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The Problem with Corporate Governance

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March 23, 2003 Draft

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The Problem with Corporate Governance

With surprising speed, corporate governance has risen from an obscure, arcane topic to a critical issue at the center of public policy debates. It was the central focus of the 2003 World Economic Forum, the target of the US Sarbanes-Oxley legislation, the subject of the UK Higgs Report and the favorite theme for conferences around the world, including the 2003 International Academy of Management Conference in Barcelona.

The great crashes of Enron, WorldCom, Tyco International, Global Crossing and a host of dot-bombs has shed light on the heretofore hidden inadequacies in the prevailing corporate governance systems. As the onion of corporate governance gets pealed, few find the deeper layers to be reassuring; rather they are cause for deeper concern.

I argue that the governance of public corporations is indeed fundamentally flawed and that independent directors are unable to protect the interests of outside shareholders due to the structure of incentives and capabilities among the actors in the three critical markets – the real market of firms, the expectations market for equities of publicly-traded firms, and the governance market of boards and auditors. I further argue that changes in the incentives governing these various actors have made the challenges to governance ever greater and that we indeed has a crisis of governance and trust that will not go away easily.

In order to improve the quality of governance, we will need to significantly alter the structure of incentives – monetary and non-monetary – and capabilities across the governance system for publicly-traded companies.

Context and Structure of the Governance Problem

There is little evidence of increasing difficulties in the governance of privately-held firms. Undoubtedly private firm governance is imperfect, but there is no sense of it being a problem. The governance problems of the day occur almost exclusively in the context of the publicly-traded firms, in particular, the widely-held publicly-traded firms. It is in widely-held, publicly-traded firms that we see boards struggling with the task at hand.

This struggle is unsurprising. For public firms, the governance challenge is created by the tension between two very different markets with very different actors. Boards are put in the position of spanning a gap that is too wide and is widening further because of changes in incentive structures.

The first is the Real Market; the market of the real operations of the firm. It is measured in terms of revenues, costs, investments, profits, losses and return on equity. The principal actors in this market are employees, customers, suppliers, competitors and regulators. The employees bifurcate into two categories, owner-managers who own an equity stake in the firm and non-owners who own no stake.

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In the Real Market, the object is cash-flow generation; that is, to generate long-term cash flow that is in excess of the cost of the capital used to invest in generating that cash flow. The greater the long-term cash-flow relative to investment, the better it is for the owners of the firm.

The second market is the Expectations Market; the public stock market in which the price of a firm's stock, and thereby its overall market value, fluctuates continuously based on expectations about the future. It is in this respect that the Expectations Market contrasts with the Real Market. The Real Market involves observable, measurable things. A sale can be observed and measured without great conflict or controversy. Similarly, a cost or investment can be observed and measured. But in the Expectations Market, prices are a function of predictions about what will happen in the Real Market in the future. These predictions are ethereal. No one can verify whether those predictions are accurate or inaccurate until time passes.

In the Expectations Market, the important measures include price/earnings ratio, price/cash-flow ratio, dividend yield, beta, and total shareholder return. Importantly, in the Expectations Market higher expectations for the future mean a higher P/E and rising expectations mean rising share price and P/E. Equally importantly, current data from the Real Market are only important to the Expectations Market as they relate to the shaping of future expectations.

The key actors in the Expectations Market are: shareholders, both owner-managers, who work for the firm as either employees or directors, and outside shareholders, who simply own stock; stock underwriters; equity analysts; and investment advisors, both institutional money managers and individual stock brokers. The object in this market is increase in shareholder value for the shareholders, both inside and outside.

Lying in between these two markets is the Governance Market. The principal actors in this market are boards of directors, which are comprised of owners-managers, sometimes major or even controlling shareholders, and independent directors. The supporting actors are professionals who work for boards, the most important of which are the auditors. The job of boards and their helpers is to govern operations in the Real Market to the benefit of actors in the Expectations Market. Boards attempt to do so by ensuring that employees in the Real Market have accountability for the decisions over which they have rights and that shareholders in the Expectations Market have transparent visibility into the operations in the Real Market.

In this respect, the Governance Market provides an important link between the two markets. In summary, the three markets can be characterized in the following way with the key actors to be discussed in detail in bold:

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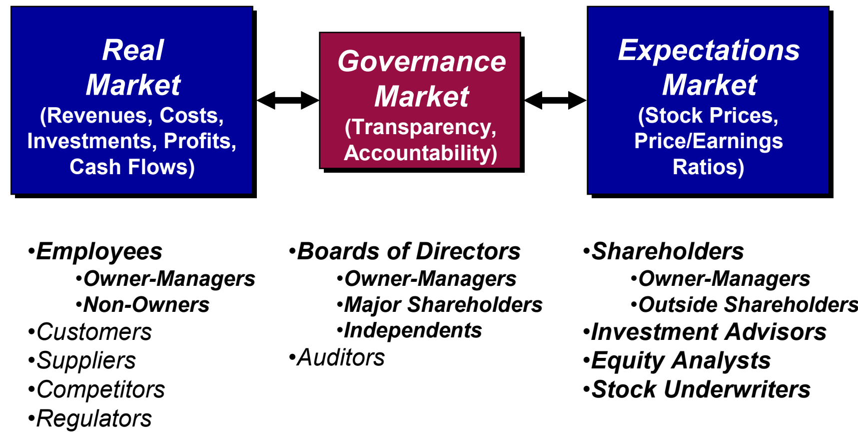
The Structure of Governance



Diagnosis of the Governance Problem

Due to the incentives of the various actors across the three markets, the independent directors have the primary responsibility for protecting the interests of the outside shareholders. The fundamental governance problem is that the independent directors simply don't have the capabilities necessary to do the job given what they are up against. When the outside shareholders of Enron needed the independent directors to stop the massive self-dealing by senior management and alert then to the massive mismatch between the Expectations Market and the Real Market (which was being ruthlessly exploited by Enron owner-managers), the independent directors were incapable. When the outside shareholders of Qwest Communications needed the independent directors to alert them to the fact that thirteen insiders were exploiting the mismatch between the Expectations Market and the Real Market by unloading $2 billion in stock before Qwest fell from $82 billion in market capitalization to $6 billion, they were unable or unwilling to help.

These massive public crashes and failures of governance represent but the tip of the iceberg. There are fundamental structural problems that are if anything worsening, not improving. To understand the dilemma of the independent directors, we need to analyze the incentives and capabilities of the key actors across the three markets – Real, Expectations and Governance.

