



How Short-Termism Invites Corruption ...And What to Do About It

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Working Paper

12-094

April 12, 2012

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**HOW SHORT-TERMISM INVITES CORRUPTION
...AND WHAT TO DO ABOUT IT**

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Abstract

Researchers and business leaders have long decried short-termism: the excessive focus of executives of publicly traded companies—along with fund managers and other investors—on short-term results. The central concern is that short-termism discourages long-term investments, threatening the performance of both individual firms and the U.S. economy.

I argue that short-termism also invites institutional corruption. I define that as institutionally supported behavior that—while not necessarily unlawful—undermines a company’s legitimate processes and core values, weakening its capacity to achieve espoused goals and eroding public trust. In the private sector, institutional corruption typically entails gaming society’s laws and regulations, tolerating conflicts of interest, persistently violating accepted norms of fairness, and pursuing various forms of cronyism.

The gaming of Securities and Exchange Commission rules by Citigroup’s mortgage-banking desk in 2007 is an illuminating example of institutional corruption in the finance industry. After exploring that case, I provide a more complete definition of gaming, and explain how short-termism invites the kind of gaming and institutional corruption that occurred at Citigroup. I then examine the key drivers of short-termism in contemporary business, and their potential effects on the behavior of both executives and their organizations.

I conclude by proposing mechanisms to deter the corrupting effects of short-termism, including changes in both business and public policy. While business leaders and policymakers have been cautious in implementing many of these countermeasures, we must seriously consider them if want to rein in the public and private costs of institutional corruption in the private sector.

1. Introduction

According to the gospel of corporate governance, managing for the long term is the only way for public companies to create durable economic value for shareholders. A few U.S. companies, such as Amazon, have consistently lived according to this maxim, even when disappointing short-term results have battered their stock prices. However, private-sector commitment to the long term has weakened—even broken down—as both corporate executives and managers of investment funds have become preoccupied with financial performance over the next few quarters, rather than with the diligent pursuit of sustainable commercial performance.

Voices in both academia and business have long decried the excessive focus by executives of publicly owned companies and the fund managers who invest in them on short-term results. The central concern is that short-termism discourages investments that offer a long-term payback, such as in research and development, and marketing and advertising. Knowing that beating the next quarter's expectations for corporate earnings by as little as a penny can raise a company's stock price, or avoid a sharp decline, executives make myopic investment decisions that undermine a longer-term, value-maximizing strategy. And that focus threatens the long-run performance of both individual firms and the U.S. economy.

Of course, many businesses need to manage both short-term and long-term horizons. When managers are running a business or investing in markets with little “edge”—that is, with little differentiation in products or services—short-term time horizons and opportunistic investing are often the way to go. In such a world of commodity products and services, a strategy of making a series of sequential short-term investments and commitments can be economically justifiable.

A long-term time horizon is most sensible where a business or investor has some edge, hopefully a sustainable edge, and when short-term risks associated with a longer-term strategy are hedged and opportunity costs minimized. Balancing the two time horizons and operating strategies can be tricky. However, when perverse, short-term incentives artificially encourage executives to ignore high-yielding, long-term opportunities, then the costs of short-termism set in.

The recent financial crisis suggests that the rise of short-termism has been especially troublesome in the finance industry, although other industries are certainly not immune to its ill effects. A case involving the mortgage-banking desk at Citigroup can help us think about how short-termism—the collapsed time horizon of both business decision makers and investors—not only sabotages an enterprise's reputation and value, but also invites individual and institutional corruption.

2. The Citigroup Story

In October 2011, Citigroup agreed to pay \$285 million in penalties to the Securities and Exchange Commission (SEC) to settle civil fraud charges related to the development and sale of a mind-numbingly complex, high-risk investment fund called Class V Funding III. The fund's assets consisted primarily of credit default swaps referencing other collateralized debt obligations (CDOs), with collateral consisting of securities backed by subprime residential mortgages. The fund packaged these assets with generous amounts of debt to provide investors with leveraged exposure to the expanding housing market. However, this leverage also

magnified the severity of losses that investors would suffer if the U.S. housing market ever experienced a downturn—which it soon did.

