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Five Ways to Heal American Capitalism

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by Roger Martin

Three things have to happen in concert to heal the ailing American democratic capitalist system:

1. **Senior executives** have to be helped out of a conflicted state in which they know they are living inauthentic business lives but are both too scared of the capital markets and too addicted to stock-based compensation to change by themselves.
2. **Boards of directors** who have drunk the Kool-Aid of stock-based compensation need to be saved from their own delusions about its effectiveness.
3. **The hedge funds** who have become so emboldened that they now hunt in predatory packs, destroying companies in order to reap arbitrage profits, need a serious smack-down.

These changes will require government intervention, not my favorite approach, but sometimes the only way.

Let's start with senior executives. As things stand, they're expected to predict the future, which they can't do, and are punished by the capital markets when they are wrong. This causes most of them to manipulate earnings to make themselves right, which is hardly conducive to psychological health as I've argued before.

Hence **Prescription #1: Repeal the 'Safe Harbor' provision of the Private Securities Litigation Reform Act of 1995**. There should be no safe harbor whatsoever for "anticipating," "projecting," "expecting," "estimating" or any of the other "forward-looking" weasel-words used by senior executives when "predicting" earnings. This will encourage senior executives to break the habit of giving guidance and, by extension, of manipulating numbers to hit their guidance numbers. They can get back to the psychologically rewarding business of actually creating value.

Now boards. They think that stock-based compensation aligns the interests of executives and shareholders. It doesn't. It aligns the interests of senior executives with their own bank accounts for reasons I have detailed elsewhere.

Boards aren't going to challenge their own dogma, especially when they are being egged on by the compensation consultants. And like the executives with respect to guidance, boards are too scared to break rank and shift from creating incentives to boost expectations to creating incentives to boost real performance. Hence **Prescription #2: Tax at a rate of 80% gains from stock-based compensation that are based on stock performance less than five years from the time of the awarding of the stock-based compensation**.

Stock-based compensation is a crummy idea. But it gets less crummy as the period lengthens over which the performance needs to occur. Doing the work necessary to have a chance of the stock price being high five years from award at least gives long-term thinking a fighting chance. Pushing realization of stock-based compensation to beyond time of retirement is even better because retired executives can't manipulate prices. It encourages strong succession planning because your pay-off is dependent on your successor doing a good job. Hence **Prescription #3: Tax at a rate of 20% gains from stock-based compensation that are based on stock performance five years or greater from the time of departure from the company in question**.

Let's turn to hedge funds and other market operators who earn their returns by arbitraging short-term market swings. They engage in manipulation too; if there aren't enough short-term market swings to generate the returns they're used to, they will do whatever is necessary, regardless of legal strictures, to manufacture short-term swings. Here, we need to attack on two fronts.

First we have to neutralize their profit equation. Hence **Prescription #4: On stock holdings of less than one year, increase the capital gains tax to 80% and reduce the portion of losses allowable for tax purposes to 20%**. And because these guys are as sneaky as foxes, declare trading strategies that attempt to circumvent this tax to be criminal tax evasion — otherwise hedge funds will swap with non-taxable investors (like charitable foundations) to produce synthetic holding periods of over one year. To neuter criticism that this will hurt small investors, create a life-time $1 million exemption for short-term capital gains and losses for individuals. Individual investors don't screw up companies; hedge funds do.

Second, we need to dramatically reduce the source of funds to hedge fund managers by dealing with their biggest supplier of capital: pension funds. Pension fund managers accept the ridiculous '2 & 20' fee structure that hedge funds charge (2% annually of assets under management, plus 20% of the upside) because pension fund managers love the treats that hedge fund managers provide: junkets and "conferences" in exotic locales, and even the payoffs from agents working for the hedge funds, as allegedly happened in the Quadrangle Group affair.

Pension funds are the soft underbelly of democratic capitalism. Peter Drucker predicted decades ago that American workers would eventually own the means of production not through a communist-style revolution but when their pension funds came to own the biggest piece of American companies.

But the vast majority of US pension fund dollars are not invested under anything approximating capitalist conditions. As a worker in a given organization, you are typically forced to have your pension managed by a single designated fund. And the rule with all monopolists is that in due course they begin to serve themselves. Hence **Prescription #5: Every worker must have a choice of at least two pension fund managers**. That will give the worker choice and power —and will discipline the behavior of pension fund managers.

If these five prescriptions were implemented — which could be relatively straight-forward — we would give companies and their senior executives the chance and the incentive to focus on building great companies over the long term rather than subjugating themselves and their companies to the traders. This would restore authenticity to the lives of our corporate leaders.

There is a sixth prescription. It is trickier to implement but it would build very productively on the five above. I will leave that one for the next post...

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