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Incentives

In order to analyze the incentives, we need to begin with the premise that every actor across the three markets will seek to maximize his or her own personal welfare, which will be defined by a combination of both financial and non-financial benefits. Financial benefits would be calculated as the maximum net present value of compensation – calculated at the actor's own discount rate– flowing from the work of the actor.

Non-financial benefits are trickier to define and measure. However, I will define non-financial benefits in terms of their contribution to subjective well-being – or in layman's terms, happiness. The literature on the subject suggests that subjective well-being increases as the individual in question feels to be:

i) a respected member of a community
ii) that the individual respects, and
iii) is respected by others.

That is to say, a first violinist for a symphony would be happy if he (or she) felt he (or she) was respected by the members of the symphony –i.e. the community that is most central and important to him (or her) – and he (or she) respected the symphony and the symphony was highly respected in the broader world.

Community culture therefore becomes an important determinant of non-monetary incentives. For example, if integrity is a cultural value that is highly important to the community, then if a member of the community acts with integrity this will garner the individual respect from the community and contribute to his or her subjective well-being. In this respect, the community in fact provides a non-financial incentive for integrity. If, on the other hand, the culture of the community does not hold integrity to be important, then the community will not provide a non-financial incentive for integrity.

So respect for self and the community of which one is a member are the key non-financial incentives at play in the three markets in question. Interestingly, if becoming rich earns one respect in one's community and one respects the community in question, then financial incentives are in fact simultaneously financial and non-financial incentives. If being rich is an anathema to the community, then financial and non-financial incentives can cancel each other out.

Capabilities

The key feature of capabilities is the knowledge an actor has to apply to the decisions over which the actor has jurisdiction. In this respect, we can divide knowledge into specific knowledge –knowledge specific to the decision at hand that is difficult and/or expensive to transfer from those experienced in making the decision– and general knowledge –knowledge that is easy and/or inexpensive to transfer from actor to actor.

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Examples of specific knowledge would include an expert salesman's knowledge of what it takes to sell a customer or a CFO's knowledge of how the market will react to a new issue of the firm's equity. This knowledge is a product of long experience that enables the individual to reach an expert interpretation of the situation. Such knowledge is difficult to transfer to a central database or to a less experienced individual. Examples of general knowledge would include last month's sales or the cost of production of an incremental unit of volume. Each of these is relatively easy to incorporate into a corporate database and be shared around the entire firm.

The existence of specific knowledge creates problems of personal agency. An individual in possession of specific knowledge will use that knowledge to make decisions that maximize their personal welfare. For example, if only the salesman knows how long it actually takes to make an average sales call and the salesman wants to make no more than four per day because he values his time on the golf course, he will be inclined to tell his superior that it takes two hours per sales call even if it really only takes one hour.

If, as in the case above, the maximization of personal welfare conflicts with the maximization of the welfare of the firm, then a principal-agent problem arises. That is, the owners of the firm –its principals– have a challenge in getting their agent –the employee with the responsibilities and the specific knowledge– to make decisions and take actions that are consistent with the owners' welfare.

This creates a link between capabilities and incentives. The challenge for the principals of a firm is to design an incentive system that encourages agents in possession of specific knowledge to make decisions that produce welfare for the firm. Those incentives can be monetary and non-monetary. The employee can be paid profit-sharing to encourage him or her to produce profits for the firm. Alternatively, the employee can be made to feel a part of a community working towards a common goal to encourage him or her to behave in a fashion that is consistent with gaining the respect of the community. Optimally, the firm can pursue a combination of the above.

With this background on incentives and capabilities, let's look at the key actors across the three markets to deduce the governance challenges produced by the pattern of incentives and capabilities.

Analysis of the Actors across the Three Markets

Non-owner Employees

The non-owner employee will maximize personal welfare, which will be defined by a unique combination of financial compensation and subjective well-being. The specific mix will be a function of the interests of the individual, the cultural environment of the firm and the other important communities of which the individual is a part.

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The community of the firm is an important and influential community. If the culture of the firm is highly shareholder value driven, this will send a message to all employees that maximization of monetary rewards is the critical goal of the corporation. This in turn will encourage employees to weight monetary compensation higher in their own mix, or alternatively to seek community cultural respect on the basis of earning high compensation. Since the average non-owner employee has plenty of potential capability to influence their own financial compensation due to their specific knowledge, the firm has a control problem in aligning the employee's interests with its interests since its interest is in shareholder value maximization and the employee's interest is in personal compensation maximization.

If instead the firm has a culture that values contribution to the community and to the welfare of customers, then this is more likely to create an internal culture for employees that values and respects them for their contribution to the community of the firm. In this case, being a team player in the internal community and working to make sure that the firm is able to help its wider community will be the sources of subjective well-being, through respect by the community of the firm.

In addition, it will be easier for the employee to respect the firm –which contributes to subjective well-being– if it has a culture featuring more meaningful goals such as helping customers and the communities instead of the highly abstract goal of maximizing value for faceless, nameless shareholders.

In addition to being abstract, the goal of increasing shareholder value is not really in the hands of employees in any event because employees work in the Real Market. Shareholder value increases only if actors in the Expectations Market decide that expectations have risen, pushing up share prices and increasing the value of shareholders of record at the time of the rise in expectations. Of course, new shareholders won't benefit from the rise because they bought at the higher price which already reflected the higher expectations.

Over the past twenty years, there has been a dramatic shift in the definition of firm missions toward the explicit goal of shareholder value maximization. Shareholder value maximization now routinely shows up in mission statements and in CEO press conferences. The highest goal of the firm and its employees has been to improve performance in a market –the Expectations Market– over which the firm and its employees have **no control**. I would argue that this shift has had the effect of convincing non-owner executives and other employees to increase the importance and weighting of financial compensation in their mix of personal welfare because non-monetary culturally-driven benefits have been driven out. The community of the firm has become a community that reserves the majority of respect for shareholder value – value that is created in the Expectations Market, entirely outside their own Real Market.

This in turn creates a bigger principal-agent problem for the firm because it increases the incentive of employees to maximize their own monetary compensation, whether or not doing so actually contributes to shareholder value.

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Having exacerbated the principal-agent problem by discouraging the development of a more valuable culture, the firm then needs to counteract the problem it has created. The most standard approach to the problem is to attempt to align the incentives of the employee and shareholders by way of stock-based compensation. This migrates non-owner employees into a second category – owner-managers.

Owner-Managers

Owner-managers have a foot in both the Real Market and the Expectations Market. In fact, they can have a foot in the third market, the Governance Market, if they are an inside member of the board of directors as well. Owner-managers can have a huge stake in the Expectations Market, like founders such as Bill Gates (Microsoft), Larry Ellison (Oracle), or large stakes, such as highly compensated executives like Dennis Koslowski (Tyco International) or Kenneth Lay (Enron), or small stakes like many, many mid-level executives and rank-and-file employees.

