FIXING THE GAME

HOW RUNAWAY EXPECTATIONS BROKE THE ECONOMY, AND HOW TO GET BACK TO REALITY

ROGER L. MARTIN

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Praise for *Fixing the Game*

"Roger Martin has written a book that is at once original, insightful, and inspirational. With his 'tell-it-as-it-is' bluntness, he chronicles the failures of modern day capitalism and offers clear and realistic policy recommendations for 'fixing the game' and building a better world for investors. If you enjoy wit and seek wisdom, this is the book for you."

—John C. Bogle
Founder and former chief of The Vanguard Group

"We've gone from an economy based on making things to one based on making things up, with Wall Street remodeled as a casino in which the expectations market, reflected in stock prices, has become more important than the real market in which real factories are built, real products are developed and sold, and real dollars show up on the bottom line. Roger Martin offers a riveting account of how the expectations game is beginning to destroy the real game, threatening the future of American capitalism. Through his brilliant analysis of the NFL (which will entrance even those who don't follow the market), he shows us how we can get back to the real game of building for the present and the future. *Fixing the Game* is a must-read for all who care about business being a positive agent for change in the world. And that should be all of us."

—Arianna Huffington
Co-founder and Editor-in-Chief, *The Huffington Post*

"*Fixing the Game* is an essential book, one that should be read by leaders in the business community and financial regulators worldwide. Martin identifies the insidious trap that can so easily seduce entrepreneurs and CEOs—the temptation to simply trade value rather than create it—and provides clear, compelling advice on how to keep focused on the real game—of creating and satisfying customers, running a business legally and ethically, and staying true to a well thought out 'real world' strategy."

—Nandan Nilekani

Chairman, Unique Identification Authority of India and former CEO, Infosys Technologies Limited

"*Fixing the Game* artfully links theory and practice, and reminds us that getting both right is important if we are going to fix capitalism. Roger Martin asks provocative questions about what constitutes good management, and forces the reader to consider the ways in which elegant logic or a compelling theory actually undermines commonsense business practice. And along the way he identifies changes—in regulation, business, and governance— that will realign private incentives with the public good."

—Judith Samuelson

Executive Director, Business and Society Program at the Aspen Institute

"*Fixing the Game* provocatively analyzes the fascinating intersection between seemingly disparate American institutions—the NFL and Wall Street. Martin brings together the worlds of finance and professional football in a richly compelling story of investors, game changers, and the best ways to fix broken markets. For football fans, business leaders, and policymakers alike, this cautionary tale shows how easy it is to game a sports contest or a market, and how the NFL's structure and policies started by legendary Commissioner Pete Rozelle can be the key to maximizing customer value and healing American capitalism."

—Paul Tagliabue
Commissioner of the NFL, 1989–2006

"At last, a gust of fresh air from one business school leader blowing away some of the intellectual smoke supporting compensation and market practices that have come to place American-style capitalism at risk. Roger Martin effectively punctures the illusion that executive stock options, speculative hedge funds, and the single-minded pursuit of stockholder value can build a strong, competitive economy."

—Paul Volcker
Former Chairman of the Federal Reserve

CONTENTS

ONE

FIXING A BROKEN GAME

We would accomplish many more things if we did not think of them as impossible.

—Vince Lombardi

When a financial bubble bursts, there's a run on scapegoats. With hundreds of billions of dollars in wealth wiped away in short order, it's natural to look for someone to blame. So, after each economy-shaking crash, the U.S. Congress goes after the evildoers with determination and vigor. In 1929, it targeted the brokers who fueled a speculative bubble with easy loans and abundant hype. In 2000, the villains were unscrupulous dot-com CEOs, peddlers of counterfeit value that never existed. And in 2008, it was executives at big investment banks, who created inscrutable derivatives from worthless mortgages.

In each case, Congress called the culprits to account at a series of acrimonious hearings, the purpose of which was to sniff out the reasons for the crash and to prevent a recurrence. Each time, once-cocky executives, now suitably humbled, faced the censure of Congress inside committee rooms and crushes of angry reporters outside them. In the aftermath, Congress worked to change regulations to ensure that future players could not engage in the kind of dangerously risky behavior that had led to each crash.

