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Nov 28, 2013

Re: File Number S7-07-13 - Dodd-Frank Act Pay Ratio Disclosure Mandate; Proposal for a Safe Harbor Disclosure Process

Via Email: rule-comments@sec.gov

Elizabeth M. Murphy, Secretary
US Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

We advise Institutional Investors, Boards and Management in the design of management structure, Pay-for-Performance, talent management and CEO Selection processes that drive longer-term shareholder value. To make wise investment decisions in U.S. listed companies, investors need disclosures that help them understand the investee company, its strategy, its risks and how the company is using management structure and compensation to drive the achievement of its stated strategy.

We support the CEO Pay ratio proposed rule and suggest improving it by adding a safe harbor that would encourage implementation of pay ratio and management layering disclosures more consistent with the intent of other Dodd-Frank Act provisions on executive compensation, risk management and corporate governance. We note that this approach offers long-term company and investor advantages that would also improve the SEC pay ratio rule cost-benefit analysis.

While our comments are broadly applicable to the proposal, we believe they are particularly relevant to the following issues:

- Questions 6,7, 21, 22, 23, 24, 25, 26, 28, 33, 34, 35, 36, 37, 38, 39, 40, 41 - further guidance to registrants on determining which roles to include and how to calculate median compensation, pay ratios, how executive pay ratios align to different levels of CEO work, innovation and risk horizons, and additional narrative disclosures required for investors;

- Questions 32, 60 - alternative ways to meet the policy intent of the Dodd-Frank pay ratio;

- Questions 61, 62, 63, - additional benefits for board and investors that are not already discussed; and

- Questions 65, 66, 67, 69 - other impacts on boards, companies and capital market formation, efficiency, effectiveness and sustainability.[1]

Using Pay Ratio Disclosure to Support Dodd-Frank Act Governance, Enterprise Risk Management and Executive Compensation Reform Priorities

The pay ratio disclosure provision of the Dodd-Frank Act was not enacted in a vacuum. It was part of a collection of legislative enactments relating to:

- Corporate governance (e.g., proxy access for long-term investors, disclosure of the board's leadership structure, compensation committee independence, consideration of compensation consultant independence);
- Risk management (e.g., risk-related limits on financial institution incentive compensation, executive compensation clawback policies to deter wrongdoing, disclosure of the relationship between compensation policies and risk management); and
- Performance measurement and executive compensation (e.g., shareholder say on pay votes, pay for performance disclosures, company policy on employee hedging of equity incentive compensation).

Accordingly, we believe that the pay ratio disclosure rule has the potential to add value for registrants and investors and should be implemented with an eye toward achieving the Dodd-Frank Act's broader strategic corporate governance and risk management goals, as well as to provide additional compensation and organizational insights to stakeholders. If the pay ratio rule is effectively implemented, we think it could become a catalyst for encouraging company improvements in strategic governance analytics and processes and for enhancing risk management, innovation and sustainable performance and capital market efficiency.

Our comments focus on taking advantage of the extensive knowledge base that already exists around organizational design, internal pay equity and behavioral dynamics. We believe that input from these disciplines could benefit the policy debate surrounding CEO pay ratio disclosure. The SEC should recognize and utilize the decades of research that relates to management structure design, pay ratios and real world behavioral dynamics in structuring the SEC pay ratio rule so as to achieve policy goals of the Dodd-Frank Act. This comment letter is based on the realization that, by encouraging boards and investors to focus on documented research findings and company-specific data rather than personal interests and bias, executive compensation disclosures could facilitate improving company organizational structure and management practices, with significant financial advantages.

[1] Data privacy concerns are also addressed in the Appendix to this comment letter.

Advancing Sustainable Value Creation with a Safe Harbor Structured Around Research Findings on Management Structure Design and Internal Pay Equity

We agree that a "one size fits all" approach to pay ratio disclosure is not appropriate, given the variations in complexity, size, structure and operations of the companies that will be covered by the rule. However, we believe that the rule could be implemented so as to encourage adoption of practices aimed at providing boards, management and investors with the information needed and insights required to apply the pay ratio disclosure process to improve strategic planning, innovation, risk management, corporate governance and efficient use of capital.

The Appendix attached to this comment letter contains a summary of organizational design and behavioral research from the United States, Canada and Britain.[2] It confirms the following principles that provide a foundation for making the rule's pay ratio disclosure process a more valuable mechanism for promoting sustainable value creation.

- Employees consistently say that a reasonable pay differential between adjacent (value-adding) management layers in their company's management structure would be a compensation increase multiple of two to 2.5 times from one management level to the next higher level;
- Each value-adding management layer ("Work Level") is worth about two to 2.5 times more in total compensation than the level directly below it;
- The current median pay ratio difference between the principal executive officer ("PEO") and the other Named Executive Officers ("NEOs") directly reporting to that role at the largest 2000 issuers in the Russell 3000 for which data is available is less than 2.5;
- The total number of Work Levels between front line employees and the PEO can vary between companies and between subsidiaries or business lines in the same company;
- Evaluation of pay differentials and the degree of delegated authority between Work Levels can provide insights into a company's organizational and operational efficiency and innovation capacity, as well as the effectiveness of its risk management and PEO succession planning processes;
- The longest accountable performance period for which the PEO and other management Work Levels are held accountable, when compared to the business and risk horizons applicable to each Work Level, is an indication of whether total compensation is linked to risk-adjusted performance;
- In many companies where management of enterprise risk exposures are central to sustainable success, the pay ratio and Work Level difference between the PEO and chief risk officer ("CRO") can be a signal of how robust the enterprise risk management function is at the company.

[2] In addition to the Appendix, research findings on optimal management structure design, internal pay equity and "Felt Fair Pay" are available at these sites: http://globalro.org; http://stores.homestead.com/CasonHallPublishersStore; http://www.jstor.org/discover/10.2307/2391950?uid=3739448&uid=2129&uid=2&uid=70&uid=3737720&uid=4&sid=21102888420493; and http://www.law.harvard.edu/faculty/bebchuk/pdfs/CEOpayslice.Oct2009.pdf.

These findings have influenced the analyses used by credit rating, governance and investor service providers. For example, GMI Ratings, Moody's Investor Services and Glass Lewis all have incorporated red flag measures of internal pay differential ratio between the PEO and direct reports to the PEO into their analytical processes. (See the Appendix for additional discussion.)[3] Recent research from the University of Delaware also supports the need for internal consistency of compensation throughout a company, up to an including the PEO.[4]

We suggest that the SEC use the pay ratio disclosure rule to expand usefulness of internal pay equity and measures beyond mere compliance reporting of relative CEO compensation ratios to capture measures of organizational efficiency, innovation, risk management, corporate governance and allocation of capital to creation of sustainable value.

Benefits from a Safe Harbor that Encourages Accurate Measurement and Effective Management of Organizational Value and Enterprise Risks

In today's knowledge-based economy, less than 25% of the valuation of the S&P 500 is comprised of tangible assets such as property, plant, equipment inventory and cash reflected in financial statements. The other 75% of the valuation is associated with intangible assets of a company, little of which is evident in financial statements prepared under GAAP. The intangible assets and market valuation of future company prospects are the real long-term value drivers for customers and shareholders. They include such intangibles as the optimal management structure design, work processes, information databases, patents, brand equity, enterprise risk management and the human capital that work within the structural capital and work systems of the enterprise.

A major advantage of identifying the median layer in the management structure and median compensation for the entire enterprise (in complying with the Dodd-Frank Act pay ratio disclosure mandate) could be development of valid and reliable information systems for reporting to the board and C-suite on structural and human capital investments, costs and risks. Development of this data would also allow more accurate reporting to the board and investors of actual and complete enterprise long-term value drivers.

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[3] Moody's research suggests that high pay equity disparity can flag succession planning risk, increase cost of capital and affect credit ratings. Analyzing Credit and Governance Implications of Management Succession Planning; Moody's Investors Service; May 2008.

