HODAK
VALUE ADVISORS

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Managing Director

April 10, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: Executive Compensation and Related Party Disclosure
File No. S7-03-06
Release Nos. 33-8655; 34-53185; IC-27218

Dear Ms. Morris:

I am writing on behalf of Hodak Value Advisors, LLC. Our research into executive compensation is used by securities analysts and asset managers to distinguish the quality of management incentives at firms in which they invest. Our analytical tools use publicly available qualitative and quantitative information to create a detailed picture of executive pay, as well as the degree to which pay is related to shareholder value, both historically and in terms of an executive's predicted wealth leverage. Furthermore, we track an evolving set of factors derived from company compensation structures, factors that research, ours and other's, indicates to be relevant to total shareholder returns. This effort involves, among other things, a detailed review of hundreds of proxy statements each year. Our research and analysis is informed by fifteen years of experience in designing compensation plans for dozens of major companies.

Our thoughts on the Commission's proposal come from the investor's perspective. We hope that our particular experience and insights can highlight issues that may be underappreciated by investors not familiar with our analysis, as well as other communities concerned with corporate governance.

Summary and Context of Our Comments

Our comments are focused on the following objectives:

- A clear statement by the *board* regarding *their* objectives and trade-offs in establishing their executive compensation program, and relating that program to the specific compensation data they present,
- A logical and consistent format for presenting compensation data with clear distinctions between targeted, accrued, conditional, vested, or realized results,
- Disclosure requirements that do not create costs and disincentives for managers to supply this data or, worse, to adopt sub-optimal compensation strategies to either fulfill or avoid those requirements.

Our objectives considerably overlap the Commission's objective of a clearer and more complete disclosure regarding the mix, size, and incentive components of executive and director compensation. However, in our view the Commission takes a step too far in seeking to mandate a summation of these components into a particular conception of "total compensation," and to require that this disclosure be "filed" rather than "furnished."

The Commission's definition of total compensation clearly reflects a thoughtful compromise of views held by many observers. However, we believe that definition is in certain ways deficient, based on too little data to allow a complete picture of changes in management wealth, and in certain ways overreaching, requiring more data than is needed to allow that complete picture, and risking the creation of perverse incentives that would undermine the ultimate goal of shareholder value maximization.

We believe that a more targeted focus on generating sufficient data to track changes in management wealth will best serve investment community.

Specific Comments on the Proposals

Compensation Disclosure & Analysis

We agree with the intent of the CD&A as a basis for establishing best practices in disclosure. However, we do not feel that the CD&A should displace the Report of the Compensation Committee of the Board (RCC). Our experience with the RCC belies the assertion that it is of little benefit to investors. While there is a lot of variation in the quality of RCCs, we are able to discern from them a wealth of significant details about company compensation structure, enabling us to derive indicators relating to the quality of corporate incentives so potent that our asset management clients can use them to significantly enhance the performance of their portfolios. Even the variations in disclosure are telling in our analysis, a variation that is specifically targeted by this proposal.

We believe that the proposed content of the CD&A belongs in the proxy statement over the names of the compensation committee. While management is primarily responsible for the reliability of the figures and statements produced by the firm, the overriding purpose for the proposed CD&A content is a description of the essential trade-offs of executive compensation. These trade-offs include not just the total compensation cost to shareholders, but also the overall attractiveness of pay packages in getting and keeping a certain caliber of executives, as well as incentives that effectively align the interests of management with the shareholders. The board is charged with making such trade-offs, not management, and the discussion and conclusions properly belong with the compensation committee. Management may be expected to weigh in on such a discussion, but not to sign off on it.

"Filed" versus "Furnished"

Aside from our concerns about where the discussion of compensation should reside, we are also concerned about the additional costs of having this disclosure "filed" rather than "furnished." The intent behind a requirement to file appears to be to get managers to pay more attention to this disclosure. This presumes, however, that the type of additional attention this will attract from management will translate into higher quality disclosure. History indicates that such a presumption is wishful thinking. Management will seek to minimize cost, risk, and competitive leakage in meeting their mandates in accordance with their fiduciary responsibilities. This logical reaction to mandates, particularly the reduction of legal risk, has often led to lesser transparency, not more.