It happened after 1929, after 2000, and after 2008—and the aftershocks of the 2008 crash are still being felt. For a clearer view of the pattern, think back to the year 2002. The economy was reeling. The NASDAQ, which sat at 5,132 on March 10, 2000, had lost two-thirds of its value by the middle of 2001, and finally bottomed out at 1,114 in October 2002—80 percent off its high. The more stable and conservative Dow Jones Average, which had peaked at 11,723 on January 14, 2000, plummeted to 7,702 by July 2002.[1] Overall, the dot-com crash lopped an estimated $5 trillion of market capitalization from American companies.[2]

As the economy cratered and scores of new-economy companies declared bankruptcy, the search for scapegoats was on. It didn't take long to identify those charlatan senior executives and to vilify them en masse. But a few were singled out for particular blame: No one company symbolized the excesses of the dot-com era—and the disastrous effects of its end—like Enron. And so no executive faced the anger of Congress quite like Ken Lay.

A loquacious and charming character, Lay had been chairman of Enron Corporation for more than a decade and had become a central figure in its undoing. Under Lay's leadership, Enron had embraced all the opportunities of the much-hyped "paradigm shift" to the Internet era, transforming from a boring, old-economy energy company to a new-age, market-making, Web-enabled powerhouse. By 2000, Enron was racking up $101 billion in annual revenue and had a market capitalization of $66 billion. *Fortune* named it America's most innovative company six years running, and it was regularly selected as one of the country's best places to work.[3] But, by the end of 2001, it was all over. That December, Enron filed for Chapter 11 bankruptcy reorganization and was, for all intents and purposes, worth nothing.[4]

Billions of dollars of shareholder wealth had vanished. Thousands of laid-off employees held now worthless pensions. Yet Lay, his CEO Jeff Skilling, and his CFO Andrew Fastow had made away with hundreds of millions of dollars, thanks to stock options cashed in during the precrash heyday. How could it have happened? How had Enron's board of directors and auditor Arthur Andersen let things go so far wrong? Was it complicity or ineptitude? And, more important, was Enron an isolated case of criminals run amok, or was its failure reflective of much bigger issues? To answer these burning questions, Congress called a multitude of hearings to grill everyone involved.

So it was that on February 12, 2002, after numerous delays, Lay found himself sitting in the Senate Commerce Committee hearing room. Well aware of the mood of the country, the senators used their introductory remarks to rip into Lay, calling him "a confidence man" unworthy of the job of carnival barker. After ninety minutes, Lay was given the floor and promptly refused to answer any questions, invoking his Fifth Amendment rights against self-incrimination.[5] Subsequent testimony did little to calm public or congressional outrage, as members of the board and outside auditors claimed management had fooled them and even Enron whistle-blower Sherron Watkins testified that Lay was "a man of integrity" who had no idea what was going on in his own company.[6]

In the wake of the Enron hearings, the government determined that it needed to take bold and tough action to make sure that there would be no repeat of this kind of mess. The damning testimony suggested there were two particularly murky problems to be dealt with: oversight and executive compensation.

On the oversight front, Congress and regulators saw a raft of compromises and conflicts. In principle, a board of directors is elected by the shareholders to represent their interests and hold those running the company to account. Similarly, an auditor is retained to provide independent financial oversight. The Enron debacle had exposed serious cracks in this structure. Board members either didn't take their jobs seriously or were unhelpfully partial to management, allowing executives to enrich themselves to the detriment of the company. Auditors weren't sufficiently independent either; they made more money from consulting to the company than from auditing its financial statements, which meant that auditors too had very strong incentives to agree with management, even to the point of overlooking financial statement fraud.

Then there was the issue of executive compensation. Companies were increasingly providing incentives in the form of stock options, with the idea that managers would be motivated to perform well and improve the business, thereby increasing the value of their options. Because these options didn't need to be expensed by the company, they were essentially free to issue, making them a very attractive and widely used compensation alternative—especially in Silicon Valley, the epicenter of the tech bubble. But these options created a problem: they gave management a huge upside reward for improved company performance but no real downside punishment for weak performance. In other words, stock option rewards gave managers the incentive to take risky actions: if the risks worked out, the managers got rich; if they didn't, the managers were largely unaffected, regardless of the damage to the company. Even if the poor performance didn't reflect very well on their decisions, managers could always argue that trends outside of their control—irrational competitors, macroeconomic shifts, and so on—had caused the damage.

The consensus in Washington was that the dot-com crash was caused by lax and conflicted oversight and by problematic compensation schemes, both of which enabled those huckster CEOs to run amok. Given that diagnosis, a series of new regulations could be introduced to fix the problems.

To address the oversight issue, Congress passed the Sarbanes-Oxley Act on July 30, 2002. SOX, as it became known, had wide-reaching effects. It mandated greater independence of boards, particularly their audit committees. It forced companies and their auditors to engage in painstakingly thorough internal controls assessment and certification. It intimidated the auditing firms (except one) into divesting their consulting arms to rid themselves of inherent conflict. It required CEOs and CFOs of public companies to sign and take personal liability for the accuracy of their financial statements. Take that, Ken Lay!