The addition of stock-based compensation alters the incentives of the manager toward the Expectations Market in proportion to the magnitude of the stock-based compensation. In order for the stock-based compensation to pay off for the owner-manager, expectations in the Expectations Market must rise. That is the only way owner-managers will gain from their stock-based compensation.

If owner-managers are in a position by which they can't actually influence expectations –for example they are relatively low in the corporate hierarchy– they will maximize personal welfare subject to not doing anything to hurt expectations. If owner-managers are indeed in a position to influence expectations –the CEO for example –they will maximize influence on expectations subject to not hurting other aspects of personal welfare. So a CEO will be reluctant to give up his or her corporate jet because that would hurt personal convenience, unless of course giving it up will increase expectations enough to overcome the cost of inconvenience.

The stronger the shareholder-value culture of the firm, the greater will be the incentive for the owner-manager to attempt to influence expectations, even to the extent of manipulating expectations to be out of line with the Real Market. This is because no community respect will be lost by aggressively promoting expectations, even if it is by way of aggressive accounting or short term actions that may hurt the firm long term. And community respect, a non-monetary incentive, will actually increase with rises in the Expectations Market. During the huge run-ups in the stock prices of Enron and Tyco, while Kenneth Lay and Dennis Koslowski received huge monetary benefits of increased value in there stock ownership positions; they were receiving huge non-monetary benefits from their communities as well. They became toasts of their respective communities, object of flattering magazine cover stories, keynote speakers at major conferences, and, in the case of Lay, sought after political advisors – that is, they became highly respected members of a community that they respected and were widely respected by others outside the community.

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To the extent that stock-based compensation indeed creates an incentive – and if it doesn't then it is useless and shouldn't have been used as a tool in the first place – the greatest incentive is to raise expectations in excess of reality and then cash out of the stock-based compensation either overtly by selling as an insider or covertly by securitizing the stock position through use of derivatives. And owner-managers, especially senior ones, have a huge specific knowledge advantage over independent board members and outside shareholders. Owner-managers will have, by a significant margin, the best understanding of how expectations relate to reality.

As owner-managers increase their share ownership, we should fully expect the independent board members and outside shareholders to be kept ever more in the dark about the relation of expectations to reality because that is the most precious form of specific knowledge. Having such knowledge enables the ceaseless arbitraging of the two markets and even worse, the building of arbitrage opportunities between the two markets. Stock-based compensation creates the incentive for owner-managers to manipulate the Expectations Market in order to create an arbitrage opportunity for which they are best positioned to take advantage.

Owner-Manager Directors

As mentioned earlier, when owner-managers –typically senior executives like the CEO and CFO– are placed on the board of directors, they become actors in each of the Real, Expectations and Governance markets. Though it is exceedingly common to have at least one owner-manager director on every board, inside directors are a danger in Governance Market, especially to the extent that they have meaningful stock-based compensation.

This is because they have a difficult self-control problem. They have a powerful incentive to promote the raising of expectations, whether or not it is in service of long-term performance in the Real Market, and to create a gap between expectations and reality and exploit that gap. They may attempt to show self-control and not act in accordance with their incentives. However, they have to fight against incentives that were put in place for a reason – to encourage them to increase expectations. As such, they are not at all well-positioned to protect the interests of the outside shareholders.

They are particularly ill-positioned to protect the outside shareholders to the extent that the culture on the board and in the firm is to pursue shareholder value maximization. In that case, the non-monetary incentive is actually oriented to increasing shareholder value regardless of its impact on the firm.

Certainly inside directors can show self-control. If they are rich enough, like a Bill Gates, or inherently interested in the Real Market more than the Expectations Market, they can ignore opportunities to benefit themselves at the expense of the outside shareholders.

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To summarize the analysis of the actors to this point, the rise in focus on shareholder value increase as the central mission of the firm has driven employees to place greater value on personal monetary rewards rather than on community respect or other non-monetary rewards. As a result, firms face an increased intensity of principal-agent problems from employees seeking to maximize personal monetary rewards. The most common response for firms is to fight the principal-agent problem by broadening application of and increasing magnitude of the stock-based compensation of employees thus turning employees into significant owner-managers.

In turn, this creates the incentive for these now owner-managers to pay more attention to increasing expectations in the Expectation Market than to increasing performance in the Real Market. In addition, it provides a temptation to the owner-managers to use their specific knowledge to create a schism between the Real Market and the Expectation Market and benefit from the arbitrage opportunity at the expense of the outside shareholders.

Finally, the most senior of the owner-managers, and the ones with the greatest both level of specific knowledge and ability to influence the Expectations and Real Markets, tend to be placed on boards as insiders and their presence makes the board’s job of protecting the outside shareholders more difficult. The only prophylactic is a culture in the firm that reins in the desire on the part of owner-managers and inside directors to create and exploit arbitrage opportunities between the Real Market and the Expectations market.

Outside Shareholders

At first blush, the incentive structure for the outside shareholders seems the simplest. They play only in the Expectations Market and their only desire is to have expectations rise after purchasing the stock. Essentially nothing else matters. Activities in the Real Market matter only to the extent that they produce a rise in expectations after the point at which the outside shareholder purchased shares.

However, this actor has gotten much more complicated with the rise of deep and broad derivatives markets with a wide variety of derivative products. Now there are two kinds of outside shareholders. The first is the traditional kind which we can call long shareholders –owners of the underlying stock or a call option–, who hope for and have a direct economic interest in rising expectations. The second is a relatively new kind, the short shareholders –owners of put options– who hope for and have a direct economic interest in falling expectations.

Both long and short shareholders are interested in one thing above all else – change in expectations. Neither makes any return on their investment under the status quo of expectations, so stable expectations are very bad for both long and short shareholders. Instead, they are highly sensitive to changes in expectations and will sell or buy based on these changes. Neither is inherently a shareholder for the long haul and is certainly under no obligation to be a shareholder (either long or short) for the long haul.

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So rather than the outside shareholders having a historical exclusive bias toward the rising expectations, they now have mixed view and wish simply for changes in expectations because it is only with changes in expectations that outside shareholders make a profit.

Short sellers have a great interest in seeing expectations for stocks they don't own currently rise above what is justifiable in the Real Market because that creates a short-selling opportunity for them. In fact, they have an incentive to induce a fall in expectations in order to cover their short positions at a lower cost.

Potential long shareholders look for expectations currently below what is justifiable in the Real Market because that creates a buying opportunity for them. They have an incentive to induce a rise in expectations after they purchase the stock.