The Commission clearly appreciates and seeks to weigh the administrative costs of gathering and publishing information. Even so, the legal risks associated with "filing" multiply the administrative costs. It already takes a small army of lawyers and managers to vet information whose disclosure creates a potential legal and competitive risk to the firm supplying it. This risk must be insured and, to the extent it is uninsurable, may become a significant cost to the specific managers required to ultimately bear the risk. Managers will face that risk with significant costs of prevention in the form of extensive staff time, legal and consulting assistance, as well as demand for compensation for bearing that risk. And we could hardly blame the board for agreeing to these added costs since they cannot do their job while pretending that the underlying sources of these costs don't exist. We strongly recommend that compensation disclosure should continue to be ***furnished***, not filed.

<u>Summary Compensation Table and "Total Compensation"</u>

We believe that the Commission's proposed Total Compensation figure would be misleading to investors. The Commission should not be in the business of mandating a particular view of total compensation, especially one that fails to account for overall impact on executive wealth.

We define pay as the year-on-year change in total, company-derived, executive wealth. Underlying this definition is our view that an executive's financial motivation is best represented by visualizing him or her sitting in their study shortly after fiscal year-end looking at a personal portfolio of company-derived wealth—cash, equity, retirement, etc.—and asking: how much wealthier do I feel now than this time last year? What has to happen to allow me to hit a really big 'number' by the time I retire? Approximating answers to these questions—from outside of that study, of course—is the basis of our analysis.

Clearly, our definition of executive "pay" is very different from what is commonly reported as "pay" in the press and, to a certain extent, mandated by the proposal. This last point is not a criticism of the Commission's requirements, or even a justification of our particular methodology, but the core of our concern about requiring companies to generate results from objective data using prescribed methods, including any "total" based on an implicitly mandated view of pay that may not correspond to wealth changes (as we define pay) or to *any other methodology* that can plausibly be proposed as a legitimate alternative to the mandated view.

Our point is not that the "Total Compensation" figure of this proposal, perhaps the most popular feature in the entire proposal, will be of no use to us since it does not conform to our view of total compensation. The point is that any Summary Compensation Table is bound to confuse pay that is accrued versus realized, current vs. deferred, or guaranteed vs. conditional to the point of either being so simplistic as to mislead the average investor, or too complex to be of much use to them without expert assistance.

We can add numbers ourselves, and exactly the way we think it should be done. We would be content to see a list of all the objective components of pay—targeted, accrued, vested, realized, etc.— in a consistent, tabular format to the extent possible, with narrative guidelines for how managers or directors make subjective assessments in the context of their overall objectives and trade-offs. In our view, the proposed rules will usefully require more data than before, but in some cases more data than is required, and less data than is ideal, which will be discussed in more detail below.

<u>Distinguishing sources and forms of compensation</u>

While the delineation of fixed vs. variable pay remains fairly clear, and the proposal to treat all equity-equivalent award mechanisms in a consistent manner is a step forward, we believe that reporting of accounting-based vs. equity-based compensation remains muddled. In the Summary Compensation Table, for instance, performance stock that is awarded under an accounting-based bonus plan is considered a stock grant versus a bonus award. If executives have the choice to take their bonus in cash or shares, simply looking at the compensation table would provide a confusing read of performance versus awards, even with the Grants of Performance-Based Awards table separating them out, and a narrative explanation possibly linking the numbers across the tables.

A better way to display such compensation data, we believe, would be in terms of the policies or standards that generate them. For instance, for each bonus plan, one could show the *target* and *actual* award levels for each executive, regardless of the form of the awards, details of which could then be presented in another table identifying performance-based equity or unit-equivalents. We believe the proposed presentation of post-employment compensation is the good example of our preferred layout.

<u>Reduced threshold for disclosure of perquisites</u>

We believe that additional detail provided about perks down to a $10,000 threshold, perks whose total value are otherwise disclosed, will not enhance the market's ability to judge executive compensation. The reader would have no idea how the relatively minor value of perks is traded off against other, potentially greater, compensation. And valuing perks is far from costless.

Perks are notoriously hard to distinguish from various indirect benefits an executive receives by virtue of his or her all-consuming job, and often difficult to quantify. We believe that greater detail in the disclosure of perks would serve little purpose beyond the voyeuristic interests of those opposed to executive "privileges" of any sort, and the hope that such details will embarrass executives into foregoing them. And if perks were surrendered, history suggests that their costs would be replaced by other, often more expensive, retention devices.

In an era before executive compensation was controversial, an old saying quaintly captured what corporate executives thought about how they were paid: "I don't have to be a millionaire, as long I can live like one." Company cars and club memberships attracted talent in a reasonably cost-effective way for many firms, and no evidence suggests that eliminating them actually lowers total compensation costs to the shareholders.