Shortly after SOX became law, the Financial Accounting Standards Board (FASB) took aim at the rampant use of stock options as executive compensation. New rules mandated that stock option grants would now be expensed on company income statements, meaning they were no longer quite so "free." Meanwhile, compensation experts piled on, advocating a move from all-upside stock option incentives to *phantom stock* incentives (technically called *deferred share units* or *restricted share units*), which gave the recipient a cash amount equivalent to the price of the stock at a specified later time, typically at retirement. These instruments were seen to correct the problem with stock options, because the manager who received them would feel both the upside and downside, just like the investor. Finally, board governance experts began to encourage substantial stock ownership by independent board directors, so that the directors' interests would be more closely aligned with those of the shareholders. Companies promptly and wholeheartedly followed the advice of these experts, keen to avoid an Enron-like demise.

In the end, a whole series of regulatory changes were adopted to prevent a future crash. Scapegoats were trotted out before Congress, root causes were determined, and laws and corporate norms were changed to address those causes. The stock market crash of 2000–2002 had been the most precipitous since 1929, some seventy years before. With new regulations implemented to fix the oversight and compensation problems that had created the dot-com market bubble, the hope was that at least another seventy years would pass before another such disaster.

Sadly, it would be less than a decade. Not only that, the next stock market meltdown would be considerably worse than the 2000 version; the next crash would threaten to bring down the entire global financial system. This time, rather than a tech bubble, it was a mortgage bubble. This time, it wasn't just the erosion of a secondary market like NASDAQ; it was a meltdown in the broader index, with the S&P 500 down 40 percent in the second half of 2008 alone. This time, it didn't mark the disappearance of a bunch of new and relatively unknown firms like Freeinternet.com; rather, this time, venerable and prominent companies like Bear Stearns and Lehman Brothers were wiped away. In fact, some of the largest firms in the world, such as Citibank, AIG, and Bank of America, would have disappeared in 2008 if not for massive government bailouts. This time, the U.S. economy needed massive infusion of spending to recover, even as it led the world into a deep recession.

ASKING THE RIGHT QUESTION

In the wake of such a spectacular crash, less than a decade after the last, one might have expected that observers would ask, What did we do wrong the last time? Why didn't our fixes, put in place to prevent another devastating crash, do what they were intended to do? How, with all of those independent and motivated directors, empowered and unconflicted auditors, and massive control procedure certifications, did this mess manage to happen again? Why didn't the CEO sign-offs and beautifully aligned incentive compensation structures work to prevent undue risk-taking and malfeasance on the part of financial executives? Is it possible that our changes addressed symptoms, rather than root causes? One might have expected that we would ask these hard questions. Yet we really haven't.

We haven't looked deeper into blameworthy CEO behavior to understand what *really* caused it. We haven't examined the broader theories that underpin our economy and that informed all of those ineffective fixes after the last crash. Instead, we've looked for a new scapegoat, chosen to operate from the same fundamental theories, and doubled down on the same fixes. We've said, "Darn it; we didn't clamp down hard enough on these companies. They took risks they simply should not have taken. Clearly, they still have oversight problems and compensation problems. Regulations are too loose and it is time to clamp down even harder."

Consequently, following the 2008 crash, more new regulations and norms have been (and will be) introduced to improve oversight and manage executive compensation with the aim of preventing a future crash. And few of these efforts will help. In fact, coming down harder on the financial services sector by increasing capital adequacy ratios, imposing a clearer regulatory oversight structure, and so on won't decrease the chance of yet another market meltdown in any meaningful way. It's true that the next crash won't be caused by irrational exuberance over new-economy stocks or by the securitization of subprime mortgages; we've fixed those particular triggers for now. But as long as we fail to understand the real, fundamental reasons behind those crashes, and the bubbles that preceded them, it is only a matter of time until we will have the next crisis.

The only way we can avoid increasingly frequent stock market meltdowns—and all the pain, suffering, and economic dislocation they cause—is to explore the theories that underpin American capitalism. Our theories about the fundamental goal of corporations and the optimal structure of executive compensation are fatally flawed and have created stock market upheavals. Acting on these theories, we have built structures into our capital markets system that threaten the future of American capitalism.

THE ORIGINS OF OUR CURRENT THEORY

In 1976, finance professor Michael Jensen and Dean William Meckling of the Simon School of Business at the University of Rochester published a seemingly