However, the outside shareholders have limited capabilities. Regardless of how much they invest in research and analysis, they possess dramatically less specific information about the relation between the Real Market and the Expectations Market than managers, owner-managers or inside directors.

As such, they are in most need of protection from the inside directors from the thing they fear most, which is to be taken advantage of by owner-managers and/or inside directors taking advantage of specific knowledge to earn a return at their expense.

Investment Advisors

Investment advisors, which include institutional money managers and personal stock brokers, give advice primarily to outside shareholders on their purchase and sale decisions – for the most part, insiders don't need their advice.

The primary incentive facing most investment advisors is to acquire and keep clients. The dominant compensation structure for investment advisors is either a fixed percentage of assets under management or a commission on activity. As such, their incentive is to acquire as many clients as possible and keep them for as long as possible.

Some investment advisors are compensated on the basis of the level of returns they produce. In such cases, investment advisors become the moral equivalent of outside shareholders with the only distinction being that they share the upside with their client rather than keep the whole upside.

And how do investment advisors acquire and keep their clients? They do so by convincing clients that their advice will increase the clients' returns on the Expectations Market over the level clients could achieve themselves or with an alternative advisor.

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With respect to capabilities, it is important to note that thanks to the leveraging opportunities provided by the derivatives markets, any investment advisor who can predict changes in expectations and be right a mere 51% of the time can become a billionaire in relatively short order investing on their own behalf. A small proportion of investment advisors do indeed invest on their own behalf and simply leverage their investing expertise by bringing advisee clients along with them in their portfolio. These investment advisors take on the characteristics of outside shareholders as discussed earlier.

For the vast majority of investment advisors, we can say that they are investment advisors rather than investors because they realize that they do not have better than a random capability to predict changes in the Expectations Market. As a result, they have the incentive to offer their advice to clients in a way that will prevent the client from accurately assessing the value of the advice – because if rigorously assessed, it will be found to have minimal value.

Making their advice assessment-proof is no easy matter. One important method is to select benchmarks for comparison that have the effect of ex post justifying whatever level of returns the investment advisor produced. A second method is to explain away short-term return problems as short-term negative fluctuations in an otherwise positive long-term picture.

Disguising performance is helped, in general, by fluctuations in the Expectations Market. If expectations don't change then it is hard to disguise the results of advice taken by clients. However, if expectations as to the recommended and shunned equities fluctuate considerably, it is easier to find benchmarks and measurement time periods that disguise the true value of the advice.

Their clients, the outside shareholders, are in a pretty unenviable position. They receive and pay for obscure advice that they can't audit from a supplier with a handicap in specific knowledge. Both advisors and clients favor fluctuations in expectations, but for different reasons. For clients, fluctuations in expectations produce the only environment in which to earn an attractive return. For advisors, fluctuations in expectations provide cover for the shortcomings in their specific knowledge.

Equity Analysts

A similar line of reasoning applies to the equity analysts. If they were actually right only 51% of the time, they would be investing on their own account making billions and not spending their time giving advice. Hence they have the same motivation to provide their analytical advice in a way that makes it difficult for clients to judge its value. Arguably, equity analysts are legendary for providing their advice in ways that make it terrifically hard to audit. They proliferate descriptors for their assessment (e.g. strong buy, defensive hold, sector overweight, etc.) and are often seen to "clarify" the meaning of their recommendations ex post.

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However, unlike the investment advisors, their advice is very public and has the effect of shaping expectations. Arguably, the ability to cause expectations to vacillate can help the equity analysts obscure the veracity or lack thereof of their advice. At best, their advice has a random impact on the Expectations Market. More likely, their advice helps produce greater schisms between the Expectations Market and the Real Market that in turn create opportunities for those with specific knowledge to exploit.

The historical incentive structure for analysts was to produce movements in expectations and hence in stock prices. The method of payment tended to be more obscure than for investment advisors. Typically investing firms who valued the product of analysts would "allocate commissions" to the firm of the analyst. The analyst's firm would then earn a profit on the trading commissions so allocated. The only analytical advice that was valuable to clients was an assessment that the current expectations were wrong because only such advice would generate a trade and therefore commission dollars. An assessment that the expectations were too high would produce a sale of the client's current holding or the decision to short the stock. An assessment that the expectations were too high would produce an increase in the client's current holding. In this way, analysts had a strong incentive to produce up and down movements in the prices of stocks.

In recent times, the prevailing incentive structure facing analysts in the large underwriting firms created a significant and problematic bias in the advice provided by a number of analysts. In the wake of deregulation of commissions in the US in 1975 (and followed in due course on major exchanges around the world), the profitability of research analysis fell dramatically as the allocated commission dollars became nearly worthless because of the low prices attached to those dollars. For example, on the NYSE, institutional commissions fell quickly to less than 10% of their pre-deregulation levels.

However, stock underwriting has continued to this day to be a highly attractive business for the investment banks and equity analysts, especially during the technology boom, used their moral authority as "experts" to create high and rising expectations for technology stocks in order to secure fees for the underwriting and mergers and acquisitions departments of their investment banking firms. And they did so, it is widely alleged, because they received attractive compensation from the profits of the associated underwriting.

It is widely understood that the cultural norms in these investment banking firms did nothing to assist the analysts in showing self-control in issuing their opinions. Rather the cultural norm of high income being associated with respect in the firm community reinforced the giving of biased advice.

While the legal clampdown on this unrealistic hyping of stocks may end this behaviour by analysts, there is still a very real concern that a mirror of the over-hyping is now taking place by which some analysts work in concert with short-sellers to generate sharp drops in expectations from which the short-sellers prosper.

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So the equity analysts join the investment advisors and the outside shareholders in having the desire to see expectations vacillate. In the case of the analysts, it began with random vacillation and in recent years has taken the form of purposeful directional moves for some analysts who received specific compensation for generating the desired move in expectations.

In terms of capabilities, the analysts have been assisted in pursuing the objects of these incentives by three things. First is the moral authority of their position as experts, ironically despite having no demonstrable ability to accomplish the very task they purported to accomplish – that is to predict changes in expectations better than randomly. Second is advances in the capital market tools –such as widespread short selling, deep and broad derivative markets– create the possibility of generating high volatility in the Expectations Market and the opportunity for those who generate the volatility to benefit. And third, the cultural norms in many of their organizations that placed generation of fees and profits ahead of treating clients with fairness and respect.

Stock Underwriters

The incentive for stock underwriters is to raise as much equity capital for firms as possible and thereby earn fees for doing so. The incentive is strong because to this day, the profitability of an incremental stock underwriting fee is exceedingly high – the incremental underwriting assignment should always be pursued aggressively.