According to the SEC complaint, the marketing materials created to sell shares in the fund “suggested that Citigroup was acting in the traditional role of an arranging bank, when in fact Citigroup had exercised significant influence over the selection of the assets and had retained a \$500 million proprietary short position of the assets it had helped select, which gave Citigroup undisclosed economic interests adverse to those of the investors.” In other words, the SEC charged Citigroup with marketing a high-risk mortgage fund while failing to disclose to clients, fully and clearly, the bank’s role in selecting the fund’s assets—and how the bank stood to profit if the assets they were promoting as an attractive investment declined in value.

Very soon after the launch of the fund in May 2007, the underlying CDOs did decline in value. By November, rating agencies had downgraded more than 80 percent of the fund’s CDOs. As a result of the portfolio’s poor performance and a subsequent default, 15 investors lost \$700 million—virtually their entire investment—while Citigroup gained \$160 million from fees and trading profits related to its bet against the fund’s CDOs.

In its complaint against Citigroup, the SEC claimed that the bank’s actions were fraudulent and violated Sections 17(a)(2) and (3) of the Securities and Exchange Act of 1933. After the settlement, in which Citibank neither admitted nor denied wrongdoing, the company issued a statement emphasizing that the SEC had not charged it with “intentional or reckless misconduct,” but rather that the bank had settled charges of negligence in misleading investors.¹ While we have no details on the negotiations leading to this settlement, we can safely assume that Citigroup argued that it could not have predicted a market meltdown, that its executives acted responsibly amid chaotic conditions, and that the bank should not be prosecuted for bad business decisions.

One month after the SEC and Citibank reached this settlement, U.S. District Court Judge Jed S. Rakoff rejected it for being “neither fair, nor reasonable, nor adequate, nor in the public interest.” His rationale was that “as a matter of law, an allegation that is neither admitted nor denied is simply that, an allegation.”

As of this writing, it is unclear whether this case will actually go to trial, because Citigroup’s behavior may not be prosecutable despite the SEC’s allegations of negligent nondisclosure—that is, deception. That is because, in its offering circular, Citigroup disclosed that Credit Suisse would control the ultimate selection of CDO assets, although the circular failed to mention that Citigroup had suggested many of the mortgages included in the CDO fund.

Using remarkably vague language, Citigroup also disclosed that it might take a short position in the fund: the bank “may be expected to have interests that are adverse” to the buyers of the security and “may provide assets...without any off-setting positions.”² With these arcane turns of phrase, Citigroup may well avoid prosecution. If so, it will show how legally weak the SEC’s case against Citigroup was, and why the agency may have been lucky to get the negligence settlement that it did.³

However, whether illegal or not, Citigroup’s negligent behavior was clearly unethical, if not fraudulent: the disclosures obfuscated the truth, violated norms of fairness, and caused substantial injury to poorly informed and unsuspecting investors. What were the principal

sources of this negligence and unethical behavior? And what role does short-termism play in this story?

The Irresistible Lure of Financial Incentives

One potential source of negligence that seems highly unlikely is ignorance of SEC rules pertaining to deceit of investors, or fraud. A more likely factor is that senior employees in the bank's CDO operation found it rewarding to game or circumvent SEC rules, while also turning a blind eye toward espoused industry norms regarding conflicts of interest with clients.

This story is consistent with the bank's pattern of negotiated settlements with the SEC. According to a *New York Times* analysis using SEC data, Citigroup settled four violations of Section 17 of the 1933 Securities Act from 2000 to 2010 pertaining to purposeful or negligent fraud. Citigroup also settled two repeated violations of Section 15 of the 1934 Securities Act.⁴ Given these run-ins, it seems inconceivable that bank executives were not familiar with legislated rules of the game pertaining to negligent nondisclosure.

In announcing its case against Citigroup, the SEC said it had identified one low-level director on the CDO structuring desk, Brian Stocker, as responsible for the bank's misconduct. However, a nearly \$1 billion transaction was unlikely to have begun and ended with Mr. Stocker. Other executives in the Citigroup Capital Markets Group probably knew about and approved the Class V III fund.