[4] "Review of an executive's compensation should be done within the context of the organization as a whole. The executive is, after all, an employee of the corporation. His pay should be considered as an extension of the infrastructure that governs the rest of the company's wage structure. Internal consistency, or pay equity, throughout the organization, up to and including the CEO, should be a natural and reasonable objective. The board should not consider executive pay separately from the structures that govern compensation of other employees, rather its design should be structured upon the same foundations and precepts." Elson, Charles M. and Ferrere, Craig K., Executive Superstars, Peer Groups and Overcompensation: Cause, Effect and Solution (August 7, 2012), pages 129 -130. Available at SSRN: http://ssrn.com/abstract=2125979 or http://dx.doi.org/10.2139/ssrn.2125979.

The benefits of viewing pay ratio disclosure in this broader context could be enormous. Other comment letters submitted to the SEC on this rule demonstrate the value that could be added by addressing current widespread problems in determining equitable, fair, and defensible CEO compensation. The Human Resource Policy Association (which includes 350 of the largest companies in the United States) provided survey results to the SEC that show a surprising and concerning lack of available and reliable organizational data and related analytics. For example, the Association survey found that 84% of company respondents could not easily calculate worldwide enterprise cash compensation for all employees.[5]

In our consulting work for Banks, and others sectors, we continued to discover organizations that do not have the following types of information for thousands of employee roles.[6]

- The location of the business unit where each role is included;
- What role is the accountable manager for each role (thus they are orphaned roles in the information system and on organization charts); and
- What the delegation of authority is from the manager to each reporting role, putting the enterprise at material risk.

In addition, these registrants lack reliable information on:

- How many total enterprise layers they have (PEO to front line);
- Cost of management by layer; and
- Median employee total compensation costs by layer.

From the perspective of long-horizon investors (such as pension funds, sovereign wealth funds, endowments and foundations), these deficiencies are very likely to be seen as material "managerial control risks and weaknesses" that should be known to the company's chief risk officer and accurately reported to the board. Where these material control weaknesses exist, we believe they should also be disclosed to investors along with a plan to remedy, in the same way that material weaknesses in internal control over financial reporting are reported to audit committees and disclosed in periodic SEC filings. The Dodd-Frank pay ratio disclosure process could provide the vehicle for identifying and addressing these shortcomings.

We recognize that it might take a transitional period before most companies could develop robust information systems to solve for these material managerial control weaknesses.[7] However, once

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[5] http://www.sec.gov/comments/df-title-ix/executive-compensation/executivecompensation-79.pdf

http://www.hrpolicy.org, http://www.execcomp.org, and

http://www.execcomp.org/Docs/Center_Statement_SEC%20Pay%20Ratio_Sept%202013.pdf.

[6] For many registrants across all sectors this is not an uncommon condition.

developed and implemented by registrants, their C-Suites and boards will be able to use the process and analytics to more effectively manage these key organizational assets and minimize associated risks.

In addition, the cost issues many have raised in reviewing the SEC's cost-benefit analysis for the Pay Ratio rule would be overwhelmed by benefits from improved insights on organizational and management structure, cost of management, clarity of accountabilities and delegated decision authorities, human capital re-deployment opportunities, PEO succession planning, risk management and corporate governance. Improved data, analytics and reporting would also create a more informed proxy voting and say on pay voting process.

One of the major advantages of calculating the median role and median compensation for the entire global enterprise and the other more useful PEO pay ratios (see the Appendix for research) would be valid and reliable information systems for reporting on structural and human capital investments, costs and risks to the board and C-Suite, in addition to valid and more reliable disclosure to investors using actual and complete enterprise data, not sampling.[8] Comparability of pay ratios across companies would also be enhanced by greater transparency on management levels of work complexity, innovation and accountable time horizons. (See the Appendix for additional discussion.)

Experts who have advised registrants on these issues (some of whom are signatories to this letter) have seen the benefits of improved information systems on organizational and management structure, cost of management, clarity of accountabilities and delegated decision authorities, human capital re-deployment opportunities, PEO succession planning and strategic leadership assessment risks. For example, at one company with 25,000 employees, the resulting potential annual impact on improved management structure and compensation investment was in the hundreds of millions of dollars. These benefits flow through to improve sustainability of return on invested capital, free cash flows, enterprise valuation and total shareholder return for long-horizon investors.

Comments on Structuring the Safe Harbor

We would be happy to assist the SEC in revising the required disclosure reporting standards to achieve the goals identified above. The minimum data needed by boards and management would include the following:

- **Total Full Time Employees ("FTE")**
    - FTE by Enterprise, by Business Unit, by Geography (Country or Hemisphere), by Management Layer
    - This includes the FTE of leased or outsourced employees where there is a 1 year or greater contractual commitment for delivery of services to the employer

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[7] Up to a three-year transition period would appear to be reasonable.

[8] The need for reliable systems and data highlights the importance of this information being "filed" with the SEC as accurate and reliable, rather than merely being publicly furnished as useful but unverified.

- The FTE count will be as of year end
- Together this will outline the TOTAL employment and workforce foot print of the enterprise worldwide and the sustainable employment value for societies the company generates

- **Total Number of Management Layers PEO to Front Line & Cost of Management**
  - Identify the total number of management layers segmented by business unit and corporate function
  - Within each management layer the TOTAL count of number of FTE employees and the TOTAL Cost of Management at each layer
    - Total Compensation cost for each global employee would include:
      - Base Salary
      - Annual Bonus
      - Any applicable Longer Term Incentive compensation
      - Estimated Pension and Benefits (e.g., as a plug number, 8% of base salary)
      - Currency adjustment to USD at year end
  - Median Role(s) (employees) up the management structure

- **The Total Number of Managers** (versus front line or individual contributors)

- **The PEO's Longest Accountable Performance Period** for which the PEO role is held accountable for, measured on and compensated

- **Total Enterprise Compensation Cost** (broken out from selling, general and administrative expenses)

- **Pay Ratios and Internal Pay Equity**
  - The median total compensation for EACH management layer up the management structure (layer to layer), including the median layer to PEO pay ratio required by the Dodd-Frank Act
  - **The PEO Total Compensation divided by the median Total Compensation of all roles in layer 2 of the management structure**
  - **The PEO Total Compensation divided by median of all roles in layer 3 of the management structure**
  - If a financial or other risk-intensive institution, the PEO Pay ratio which is the PEO Total Compensation divided by the total compensation of Chief Risk Officer role

Table 2 in the Appendix provides a sample analytics and reporting format for aggregating this information. Such organizational capital analytics would provide the C-Suite and the Board with organizational insights about structural and human capital investments and how they are currently deployed, as well as workforce and management structure design and options for possible redeployment that would increase economic profit and productivity.

Correspondingly, disclosures needed by investors to effectively evaluate management of organizational capital, corporate governance and risk management would include:

- **Total Full Time Employees (FTE), including leased employees**
- **Total Number of Management Layers PEO to Front Line & calculation of Median Role(s)**
- **Total Number of Managers** (versus front line or individual contributors)
- **The PEO's Longest Accountable Performance Period** for which the PEO role is held accountable for, measured on and compensated
- **Total Enterprise Compensation Cost** (broken out from selling, general and administrative expenses)
- **The Pay Ratios and Internal Pay Equity**
  - **The median total compensation for EACH management layer up the management structure (layer to layer), including the median layer to PEO pay ratio required by the Dodd-Frank Act**
  - **The PEO Total Compensation divided by the median Total Compensation of all roles in layer 2 of the management structure**
  - **The PEO Total Compensation divided by median of all roles in layer 3 of the management structure**
  - If a financial or other risk-intensive institution, the PEO Pay ratio which is the PEO Total Compensation divided by the total compensation of Chief Risk Officer role

These disclosures should ideally be provided in a table format that allows for easy XBRL tagging (see http://en.wikipedia.org/wiki/XBRL_International) and thus for inclusion in financial and other databases, to facilitate analysis by investors, credit ratings agencies, proxy advisors and other investment service providers. Five-year trend lines are needed to capture time frame data that materially impact company performance and valuation and are central to any company's capacity to create sustainable value. Table 1 in the Appendix is a sample reporting format for investors.

In evaluating the information required by investors, it is important to stress that the PEO pay ratios to the median of both management layers 2 and 3 are needed. Because the number of senior executives in layer 2 is often minimal, it could be relatively easy for some companies to increase total compensation of that level to present an artificial view of the management structure, compensation and enterprise internal pay equity. Inclusion of layer 3 (direct report roles once removed from the PEO) will provide a more accurate picture, capture more of the most likely sources for senior management succession and mitigate opportunities to manipulate the data.