The sale of an underwriting is indeed an interesting challenge, particularly the pricing thereof. New shareholders, who want to earn an acceptable return on purchasing some of the newly-issued stock, want to see a price that does not fully incorporate all future expectations – or there will be no upside for them. The job for the distribution arm of the stock underwriters is to convince purchasers that the true expectations are higher than the price would warrant – so the new issue is a good buy.

But simultaneously, the stock underwriter has to convince the issuer that future expectations are so low that the issue shouldn't be priced too high. The stock underwriter uses specific knowledge – i.e. data from their distribution arm from conversations with potential buyers of the new issue – to convince the issuer that expectations are low (while convincing potential buyers that true expectations should be much higher).

In essence, the stock underwriter's job amounts to creating a gap between the expectations of the issuer and the expectations of potential buyers of the issue. In the case of a new issue for an existing public company, the underwriter can either suppress the Expectation Market for the stock prior to the new issue or hype the unrealized expectations to potential buyers to create the necessary gap. Both of these tactics can be accomplished utilizing the equity analysis and sales and trading arms of the underwriter. In the case of an initial public offering (IPO) there is no public market

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expectation to suppress; rather the suppression is related to the private expectations of the pre-IPO owners of the private firm.

Thus, like the investment advisors and equity analysts, the stock underwriters have the incentive and the capabilities to move around the Expectations Market relative to the real market in ways that benefit them, without regard to the impact on any other player.

Net Impact on the Governance Market

Every key actor we have discussed thus far across the three markets has the interest in experiencing and/or the incentive to produce swings in the Expectations Market. The independent directors have neither the incentives nor the capabilities to do the job assigned to them under these circumstances.

The outside shareholders have a powerful interest in changes in the Expectations Market. Change is their only interest and, depending on whether they are short or long shareholders, their interest is in changed expectations in a particular direction. However, among all the actors discussed thus far, the outside shareholders have the lowest capabilities to realize on their interests.

Owner-managers and non-owner employees trump them in terms of their specific knowledge of the Real Market and potential mismatches with the Expectations Market. In addition, owner-managers and non-owner employees can actually influence performance in the Real Market. Owner-managers have a powerful incentive to use the specific knowledge twinned with the ability to influence the Real Market to create and exploit schisms between the Real Market and Expectations Market. So they have the incentive and the capability to cause the shifts in the Expectations Market – notionally what the outside shareholders desire – but they can cause and exploit shifts at the direct expense of potential or actual outside shareholders. That is to say, they need an unsuspecting outside shareholder to either sell their over-priced stock or to buy from them under-priced stock.

The Equity analysts also have the incentive to cause vacillations in the Expectations Market to both cover up their own inability to predict changes in the Expectations Market and to either to generate commission dollars or to assist in generating underwriting fees. They have capabilities generated by at least some modicum of moral authority and public profile to influence the Expectations Market with their predictions. In any case, they also need unsuspecting outside shareholders to either buy overpriced new issues or stock priced at a level in the Expectations Market that is based on analysis for which the incentive is to cause movement not to accurately predict.

The stock underwriters have the incentive to influence the Expectations Market to open up a gap between the Real Market and the Expectations Market that enables them to sell the underwritten issue and earn attractive fees. They have the specific knowledge advantage of knowing the potential and actual buyers and their expectations through

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their distribution arms. The greater their ability to manipulate expectations prior to the issue, the better their ability to underwrite and smoothly distribute the new issue.

The investment advisors have the incentive to cause the Expectations Market to vacillate to help cover up their inability to actually predict changes in that market. The greater the turbulence they create, the more difficult it is for their clients, the outside shareholders, to assess whether they are receiving value for the fees they pay for the investment advice. While investment advisors generally don't have the public profile of the equity analysts and thereby less ability to generate vacillations in the Expectations Market, collectively their advice can certainly have an impact.

Across these actors, the cultural norms that once served to discourage utilizing capabilities to maximize incentives at the expense of the outside shareholders, if anything, have been breaking down. Owner-managers increasingly work for firms dedicated to shareholder value maximization that shower them with stock-based compensation. Investment banks, the homes of underwriters and equity analysts, appear increasingly to have cultural norms that value making ever-increasing returns at the expense of treating clients fairly or at least transparently.

Essentially, the structure is such that the bulk of the players have the incentive to jerk around the expectations market because they benefit from vacillating expectations. It is optimal for all of these players if expectations fluctuate around reality rather than increase in lock-step with reality because that creates arbitrage and fee opportunities for a phalanx of players; opportunities for which there are few remaining cultural limitations against exploiting.

Independent Directors

So where does these leave the independent directors? I will address that first in the context of the absence of a major or controlling shareholder and then turn to that specific case.

They face outside shareholders, who hope for expectations to move in a direction favourable to themselves and look to the independent directors to protect them against exploitation. In particular, they don't want to buy a stock from someone whose dramatically specific knowledge advantage enables them to know that it is distinctly overvalued or sell a stock to someone who knows that it is distinctly undervalued. That is, they do not want some actor to have created a schism between the Expectation Market and the Real Market with the intent to exploit the schism at their expense.

But they also face owner-managers with capability and incentive to manipulate expectations to their own benefit and substantial limitations to their self-control. And the most senior of these owner-managers are with the independent directors on the board and have every incentive to keep the independent directors in the dark. Meanwhile, investment advisors, equity analysts and stock underwriters have the incentives and capabilities to manipulate expectations for their own purposes. So in many respects,

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the independent directors are quite alone. Their only helpers are the professionals (auditors, compensation consultants, etc.) who, with the recent changes in governance, they at least get to hire. But they can't provide much help to the independent directors either.

What are the capabilities of and incentives for independent directors to deal with this challenge? Capability is the easier piece of this question. Independent directors are at a distinct specific knowledge disadvantage as to the operations of the firm for which they act as director relative to the senior management and the owner-managers on the board. Senior management is in a position to provide independent directors with whatever information they see fit and have the capacity to restrict access to information they don't want independent directors to see. Independent directors spend only a tiny fraction of the time spent by senior executives on the operations of the business and no matter how smart and diligent the independent directors, they will never match the specific knowledge of management. The best they can bring to bear is broad expertise and insight from other markets that management can utilize if they so desire.

While many assume that this specific knowledge deficit can be overcome through the hiring of professionals, principally auditors, by the independent committee of the board, this simply is not the case. In the end, the important audit decisions come down to judgment –i.e. is this an asset or an expense, as in the case of WorldCom – and management is always in a better position to argue its case than the auditors to argue theirs. Indeed the level of scrutiny and regulatory changes in the wake of the recent scandals will embolden auditors, but none of the changes will help them overcome the specific knowledge deficit.

