# Why Roger Martin believes the corporate world needs to be overhauled—starting with excessive CEO compensation

**The head of Toronto's most prestigious business school has a seditious idea, and it might save us from financial catastrophe**

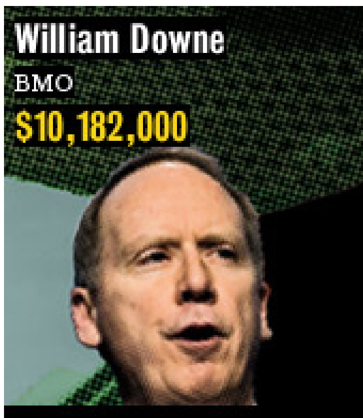
**By Jason McBride**

(Image: Daniel Ehrenworth)

**Last fall's Occupy Toronto** protest was more of an idea than a place, a kind of free-floating rage against what is perceived as an unjust, morally skewed, out-of-control, soul-sucking machine. The number of protesters ranged from a few hundred people to 3,000, depending on the day, and the camp at St. James Park possessed a vibe similar to Occupy camps around the world. Gordon Lightfoot and Rachel McAdams dropped by. The placards that hung from tents or rested on the grass—"Corporate Greed Hurts Everyone," "Reclaim Your Life!"—could just as easily have been found in London or Atlanta or Calgary.

Almost from the beginning, critics were quick to say that Occupy Toronto was misguided and irrelevant, a copycat protest at best, and a case of rich envy at worst. Corporate kleptocracy is not nearly as bad here as it is in the United States, the argument went, and our economy has triumphantly eluded any deep, lasting meltdown. Canadian executives are not, for the most part, cut from the same overpaid, underhanded cloth as American CEOs. In Canada, super-elite is just a passenger class on Air Canada. "We obviously have a very different situation here," Stephen Harper said in response to the claims made by Occupiers. "We didn't bail out our banking sector. Our banking sector is the strongest in the world." In other words, put down the sign, comrade, nothing to complain about here.

While it's true that economic disparity is not as pronounced in Canada as it is in the States, and the European Union could take a few pages—maybe even a whole chapter—from our playbook, the smugness is




unwarranted. The Conference Board of Canada, a not-for-profit economic research organization, has found that we've been outpacing the U.S. in income inequality since the mid-1990s. The ratio between the top 10 per cent and the bottom 10 per cent of earners is now 10 to one (in the early '90s, it was eight to one). The country's wealthiest one per cent account for 32 per cent of all income growth between 1997 and 2007—the largest percentage in our recorded history. In 2010, the average Canadian income was $44,366, while that same year the average compensation for the country's 100 highest-paid CEOs was more than $8 million. Frank Stronach, the former head of Magna International, received roughly $40 million a year over the last decade and in his last year at Magna pocketed $62 million. (In 2007, he set a Canadian record by collecting over $70 million in compensation.)

"There's way too much money going to far too few people," says Roger Garland, a former international banker and Four Seasons exec. "The abuses are known to everybody." The economist Armine Yalnizyan has referred to this era as "Canada's neo-gilded age," pointing out that whether the economy has grown or faltered, "the rise of the rich has been unstoppable." And the consequences affect all of us: reduced social mobility, higher health care costs, a growing discontent.

Just as Michael Pollan articulated how our food system is broken and Bill McKibben became the go-to guy on the dangers of climate change, Martin is now the economy's village explainer.

It was once possible to believe that a rising tide lifts all boats, but now it seems more likely to sink them. After the country's six biggest banks announced record combined profits of $23.6 billion last December, RBC, BMO and CIBC cut over a thousand jobs, lowering costs, they said, in anticipation of an economic slowdown in 2012.

A couple of months earlier, Statistics Canada reported that a record 35,000 jobs were lost in the finance, insurance and real estate sectors. This was business as usual. Wasn't it?