Attention to Development of Coordinated Disclosure Process

If the SEC is not now able to implement a disclosure regimen that applies the suggested broader management structure design and related research on organizational and strategic leadership risk, we believe the issues raised in this comment letter deserve continued attention. In that event, we recommend that the SEC seek out advice from experts in management structure and accountability, including related internal pay equity design, and start an initiative with participation of its Investor Advisory Committee and Issuer Advisory Committee to explore development of an approach to corporate disclosures that will encourage improved management of organizational design, enterprise risk management, corporate governance and efficient use of structural, human, natural and financial capital.

We believe that improved reporting to the C-Suite and boards, combined with transparent disclosures to investors along the lines described above, will contribute to materially better performance of investee companies, more sustainable returns for investors and more efficient capital markets overall. These are significant cost-benefit advantages that should not be overlooked.

If our firm can be of assistance in finalizing how the pay CEO ratio rule is implemented or providing more information, feel free to contact us.

Respectfully submitted,

Mark Van Clieaf,
Managing Director, MVC Associates International

Member, Society for Human Resource Management Investor Metrics Task Force
Member, World at Work (formerly American Compensation Association)
Member, NACD Blue Ribbon Commission on CEO Succession Planning
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cc: U.S. Securities and Exchange Commissioners

Hon Mary Jo White, Chairman

Hon Kara Stein, Commissioner

Hon Luis Aguilar, Commissioner

Hon Daniel Gallagher, Commissioner

Hon Michael Piwowar, Commissioner

United States Senate Banking Committee

The Honorable Tim Johnson, Chairman

The Honorable Mike Crapo, Ranking Minority Member

United States House of Representatives Committee on Financial Services

The Honorable Jeb Hensarling, Chairman The Honorable

Maxine Waters, Ranking Minority Member

Appendix

Table 1

Proposed Table Layout for Organizational Capital & Pay Ratio Disclosures For Investors

	Yr 0	Yr 1	Yr 2	Yr3	Yr 4	4 yr Absolute Growth (Change)	4 yr % Growth (Change)
Total Full Time Equivalents (FTEs)							
Total # Managers							
Total # Layers (PEO to Front Line)							
Longest Accountable Performance Period for Principal Executive Officer							
Total Enterprise Compensation							
PEO Total Pay Ratio to Median Total Pay 2nd Management Layer							
PEO Total Pay Ratio to Median Total Pay 3rd Management Layer							
PEO Total Pay Ratio to Median of Enterprise (Dodd Frank)							

Research Background on Management Structure and PEO Pay Ratio(s) Reporting and Governance / Risk Insights for Boards and Disclosures for Long Horizon Investors

Pay Ratio and Optimal Management Structure Design Research

Starting with work that Elliott Jaques and the Brunel Institute for Organization and Social Studies (BIOSS) initiated, more than a dozen research studies investigated the relationship between differential pay, position in the management structure and corporate hierarchy, the time-span of decision discretion of a particular role and the nature of role complexity.

These studies involved over 1,000 participants – from PEO to manager levels in the U.S., Canada and the U.K. – concluding that the "Felt Fair Pay" ratio and differential compensation between the real work in organizations consistently differed by a multiple of two. Also see the follow up research studies in the USA undertaken by Roy Richardson and Edna Homa.

The research identified that each value-adding management layer - called a "Work Level" - should be worth two times more in **Total Compensation** than the level directly below it (Manager to Direct Report role relationship in the management structure) *if the manager role is designed properly and truly performing differential and value adding wor*k. When analyzing the entire management structure the **median** Pay differential at each management layer is the proper analysis method and not the **average,** which would be distorted by outlier pay data and outlier pay ratios in the management structure.

The Felt Fair Pay research findings were based on Total Compensation and not Total Cash Compensation.

Recently, MVC Management Corporation undertook an extension of this management structure and "Felt Fair Pay" research at the request of Board clients and analyzed the PEO to Median NEO pay ratios for the USA. They analyzed the 2035 largest USA issuers in the Russell 3000 for which 3 yr Named Executive Officer (NEO) Pay data was available (2003 – 2005).

Removing the outlier data, the results of the updated research identified that PEO Pay Ratio some 25 years since the last major study had been conducted confirmed the Fair Pay ratio for America's top managers at 2.45 (CEO to other NEO's). Over the last 60 years the Manager to Direct Report pay ratio has been consistently identified as seen as equitable and fair in the 2 to 2.5 times broad range as a guiding organizational principle and corporate governance check.

http://www.prnewswire.com/news-releases/internal-pay-equity-key-to-fixing-a-broken-PEO-pay-system-new-research-shows-excessive-PEO-pay-may-link-to-performance-failure-and-business-risk-58367222.html

http://www.mvcinternational.com/documents/MVC_Pay_PEM_2007F.pdf http://www.sec.gov/comments/df-title-ix/executive-compensation/executivecompensation-303.pdf

When the PEO total pay ratio in relationship to Layer 2 (direct reports) and Layer 3 (direct reports once removed from the PEO role) becomes too large the research has identified the following material risks for investors:

- Named executive officers and or Layer 3 roles may lack appropriate delegated decision authority creating organizational risks due to an overly dominant PEO

- Layer 2 and Layer 3 may not have appropriate accountability and or authority for creating the Future Value and innovation of the Enterprise when as of March 2013 the Future Value was approximately 50 % of the Valuation of the S&P 500

- PEO succession planning risks as evidence that **too large a PEO pay ratio identifies** (> 3X to layer 2 and > 6 X to layer 3) both structural and talent gap material risks for PEO continuity

- Materials weaknesses in Board processes, Director Independence and execution of Fiduciary Accountability and possible credit risk for bondholders.

Defining What to Measure and How for the Median Employee Compensation

The research on Internal Pay Equity, "Felt Fair Pay" and Internal Pay ratios identifies that the "Felt Fair" compensation identified by the managers and direct reports as equitable pay differentials was based on Total Compensation and NOT base salary only.

For consistent global application across countries and in meeting the intended application for good Corporate Governance, insightful pay ratios and Dodd Frank compliance, Total Compensation for each employee and the median employee compensation by layer should be calculated and include the following pay elements:

- Base Salary
- Annual Bonus
- Any applicable Longer Term Incentive Compensation
- Estimated Pension and Benefits (use an estimated 8 % of base salary)
- Currency adjustment to USD at year end

The estimated 8 % of base salary as a pension & benefit cost is based on a review of the Mercer global pension and benefit global database and calculation of the Median pension and benefit cost for the world.

Identifying the median role (employee) and median compensation in the management structure is easily done by:

1. Doing a database query to count the number of management layers from the PEO to the Front Line employees (deepest depth structure in the management reporting structure)
2. Counting the median layer (mid-point between Layer 2 and the deepest front line employee) and not including the Principal Executive Officer (PEO) in that count
3. Running a query on the median pay for each layer in the management structure
4. Calculating the Median Enterprise compensation by taking the Median TOTAL compensation of each role managerial layer
5. See Table 2 for an example USA registrant

PEO Pay Ratio, Management Structure, PEO Succession Risk & Corporate Governance

Subsequent to the recent 2007 research by MVC Management and the previous research, Moody's (the bond rating service) confirmed the validity of material capital markets risk and they outlined their policy in assessing the PEO pay differential at > 3X to the other Named Executive Officers as a Red Flag for PEO succession and corporate governance risk and for input into corporate credit rating risk down grade. Moody's outlines this further in a number of their credit rating special comment white papers (2005, 2006, 2007 and 2008).

GMI Ratings and its predecessor companies (Governance Metrics International and The Corporate Library), as the leading Governance Risk Rating firm in the world adopted the same policy and now reports and RED FLAGS all PEO to Median NEO pay ratios greater than 3 times.

Applying the research and "Felt Fair Pay" principles, if the PEO to median of total pay differential to all 2nd layer role relationships is greater than 3X then this "Red Flags" a material risk related to corporate governance, delegation of authority, PEO succession and long-term enterprise continuity - all clearly material risks for investors.[9] This PEO pay differential indicator correlates highly with an overly dominant PEO, possibility of failure to delegate authority, lack of PEO succession candidates in the 2nd layer, and weak corporate governance by the Board of Directors.