The Options Exercised and Stock Vested Table

We believe that the Options Exercised and Stock Vested table is very good as proposed and the reiteration of the grant date fair value is very helpful for showing the net cost of realized option values over time. It is not clear, however, how the company would report grant date value in a period when an executive might exercise options from multiple grant dates in a single year. We're supposing that the company would have to report grant date value per option for every set of options exercised, which may be a cumbersome disclosure, though one we would welcome since it supplies unique data. This would, in fact, be a good table to include all realized compensation noted elsewhere as conditional, such as stock units or stock appreciation rights, especially if they are elsewhere assigned a grant-date value. Furthermore, it would be extremely helpful to see options (or other option-equivalents) that were cancelled or forfeited along with the grant-date values attributable to them.

Inclusion of all earnings on deferred compensation

The proposed rule to note the full cost to the company of the executive's earnings on deferred compensation appears to react to criticism that the company is paying more, and the executives are "earning" more, than is currently disclosed. Current disclosure is limited to "above-market" earnings. We disagree with intent of this proposal, and are concerned about its potential effect.

The intent is flawed in that the company, through such deferral accounts, is plainly getting a capital benefit from its executives, a benefit they would have to replace in the bond market at some rate of interest should the deferrals be withdrawn. Similarly, the executives have an opportunity cost to that capital they are supplying the company through those deferrals. To suggest that the interest they would have earned by taking that money out of the company and buying its bonds in the open market, without any disclosure that said interest was somehow "executive compensation," seems to encourage the latter device. Would the company really be better off if it had to go through the bond market to get what it gets now from its executives without transaction costs?

Elimination of the Performance Graph

We agree that the requirement for the Performance Graph is outdated. In 1992, the average investor couldn't toggle over to Yahoo! and look up historical stock prices for any firm, peers, or sector index that they wanted, as they can today. Instead, we had to rely on the company's self-selected peers which most registrants, somehow, outperformed. If the table is to be preserved in any form, perhaps the self-selection of peers could be made optional, and only an appropriate sector index could be required as a benchmark. For our money, the chart can just be dropped.

Named Officers to be included

We like the idea that the principal financial officer be specifically included as a named executive officer since past experience clearly shows that corporate meltdowns were highly unlikely to have occurred without at least the collusion of the CFO. We are now wiser to the fact that unusual levels of or variations in CFO compensation are a red flag for investors. However, we see no reason that other officers beyond the corporate executive suite should be included in this disclosure, and several reasons well-asserted by others. Keeping the non-executive high-earners off the table will prevent year-end fire drills that don't add any value to the investors.

Proposed additional requirements

We recommend a couple of additional disclosures that we believe could enhance transparency. Instead of the Holdings of Previously Awarded Equity table, we would favor the listing of each set of options, their strike prices, and expiration dates for each named officer. The proposed requirement persists in aggregating the cumulative exercisable and unexercisable options and their respective in-the-money values, plus footnote disclosure of expiration dates. The proposed practice seems nearly as detailed as our suggestion, and perhaps equally cumbersome, but out of step with disclosure trends by sticking with the notion that an option's value is simply the degree to which it is in-the-money.

We would like to see a tabular presentation of the various elements of compensation to be awarded under severance or change-of-control, especially the amount of equity that would be affected by early vesting provisions.

We agree that Form 8-K is perfectly appropriate to record any changes in compensation, such as the calculation of bonuses when practicable. However, until a simple sorting mechanism is put into place to allow all 8-K submissions specific to compensation to be compiled in a single report, it would be nice to have such a report from the prior period accompany the overall compensation disclosure. The Commission's apparent concern that current rules are prompting over-disclosure of compensation information in the 8-K filings is laudable, if inconsistent with prior criticisms. While we tend to view most 8-K compensation disclosures as useful, we also agree with those who don't consider certain of those disclosures "material." Nevertheless, we prefer to see proxy updates no longer required to be disclosed in 'real-time' to be required at least once per quarter.

Potential Unintended Consequences

This proposal would usefully add significant data that firms like ours cannot now obtain directly. Unfortunately it would also mandate a particular view of pay and a requirement to file that will do little to help investors either carefully map historical wealth changes or predicted wealth leverage.