Yurt feelings: the Occupy protesters were cleared out of St. James Park last November, but they promise to return this spring. (Image: Photographs by Ian Willms. Collage by Bradley Reinhardt)

**While Occupy ostensibly has no leaders, it's had no shortage** of unofficial spirit guides: the *Adbusters* editors Kalle Lasn and Micah White; the journalist Chris Hedges; the anarchist and anthropologist David Graeber. The shaggy Slovenian pop philosopher Slavoj Žižek addressed the thousands gathered at Zuccotti Park in New York last October and said, "The problem is not corruption or greed; the problem is the system."

It was a sentiment that Roger Martin, had he been on the barricades, could have just as easily expressed. Martin is the dean of the University of Toronto's Rotman School of Management, where he makes almost $400,000 a year. Before that he was a consultant pulling in around $3 million a year. He's a graduate of the Harvard Business School and counts among his friends some of the top executives at the bluest of blue-chip firms. He lives in Yorkville and often plays tennis at the Granite Club. He wears crisp shirts with monogrammed French cuffs.

If the Occupiers knew just these broad details, they would have likely held Martin in the same contempt they hold Michael Bloomberg. But if they'd read Martin's latest book, *Fixing the Game*, or any of the recent blog posts and op-eds he's written for Reuters and the *Harvard Business Review* websites, or sat in on one of the classes he teaches or any of the 65 presentations he gave last year (to universities, management conferences and government task forces), they would find an ally whose boat-rocking ideas dovetail with their own disaffection. Martin is a great believer in business as "an agent of positive change," but he argues that business has failed, spectacularly, to fulfill this role, largely because of its misplaced faith in erroneous economic theory: specifically, that the primary purpose of any corporation should be the maximization of shareholder value. As he put it, in a somewhat different way, on*Fortune*'s website: "The problem isn't that Wall Street broke the rules to their own benefit,

it's that the rules themselves are unhelpful." Boiled down, Martin's solution is simple enough to be scrawled on a protest placard: *Eliminate short-term stock-based compensation!* If we don't, he argues, capitalism could collapse in on itself entirely—and take all of us with it.

A specific part of the system, in Martin's view, has been broken since 1976. That year, the dean of the University of Rochester's business school, William Meckling, and a Rochester business professor named Michael Jensen published a paradigm-shifting paper that articulated a new corporate model. In the paper, which would become the most cited in the history of business academia, Jensen and Meckling pointed out that executives, who were essentially hired help, were too often acting in their own self-interest rather than in the interest of the firm. Size and growth were rewarded, not improved stock performance. This, in turn, had led to imperious CEOs running bloated, complacent and inefficient conglomerates where shareholders, who received only moderate returns, were unable to exert much influence. The answer? Recalibrate and refocus; the singular goal of a firm became the maximization of return to shareholders. And the best, most logical way to maximize shareholder return was to fix executive compensation to the rise and fall of a firm's stock price. Executives would then also be shareholders themselves, the thinking went, and, as Martin puts it, "*very* interested in increasing shareholder value, because, when it increased, so would their own compensation."

But it didn't really work. Or, rather, it only worked for a few companies, and only for a short while. Compelled by Jensen and Meckling's theory, executives inextricably linked the real market (the business of designing, making and selling products and services) to the expectations market (the business of trading stocks, options and derivatives). CEOs at companies like GE, Cisco Systems and Nortel shifted their focus from customers to stock analysts and began to invest in short-term strategies, often getting out before a crash. Between 1960 and 1980, CEO compensation per dollar of net income earned for the 365 biggest publicly traded American companies fell by 33 per cent. But in the years after Jensen and Meckling's paper was published, that compensation doubled, and from 1990 to 2000, it quadrupled. For Martin, this was the beginning of the end. Such a system inevitably resulted in enormous discrepancies in the relative payment of executives and workers while also producing excessive risk taking and intense, chronic volatility. Which, in turn, created the opportunity and incentive for people to exploit that volatility. Martin blames pretty much every financial catastrophe since the late '70s—two market meltdowns, the tech bubble, the housing bubble, Enron, WorldCom and various other corporate scandals, the current European imbroglio—on the adoption of Jensen and Meckling's model. It isn't that companies or executives are necessarily evil (or not always); they're just doing what they think they're mandated to do. Anything else would be insubordinate.