It is easy to overpay the 2nd layer of management and have a large PEO pay differential with the 3rd layer of management (the PEO role being the 1st layer of management down from the Board). It is the 3rd layer where the work, accountability and decision authority may be more operationally focused depending on the complexity of the enterprise and how many layers of management the firm has.

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[9] Key findings on optimal management structure design, internal pay equity and "Felt Fair Pay" are archived at these sites: http://globalro.org; http://stores.homestead.com/CasonHallPublishersStore; http://www.jstor.org/discover/10.2307/2391950?uid=3739448&uid=2129&uid=2&uid=70&uid=3737720&uid=4&sid=21102888420493.

A further and more insightful check of PEO pay ratios is required for investors (equity and debt). If the PEO to median total pay differential to all 3rd layer role relationships is greater than 6.00 X then this further validates structural problems and PEO succession and future value risks. This wide Pay Differential gap indicates a failure to provide effective delegation of authority in the management structure.

As well, it is the 3rd layer of Management from which many next generation of PEO succession candidates usually are selected depending on the ages of the second layer incumbent talent pool.

The Board should be provided with an enterprise analysis of management structure and Pay ratios once a year that is similar to Table 2. This includes identifying any Red Flags for corporate governance reporting and investor disclosure.

This is why reporting and disclosing the total number of layers, total number of managers, total FTE in the enterprise is also important for Boards and Long Horizon Investors in understanding the shape of the management structure and workforce productivity for shareholders. These context-setting organizational insights also assist effective comparison between PEO Pay Ratios within the same company and across companies.

[See Table 3 with examples of PEO Pay ratios and how they vary due to changing management structure and organizational complexity.]

If the issuer is a financial institution, disclosure of the PEO to Chief Risk Officer (CRO) total pay ratio can provide great insight and has been confirmed to us by a number of former Bank PEOs. Their view is, if the Pay differential between the PEO to CRO roles is greater than 3X, then this indicates the structure and authority of corporate risk function and caliber of executive leading such a critical function for shareholders is inadequate. To further improve this disclosure, the PEO pay differential to the median of all role relationships in the second layer of the corporate risk function would also benefit investors.

Banks today disclose all their Enterprise Compensation through a compensation and benefits line item in their financial statement, along with a total-stock based compensation disclosure line item. Added together, these create the bank's total investment in structural and human capital, which we call Organizational Capital. With this disclosure an investor can then determine the banks' Return on Organizational Capital (ROOC), calculated as NOPAT / Total Bank Compensation.

This represents the shareholders' performance and return on what has been invested in the structural and human capital of the enterprise. It can then be compared across peer banks to see the relative performance of structural and human capital productivity. A bank that overpays its PEO and top 200 – 300 + officers will have a lower Return on Organizational Capital compared to a bank that pays closer the median of the rest of banking industry. This disclosure is available for all banks today in the United States.

All listed companies, like banks, should be required to provide breakout disclosures on Total Enterprise Compensation costs as separate from SG&A costs and have this disclosed in either their financial statements or the proxy statement. This would allow for more insightful investor analysis of organizational capital productivity and / or under-investment. It could also have a secondary effect of moderating any rise in total enterprise compensation costs for shareholders.

Table 2:
Sample Organizational Capital, Management Structure & Pay Ratio Reporting For Boards

Mgmt Structure & Layering	Median Total Rewards by Layer	Lyr to Lyr Pay Ratio	CEO to Median Lyr2 Pay Ratio (Red Flag 3X)	CEO to Median Lyr 3 Pay Ratio (Red Flag 6X)	CEO to Median Enterprise (Dodd-Fank)
CEO-1(Sum Comp Table Pay)	$ 9,801,101				
Lyr2	$ 2,451,257	4.00	4.00		
Lyr3	$ 771,203	3.18		12.71	
Lyr 4	$ 422,199	1.83			
Lyr 5	$ 209,336	2.02			
Lyr 6	$ 144,997	1.44			
Lyr 7	$ 133,553	1.09			
Lyr 8	$ 83,429	1.60			
FL Mgr & Indv Contr = Lyr 9	$ 64,666	1.29			
FL Mgr & Indv Contr = Lyr 10	$ 54,448	1.19			
Front Line Employee = Lyr 11	$ 27,013	2.02			
Enterprise Median= CEO to Lyr11	$ 144,997				
Median 2 = Median Lyr 2 to Lyr 11	$ 139,275				
CEO Pay Ratio to Median Balance of Mgmt structure per SEC filing rule (Dodd-Frank)	$9.8M divided $ 139,275				70.37
CEO Pay Ratio to Median Front Line Employee					362.83
Global SBU's	10				
Total FTE	29,000				
North America		15000			
Europe		6000			
South America		2000			
AsiaPac		6000			
Total Mgmt Layers (CEO to Front line)	11				
PEO Longest Accountable Performance Period	5 yrs				
Total Enterprise Compensation Costs - Yr End	$ 1,350,583,338				
Total 5 Named Officer Compensation Cost - Yr End - SCT	$ 27,353,875				

Table 3:
How Median PEO Pay Ratios change by different Organization Structures and Management Layering

	A	B	C	D	E
1					
2		**5 Work Levels**		**7 Work Levels**	
3	**Using 2.5 X Felt Fair Pay ratio by Work Level**				
4				**Layer**	**Median TDC by Layer**
5			**Median TDC by Layer**	PEO 1	$ 9,277,344
6		**Layer**		2	$ 3,710,938
7		PEO 1	$ 1,484,375	3	$ 1,484,375
8		2	$ 593,750	4	$ 593,750
9	**Median**	3	$ 237,500	5	$ 237,500
10	**Mgmt Structure**	4	$ 95,000	6	$ 95,000
11		5	$ 38,000	7	$ 38,000
12					
13		**PEO**	$1,484,375.00		
14		**Median**	**$ 166,250.00**		
15					
16		**PEO / Enterprise Median**	**8.93**		
17					
18				**PEO**	$ 9,277,343.75
19				**Median**	**$ 415,625.00**
20				**PEO / Enterprise Median**	**22.32**
21					
22		PEO / Front Line Pay Ratio	39.06		244.14
23					

Evidence of Excessive PEO Pay Ratio, Poor Performance and Enterprise Risk for Shareholders

In the recently released research commissioned by the New York Times related to Pay and Performance, and PEO Pay ratios the research further validated the performance risk for investors and efficient capital markets.

http://www.nytimes.com/2013/10/13/business/when-the-stock-price-hides-trouble.html?src=me&_r=0

http://knowledge.ckgsb.edu.cn/2013/10/09/policy-and-law/the-rich-and-the-rest-executive-pay-corporate-growth

http://www.organizationalcapitalpartners.com/SiteAssets/latest-news/MVC_P4P_NYTimes.pdf

Eighteen Fortune 300 companies delivered a 5 yr combined economic loss of $134 billion over 5 years. All 18 companies had an ROIC less than WACC over 5 years and destroyed intrinsic shareholder value. The 90 named officers of these 18 companies were granted $ 3.1 billion in 5 yr realizable compensation.

The hidden headline is the PEO to Median Other Named Executive Officer pay ratio for the 18 companies was on average 3.2 X, greater than the Moody's and GMI Red Flag of 3 X, and a number of these Value Destroying companies had significant PEO to median NEO pay ratio in the 3.5 to 4.9 range further validating the investor risk when there is an excessive PEO pay differential.

Dodd-Frank PEO Pay Ratio to Median Role / Employee of Enterprise – Improving Comparison of Disclosures

The National Investor Relations Institute recent comment letter to the SEC makes a point that there is a risk that pay ratio disclosures will be inappropriately used to make comparisons between companies across various industries and with different levels of organizational complexity. However, there is always potential for misuse of any disclosure. We support the proposed SEC rule. By requiring companies to focus on internal pay equity, rather than allowing boards to chase pay levels at companies with different organizational structures, competitive environments and human resources issues without adequate contextual data, the proposed rule is a major step in the right direction. Nevertheless, we believe that added disclosures encouraged by the safe harbor would reduce potential for ill-informed cross-company comparisons by making information available that enhances the ability to do more nuanced compensation comparisons.