Instead, this proposal attempts to answer a more difficult question: Why are executives paid as much as they are? We believe that there are inherent limits to what any outside investor can, with any amount of disclosure, interpret regarding *levels* of compensation. Unfortunately, much of the support for the current proposal seems based on the premise that CEO pay is too high. But there is no possible basis for concluding that for any given company within the total context of the net cost to the shareholders while accounting for competitiveness and alignment. Thus, the major beneficiaries of this proposal will be not analytic critics of executive incentives like us, but social critics of executive pay with a non-empirical sense or feeling that what is now paid is not "right."

If, perchance, CEO pay is driven largely by the market for talent, or any other reason besides investor ignorance, then certain additional disclosure may create additional costs to shareholders with little corresponding benefit, including a cost of capital benefit from improved transparency. Further disclosure may, in fact, degrade the ability of companies to compete with those not required to make similar disclosures, and may reduce a dimension of potential competitive advantage for all companies forced to make disclosures of competitive interest. Worse yet, in an attempt to minimize the competitive or other impacts of enhanced disclosure requirements, a company may change their incentive plans in a manner that negatively impacts executive behavior. Even where that impact is understood, management and the board may still consider the cost of inferior compensation structures preferable to the cost of disclosing what their board sincerely believes to be optimal ones.

<u>Beyond the administrative costs</u>

The Commission estimates the administrative costs of complying with this proposal at $164 million. $70 million of that is assumed for services of outside professionals, an amount that would account for about 120 hours of additional outside help per firm (assuming $400 per hour of lawyer or consulting billing across 1500 registrants). These costs will be borne, or course, by the shareholders, with the beneficiaries being mostly the law and consulting firms—firms that nominally, ironically, bear a significant share of the blame for the current need for more disclosure.

We believe that these administrative costs fail to sufficiently account for the need to overcome compliance risks where concern for satisfying new rules is multiplied by the potential legal risks associated with sufficiency and completeness under a regime of CEO and CFO certification.

Beyond the administrative and legal costs will be the costs of insuring against the legal risks that cannot be prevented and, to the extent that the risk is uninsurable, in higher compensation to those within the firm who bear the greatest portion of this risk. Ironically, those individuals most likely to need the additional compensation for bearing the additional risk created by this proposal will be the public company CEO and CFO. Resolving these concerns alone can easily add up to an extra 120 hours of outside help. Most of these costs can be avoided by allowing compensation disclosures to continue being "furnished" rather than "filed."

<u>Weaker Incentives</u>

Boards of directors are acutely sensitive to bad press about the compensation of their managers. They make all decisions regarding executive compensation by accounting for their "optics," i.e., how they look to outsiders. While it is not entirely bad that boards feel the scrutiny and react to it, it is plain to us that a board with a choice between an optimal compensation strategy and one that looks good to outsiders will almost always choose the latter. Our research convinces us that many boards are adopting sub-optimal compensation strategies specifically in response to additional scrutiny.

As noted earlier, the main effect of this proposal is not to increase data available to sophisticated investors able to compile a detailed analysis of company incentives, but to improve the availability of compensation data by compelling firms to process and display the data in a particular way aimed at informing the less sophisticated investor. Since the required format of the data focuses on year-to-year changes in pay, as opposed to either year-to-year changes in wealth or longer-term accumulations of pay, we believe that the main effect of this proposal will be to further encourage the trend we have seen toward shorter-term, less leveraged incentives, and less willingness to defer compensation or otherwise tie up accumulated wealth within the firm for a later payout.

One example of this tendency would be annual grants of so-called “fixed-value” equity. This is a situation where the board estimates a value of equity to be granted in terms of a target value of compensation. The main benefit, from an “optics” perspective, is to insure that not too much of an executive’s compensation comes in equity grants in any given year. This is not the place to get into all the perverse incentives created by fixed-value grants versus, say, front-loaded or fixed-share grants, but a clear effect of such a grant policy is to create an apparent smoothness to annual pay while distorting the long-term relationship of pay versus performance.

There are a myriad of perfectly good compensation strategies that are likely to be avoided that provide more potent incentives over the tenure of an executive, but risks the perception of overpaying if the pattern of shareholder returns is generally favorable, but uneven—a fairly common pattern in corporate America. We would also not be surprised to see a rise in subjective determination of otherwise “objective” criteria in the funding or distribution of executive awards, thus diluting the incentive power of objective, definitive rewards simply to skirt requirements for divulging what many companies might feel is sensitive information. I am including a more complete discussion of how good “optics” can yield sub-optimal incentives from my paper “Letting Go of Norm: How Executive Compensation Can Do Better the “Best Practices” published in the Fall 2005 issue of the Journal of Applied Corporate Finance.