Indeed, the SEC complaint shows that Mr. Stocker was regularly communicating with other Citigroup executives about structuring the fund.⁵ How could these executives have approved such a wrong-headed transaction? Like many other bank officers at the time, they had plenty of financial incentives to game SEC disclosure rules and violate espoused norms of behavior. Once the housing market turned and clients complained, their game was revealed.

We know that Mr. Stocker himself had a substantial financial interest in structuring and successfully selling CDO products. For 2007, the year in which the Class V III fund was structured, sold, and failed, Mr. Stocker received a bonus of \$1.05 million—plus a \$2.25 million “guaranteed bonus.”⁶ If he received a cash payment without a holdback, that total bonus award was more than 60 times the medium U.S. household income for 2007, and put Mr. Stocker in the top 0.1 percent of U.S. earners.

One can only speculate what Mr. Stocker's bonus would have been had the fund been successful for clients rather than for Citigroup. Would it have been lower because the bank did not accrue profits from its short position? In any case, if Mr. Stocker's senior colleagues were paid in a similar fashion, it would be hard to avoid the conclusion that the short-term time horizon covered by the bank's incentive program—12 months—and performance metrics that failed to disable incentive payments after an investment disaster for clients contributed to Citigroup's negligence and corruption.

This conclusion would be consistent with multiple recent criminal and civil lawsuits brought by the SEC against mortgage bankers and hedge fund managers who allegedly inflated the values of portfolios tied to their annual bonuses.⁷ This story is also consistent with that of 18 other financial companies found to be repeat offenders of securities laws over the past 15 years.⁸ This is a business where cutting corners and gaming the system appears to be common.

Still, could Citigroup executives have been oblivious to the harm to the bank's all-important reputation? Why would they have tolerated or supported such a shoddy transaction? After all, the Citigroup executives probably thought of themselves as responsible investment bankers. What besides financial incentives and avarice is a work here?

3. The Link between Short-Termism and Corruption

A growing body of research, based on both laboratory experiments and detailed case studies, suggests that we are all susceptible to overestimating our ability to do what is right, and therefore sometimes act unethically without meaning to.⁹ Contemporary research also tends to stress the strong impact of outside influences on our ethical choices, including the time available to make decisions, or the way organizations frame expected outcomes as losses or gains.

This research also helps explain how many of us tend to interpret conflicts of interest—such as those embedded in Citigroup's CDO transaction—in a favorable personal light based on views of ourselves as superior ethical beings. This is especially problematic when rules or norms concerning conflicts of interest have more than one interpretation. Under these circumstances, we often choose interpretations that best serve our self-interest, according to this research.

However, while certainly relevant to the Citigroup story, these explanations do not fully reveal the critical drivers of the bank's negligent behavior. One such driver—indeed, a primary driver of Citigroup's corruption, I contend—involves the curse of short-termism: collapsed time horizons that undermine ethical standards and promote institutional corruption. In this context, institutional corruption refers to institutionally supported behavior that—while not necessarily unlawful—nevertheless undermines the institution's processes and core values, weakening its capacity to achieve espoused goals, and diminishing public trust in the institution.

The Elements of Institutional Corruption

In the private sector, institutional corruption typically involves any of four key behaviors:

- Gaming society's rules and regulations, such as professional accounting standards and the Securities and Exchange Commission Act of 1933.
- Tolerating undisclosed or poorly disclosed conflicts of interest, such as when Citigroup allowed its traders to bet against the Class V III deal promoted and sold to clients.
- Violating accepted norms of fairness, such as in executive compensation.
- Maximizing self-interest by pursuing various forms of cronyism, such as by exploiting connections with the political community to convince policymakers to relax society's rules and regulations.¹⁰

The standards for defining such institutional corruption include both a private procedural standard and a public trust standard: that is, the public's judgments about the fairness of the institution and any social injury it may have caused. The first three behaviors tend to subvert the institution's legitimate mission. All four tend to diminish public trust in the institution.