For example, if a company has 5 Layers of Management, a median compensation for layer 5 at $ 38,000 and uses a "Felt Fair Pay" and internal pay equity differential of 2.5 X per layer, then the PEO Pay Ratio under Dodd-Frank disclosure rule for this company is 8.93. (See Table 3.)

A company that is much more complex and global might have 7 or more layers. Following the same management structure and pay ratio principles and calculations would result in a PEO Pay Ratio of 22.32 times. This would also result in a Median CEO pay level of applying "Felt Fair Pay" ratios of $ 9.2 million.

This aligns very closely to the median S&P 500 CEO total pay as identified by Professor Steven Kaplan for 2011.[10] Thus the shape of the management structure, complexity of the company, number of business units, number of layers, and number of FTE, and location of the FTE around the world will all impact the validity, reliability and interpretation of the PEO to Median Enterprise disclosure and its application for strategic corporate governance and proxy voting by investors.

Including organizational shape and complexity-related disclosures as part of the narrative in describing the PEO / Median of Enterprise disclosure would reduce the potential for misinterpretation when comparing pay ratios between peers. The most critical additional disclosures to provide effective interpretive and comparative insights of the PEO to Median Pay employee ratio (under Dodd-Frank), include:

- **Total Enterprise FTE (globally), including leased employees**
- **Total Number of Management Layers (deepest structure PEO to Front Line Employee)**
- **Total Number of Managers**
- **Longest Accountable Performance Period for the PEO**
- **Total Enterprise Compensation Costs**
- **The PEO pay ratio to the median of roles in layer 2 of the management structure**
- **The PEO pay ratio to the median of roles in layer 3 of the management structure**

Dodd Frank PEO Pay Ratios, Levels of Innovation, CEO Role Complexity, LTIP Design Alignment and PEO Pay Ratio Interpretation

The additional disclosures outlined above (i.e. # FTE, # Layers, Enterprise Total Compensation, PEO to Layer 3, etc) would provide boards and investors with valuable insights for creating higher performing companies and ensuring consistency between management structure and compensation, both for the CEO and enterprise wide. Table 4 outlines, based on pro-forma assumptions using Felt Fair Pay

[10] http://faculty.chicagobooth.edu/steven.kaplan/research/kgovppt.pdf

principles and procedures from Table 3, what three different CEO pay ratio disclosures might look like and how these benchmarks could be applied by a Board and Investors.

As an example, if a company has CEO to Enterprise Median Pay Ratio of 21 X, then information on the following factors would be needed to determine whether differential CEO work complexity and skill requirements are sufficient to justify the corresponding pay differentials and 21 X versus 7 X pay ratios shown in Table 4r:

- Level of CEO role complexity
- Level of innovation
- Strategic risk horizon
- Key Performance Indicators (KPI's)
- LTIP design

If a company's level of Innovation, strategic risk horizon and Level of Value creation align to a Level CEO 3 role when the Dodd-Frank PEO to Enterprise Median pay ratio is approximately 20 to 25 X, then the CEO role would appear to be materially over-compensated by a factor of 3 times (7x vs. 21 X) in terms of Fair and Equitable PEO compensation relative to the level of CEO role complexity. Boards and Investors could use these proxy benchmarks as key inputs into analyzing the Level of Complexity of CEO work alignment with the level of defensible total "Felt Fair" compensation and its requisite PEO Pay Ratio. This analysis could influence executive compensation, management structure and accountability design, capital allocation, strategic governance and structural and human capital strategy decisions.

Table 4
Dodd Frank PEO to Median Enterprise Pay Ratio Benchmarks and Alignment to Levels of Innovation, Risk Horizons

CEO Level of Work Complexity	Level of Innovation	Strategic Risk Horizon	Value Creation for Whom	Key Performance Indicators & or Contribution To	OVA and Equitable Dodd Frank CEO Pay Ratio Aprox Benchmarks
5	Global Business / Societal Innovation	20 yrs +	Humanity/ Future Generations LT Shareholders	Nation Building, Economic and Political System Innovation, Innovation for Energy-Food-Water Security for Humanity , Climate Change, Enterprise Sustainability, Global Peace & Security	**21X**
4	Global Industry Structure Innovation	10 -20 yrs	Individual Societies / Triple Bottom Line	Future Value for Societies, Asset & Business Portfolio Stewardship / Citizenship, Triple Bottom Line, Corporate Responsibility to Societies	**14X**
3	New Business Model Innovation	5 - 10 yrs	Customers, Employees & Shareholders	Future Value for Stakeholders, ROIC > WACC, Economic Profit, Business Model Viability, Customer Loyalty, Employee Engagement	**7X**

Data Privacy and Pay Ratios

Data privacy rules will have to be observed. For example, the European Union has a Safe Harbor agreement with the US, so data transfer can be done legally and should retain the same rights as is held in Europe.

The second way to access the data is under contracts that use sets of model clauses drafted by the European Commission. Please see:

http://export.gov/safeharbor/

http://ec.europa.eu/justice/data-protection/document/international-transfers/transfer/index_en.htm

Removing any personal identifiers (name, phone number, badge number, email address, company personnel number) from any databases to be accessed or data exports could also address many of these privacy concerns.

The focus is on the management structure, roles, compensation, pay ratios and NOT the people.

Glossary of Terms

The following is a list of terms related to effectively defining Accountability, Authority, Felt Fair Compensation and Pay Ratios in management structures that are employment hierarchies.

Accountability	A relationship where one role (manager) is held to account to another role for its actions and decisions in the managerial structure or other body authorized to approve and or which has a fiduciary duty to others
Authority	Legitimate decision right or action vested by delegation with power vested to invest resources and capital (structural, human, intellectual, financial) to create value for customers and shareholders
Level of Complexity	Level of complexity is determined by the number of factors, their inter-relationships and rate of change in those factors to be taken into account in making a decision
Decision	The making of a choice with a commitment to a future goal and the investment of capital (structural, human, intellectual, financial)
Delegation	The act of assigning an accountability for a performance outcome and the related resources to direct reports and other roles to exercise judgment and discretion for investing those resources to create value
Felt Fair Pay	A level of total compensation payment that is seen by the role holder, manager and manager once removed (MoR) as equitable payment based on the differential work of the role (accountability and authority)
Front Line Role	A role that is accountable for direct outcome work assigned by the manager and is at the front line of delivery of value to customers
Full Time Equivalent	**Full-time equivalent** (**FTE**) is a unit that indicates the workload of an employed role in a way that makes workloads comparable across various contexts. FTE is often used to measure a roles involvement in a project, or to track cost reductions in an organization. An FTE of 1.0 means that the role is equivalent to a full-time worker, while an FTE of 0.5 signals that the worker is only half time. In The U.S. federal government, FTE is defined by the Government Accountability Office (GAO) as the number of total hours worked divided by the maximum number of compensable hours in a full-time schedule as defined by law.