<u>Less information about incentives</u>

The requirement to “file” may also chill discussion between managers and investors regarding compensation. Such conversations are currently used by governance-oriented fund managers and investors to raise awareness of best practices among specific managers in the hopes of getting their company to adopt some of those practices.

As mentioned earlier, most of the information requested of the CD&A can already be found in the CCR. Since the CCR is furnished and includes financial data that is not “material,” management teams inclined to be open about their practices can safely discuss these items without fear of triggering potential liabilities associated with disclosure of “soliciting material” or the selective disclosure of material, non-public information. Thus, once compensation disclosures become included in a “filed” document, one more avenue for dissemination of market-relevant information may become closed to conscientious investors, and we will be left with nothing more than what management chooses to disclose regarding compensation within mandates, which past experience suggests will amount to little more than they disclose today.

Higher CEO pay

A major premise motivating this proposal is that the public lacks sufficient knowledge about CEO pay, and that this ignorance impedes the ability of investors to impose sufficient discipline on pay. If this assumption is correct, then there should be a relationship between additional disclosure and moderated CEO pay. Unfortunately, history provides evidence of the opposite. It would be ironic, if not entirely predictable, for CEO pay to continue to rise after the implementation of this proposal and, in part, because of it.

Commissioner Campos stated that given the new disclosures "the shareholders will have no one to blame but themselves if executive pay continues to rocket upward in a way they aren't comfortable with." We believe this statement is flawed on two grounds: (a) procedurally, shareholders will, in fact, have no better recourse for their discomfort than they do now, i.e., uncontested board elections, non-binding proxy votes, etc.; (b) substantively, the criticism this comment was meant to address assumes that executive compensation is driven far more by board profligacy or laziness than by market forces. But there is no real evidence, aside from criticisms of the process of pay setting, that this is the case. And the process has, if anything, become more demanding, not less, over the fourteen years since the last overhaul of compensation disclosure.

On the other hand, we know that those required to bear greater risk inevitably seek and gain greater rewards for doing so. One of the hallmarks of executive life over the last couple of decades has been the increased risk associated with decision-making at the top, both for companies facing globalization and executives recruited to take on that challenge. This proposal will at least marginally increase both the personal and professional risk to senior executives subject to these more stringent rules and the liabilities they impose.

While there is a public benefit to shaming the occasional executive who has truly been overpaid and the boards who pay them, we believe only a minority of negative stories regarding CEO pay actually report situations that, on closer inspection, are beyond justification. The increased scrutiny of executive rewards and the sensational, often one-sided way they are reported has also increased the professional and reputational risks of executives. Both of these tendencies were demonstrated in the manner in which John Blystone's compensation was reported during his last two years as CEO of SPX. Not a single paper that publicized Mr. Blystone's $38 million restricted stock grant of 2002 subsequently reported Mr. Blystone's forfeiture of what was by then $40 million worth of still-unvested stock when he was pressured to resign two years later.

The proposed rules also increase legal risks that, as noted before, largely fall on the CEO and CFO. Again, that risk has a potential benefit in encouraging care regarding the accuracy and completeness of disclosures, but it is a risk, as all others, that will increase compensation demands for bearing it.

Conclusion

We strongly believe that transparency serves public companies and their investors well. We believe that executive officers should be accountable for providing good information in good faith to investors, including information regarding their compensation. We believe that this proposal will add to the overall amount of useful information that will be available to serious analysts of corporate performance and investors overall. However, we caution the Commission not to adopt the unconstrained "more is better" philosophy of disclosure. In particular, we feel that the Commission should make a stronger distinction between data on relevant details of compensation, i.e., data that would respect the competitive boundaries between firms and public company shareholders, versus information that caters to the social critics uninterested or unconcerned with the overall trade-offs between levels of compensation, competitiveness, and alignment that boards must weigh to responsibly discharge their duties to all their shareholders.

I would be pleased to discuss or explain any aspect of this comment, if the Commission wishes, at the contact information below.

Sincerely,

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Webmaster’s Note:

The attachment, “Letting Go of Norm: How Executive Compensation Can Do Better than ‘Best Practices’,” by Marc Hodak, Hodak Value Advisors printed in the Journal of Applied Corporate Finance, Fall 2005 may be found at

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=816825