What are the incentives of independent directors and why do they go on boards in the first place? I can think of six categories of reasons with varying incentive effects on the quality of corporate governance.

1) Compensation

   The first potential motivation is that the compensation is attractive – i.e. compared to available alternatives it is a good way to make money for the independent director in question. I would argue that this is rarely the case unless significant stock-based compensation is involved. Furthermore, if the compensation is attractive without it being of the form of stock-based compensation, then I would argue that the wrong person has been picked in the first place. I would argue that for most firms offering a simple retainer and per diem compensation structure to directors that the compensation is below the level of their opportunity cost. That is, unless the director has very low capabilities and is unable to bring even a modicum of broad expertise to the table.

   However, some directorships offer heavy stock-based compensation, which can be enormously attractive. But in this case, it turns the "independent director" into

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the yet another owner-manager with all the attendant problems of owner-managers on the board – i.e. they will have the self-same incentive to focus on raising expectations not real results. This is of course, only the case if the primary incentive for them to come on the board was monetary compensation. If they happened to receive stock-based compensation but that was not relevant to their decision, that wouldn't be a particular problem.

So net, compensation is unlikely to be the key motivator for an individual to seek or accept membership of a board as an independent. In two cases, it can be the motivator, but if it is, that is a bad thing for corporate governance. If the straight retainer and per diem fees are attractive versus opportunity cost and the prime motivator for joining the board, then the director is likely to have no meaningful capacity to provide good governance. If attractive stock-based compensation is the driving force, then the director will be incapable of distinguishing him or herself from the owner-managers on the board in terms of the "independence" he or she would bring to the board.

So net, compensation is either an unlikely or bad motivator for serving as an independent director.

2) Personal Growth

Some directors indicate that they join boards for personal growth opportunity. They want to learn about a particular industry or about governance in general. This is a pretty benign reason to join a board from an incentive standpoint compared to joining a board for compensation reasons as above. However, being motivated by personal growth makes it still less likely that they are likely to have the specific knowledge to provide meaningful governance protection for the outside shareholders, especially if doing so gets in the way of personal learning.

So net, personal growth is a rather benign, but unhelpful motivation for serving as an independent director.

3) Personal or Corporate Favors

This probably happens less in the current environment, but certainly there is history of going on boards to garner favors from the corporation. Historically, this was the rationale for industrial company CEOs to go on the board of their bank. The assumption was that when the going got tough, the bank would be unlikely to cut off credit or call the loan of the CEO-director's company.

More recently the practice has taken a personal turn by which board membership gained personal consulting contracts for the directors or other non-monetary benefits such as box seats to sporting or cultural events.

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This motivator for joining a board is an unalloyed bad thing because the incentive is to trade approvals for actions that enrich manager-owners and other insiders at the expense of outsiders in exchange for the desired personal or corporate favors.

4) Personal Prestige

Another potential motivator is the personal prestige to be garnered by being a member of a board of a publicly-traded company. This is quite feasible given the attention showered on directors. However, the incentive then for the personal prestige-oriented director is to act in whatever way is necessary on the board to maintain their place on the board because removal from the board due to non-cooperation would diminish personal prestige.

So net, the motivator of personal prestige is an unhelpful thing for good governance.

5) Board Community

Yet another potential motivator is to become a valued member of the community of the board in question. Consistent with the earlier discussion of subjective well-being, it would be unsurprising if an individual would seek to become a respected member of the community represented by a given board, especially if he or she respected that community and it was respected by the broader community outside the board.

However, if this were the motivator for joining a board, we would expect the director in question to strictly obey the cultural norms on the board in order to earn and maintain the respect of the rest of the board members representing the board community. In essence, this is an incentive to not rock the boat.

The nature of the outcomes with this motivation depends on the dominant culture of the board. If the dominant culture is to act in a fashion that favors the insiders and owner-managers over the outside shareholders, then the board community-motivated independent director will have the incentive to go along with the remainder of the board. If the dominant culture is to protect the outside shareholders, than the board community-motivated independent director will also have the incentive to go along with the remainder of the board.

Thus, if the culture is bad, the independent director is not motivated to improve it and if the culture is good, the independent director is superfluous. So again, this is not a motivation that ends up providing value to good governance.

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6) Public Service

The final potential motivator is public service broadly defined. The independent director would in this case be motivated by the notion that he or she can provide an important service to the public at large by protecting the outside shareholders and thereby protecting a fundamental structural underpinning of capitalism. In such a case, their incentive for action on the board would be to protect outside shareholders regardless of how unpopular that would make them within the board community.

Certainly it would be a great positive for governance for there to be such public service motivated independent directors on boards. However, there are three practical constraints to this positive occurrence. First, such directors have to be willingly elected onto boards. This is likely to the extent that the CEO and other owner-managers on the board already want good governance. It is highly unlikely in the case that they don't really want good governance – which is, of course, the circumstances in which the outside shareholders actually need strong independent directors.

Second, it is not clear that such directors will be plentiful. They have to take a badly paying job in which they have to be consistently at odds with the immediate board community, all for the benefit of nameless, faceless outside shareholders that they don't even know. This is hardly an attractive proposition.

Third, for the most part, independent directorship is not thought of as public service generally. So even if an individual would be willing to take on the task of being an independent director for public service reasons, it would not, at least in the current environment, be seen by others as public service. This would have the effect of lowering the potential non-monetary benefit of the position.

In summary, most of the motivations for becoming an independent board member – i.e. compensation, personal growth, personal or corporate favors, or personal prestige – produce an incentive structure for the director in question that minimizes the likelihood that they will act in a fashion that promotes better governance. Under the other potential motivations – i.e. board community and public service – the incentive to promote good governance is only likely to be present if good governance would have been the result without the presence of the independent director in question.

The net result, then, is that independent directors have neither the capabilities nor the incentives to enforce good governance or protect the interests of outside shareholders. Ironically, the independent directors with the best governance motivations will be invited to join boards that are already committed to good governance and when they get onto those boards will be encouraged by the board community to be vigilant with respect to protecting outside shareholders. So they will have an insignificantly positive impact on an already good situation.

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So in the general case, thanks to high levels of stock-based compensation, owner-managers – particularly those with board seats – have the capabilities and the incentives to manipulate the Expectations Market to create schisms with the Real Market which they can exploit. They are aided by investment advisors, equity analysts and stock underwriters, all of whom have an interest in a vacillating Expectations Market, for a variety of reasons.