	For example, if the normal schedule for a quarter is defined as 411.25 hours ([35 hours per week * (52 weeks per year – 5 weeks regulatory vacation)] / 4), then someone working 100 hours during that quarter represents 100/411.25 = 0.24 FTE. Two employees working in total 400 hours during that same quarterly period represent 0.97 FTE.
Layer	A reporting role relationship (manager to direct report) in an accountable management structure
Longest Accountable Performance Period	The targeted completion time for the longest accountable activity or strategic program / initiative into the future for which the role is held to account for performance, has delegated authority and decision discretion to invest resources, create value and a return on the invested capital
Manager	A role held to account for the direct output of that role and the delegated accountability and outcome of direct report roles and direct report roles once removed, including the minimum managerial decision authorities of hire, removal from role, assignment of type work, goal setting, appraisal of performance, and rewards
Principal Executive Officer (PEO)	The first full time accountable role in a managerial hierarchy of a corporation which is being held to account for specific strategic and operations goals established by the board of directors and has been delegated authority by the board to exercise good business judgment in the investment of capital
PEO Pay Ratio	The pay ratio between the PEO total compensation and total compensation of other roles in the management structure
Return on Invested Capital (ROIC)	The Return on Invested Capital is calculated as Net Operating Profit after Tax divided by Total Invested Capital (including intangible capital adjustments)
Role	A role is a position in a management structure where the manager has set clearly defined metrics, targets, by when including its level of expected innovation, longest expected accountable performance period, and delegated resources (operating or investment capital) and delegated decision authority to exercise judgment to meet established goals set by the manager

Strategic Risk Horizon	Furthest into the future that a role is required to conceptualize the future(s), innovate, set milestones and invest risk capital for investors to reach a future state and a Return on Invested Capital (ROIC)
Total Compensation	The total amount of compensation adding together the elements of compensation including base salary, bonus, long term incentive, benefits and pension
Work	The exercise of judgment and discretion in making decisions in carrying out goal directed activities (what, by when, with what quality standards and what resources) as assigned by the manager
Work Level	A unique and clearly differentiated level of work complexity, level of innovation and targeted completion time for value creation that is differentiated in the management structure; there may be 2 or more layers in a single Work Level

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Felt Fair Total Pay Differentials (FFP)
using 2.5X Pay Multiplier from Highest Compensated Front Line Manager ($120,000)

Work Level (CEO Level)	Work Level & Level of Innovation	Longest Time Span for Planning and Decision Making	Fair Pay Equity Multiplier	Total USD $ Pay Bands (FFP)
		50 yrs	97X	$11,718,750
7 (CEO 5)	Global Business / Societal Innovation	25 yrs		
		20 yrs	39X	$ 4,687,500
6 (CEO 4)	Global Industry Structure / Corporate Citizenship Innovation	15 yrs		
		10 yrs	15.6X	$1,875,000
5 (CEO 3)	New Business Model Innovation	7 yrs		
		5 yrs	6.25X	$750,000
4 (CEO 2)	New Product, New Service, New Market	3 yrs		
		2 yrs	2.5X	$300,000
3 (CEO 1)	Process Innovation			

		1 yr	1X	$ 120,000

Felt Fair Pay Table Copyright © MVC Management Corporation 2012

2.5 X Pay differential Multiplier based on research for felt fair pay based on truly differential and value adding work.

$ 120,000 as the highest Paid front line Manager across 4 job functions based on 4000 compensation data points

Here's One Way to Get a Grip

Paying the CEO a set multiple of what the next layer of executives collect goes down well with shareholders. Internal pay equity, as it's called, also demonstrates that the board is serious about finding the next CEO inside the company.

Is there anything directors can actually do to moderate CEO pay? You bet. Internal pay equity does just that. It limits the top guy's compensation to a multiple of the company's four other top-paid executives, whose comp—like the CEO's—is deconstructed in the proxy statement.

Among those that have imposed this ceiling are ConocoPhillips, DuPont, and Whole Foods Market Inc. Another is CPS Energy, a municipally owned utility in San Antonio, Texas. Until 2005, CPS's board of trustees had used peer benchmarking to set the pay of CEO Milton B. Lee, continually ratcheting it up to the point that in 2005 he earned \$548,803 in total compensation—a sum that put his comp in the 25th to 30th percentile of all CEOs, high for a municipal utility. Enough, said the board, turning to Mark Van Clieaf of MVC International, a consulting firm in Tampa, Florida, to look for other ways to do things.

Van Clieaf soon discovered that the trustees were benchmarking CPS against a grab bag of far more complex energy, telecom, and Internet businesses. One so-called peer was IAC, the Internet company founded by Barry Diller, consistently one of the most highly paid executives in the U.S. What did the owner of Match.com have in common with a local utility? Not too much, obviously. "We felt we had to be fair, but what was fair?" says Stephen Hennigan, executive vice president of San Antonio Federal Credit Union, who was then outside chairman of CPS's board (the job rotates among trustees) and head of the personnel committee that oversaw compensation. Hennigan, now 44, wanted another benchmark.

Van Clieaf, a proponent of internal pay equity, urged the board to look at the pay multiples within the company, from the level of front-line manager on up through some eight layers of management to the CEO. The trustees discovered three things: The company had too many management layers, the productive managers were underpaid in light of what they actually did, and the CEO was earning nearly three times as much as his 13 direct reports. "We asked ourselves, how is the CEO's work three times more complex to justify three times more pay than the next level down?" says Hennigan, who recently moved to the audit committee.

The question not only opened up a discussion of strategy but also enabled the board to identify what it really needed from its CEO. The trustees wanted Lee to work at a higher level of innovation to prepare the company for potential competition over the next decade and to get his managers focused on energy efficiency and renewable energy sources like wind and solar power.

To help the CEO carry out this new mission, CPS set out to restructure management, eliminating two levels to speed up decision-making. "It now took us 24 hours to respond to customers' critical business needs, as opposed to 30 days," says Aurora Geis, 43, senior credit officer at San Antonio Federal Credit Union, who took over as CPS's personnel committee chair in 2008. At the same time, people were made accountable for these decisions, and their comp indicates that the utility is on track to realize significant savings from the restructuring.

The CEO has fared well too. His total comp reached \$680,000 in 2007. But

on CEO Pay

by Julie Connelly

HOUSEDRAW

the 35% raises of the two senior vice presidents who report to him reflect a reduction in Lee's pay ratio, to a maximum of twice what they make. Lee, who could pocket as much as $734,000 for 2008, would probably be making more had the board stuck to peer benchmarking as a way to compensate him. But he's happy. For one thing, he agreed to the new compensation system because it was part of a general reorganization he liked and was spearheading. "My job became more exciting," he says. "I got out from under day-to-day operations, which are handled at the level below me now, and that freed me up to do the thinking about long-term strategy. I have the time to see how other companies are handling their businesses, and I work with my board to talk about strategy instead of the execution of strategy." Lee, 61, notes that pay is seldom at the top of the list of what managers like about their jobs. "Maybe my pay could have gone up to a higher level under the old system," he says, "but I'm setting up this organization for the future. And if I do it right, we'll never have to do it again."

Could internal pay equity for the CEO and other top executives work at other companies? It's certainly something board members, especially those on the comp committee, should be considering, along with benchmarking and pay for performance. But as Van Clieaf himself cautions, "Internal pay equity is not a governor to bring down CEO pay." The guiding principle of pay equity is differential pay for differential work. That means the higher the level of management responsibility, the higher the level of valued-added work that should be expected from the managers. Says compensation consultant Frederic W. Cook, who runs his own firm in New York City: "Other executives don't expect to be paid what the CEO is paid, but they do expect to be paid what they think their jobs are worth, what they think is fair in relation to what others are getting." David Swinford, CEO of Pearl Meyer & Partners, a compensation consulting firm in New York City, agrees. "People take no pride in the fact that their CEO is the highest-paid in their industry," he says. "But they are proud to be part of a team that is paid fairly."

It's no secret that at too many companies, CEOs are hogging an increasing portion of the compensation pie set aside for top managers. In 2006, according to the most recent figures available from Equilar, which specializes in benchmarking executive compensation, the median multiple for CEOs of S&P 500 companies was 2.96 times the median pay packages for all other top managers identified in proxies, the so-called named executive officers, or NEOs. In the 1980s, according to a study of 300 of the largest corporations by the Federal Reserve Board, the ratio was 1.58.

Alas, there is no clear-cut "right" multiple that boards can use as a template. "If you're in the range of two times or three times for the CEO and the next four executives and somewhere around 100 times for the CEO and the average employee, you're in the mainstream," says Michael Kesner, a principal in the executive-compensation practice at Deloitte Consulting LLP. There is a feeling that anything more than a multiple of three between the CEO and the next layer of managers is too much. Moody's Investors Service regards a ratio greater than three as a potential red flag indicating poor governance, which in turn can have an impact on the company's debt rating. "In and of itself, a high ratio won't affect the debt rating, but it's one of the things we look at," says Chris Plath, assistant vice president for governance at the rating agency. The Securities and Exchange Commission would like boards to disclose the extent to which they use internal pay equity ratios in setting CEO pay, although the agency has neither made that mandatory nor said anything about what ratio might be appropriate.

"I DO NOT BELIEVE WE'VE EVER RECOMMENDED AGAINST A DIRECTOR PURELY DUE TO INTERNAL PAY EQUITY ISSUES," SAYS THE HEAD OF THE GOVERNANCE INSTITUTE AT ISS.