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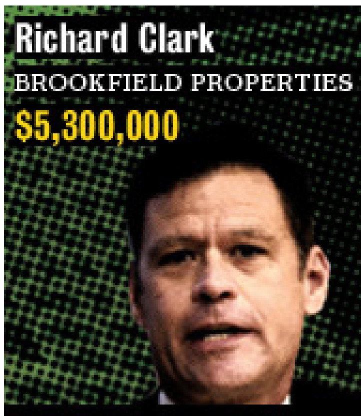
the current European imbroglio—on bloated CEO compensation.

Martin's *Fixing the Game* has a breezy, exclamation point–laden tone that's unflaggingly enthusiastic even when it's taking shots at hedge fund tycoons. (In person, Martin can also be disarmingly informal: he describes the economist James Tobin to me as "one smart dude.") This tone camouflages a truly urgent, radical manifesto, made all the more radical because Martin is a business world insider. His argument flies in the face of all we thought corporations should be, and have been, for the last 30-odd years. The best defence, as the

adage goes, is a good offence, and in his defence of what he regards as the proper role of capitalism, there's no doubt that Martin—jaunty, card-carrying member of the elite though he may be—is definitely on the offensive.




"Few career criminals think of themselves as criminals," he says. "They tell themselves there was no victim, everyone else was doing it, etc. There's a system that enables them to tell themselves that they're doing the right thing. Do you call it unethical when your board says, 'Please improve expectations of future performance and don't do anything else, my boy'? The current system provides a built-in excuse for bad behaviour." Restraint isn't rewarded, greed is.

(Image: Photographs by Ian Willms. Collage by Bradley Reinhardt)

**Before Martin was dean at Rotman, a position he took** in 1998, and before he was a director at Monitor, a Boston-based global strategy consulting firm where he worked for 13 years, Martin was a jock. At Harvard, he played and coached volleyball while obtaining his undergraduate economics degree and his MBA. He's now a regular golfer and sits on the board of Tennis Canada. He's a big fan of the New England Patriots. At 55, he's compact, lithe and energetic, and even when he's sitting in his suit and tie in his sunny, third-floor office overlooking St. George Street, it wouldn't be a surprise to see him launch into a jump set at any moment.

Sports provide literary inspiration and metaphoric guidance as well. The subtitle of *Fixing the Game is Bubbles, Crashes, and What Capitalism Can Learn from the NFL*, and it was obviously composed with an eye to the bestseller list—football's never been more popular or lucrative, and how many captains of industry are also armchair quarterbacks? Martin loves a clever, precise, accessible analogy. In *The Opposable Mind*, his 2007 bestseller, he argues that, just as the opposable thumb works against the fingers and hand, the brain can productively use the tension of opposing ideas.

For Martin, there are three things that business can learn from the NFL. One, keep the real market and expectations market completely separate. Two, focus on keeping your fans, or customers, happy. Three, the rules of the game must constantly be tweaked so that no one side enjoys an unfair advantage that will harm the collective good. In Martin's schema, the real market in professional football is the game itself—two teams head out on the gridiron, throw passes and score points, until there is, at the final whistle, a real winner and loser. The expectations market is the gambling that surrounds those real-life games. Bettors imagine what will happen on a given Sunday's game and place a wager on that outcome. In the NFL, however, in order to even out the betting on favoured teams and underdogs, bets are based on a point spread—that is, the difference between the two opposing teams' final scores. If the New England Patriots are favoured to beat the Buffalo Bills by 10 points and then go on to win by 17, they've exceeded the spread by seven points. Over time, if the Patriots continue to win, they are increasingly predicted to be the favourite in each game they play; the spread grows.

