management are required to differentiate unique work contribution at various levels in the managerial hierarchy.
The key determining work / job analysis principle is NOT size but complexity of work.
See footnotes iii and iv.

iii

40 years of research about what is known as Work Levels or Requisite Organization principles has been applied in such far ranging organizations as the U.S. Army, Ford Motor Company, Whirlpool Corporation, Quaker Oats, Halliburton Corporation, Sandia Labs, CRA Mining in Australia, Bank of Montreal, Canadian Imperial Bank of Commerce, Standard Bank of South Africa, National Health Service, UK and Unilever in over 80 countries.

The underlying theory, backed up by field implementation is that there are fundamentally different strata of work complexity that define how many layers an organization truly requires, what is the unique contribution at each level, and what type of human capabilities are required at each of the "Main Levels" of the real organization structure that are requisite for each level.

The history of these concepts began in 1965, at the Brunel Institute for Organization and Social Studies (BIOSS) in London, UK, founded by Dr. Elliott Jaques.

A complete bibliography related to this area can be found at:

http://WWW.canadiancentre.com/ejbiblio/ejbiblio.htm

MVC Associates International
2001 North Rocky Point Dr E, Suite 200, PMB 2034
Tampa, Florida, 33607
813-920-9123 / fax 813-926-2487
www.mvcinternational.com

iv

The complexity factors would include but not limited to the variety of different business models operating within the enterprise, the variety of resource and capital management, and the variety of stakeholder groups to be managed given the number of different businesses and countries in which the enterprise operates. Not merely the size of business and number of employees.

v

MVC Associates International, during the 1990's completed 350 interviews at the Global CEO, Group President, President and VP/GM levels to uncover how these complexity jumps in General Manager roles should be designed differently to add value to the enterprise, and what are the differential skills at each level that drives shareholder value.

Unilever, during the 1990's undertook over 1000 interviews in over 40 countries in furthering the implementation of Work Level concepts. The following is from a related monograph about the project.

" How could a national company with a turnover of $1 billion manage with the same number of management levels as a comparatively small company with say a $200 million turnover? How could their managing Directors both be in Worklevel 5? At first sight the analysis, which led to this conclusion, was greeted with disbelief by the larger company. So the interviewing and analysis was done again and again. The result remained the same. **Complexity not sheer size was the driving force of the new approach"**

vi

e.g. it appears CALPERS, one of the largest and most influential U.S. pension funds is about to make the same mistake as part of their activist role in Board governance, and the launching of their new Executive Compensation Metrics model.

You cannot compare CEO / executive roles and related compensation, unless you have an indication of the Level of Work Complexity of the roles you are comparing. Not ALL CEO roles are at the same complexity level. Secondly, to link pay to CEO / enterprise performance, the duration of time for comparison must be at least 3 and ideally 5 years.

While we applaud the effort and CALPERS leadership on this issue, the suggested framework to analyze executive compensation and related metrics would appear to have some structural problems in the constructs being used to compare CEO / executive roles, related compensation, and performance.

See http://www.calpers-governance.org/alert/exec-comp/exec-model.asp

MVC Associates International
2001 North Rocky Point Dr E, Suite 200, PMB 2034
Tampa, Florida, 33607
813-920-9123 / fax 813-926-2487
www.mvcinternational.com

vii

The MVC Associates International analysis was completed in 2000 using data supplied by Stern Stewart and analyzed data from the 1994-1999 time period.

Merrill Lynch – The Market Economist – March 14 , 2003

While their forecast on ROIC-only included plant and equipment not total cash- they estimated that in 2002 for 75 % of the S&P 500 based on market cap, their cost of capital was outrunning their returns on capital.