Activist investors also stop shy of defining what is or isn't appropriate by means of multiples. Institutional Shareholder Services says it weighs internal pay disparity—something it defines as "excessive differential between CEO total pay and that of the next-highest-paid named executive officer"—when deciding whether to recommend that shareholders vote against or withhold their votes from compensation committee members and even entire boards. That's not the only factor, however. "I do not believe we've ever recommended against a director purely due to internal pay equity issues," says Carol Bowie, who leads ISS's governance institute. How much is "excessive?" "We don't have any hard-and-fast policy on that. We're looking at it on a case-by-case basis," Bowie says.

Some investors are demanding to know the degree to which companies weigh pay equity multiples in setting executive compensation. Denise Nappier, treasurer of Connecticut and principal fiduciary of a state employee pension fund with assets of $25 billion, filed shareholder resolutions against retailer Abercrombie & Fitch and grocery chain Supervalu in January 2008, calling on them to disclose "the role of internal pay equity considerations in the process of setting compensation for the CEO and the NEOs." Abercrombie & Fitch's 2007 proxy showed that CEO Michael Jeffries earned 6.16 times more than the next-highest-paid officer. At Supervalu, chairman and CEO Jeffrey Noddle outearned the next-highest-paid executive by a multiple of 3.98. "Some pay gaps were troubling. We were interested in having them explained," says Meredith Miller, Connecticut's assistant treasurer for policy.

Nappier settled with the two companies after they agreed to disclose more information in their 2008 proxies. They did so. Both outfits reduced the CEO's comp and also increased what they paid those reporting to him, bringing the multiples to a more acceptable range of three. Abercrombie's 11-page 2008 compensation discussion and analysis made glancing reference to internal pay equity but went into considerable detail about how the company had arrived at the pay packages for its top officers. Supervalu's 2008 proxy covered much the same ground in a 17-page explanation. The comp committee added that it "will review periodically the relationship of target compensation levels for each named executive officer relative to the compensation target for Mr. Noddle." Nappier withdrew her suits, and Miller says the two companies "responded very well to our concerns. They signaled the new compensation trend of companies' being willing to roll up their sleeves and talk about how they compensate people."

At most companies, market data and individual performance are what drive CEO compensation, according to consultant Michael Kesner. He estimates that only about 15 of the S&P 500 companies apply internal pay ratios. Whole Foods has a system of its own, using only cash salaries and incentives paid in cash in its ratio. It also effectively caps CEO John Mackey's comp at 19 times the average annual wage the company pays its full-time employees. In 2007 Mackey, a co-founder of the company, came in well below that, having voluntarily reduced his salary to $1 a year ("I am now 53 years old, and I have reached a place in my life where I no longer want to work for money but simply for the joy of work itself," he announced). He took no bonus or stock awards that year either, and didn't appear to receive any options. He did collect $297 in the form of a company contribution to his 401(k).

An examination of how internal pay works also highlights any problems a company might have with management succession. When the CEO regularly earns more than three times as much as the next level of managers, "it does suggest there is no one else in line," says compensation consultant Donald Delves of the Delves Group in Chicago. Worse, Pearl Meyer's David Swinford thinks a big disparity between the CEO's comp and everybody else's can be what he calls "demotivational." The company is obviously a one-man band instead of a team—how else could the board justify that compensation? Consultant Mark Van Clieaf recalls a client whose CEO was paid $8 million while the executives at the next level down were getting about $1.5 million each. When the consultant looked into the responsibilities of the CEO and the people under him, he discovered that the CEO was allowed to spend $75 million a year without board authorization, but his direct reports each had a limit of $3 million. "So maybe you'd conclude that the CEO was making all the decisions," Van Clieaf says. "And we found out that he was making all the key ones." The board realized from this discovery that none of the senior vice presidents it was considering as a future chief executive really had the experience or the ability to take on the top job.

But often senior VPs do include potential CEOs, and in their case huge pay disparities may send an unspoken message that the board has no interest in grooming them for the next step up. "If pay is a demonstration of value, a big gap suggests that the second-tier managers aren't as highly valued as the CEO," says Carol Bowie of ISS. What does that say about the company's succession pipeline? Come the day when the one-man band gets hit by the proverbial bus, the board will be forced to buy a new CEO rather than promote one, with all that implies for compensation costs. "The biggest megaphone a company has to communicate that someone is valued is the pay system," says Jeffrey Hyman, a consultant with Exequity who works out of Wilton, Connecticut. "If you as the No. 2 earn half of what the CEO earns, you would feel pretty good about where you are."

"THE BIGGEST MEGAPHONE TO COMMUNICATE THAT SOMEONE IS VALUED IS THE PAY SYSTEM. IF YOU AS THE NO. 2 EARN HALF OF WHAT THE CEO EARNS, YOU WOULD FEEL PRETTY GOOD."

Looking at the internal pay equity ratio forces directors to focus more on the team at the top, whether or not its members are in line for the CEO position. But pay equity also has to be examined within the context of the company's industry. Directors need to be aware of what competitors are paying, since a company can have a perfectly equitable system within its own ranks but still be under- or overpaying by the industry standard. Whole Foods found itself in the former camp. It raised its salary cap in 2006 from 14 times the company's average annual wage to today's 19 times to prevent key managers from being poached by other companies offering fatter pay.

Proponents of equity pay love to cite how DuPont got a handle on CEO comp in 1990—and how the CEO himself initiated the solution. The company has been living with this form of compensation since then-CEO Edgar S. Woolard decided that he would stop chasing surveys and limit his pay to 1.5 times what the company paid its executive vice presidents. Woolard chose this group because they ran DuPont's businesses and made the decisions on prices and new products, albeit with his guidance. Today DuPont keeps its CEO in the range of two to three times the average of all the company's executive officers, not just the top four mentioned in the proxy. "The reason why compensation committees should be interested in internal pay equity is to give them a second perspective on how to pay people—not just the market perspective," says consultant Frederic Cook. "It's a second data point."

It also reinforces the idea that there is a team at the top of the company—and that every team member is accountable to shareholders for how well the company fares.

Executi

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PEMs: The Magic Bullet?

Pay Equity Multipliers can help compensation planners see the bigger picture

By Mark Van Clieaf

Here's a perfect example of why Directors shouldn't accept traditional "comparative" pay data at face value:

The 2005 cash compensation for Johnson & Johnson's CEO was $4.5 million, compared with the $3.8 million Eli Lilly paid its CEO. If taken at face value, you might assume the Eli Lilly CEO role was underpaid, given that both are CEO positions at major pharmaceutical firms. But when you look beneath the surface and incorporate appropriate executive job analysis factors, you find the CEO role at J&J is over five times more complex than the CEO role at Eli Lilly.

When properly "job-matched" for the level of role complexity/added value and then calibrated to reflect a role five time less complex, the *true* comparable J&J compensation that Eli Lilly Directors should use would be $1.7 million rather than $3.8 million – more than a 100% difference.

See *PEMs*, p. 2

Are You Prepared for Change?

Caution: New regs may not ultimately have the desired effect

By Paul R. Dorf, Ph.D., APD

The annual review and analysis of corporate filings for public companies is in full swing. Almost invariably, this scrutiny brings with it an outcry concerning the exorbitant levels of executive compensation and the lack of a direct relationship between what some executives made and the financial performance of their companies. In addition to articles that highlight some of the more egregious excesses, there are investigative reports that identify illegal – or at best, highly questionable – activities. Given the propensity of the public and investors to recoil at the issue of excessive executive compensation, it's no wonder that these two groups have put considerable pressure on regulators to control and/or reduce executive pay in recent years.

Market-Driven

With recent regulations and structural changes as the baseline, this raises the question of what the future holds. In trying to answer this question, it's important to understand how compensation levels are set. Assuming that the underlying purpose is to enable an organization to recruit and hire the best talent to meet its business needs, it naturally follows that a

See *Change*, p. 10

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PEMs (continued from p. 1)

If Directors and their compensation consultants lack a meaningful process for job matching and compensation calibration, they could be making pay decisions with compensation data that's not truly comparable or legally defensible, and may be overstated by 50% to 100%.