Stock prices, in Martin's view, are just like point spreads. Expectations determine price, and the more investors buy, the more the stock price rises. A company such as Research in Motion—on whose board Martin sits—has real factories with real workers who get paid real money to make real BlackBerrys to sell. At the end of the year, as a result of these real-life activities and products, RIM generates real profits or losses. At the same time, there's an associated expectations market that asks (and has been obsessively asking for the last year): how do we think RIM will perform in the future? Based on that collective belief in the future, rather than RIM's accomplishments or failures in the real world, we decide whether or not to buy RIM's stock. In the

late ’90s, following its IPO, the company instituted a rule that forbade its employees from discussing share prices at work; anyone who did had to buy everyone else a doughnut. The doughnut rule, according to Martin, is still in effect. “People inside RIM thinking about the expectations market rather than the real market is not a problem,” Martin said to me in an email. “People outside focusing exclusively on the expectations market is.”

He conjures a corporate world that existed prior to the advent of shareholder value theory, a cozy community where companies and customers coexisted in a relationship of mutually beneficial harmony.

In the NFL, there’s a strict, rigorous prohibition regarding its expectations market to ensure there is no manipulation of the spread: anyone employed by the NFL, from the water boys to the running backs and the owners, is prohibited from betting on the games. Those who do so risk being banned from the league for life. In the business world, however, we insist that a CEO—whom Martin refers to as the moral equivalent of the quarterback—*must* play in the expectations market by giving him the vast majority of his compensation in stock options, restricted securities and the like. Meckling and Jensen believe such compensation is an incentive to boost performance in the real market, and that improving a company’s real-life performance should correspondingly boost its stock price. But according to Martin, that’s very rarely true. Over the last decade, Microsoft’s earnings have been incredibly impressive—both revenue and profit have tripled—but its stock has remained stuck at $20 to $30 a share. Microsoft, like the Patriots, is now expected to do very well, and so the best it can do is meet expectations, rather than exceed them. “A company that chased expectations straight over the cliff was Nortel,” Martin told me. “When it got up to a market capitalization of $280 billion it needed to take ever more dangerous and risky measures to try to meet these exceedingly high expectations. So they financed customers to buy their products and other such highly risky things.”

Stock-based compensation is thus only an incentive to improve performance in the virtual reality of the expectations market, and the myriad, deliberately mystifying ways that CEOs have created to do this—hyping stocks, making inadvisable acquisitions in order to suggest growth, “aggressive” accounting—are ethically and legally ambiguous. For Martin, too many people are making money by trading value rather than creating it, and for them to make that money, someone else has to lose it. If you bet against mortgages, say, and make $3 billion, someone else has to lose that $3 billion. It’s a zero-sum game.

Martin believes incentive compensation, stock-based or otherwise, simply doesn’t work in a knowledge economy. If I pay you per button to sew buttons on shirts, you’re pretty likely to sew on as many buttons as you can. But as soon as judgment and decision making enter into the equation—say, you are the person deciding which colour of buttons goes on which style of shirt—the positive effect of increased compensation on labour output is negligible. “I like Ed Clark,” Martin says, referring to the CEO of TD. “But he doesn’t need to be paid $11 million a year. If you said to Ed, ‘Do you try harder because we give you 11? Do you come in earlier? Stay later? Think harder?’ No. So what was the utility to the shareholder to pay him that extra five?To make him not feel underpaid versus his peers for doing the same job. To give him the feeling, the warmth, that the company’s not ripping him off. It’s the same with pro athletes. Are you telling me if you paid Dion Phaneuf half as much he’d play less hard?”

***Fixing the Game* was published last year, and it couldn’t** have come at a more perfect moment. If 2011 was the year of the protester, it was also when class warfare in North America repeatedly blew every other issue off the front page. A graph published on Politico showed a 400 per cent increase in media use of the phrase “income inequality” after Occupy Wall Street began in mid-September. The hangover from 2008

wasn't just lingering, it was getting worse: the S&P 500 still had not fully recovered, U.S. home foreclosures continued unabated, and unemployment remained above pre-recession levels. Every week brought fresh news that seemed to provide further, dramatic context for Martin's arguments.*Fixing the Game* was excerpted in the *Globe and Mail*, in *Bloomberg Businessweek* and on the Huffington Post. When the attention-seeking trader Alessio Rastani went on the BBC to say that Goldman Sachs ruled the world, Martin nodded knowingly in the *Star*: "This guy was absolutely correct." In another prescient moment in early February, Martin joined Malcolm Gladwell, an old acquaintance, at a panel discussion about the growing income gap and the lack of outrage over that disparity. "What I find intriguing," Martin said, "is how much some members of the talent class are willing to push things when they're already massively rich."