The outside shareholders are particularly vulnerable to the downside of such machinations, but have little in the way of capabilities with which to defend themselves. They look to the independent directors to protect their interests, but those independent directors have neither the capabilities (i.e. specific knowledge) nor the incentives to protect the outside shareholders when the outside shareholders need them – they have the proper incentives only when not needed.

That is the fundamental problem with corporate governance. Given the current context, it is not designed to work. It works only by exception not by rule. That exception is when managers/owner-managers decide that they want to have good governance for intrinsic reasons. In such cases, all the governance rules – independent directors, audit committees, board meetings, etc – are superfluous because good governance happens on principle not due to fiat.

What is the Hope for Good Corporate Governance?

On the current course there is little hope for improved corporate governance. As many features of the environment are deteriorating as are improving. Fundamental changes are needed in the governance context for corporate governance to improve.

With respect to the deteriorating features, there are at least three trends that continue to worsen the governance context. First, there is little diminution in the trend toward more owner-management with greater stakes in the Expectations Market. In the wake of the recent stock market scandals, there has been a drop in enthusiasm for stock options as the form for stock-based compensation, but not diminution of enthusiasm for stock-based compensation in general. So the dominant compensation theory still holds that stock-based compensation aligns owner-managers with outside shareholders when it does just the opposite.

Second, there is no diminution in the trend toward making shareholder value increase the centerpiece of corporate missions. Focus on shareholder value diminishes self-control and encourages managers to maximize their own personal monetary benefit.

Finally, increasingly sophisticated capital market tools enable the ever more efficient arbitraging of schisms between the Real Market and the Expectations Market. Owner-managers can now secretly securitize their stock and option holdings to exploit schisms in ways they could never do 15 years ago. For example, an owner-manager-director can sell the upside on his or her stock/option position and protect against the downside

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in an extremely tax-efficient manner and avoid having to disclose the transaction in any way.

On the other side of the ledger are a couple of steps that have been taken in a direction favoring better governance. The first is new rules to increase the transparency of equity analysts and stock underwriters. While they can continue to do much of what they could and did do previously, they now have to disclose more thoroughly than ever. This will help outside shareholders be more wary than previously. The second is the requirement under Sarbanes-Oxley for CEOs and CFOs – the two insiders most likely to be inside directors as well – to certify their firm's financial statements. This will up the ante considerably on the price to pay for purposefully confusing outside shareholders.

Many of the recent changes simply won't make a difference. The increase in numbers of independent directors and their placement in key committee roles won't improve governance meaningfully because of the capability and incentive problems with independent directors outlined above. The detailed rules of procedure governing audit committees and auditors won't change much given the capability mismatches between management and audit committees/auditors and the unchanged basic incentive structures.

Necessary Fundamental Changes in Governance Context

Three fundamental changes in the structure of the governance context are required to address problems of corporate governance.

1) Reducing the stock-based compensation for managers and directors

    We simply must overcome the myth that stock-based compensation aligns the interests of managers and directors with the interests of outside shareholders. It doesn't. It would be very handy if stock-based compensation did so. However, the current theory of stock-based compensation ignores the impact on the Expectations Market of stock-based compensation. The theory of stock-based compensation assumes that it will motivate managers and directors to accomplish great things in the Real Market and that the pay-off for them and the outside directors will come in the Expectations Market. There is neither logic nor data to support this notion.

    Either stock-based compensation is an incentive for action or not. If it is not an incentive, then it is silly. Recipients of stock-based compensation would simply see themselves getting paid more or less on the basis of random fluctuations in the Expectations Market in which they played no role at all. If it is an incentive, then managers will take actions to raise expectations because that is the direct incentive effect. Only by raising expectations will the manager or director reap the reward of the incentive.

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In this way, stock-based compensation focuses the attention of managers and directors on something they can't and shouldn't control – the Expectations Market. Focus on the Expectations Market places their focus on the same market as the investment advisors, equity analysts and stock underwriters, all of whom have the incentive to play with the Expectations Market as well.

Only by reducing or eliminating stock-based compensation can the managers and directors be focused on raising performance in the real market rather than on playing with expectations. Outside shareholders will still need to contend with the games played by investment advisors, equity analysts and stock underwriters, but at least they don't have a major specific knowledge disadvantage against those players like they do against managers and, to a lesser extent, directors.

2) Eliminating the capacity for owner-managers to exploit specific knowledge

To the extent that stock-based compensation is reduced but not eliminated, the second piece of the change puzzle that is necessary is the elimination of the capacity of owner-managers and, again to a lesser extent, directors to exploit specific knowledge at the expense of outside shareholders. Eliminating the capacity to exploit their specific knowledge advantage will eliminate the incentive to create an exploitable schism between the Real and Expectations Markets in the first place.

This can be accomplished by requiring owner-managers and directors to pre-announce intentions to sell and buy stock and only be able to complete the transaction after the Expectation Market has time to react to the information inherent in the announcement. Currently, the announcement of on insider trading occurs after the transaction. That allows the owner-manager to exploit the specific knowledge at the expense of shareholders without such knowledge. The existence of the exploitation possibility encourages the building of the exploitation opportunity in the first place.

With required pre-announcement, the market can react to the information and close the gap between the Real and Expectations Markets thus wiping out the exploitation opportunity and wiping out the incentive to create any future such opportunities.

3) Reinvigorating the self-control of all actors through greater emphasis on moral purpose and community

Undoubtedly the trickiest but probably the most important change is a fundamental cultural change in all the organizations involved in the governance structure – i.e. publicly-traded firms, investment banks and investment advisory organizations. While owner-managers, directors with stock-based compensation, investment advisors, equity analysts, and stock underwriters all may have the

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monetary incentive and the capability to take advantage of the outside shareholders, that doesn't mean they necessarily will. They may, in the face of the monetary incentives and capabilities, decline because they think that taking advantage of the outside shareholders is wrong and they are able to assert self-control over their own actions. Just as each of us would hope we would return to its owner a cash-laden wallet found on a park bench, even though we would have both the monetary incentive and capability to keep it.

This self-control is strongly influenced the non-monetary incentives brought to bear by the cultural norms of the relevant community. In the key organizations of the governance structure, the cultural norms promote self-aggrandizement more than they promote self-control. Quite simply, that bias will need to reverse itself if we are to see higher quality governance.

First and foremost is the shareholder value driven cultures of publicly-traded firms. As mentioned, the trend has been toward placing shareholder value appreciation ever closer to the focus of the mission of the firm. I would argue that this is counter-productive for both governance and, ironically, for producing shareholder value appreciation. Shareholder value appreciation is simply not motivational for employees of a firm. There is no community to be had with shareholders. They are nameless and faceless and are under no obligation to hold their shares more than an instant. They are also, by definition, never satisfied. If employees do something that produces a great bump in shareholder value, then that bump was created by a new shareholder buying the stock at the appreciated value. The new shareholder's first question is: What are you going to do for me next? There is no sense of basking in the warm glow of appreciation from the shareholders because they want more, more, more. And if shareholders don't get more, they exit the firm's community by selling the stock.