'Felt Fair Pay'

The framework behind this calculation of truly comparable compensation is called Levels of Work, which also incorporates related research on organization design, differential pay and what are known as Pay Equity Multipliers (PEMs). Although our example concerns CEO roles at two competing firms, PEMs have just as much (if not more) value when used as an *internal* measurement tool for job design of truly differential work that justifies differential pay.

Pay Equity Multiplier analysis has identified excessive pay at the CEO management level, as well as excessive total enterprise compensation as a result of redundant management layers.

Over the last 25 years, starting with work that Elliott Jaques and a U.K. university organization called BIOSS initiated, more than a dozen research studies have investigated the relationship between differential pay, position in the corporate hierarchy and the time-span of discretion of a particular role. These studies involved over 1,000 participants – from CEO to manager levels in the U.S., Canada and the U.K. – concluding that the "felt fair pay" and differential compensation between the real work in organizations consistently differed by a multiple of two. In other words, the research identified that each work level should be worth two times more in total compensation than the level directly below it *if roles are designed properly and truly perform differential work*.

That last part is important, because not all companies get organization and differential work design right. In fact, a recent analysis we did for one client identified eight distinct levels of management with an average total compensation at each management level ranging from $52,500 to $3 million (*see chart on page 12*). For management levels four through eight, the PEMs between upward cascading management levels were all below 1.5, indicating possible lack of differential and value-adding work in the management hierarchy, and also that the company is probably over-layered – wasting shareholder capital through poor organization/compensation design. In this case the compensation costs of this over-layering and over-titling was contributing to *excessive enterprise compensation* estimated at over $55 million a year. But such a compensation analysis won't provide insights into how to effectively re-align the organizatioal structure and compensation design to create improved customer and shareholder value without an appropriate analysis of the "real work" — and to what extent it adds real and differential value at each management level.

The analysis also revealed an excessive gap (a PEM of over 3) between CEO compensation and that of second-tier management, and a further excessive gap (a PEM of over 7) between the CEO role and third tier management. So what should have been an evenly sloped downward curve depicting differential work and equitable total compensation at each level in the management hierarchy instead resembled a steep drop from the mountain peak of the CEO role followed by a flat prairie of lower-level redundant management layers.

Red Flags

This real world example is the worst of both worlds for shareholders, Boards and management, because the Pay Equity Multiplier analysis has identified excessive pay at the CEO management level, as well as excessive total enterprise compensation as a result of redundant management layers.

See PEMs, p. 3

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PEMs (continued from p. 2)

Why is this important? Because a recently-released Moody's Investor Service memo states that a CEO-to-direct-report Pay Equity Multiplier greater than 3.0 ("…when CEO pay is more than triple that of any other executive named in the proxy statement…") will be a red flag when it comes to evaluating how executive pay structure affects a company's creditworthiness and debt rating. Thus, poorly designed compensation structures will impact the firm's cost of capital. Moody's also says such disparities tend to indicate a weak Board and poor corporate governance.

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The research on felt fair pay backs up Moody's assessment of what constitutes equitable compensation, noting that a PEM of 4.0 between the CEO role and direct report roles *once removed* from the CEO (i.e., between the first tier and third tier of management) is felt fair pay for truly differential levels of work and decision authority. The CEO-to-third-management-tier Pay Equity Multiplier is a better analysis, because it's difficult to overpay the third tier of management and not disrupt the total pay structure of the company. An executive pay multiplier of *more than six times* across the top three levels of executive management should be a red flag for Directors and shareholders as it relates to excessive CEO compensation.

The core problem today is that too many Boards and compensation consultants fail to recognize the difference between *operational* work, measurement and pay and *strategic* work, measurement and pay. It's the more strategic work of creating growth, profit and return from new products, new markets and new business that defines the "differential work" that justifies the higher levels of strategic pay PEMs are intended to measure.

What we usually find, however, is that too many CEOs are being overpaid for doing primarily operational work, and this operational focus tends to create organizations with redundant layers of management and wasteful compensation practices.

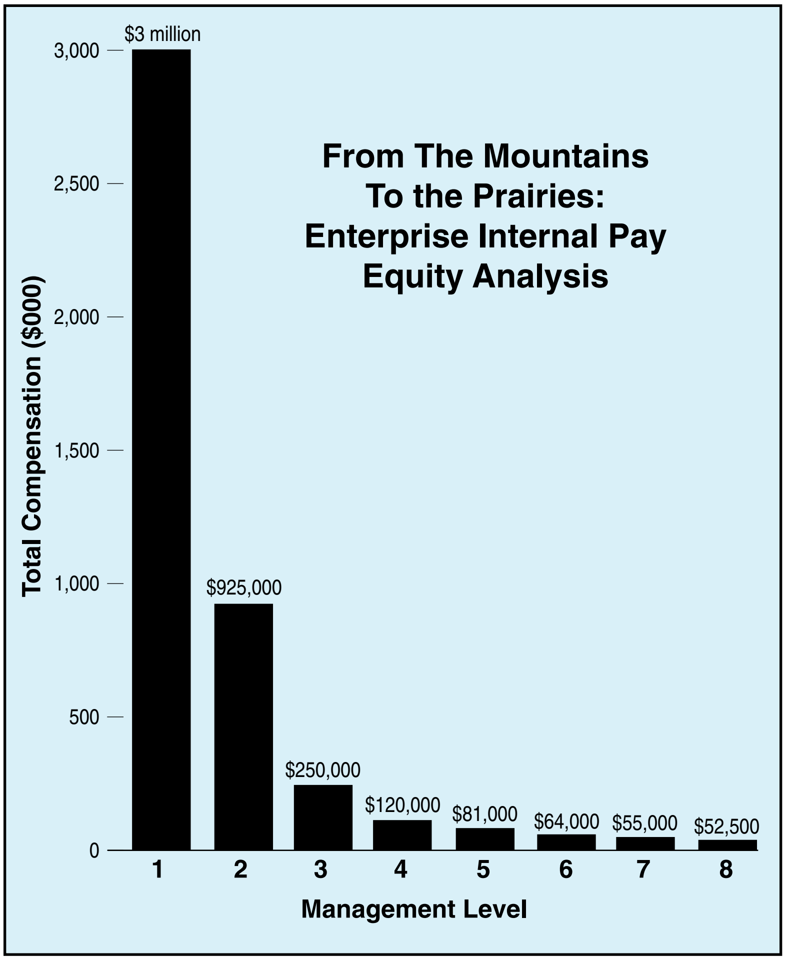
What To Do

Now that Moody's has included a CEO/internal pay multiplier analysis and internal pay equity on its list of criteria for debt rating and corporate governance, Boards and Compensation Committees should expect pressure from global institutional investors, money managers and the proxy voting community to change proxy voting guidelines to include internal executive pay equity analysis. Given this new scrutiny, Boards and Compensation Committees should:

- Conduct an enterprise-wide pay multiplier analysis that identifies, at each management level, average total compensation and the corresponding Pay Equity Multipliers.
- Take the average total direct compensation for direct reports once removed from the CEO role (roles reporting to the level of management who report directly to the CEO role) and multiply by four to get a fair and equitable PEM for the CEO role, then compare this internal pay equity target for the CEO role with current CEO compensation.
- Look for evidence in the PEM analysis of either excessive compensation at the Named Executive Officer level and/or possible excessive enterprise compensation resulting from over-layering in the lower management levels.
- If you find that CEO Pay Equity Multipliers are excessive, create a plan to further review and align management accountabilities relative to executive pay structures to make them equitable and defensible.

See PEMs, p. 12

PEMs (continued from p. 3)



- Design and approve strategic metrics and longer performance timeframes for Named Executive Officers that are linked to the company's innovation and growth strategies, aligning them with executive pay and the appropriate PEMs.
- Ensure that each management level is accountable for differential and value-adding work and not wasting compensation, using such executive job analysis factors as levels of innovation, levels of resource complexity and the planning horizon, rather than traditional factors like the size of business, budget or headcount.
- Realign and redesign enterprise-wide work and accountability structure so that each management level is accountable for differential work that creates differential value for customers/shareholders and justifies differential pay. ▮▮

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