Martin's timing may have seemed prescient, but in fact he first connected the compensation and incentive dots at a speech he delivered at a Ditchley Foundation conference in Quebec in 2003, and then again in a *Barron's* editorial. The American economy had just emerged from the post-9/11 downturn, and the business community wasn't interested in fixing a system that didn't seem broken. He received a couple of letters, but Wall Street generally yawned.

Then the 2008 financial crisis hit, the housing market collapsed, banks teetered. Soon, people like Paul Volcker, the former U.S. Federal Reserve chairman, who was in the audience at the Quebec conference, started calling Martin's office to ask for the "football paper" as a key to understanding what was happening in the capital market. Everyone wanted to know why the sky was falling, why corporate malfeasance had become so commonplace: the *Harvard Business Review* and the *Financial Times* both commissioned pieces that allowed Martin to further refine and expand his arguments; investment firms asked him to present at their client days. Just like Michael Pollan articulated how our food system is broken and Bill McKibben became the go-to guy on the dangers of climate change, Roger Martin quickly became the economy's village explainer. A *Forbes* review of *Fixing the Game* said, "Buy the book. Read it. Implement it. The very future of our society hangs in the balance." The journalist Chrystia Freeland, a long-time friend of Martin's who sits on the Rotman advisory board, believes the book, which she calls "brave," has made a real impact. "It's tapping into an important and increasingly forceful critique," she says—one that echoes thinkers like Dominic Barton, who demanded a shift from "quarterly capitalism" to long-term capitalism, and the economist Willem Buiter, who suggests that financial regulators are not necessarily bad or corrupt but conflate Wall Street's interests with those of the community as a whole. Martin's ideas found purchase at the pinker edges of the political spectrum: "I'm a big believer in the way that Roger has framed this," says Hugh Mackenzie, an economic consultant who quoted Martin in the several reports on executive compensation he has authored for the Canadian Centre for Policy Alternatives. "We have glorified what amounts to a form of gambling."

Some CEOs and some of Martin's peers consider the book seditious. Reviewing *Fixing the Game* on the Huffington Post, Mark Zupan, the current dean of the University of Rochester's business school, argues that Martin makes the erroneous assumption that investors and analysts are incapable of seeing through manipulation by "flash-in-the-pan managers." Zupan also proposes Jensen and Meckling's paper has had the positive, long-term effect of making firms more beneficially assess how compensation is vested. Even sympathetic business-world figures like Craig Alexander, the chief economist at TD, are skeptical of Martin's analysis. "I'm not convinced that compensation was the primary cause of the financial crisis," Alexander says. "I think it was driven by broader economic and financial trends. It's difficult to find anybody who *isn't* to blame for what happened." Some of this skepticism, however, may have more to do with the financial community's resistance, even hostility, to change. The foxes, to paraphrase Freeland, are not asking for a better henhouse to be built. "Martin is challenging conventional thinking," Roger Garland says, "but tell me how the behaviour of Goldman Sachs has changed since 2008. I know a lot of those people. They're not going

to say, 'I'm going to go work for a lot less.' "

Martin draws a parallel between himself and Mark Carney. Both left lucrative corporate jobs—Carney worked for Goldman Sachs for 13 years—for what Martin terms "public service," and I get the sense he regards himself as the embodiment of the greater good he believes is business's true purpose. Not a martyr, but an example. Even when Martin is in a provocative, contrarian mood, he's a living, breathing pep talk. In his acknowledgements in *Fixing the Game*, he writes, "I am critical of some institutions…however, I want to be clear that I bear no ill will to the people inside them." Martin is out to fix the game, not take the ball away.