The Behavioral Hypothesis

The link between short-termism and institutional corruption can be summarized as follows. The shorter the time period for measuring individual and organizational performance, the larger the

rewards and penalties directly tied to these short-term measures, and the weaker the accountability for long-term adverse consequences, the greater the incentive for institutions and their executives to secure short-term rewards by gaming society's rules, tolerating institutional conflicts of interest, violating common decency or other standards of fair conduct, and resorting to cronyism as a way of maximizing self-interest.

This hypothesis will ring true to those familiar with the perverse systems for measuring and rewarding performance and the sloppy board oversight that led to so many corporate governance scandals in the first decade of the 21st century. These included accounting shenanigans at WorldCom, HealthSouth, Adelphia Communications, Global Crossing, Dynegy, Cendant, Qwest, Rite Aid, Computer Associates, Sunbeam, Hollinger International, Xerox, AIG, Fannie Mae, and Freddie Mac, and the dramatic collapse of Enron—a category-defining case of institutional corruption.

My argument will also ring true to those familiar with the story of the savings and loan crisis during the 1980s, when the government's implicit or explicit guarantees of virtually all subprime mortgages allowed banks to operate under "soft budget constraints"—that is, banks could count on surviving even after life-threatening losses. Given weak limits on the opportunism of banks and their executives, the short-term benefits of extracting as much value as possible replaced their espoused goal of creating long-term value for shareholders, even if that approach raised institutional risks exponentially and led to eventual insolvency. In their classic analysis of the S&L crisis and other financial crises of the 1980s, George Akerlof and Paul Romer characterized the gaping disparity between what bank owners and executives captured over the short-term and the losses they created as "looting."¹¹

Such corrupt behavior persisted after Congress passed the Sarbanes-Oxley Act in 2002, in response to the accounting scandals of the 2000s, as evidenced by the behavior of mortgage banks, investment banks, and credit-rating agencies in writing, securitizing, and grading toxic subprime mortgages, which led to the 2008 financial crisis. Whatever the role of criminal intent in these cases, financial rewards large enough to dwarf the risks of prosecution, and a lack of long-term consequences—such as "clawbacks" of executive bonuses if gains proved unsustainable—made corruption more tempting.¹²

My claim about the ill-effects of collapsed time horizons will also appear plausible to those familiar with the observations of distinguished management scholars and business leaders who have thought deeply about the high institutional costs of personal opportunism and the challenges of defining and sustaining institutional integrity. These include historical figures as Chester Barnard, Philip Selznick, and Kenneth Andrews,¹³ as well as contemporary leaders studying the destructive effects of short-termism in business under the Aspen Institute's Corporate Values Strategy Group.¹⁴

This proposition is similarly consistent with research showing how compensation for executives—especially bonus contracts—influences accounting choices, efforts to manage corporate earnings, and strategies designed to boost stock prices artificially.¹⁵ It is also consistent with the claims of legal commentators that compensation based on short-term employment contracts, stock-based compensation, and maximization of stock price is a key driver of short-termism and its ill-effects.¹⁶ Organizational economists similarly hold that executives with significant personal stakes in some economic outcome may jeopardize the long-run interests of owners, such as the market value and integrity of the institution.¹⁷ Finally, the ongoing work of

social scientists pursuing laboratory research on the psychological effects of money on the short-term behavior of human subjects is ideally placed to develop important insights about the link between short-termism and institutional corruption.¹⁸

One of the most pernicious and ubiquitous forms of institutional corruption is institutionally supported gaming of society's rules and regulations.

Gaming and Institutional Corruption

Gaming occurs when corporate institutions pursue one or both of two trust-destroying strategies: (1) lobbying the writing of society's laws and regulations, with the goal of creating loopholes, exclusions, and ambiguous language that give firms opportunities to "work around" the rules' intent; and (2) actually circumventing the rules by exploiting those loopholes, exclusions, and grey areas of the law.

The first is a *rule-making* or influence game; the second is a *rule-following* or compliance game. Like other forms of institutional corruption, gaming takes root where financial stakes are high and accountability for institutional integrity is low. It also occurs, as I will show, where short-term approaches to measuring and rewarding performance dominate the business landscape.

