

Shareholder Value Advisors

April 10, 2006

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

REFERENCE: FILE NUMBER S7-03-06

Dear Ms. Morris:

I am the President of Shareholder Value Advisors Inc., a consulting firm that helps companies improve shareholder value through better performance measurement, incentive compensation and valuation analysis.

This letter provides my comments on the Commission's proposed amendments to the disclosure requirements for executive and director compensation. The following sections of the letter cover the basic objectives of management compensation, the information needed for investors to assess the strength and cost-efficiency of top management incentives and specific recommendations for changes in the proposed tabular presentations and CD&A.

The basic objectives of management compensation

Management compensation has three basic objectives:

- **Provide strong incentives:** give managers sufficient incentive compensation to motivate them to work long hours, take risks and make unpleasant decisions to maximize shareholder value,
- **Retain key talent:** give good managers sufficient total compensation to attract and retain them, particularly during periods of poor performance due to market and industry factors, and
- **Limit shareholder cost:** limit the cost of management compensation to levels that will maximize the wealth of current shareholders.

The proper measure of management's incentive to increase shareholder value is the sensitivity of management wealth to changes in controllable shareholder wealth, what we call "wealth leverage." Managers, like shareholders, seek to maximize their wealth, not current year income. A manager's wealth includes the present value of expected future compensation, i.e., future salary, bonus, stock/option grants and pension, as well as the value of current stock and option holdings. Wealth leverage is the ratio of percent change in management wealth to percent change in controllable shareholder wealth. A "pure" entrepreneur, who has 100% of his wealth in company stock, has a wealth leverage ratio of 1.0 because any percentage change in shareholder wealth results in an equal percentage change in the entrepreneur's wealth.

My research with Professor S. David Young of INSEAD (see the attachment, Stephen F. O'Byrne and S. David Young, "Top Management Incentives and Corporate Performance," *Journal of Applied Corporate Finance*, Fall 2005) shows that:

- The median company (in the S&P Execucomp database) has top management wealth leverage of 0.43, i.e., a 10% change in shareholder wealth changes management wealth by 4.3%,
- There is wide variation in the strength of top management incentives; the bottom quarter of companies have wealth leverage below 0.25, while the top quarter have wealth leverage above 0.63,
- For the median company, almost all wealth leverage comes from stock and option holdings, not current compensation (or changes in the present value of expected future compensation), and
- Companies with higher wealth leverage significantly out-perform their industry competitors. On average, an increase of 0.1 in wealth leverage increases a company's annualized excess return by 0.9 percentage points.

The information needed to assess the strength and cost-efficiency of top management incentives

To evaluate the strength and cost-efficiency of top management's incentive to increase shareholder value, an investor must be able to estimate top management wealth leverage and the company cost of top management compensation. A strong incentive will not be cost-efficient if it is combined with a level of pay that wipes out the shareholder wealth gain normally associated with the strong incentive. To assess the cost-efficiency of a company's top management compensation, an investor needs to know:

- The company's top management wealth leverage,
- The average excess return achieved by companies with similar wealth leverage,
- The company's total compensation cost relative to market pay levels, and
- The average pay premium of companies with similar wealth leverage.

If a company's wealth leverage is high enough to be associated with a positive excess return and the company pays below average for companies with similar wealth leverage, then the company's compensation is clearly cost-efficient (because companies with equal wealth leverage and higher compensation cost provide their shareholders with a positive excess return). If a company's wealth leverage is low enough to be associated with a negative excess return and the company pays above average for companies with similar wealth leverage, then the company's compensation is clearly not cost-efficient (because companies with equal wealth leverage and lower compensation cost provide their shareholders with a negative excess return). To evaluate cost-efficiency at companies that fall outside these two groups (i.e., companies with wealth leverage at a positive excess return level, but with above average compensation cost or companies with wealth leverage at a negative excess return level, but with below average compensation cost), an investor must estimate the dollar magnitudes of the projected excess return and the compensation cost premium or savings.

Professor Young and I have estimated top management wealth leverage by calculating a company's average top management wealth return for each year of the period 1995-2004 and then calculating the slope of a regression trendline relating average management wealth return to excess shareholder return. The slope, which gives the average ratio of management wealth return to excess shareholder return, is the company's average wealth leverage for the period. Our analysis required many estimates and highlights key data

deficiencies in public disclosure. In the next section, I outline additional disclosures, beyond those in the proposed regulations, that would significantly enhance investors' ability to accurately estimate top management wealth leverage.