So shareholder value appreciation as a defining purpose does not inspire or create a sense of community for employees. But it does encourage them to think that personal monetary value appreciation is a legitimate goal for them as part of the corporation – that is what the highly valued shareholders want exclusively and the corporation bends over backwards to try to deliver to them. Why shouldn't employees have the same goal and the same defining purpose – maximize personal economic benefit from employeeship of the corporation?

This attitude exacerbates the principal-agent problems throughout the firm, which promotes stock-based compensation as the solution, which in turn produces the incentive to create Real Market-Expectations Market schisms to exploit, which in turn hurts performance in the Real Market and shareholder value creation in the Expectations Market – the exact opposite of the desired outcome.

Instead firms need to stop focusing on something they can't control anyway – the Expectations Market – and stop pandering to shareholders who can never be satisfied anyway. Instead they need to have a defining moral purpose for the

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firm that will motivate and excite employees. It should create a community in the firm of which employees are proud and happy to be valued members. And if the defining purpose involves making the broader community a better place, then the firm community, of which employees will attempt to be a valued member, will be valued and respected by those outside the community. This configuration has the possibility of creating a culture in which service to the customer, service to fellow-employees and service to the firm provide strong non-financial benefits of respect and community to employees. This will buttress their self-control and diminish the nascent principal-agent problems. And in doing so, it will ameliorate the governance problems created with owner-managers.

Ironically, in doing all of these things, this approach will in fact be more likely to produce shareholder value appreciation than an explicit and central goal of pursuing shareholder value appreciation. Having a motivational defining moral purpose will help produce a motivated, self-controlled employee base with diminished principal-agent problems and a devotion to creating value for customers. This in turn raises the likelihood of the firm achieving competitive advantage, which is the only thing that produces long-term shareholder value appreciation as illustrated in the following diagram:

The Role of Moral Purpose

It is hardest to create and stick to this kind of defining moral purpose in a widely-held, publicly-traded corporation. The din from the capital markets insisting on the primacy of shareholder value maximization is so loud, it is hard to think straight and it is easiest to fall into the trap of attempting to produce shareholder value appreciation and by doing so actually fail.

It is in this respect that a major or controlling shareholder, the final as-yet-unexplored actor to which I referred earlier, can play a critical role. The major or

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controlling shareholder has the moral authority to set and compel adherence to a defining moral purpose and let the shareholder value appreciation take care of itself. Their moral authority stems from holding a large or majority portion of the equity. Unlike a non-government organization (NGO) or non-owner employee calling for a focus on something other than shareholder value directly, majority shareholders can't be accused of having no meaningful interest in shareholder value appreciation. They do, they can just be smarter about how to go about creating the shareholder value and that is to move upstream from shareholder value to sustainable competitive advantage and defining moral purpose. Their leadership can build a respected community and outside the firm that will increase the self-control of employees.

The attitude and behavior of the major and controlling shareholder makes a substantial difference in the culture of the firm and the behavior of managers. Consider the contrast between Philip Anshutz and Ken Thomson. Philip Anshutz is the biggest shareholder by far of Qwest Communications International Incorporated and until very recently its Chairman. He helped define the culture of Qwest, by selling over $1.5 billion in stock before Qwest's stock fell from a monthly high of $51.52 in August of 2000 to $3.26 in August of 2002. By that time, the 1.45 billion shares in the hands of (largely) outside shareholders had fallen in value to $4.5 billion, only three times the amount this one insider cashed out during the time of wildly inflated expectations. Twelve other insiders followed Anshutz' lead and sold $500 million in shares during the same period. Qwest and various members of Chairman Anshutz' senior management team are or have been under investigation for various aspects of fraud perpetrated against outside shareholders.

In contrast, Ken Thomson, controlling shareholder of Thomson Corporation, and until recently its Chairman, has maintained his family's dominant stake in Thomson over a long period of time during which he both committed the family to reinvest 50% of their dividends received back into the Thomson stock, regardless of the prevailing price and encouraged senior management to invest for the long term good of the firm, not to please shareholders in the short term. During his Chairmanship, the shareholder value of Thomson increased from under $500 million to over $17 billion.

Cultural changes also need to be engineered in investment advisory firms, equity analysis firms and stock underwriting firms. As the recent events have demonstrated, in some equity analysis departments of investment banks, internal community respect actually is enhanced by engaging in the defrauding of outside shareholders. Hence we see reports of emails exhorting the sales force to "put lipstick on this pig and go sell it," at the same time the analysts were hyping the stock. A criminal ashamed of his or her activities would not brag about it in their community. Only a community that showers respect on those who engage in fraudulent behavior will generate open, public behavior of this sort.

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> The actors in the Expectations Market will have to reassess the cultures of their organizations to understand the role that those cultures play in undermining the long-term effectiveness of the market on which they depend for their livelihood – the Expectations Market. Without improvements in the behaviors in these Expectations Market industries they will wither away over time.

Conclusion

There is a fundamental structural problem with corporate governance. Rather than thinking of the major scandals as the product of aberrant behavior, we should think of it as the expected behavior with the governance context now in place. The recent and proposed changes in governance regulations will not have a major impact on the problem with governance because they leave in place and largely unchanged the fundamental incentives and capabilities of the key actors in the governance system.

In the current governance system, the independent directors are put in an impossible situation in which they have neither the incentives nor the capabilities to protect the outside shareholders when the outside shareholders need them. Ironically, the independent directors are well-positioned to protect the outside shareholders when they don't need protection, and ill-equipped to protect them when they need protection most.

To give the independent directors a fighting chance of producing good governance when it is needed, the governance structure needs to be improved by reducing the entanglement of the Real Market with the Expectations Market. The entanglement is currently driven by the stock-based compensation of firm managers and directors, combined with their ability to utilize their specific knowledge for their own benefit.

Most importantly, the governance structure needs to be enhanced across all three markets of the governance structure by improving the cultural norms. The net change required is a strengthening of the non-monetary incentives for behavior that would put a higher community value on self-control behaviors. This net change will require a dramatic reduction in the role of shareholder value appreciation in the missions of publicly traded firms. Counter-intuitively, this change holds the promise of not reducing shareholder value appreciation, but rather enhancing shareholder value in a fashion that supports good governance, strong independent directors, and well-protected outside shareholders.

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