Gaming also takes root when legislative and regulatory processes are chaotic. Ambiguous rules—and rules that apply only to an extremely narrow set of conditions—typically reflect compromises among parties that cannot agree, and intensive lobbying by parties that know exactly what they want.

Of course, discriminating between gaming and simply living with compromise and "legislative mush" is not always easy. Piercing this complexity requires case-by-case analysis of the intent of a law or regulation and whether a company's leaders seek to subvert it for private gain. If their goal is to do so through essentially lawful means, the behavior qualifies as gaming.

Gaming injures the institution itself when claims of foul play undermine its reputation (as in the Citigroup example) and reduce its commercial prospects. Gaming also inflicts social injury when it compromises public welfare and the intent of public policy. In fact, intensive gaming of society's rules creates the alarming prospect of a rupture in the social contract between the capitalist system and the citizenry—with highly uncertain but unpleasant political results.

The Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) of 2010 provides ample evidence that the business community is effectively playing both the rule-making game and the rule-following game. I am referring to the massive lobbying by large financial institutions and their industry associations regarding trading activities permitted under the so-called Volcker rule. That rule generally prohibits deposit-taking banks from engaging in proprietary trading, or otherwise putting their federally insured deposits at risk.

Proprietary trading, which can be enormously profitable for these banks, involves the purchase and near-term sale of high-risk investments for the banks' own accounts. The finance industry's well-funded lobbying during the writing of the law—as well as during the SEC's rule-making phase—has aimed to gain as many exemptions as possible from prohibited trading, and a broad definition of permitted market-making activity to allow maximum flexibility.

Lobbying of regulatory agencies charged with implementing Dodd-Frank is particularly important to affected banks because the chaotic legislative phase did not address many important technical issues. To the extent that this lobbying subverts the aim of the act to reduce excessive risk-taking by systemically important banks, it is a prime example of a rule-making game.¹⁹

A rule-following game is also taking shape, with banks gaming the intent of new regulations by disguising banned proprietary trading as customer-related activity. Only days after Congress approved the Dodd-Frank Act, rumors spread that major banks would be looking for ways to side-step the Volcker rule by bringing clients into trades they were pursuing “for the house.”

More concretely, in March 2012 both Deutsche Bank and Barclay’s Bank announced that they had changed the legal structure of their huge U.S. subsidiaries to shield them from new Dodd-Frank regulations, which would have required both banks to pump new capital into their U.S. operations. As a result, neither bank is now classified as a “bank holding company” under the law—meaning that neither will have to comply with new capital requirements for such companies.²⁰ What the extent of such evasive practices will be as the Dodd-Frank phases in remains to be seen.

The persistence of gaming by the finance industry cannot be justified as a legally sanctioned form of self-interested behavior. While all businesses have a right to petition or lobby the government to shape rules to benefit their interests, lobbying that allows businesses to easily side-step rules in ways that subvert legislative intent undermines the legitimacy of U.S. capitalism.

Although gaming has occurred ever since religious and secular societies first started issuing “commandments” and rules, public disgust regarding corrupt behavior by the business community has never been as profound as it is today. According to the Edelman Trust Barometer, an annual global survey, just 46 percent of “informed” Americans in 2011 said that they trusted U.S. business, down from 54 percent in 2010. These results place public trust in the private sector in the United States behind that in Brazil, India, Italy, and China—and within 5 points of Russia!

What’s more, only 25 percent of informed Americans surveyed by Edelman in 2011 trusted bankers to do the right thing—down from 71 percent in 2008. The comparable numbers for China and India are 90 percent and 87 percent.²¹ These findings are roughly consistent with a survey conducted by the Chicago Booth/Kellogg Financial Trust Index in 2009 showing that “only 19 percent of the U.S. public trusts the financial system.”²²

Given the remarkably low level of public trust and confidence in U.S. business institutions, we may be approaching a tipping point beyond which some, including large financial institutions, may no longer be politically viable in their current form. The proposal of Senators Ted Kaufman (D-Del) and Sherrod Brown (D-OH) during debate on the Dodd-Frank Act to break up the nation’s largest banks won 33 of 94 votes.