While Professor Young and I have calculated annual wealth returns and used a multi-year statistical analysis to estimate top management wealth leverage, other analysts and investors may prefer to rely primarily, if not exclusively, on current year disclosures to estimate the strength and cost-efficiency of top management incentives. These analysts and investors will need to estimate the percentage distribution of executive wealth by key components, make judgmental estimates of the wealth leverage of each component and then calculate a weighted average of component wealth leverage, as shown in the following table:

Wealth Component	Percent of Executive Wealth	Estimated Component Wealth Leverage	Contribution To Total Wealth Leverage
Base salary and other fixed pay	37%	0.0	0.00
Incentive compensation	38%	0.2	0.08
Stock holdings	12%	1.0	0.12
Option holdings	13%	1.8	0.23
Total Wealth Leverage			0.43

The most difficult part of this calculation is estimating the wealth leverage of the present value of expected future incentive compensation. These analysts and investors will be looking for clear narrative disclosure of the factors that affect this wealth leverage. In the second section below, I outline additional questions that should be answered in the Compensation Discussion and Analysis to assist analysts and investors in estimating this key wealth leverage.

Specific recommendations: tabular presentations

The tabular presentations should provide sufficient information for investors to compute each executive's wealth return for the year. To compute an executive's wealth return for a year, an investor needs to know beginning wealth, ending wealth and cash received. Beginning (or ending) wealth is the present value of expected future compensation plus the value of holdings. Holdings include stock and options holdings as well as the expected value of cash long-term incentive awards and deferred compensation. An investor will use the compensation reported in the Summary Compensation Table to estimate the present value of expected future compensation and the cash (or cash equivalent benefit from a perquisite) received from salary, bonus and other compensation. Reporting actual (instead of target) bonus in the Summary Compensation Table simplifies the calculation of cash received, but complicates the estimation of expected future bonus. We recommend that the CD&A require discussion of differences between Summary Compensation Table compensation and target compensation so an investor can adjust his estimate of the present value of expected future compensation for current year differences between actual and target compensation.

The Summary Compensation Table should have all long-term incentive compensation awards, including non-stock incentive awards, reported on an expected value basis.

Reporting realized values for long-term incentive compensation distorts wealth leverage estimates because the entire realized value is related to the shareholder return in the year of payment, but may have been largely generated by prior year returns. Reporting realized values for annual bonus compensation does not create a similar distortion because there is no uncertainty about the performance year to which the bonus is attributable. The year end expected value of all holdings, including cash long-term incentive awards and deferred compensation awards, should be reported in the various holdings tables. A pension table that reports the executive's expected retirement benefit can be used by an investor to estimate the present value of the executive's expected future pension benefits.

To determine cash received during the year, investors must be able to distinguish cash from deferred compensation in the Summary Compensation Table and determine the cash realized from stock sales and the payment of deferred compensation. To estimate the cash received from stock sales, investors need to know the dollar amount of option exercise gains and stock grants that vest and the market price at the time of exercise or vesting so they can accurately estimate the number of shares needed to pay income taxes. Knowing the number of shares needed to pay taxes and the shares held at year end, investors can accurately estimate the number of shares sold for cash during the year.

My specific recommendations for changes in the proposed tables are:

Summary Compensation Table

- Performance-based compensation under a long-term plan that is not tied to the performance of the company's stock should be reported on an expected value basis in the year of grant. I recommend that the amount earned from the award be reported in the table currently captioned "Option Exercises and Stock Vested".
- The age of each executive should be reported in the table. To estimate the present value of expected future compensation, an investor must estimate years to retirement. Knowledge of the executive's age is essential to estimate years to retirement.

Grants of Performance-Based Awards

- The exercise price of performance-based options should be reported.

Outstanding Equity Awards at Fiscal Year End

- The expected value of unexercised options should be reported. The expected value is the fair value from an option pricing model adjusted, for options subject to performance conditions, to reflect the number of shares expected to vest.
- The expected value of stock grants should be reported. The expected value is the market value of the grant shares adjusted, for grants subject to performance conditions, to reflect the number of shares expected to vest.
- The expected value of incentive plan units, shares or other units should be reported rather than the market or payout value.

Option Exercises and Stock Vested Table

- The stock price at the time of exercise or vesting should be reported so investors can estimate the number of shares needed to pay income taxes.
- The value of cash incentive awards earned should also be reported in this table.
- The number of shares forfeited for failure to vest should be reported to assist investors in distinguishing between shares that fail to vest and shares that are sold for cash.

Retirement Plan Potential Annual Payments and Benefits Table

- The annual increase in the actuarial value of defined benefit plans reported in the Other Compensation column of the Summary Compensation Table should be shown in this table so an investor can accurately determine the amount of Other Compensation that should be included in cash received during the year.

Beneficial Ownership Table

- The number of shares owned at fiscal year end should be reported so investors can more accurately estimate stock sales and purchases during the year.