**The Occupy movement can be divided into two distinct strains**—the radicals and the reformers—and each will attempt to control the movement in the coming months when, presumably, the Occupiers return to the streets in great numbers. The radicals—the Marxists and anarchists—want to throw out the capitalist baby with the polluted bath water and start over from scratch. The reformers want to figure out how to change the system we've got, to make it more equitable and just.

Martin is a sworn reformer. He swells with praise for the companies and individuals he believes have produced real, enduring value: Bill Gates, Johnson and Johnson, Procter and Gamble. "Roger wants to believe we can be better," says Jennifer Riel, a former Rotman student and now Martin's right hand; she has edited a good deal of his writing, including *Fixing the Game*, and co-teaches classes with him. "So how do we create structures that enable us to be our better selves? Saying that we're victims of greed and that's who we are as human beings—what can you do from that position to make things better?" Because of Martin, the Rotman school has developed a reputation for promoting corporate social responsibility. It's an incubator where professors tackle even uglier economic problems, like human trafficking. "The modern MBA student is much more meaning-oriented than in my generation," Martin says.

The current system provides a built-in excuse for bad behaviour. Restraint isn't rewarded, greed is

His grand solution to our flawed system is no easy thing to achieve. He believes that we not only need to rethink how corporations should work, we also need to ensure that capitalism can improve society rather than undermine it. We need to encourage our executives and firms to adopt structures, innovations and incentives that are focused on customers and the "protection and enhancement of the civil foundation." Forget Milton Friedman's maxim that the business of business is business; instead, champion CEOs, like The Body Shop's Anita Roddick, who have boosted profits while making the world safer for animals. Martin conjures a corporate utopia that existed prior to the advent of shareholder value theory, a cozy community where companies and customers coexisted in a relationship of mutually beneficial harmony. In this world, companies made things that people really wanted, and they made real money (if a bit less money) by selling people things they really needed. It's a pleasant, nostalgic vision. After 1976, if you buy Martin's rendering, that world was lost, executives were devoured by self-interest, and the civil foundation upon which capitalism depends eroded.

Martin conveniently ignores that even if George Soros or James Simons, hedge fund billionaires he scorns in *Fixing the Game*, have made their money in somewhat abhorrent ways, they've also returned a lot of that money to various communities—Soros through human rights and health initiatives, Simons in his support of science and mathematical research. Do they believe themselves to be living inauthentic, unhappy lives? I suspect, too, that an Occupier might easily turn the theoretical tables on Martin. Many of them would regard his faith in capitalism and corporate rule, no matter how valorized, as itself dishonest, myopic and soul shrivelling. Value is in the eye of the consumer. When I asked Martin if he would join me on a visit to the Occupy camp, he smiled broadly and said no. "I would not find myself in common cause with the ones who don't have an alternative for democratic capitalism," he said. "But the ones who say we've got to fix some

fundamental things about Wall Street, its relationship to the economy, how it works, how we regulate it, I have common cause with that segment."

"That segment," which dominates much of the Occupy movement in Canada, is not asking for anything truly radical. What Occupy wants here is neither anarchy nor socialism, but simply the fair distribution of middle-class opportunity: good, reliable jobs with benefits and pensions; affordable housing and transit; a decent education that doesn't require punishing debt; a government that provides reasonable social support; and corporations whose zeal for profits doesn't ruin lives. Martin wants this too—
he sometimes sounds like a farmer who wants to return to the days when family farms fed the entire country—and out of such idealism emerges the same hope that galvanizes the Occupiers. He's a pioneer of a kind of retro-capitalism that shares much with the yearning for authenticity, verisimilitude and honesty that has found expression in everything from organic food to urban design. "Bad theories can take a long time to be undone," he says. "But they don't last forever. If you were living in the Czech Republic or Latvia, you had to wait a long time for a bad theory to dissipate. Sure enough, it did. I think things can burble along, burble along, and then fall off of cliffs. I absolutely believe that."