HODAK
VALUE ADVISORS

Marc Hodak
Managing Director

September 15, 2009

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proxy Disclosure and Solicitation Enhancements, File No. S7-13-09

Dear Commissioners:

I am pleased to submit the response of Hodak Value Advisors in its capacity as an advisor to investors on management incentives. We review hundreds of proxies per year as part of our research and analysis of compensation practices and trends. The advice we offer to the investment community is based on our detailed analysis of the structure of incentive compensation plans based on public disclosures. Thus, our comments are offered from the perspective of a firm that uses proxy data for the express purpose of determining how executives are paid, and what it means for the shareholders.

The Owner of Disclosure

We are gratified that this proposal revisits perhaps the most misguided mandate in the 2006 disclosure rules affecting executive compensation, i.e., the rule requiring the CD&A to be filed by the company under Item 407(e)(5) of Regulation S-K. Two of the primary objectives of the 2006 disclosure rules, as with the current rules, were to improve the quality of the disclosure and to increase accountability for the board over executive compensation. Having the CD&A "filed" by the company rather than 'furnished" by the Compensation Committee defeats both of those purposes.

It remains an illogical requirement for management to be responsible for issuing a disclosure covering a responsibility of the board, i.e., oversight of executive compensation. Also, as I noted in my original response to this rule when it was proposed, nothing was more likely to defeat the hope of a "plain language" disclosure than the requirement that it be filed, which triggers potential liability associated with disclosure of "soliciting material." This guarantees that the verbal description would be a document written by lawyers instead of directors or their advisors. Needless to say, this prediction has been borne out. As the compensation tables have gotten all the press, providing numbers that the public could easily digest, the CD&A has become virtually unreadable to anyone except experts, and has been continually criticized by the commission for failing to conform to plain English. The commission might as well hope for unicorns to publish poetry than to expect a legal notice with implications for CEO and CFO certification requirements to be written in plain English. We need to revert to a furnished Compensation Committee Report.

General concern

While we very much agree with the intent of the proposed rules, we are skeptical that rules specifying summary total figures for current year results are actually benefitting shareholders. There are a couple of reasons for this. First, the board must make difficult trade-offs in deciding what to pay in any given year. The amount they offer will affect their odds of attracting or retaining the executives they most need. They must decide how best to align pay with performance in order to create positive incentives. They must induce their managers to accept the risk of uncertain, performance-based payouts with higher target compensation than they otherwise might offer. They must weigh attraction and alignment benefits against the need to keep overall compensation costs competitive.

Given the need to satisfy all of these objectives at once via a balance among their conflicting aims, disclosure ought to provide a sense for how the board achieved that balance. Unfortunately, disclosure rules as they have evolved and continue to evolve have distinct quantitative and qualitative sections. The quantitative sections show what was actually paid year-by-year. This part of the disclosure commands overwhelming attention. Almost nobody pays attention to the qualitative descriptions in the CD&A that are the only source of explanation for why those numbers look the way they do.

Disclosure is designed to impact behavior, and it does. As a result of the focus on current numbers rather than their explanations, the board is also focusing on the current figures, regardless of what the cumulative rewards might have been over a business cycle or over a manager's tenure, or any other inter-temporal relationship between pay and performance. The net effect has been to dramatically shrink the time horizon over which boards of directors evaluate the relationship between pay and performance to a single year. Given the nature of the scrutiny enabled by the current form of disclosure, they can hardly do anything else. Our research clearly indicates that a multi-year incentive plan creates more value-creating behavior than a single year incentive. Unfortunately, companies are migrating away from them.

Given the proliferation of 'long-term" incentive plans (LTIPs), it might seem that companies are adopting longer-term time horizons, but this is an illusion. To the extent that LTIPs are driven by the same metrics as the short-term plans, the LTIP simply reinforce short-term behavior. To the extent that LTIPs are based on different metrics, they dilute management's focus by the lack of a governing measure. These critiques are supported by research that shows that multiple incentive plans weaken incentives, not strengthen them. Thus, the newer disclosures, with their emphasis on quantitative results from the most recent year are pushing two bad trends—a greater focus on current year pay related to current year performance, and a proliferation of multiple incentive plans for any given employee, diluting their focus. We would judge each of the proposed rules against a standard of whether it is reinforcing this trend, or reversing it. Unfortunately, the proposed revisions to the compensation tables continue to confuse pay that is accrued versus realized, current vs. deferred, and guaranteed vs. conditional.

If shareholders were able to ignore the noise about raw levels of compensation, or even about current year pay versus current-year performance, if they could make fine distinctions regarding how well the board is achieving the overall balance between retention, alignment, and cost, then we could forgive the overwhelming attention by non-shareholders on raw dollar amounts, which necessarily seem excessive against the scale of the average earner. There are, of course, a large number of shareholders, especially in terms of votes, who care about how those critical trade-offs are being met regardless of the noise. But there are few shareholders willing to buck the media when it has found a target of its outrage. This can lead to "optics" overruling good governance.

Consider an incentive plan that does what it's supposed to: it offers managers a fixed share of actual profits each year, and it retains two thirds of those bonuses to be paid out in the next two years. In those succeeding years, profits decline slightly, justifying a partial claw-back of the banked amounts, but still allowing a payout of the remainder. How should this be disclosed? If the amounts actually paid are disclosed, then in the third year, management will appear to be paid decent bonuses for a profit decline, which would look bad. If the amounts are presented as fully being paid in the first year, then the total amount actually paid over time will be overstated. Anyone, of course, can read the narrative that explains a pattern that looks anomalous in any given year. But since no one actually reads those explanations, directors are defaulting to plans that are easy to explain in any given year by the numbers alone, even as they decry 'managing by numbers." Disclosures should leave room for a focus on multiple-year plans if that is what a company primarily uses to compensate its managers, but they don't have that freedom.

Final note

In 2006, then-Commissioner Campos' stated that given the new disclosures "the shareholders will have no one to blame but themselves if executive pay continues to rocket upward in a way they aren't comfortable with." I disagreed with that statement because I believed that executive compensation was and is driven far more by market forces than by a conspiracy of CEOs and their boards. Anything that makes the job more costly or risky will affect the shareholders. "Excess pay" over the one million dollar 162(m) limit might be good for the shareholders based on the necessary trade-offs made by the board, but taxing pay above that limit will be a tax on the shareholders, not management. CEO and CFO pay have, of course, continued to outpace everyone else's pay on a grant-date basis. Their pay will go up commensurate with the additional risks of their jobs, and the costs associated with those risks will be borne by the shareholders. The SEC should seek ways to enable better compensation decisions by the board rather than engage in indirect, and ultimately futile attempts to limit compensation of executives.

Sincerely,

Marc Hodak
Managing Director
Hodak Value Advisors

212-877-1297
mhodak@hodakvalue.com