Specific recommendations: CD&A

A critical objective of the CD&A should be to assist investors in estimating the wealth leverage of the present value of expected future compensation. If a manager has a fixed percentage interest in future income or a fixed share stock or option grant, the present value of the manager's expected future compensation will be highly sensitive to changes in shareholder wealth. If the company's net income or economic profit doubles, the present value of expected future compensation from a fixed percentage interest in income will also double. If a manager receives an annual stock or option grant of a fixed number of shares, the present value of the manager's expected future stock/option compensation will double when the stock price doubles. If, however, the manager's expected future compensation is denominated in dollars, or determined on the basis of competitive compensation levels without regard to company performance, the present value of expected future compensation will have very little sensitivity to changes in shareholder wealth.

I recommend that companies be required to answer the questions listed below. These questions will ensure that the CD&A provides information to assist investors in estimating the wealth leverage of the present value of expected future compensation and also clarify three issues that can easily distort an investor's estimate of an executive officer's wealth return: special awards that are not part of the company's target total compensation, non-annual grant frequencies for long-term incentive awards and significant non-company related wealth.

- Does the company have a target share concept for top management compensation (e.g., a target share of income for cash bonus and stock compensation, or a target share of income for cash bonus and a target share of value for stock compensation)? If so, how is the target share defined?

- Does the company have a competitive position target (e.g., 50th percentile pay)? How does the competitive position target vary with company performance? How does the compensation reported in the Summary Compensation Table differ from target compensation levels? What is the grant frequency of the company's long-term incentive awards (if not annual)?
- How does the company measure, or judgmentally assess, the strength of management's incentive to increase shareholder value (e.g., percent of pay at risk, wealth leverage)? What is the company's target, if any, for the strength of management's incentive to increase shareholder value?
- Does the company have a target for stock and/or option holdings as a percent of salary (or other measure of current compensation)?
- Is the non-company related wealth of any executive officer sufficiently large to materially reduce the executive's wealth leverage?

In summary, I recommend changes to the proposed regulations to ensure that:

- The tabular presentations (with the aid of the CD&A commentary) provide sufficient information for investors to compute each executive's wealth return for the year, and
- The CD&A provides sufficient information for investors to reasonably estimate the wealth leverage of the present value of expected future compensation.

Sincerely,



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Steve O'Byrne is President and co-founder of Shareholder Value Advisors Inc., a consulting firm that helps companies increase shareholder value through better performance measurement, incentive compensation and valuation analysis. His publications include:

- "Top Management Incentives and Corporate Performance" in the *Journal of Applied Corporate Finance* (Fall 2005)
- "How to Boost Pay for Performance" in *Financial Executive* (November 2004)
- "Should Directors Ever Sell Their Shares?" in *Directors & Boards* (Summer, 2002)
- *EVA and Value Based Management* (with Professor David Young of INSEAD), McGraw-Hill (November 2000)
- "Does Value Based Management Discourage Investment in Intangibles?" in *Value-Based Metrics: Foundations and Practice*, edited by Frank J. Fabozzi and James L. Grant (2000)
- "EVA and Its Critics" in the *Journal of Applied Corporate Finance* (Summer 1999)
- "The Measurement of Post-Acquisition Performance: Toward A Value-Based Benchmarking Methodology" (with Professor Mark L. Sirower of New York University) in the *Journal of Applied Corporate Finance* (Summer 1998)
- "EVA and Shareholder Return" in *Financial Practice and Education* (Spring/Summer 1997)
- "Executive Compensation" in the *Handbook of Modern Finance* (1997)
- "EVA and Market Value" in the *Journal of Applied Corporate Finance* (Spring, 1996)
- "Be Bold With Wealth Incentives" in *Directors & Boards* (Fall, 1995)
- "Total Compensation Strategy" in the *Journal of Applied Corporate Finance* (Summer, 1995)

Prior to co-founding Shareholder Value Advisors in 1998, Mr. O'Byrne was head of the compensation consulting practice at Stern Stewart & Co. (1992-1998) and a Principal in the executive compensation consulting practice at Towers Perrin. Prior to joining Towers Perrin in 1979, he worked in the tax department at Price Waterhouse and taught mathematics at Loyola University of Chicago. Mr. O'Byrne holds a B.A. degree in political science from the University of Chicago, an M.S. in Mathematics from Northwestern University and a J.D. from the University of Chicago. He is a member of the New York Society of Security Analysts, a certified public accountant and a member of the Illinois bar.

Webmaster's Note:

The attachment, "Top Management Incentives and Corporate Performance," by Stephen F. O'Byrne, Shareholder Value Advisors and S. David Young, INSEAD printed in the Journal of Applied Corporate Finance, Fall 2005 may be found at

<http://www.valueadvisors.com/OByrne%20%20Young%20JACF%20Fall%202005.pdf>