These findings also strongly suggest that the perceived legitimacy of many business institutions is at substantial risk—and the erosion of public trust is central to defining institutional corruption in the private sector. But what are the sources of short-termism in the first place? And how does short-termism foster one of the most pernicious and ubiquitous forms of corruption: institutionally supported gaming of society’s rules and regulations?

4. Sources of Short-Termism

Short-termism—a preference for near-term actions that have negative long-term consequences—has received considerable academic attention for 30 years.²³ These analysts have found it difficult to actually measure changes in managers' time horizons and their impact on investment decisions. However, short-termism in management culture seems to have three sources: firm-related sources (incentive systems for executives and CEO turnover), market-related sources (the stock market), and individual-specific sources (the impatient self).

Incentive Systems for Executives

Performance measures and rewards are the building blocks of any financial incentive system. In the case of corporate executives, where payments and stock options are often linked to a 3-to-12-month time horizon, short-term behavior is an inevitable result.²⁴

Table 1, prepared by HBS Professor Andre Perold for a presentation we made together, shows the relationship between pretax earnings of five leading investment banks and executive compensation in the decade before the 2008 financial crisis. From 1997 to 2007, these firms paid out double their pre-tax income in salaries and benefits each year.²⁵ And the metric for determining annual bonus pools in most investment banking firms is annual *revenue* growth. This practice obviously emphasizes short-term (12-month) revenues over profitability and longer-run value creation for shareholders.²⁶

Given this record, it should be no surprise that short-termism and casino-like risk-taking were prevalent during the buildup to the financial breakdown. The numbers show just how great the incentives were to “win big” by maximizing short-term self-interest, even when financial and regulatory risks were legion. The Citigroup case attests to the impact of basing executive compensation on short-term measures. The SEC lawsuit cites communication among executives expressing a desire to get credit and bonuses for profits from the Class V III transaction. Not surprisingly, business executives are no different from anyone else in responding with lightning speed to the metrics used to evaluate and reward their performance.²⁷

Table 1. Relationship between Pretax Corporate Income and Salaries and Benefits for Executives at Major Investment Banks, 1997-2007 (in billions of dollars)

Pretax Income							Salaries and Benefits						
	Merrill Lynch	Morgan Stanley	Goldman Sachs	Bear Sterns	Lehman Brothers	Total		Merrill Lynch	Morgan Stanley	Goldman Sachs	Bear Sterns	Lehman Brothers	Total
1997	3,050	4,274	3,014	1,014	937	12,289		7,962	6,019	3,097	1,727	1,964	20,769
1998	1,972	5,385	2,921	1,063	1,052	12,393		9,199	6,636	3,838	2,112	2,086	23,871
1999	3,883	7,728	1,992	1,064	1,589	16,256		11,153	8,398	6,459	2,286	2,707	31,003
2000	5,522	8,526	5,020	1,172	2,523	22,763		13,730	10,936	8,491	2,814	3,931	39,902
2001	1,182	5,684	3,969	934	1,692	13,188		11,269	9,397	7,700	2,529	3,437	34,332
2002	3,566	4,633	3,253	1,311	1,343	14,106		9,426	7,933	6,744	2,508	3,139	29,750
2003	5,433	5,334	4,445	1,772	2,464	19,448		9,570	8,545	7,393	2,881	4,318	32,707
2004	5,616	6,640	6,676	2,022	3,494	24,448		10,596	9,880	9,591	3,254	5,730	39,051
2005	7,231	7,361	8,273	2,207	4,829	29,901		12,441	11,002	11,688	3,553	7,213	45,897
2006	10,426	11,000	14,560	3,147	5,905	45,038		15,100	14,387	16,457	4,343	8,669	58,956
2007	(14,458)	3,441	17,604	193	6,013	12,793		15,903	16,552	20,190	3,425	9,494	65,564
	33,423	70,006	71,454	15,899	31,841	222,623		126,349	109,685	101,648	31,432	52,688	421,802

The risks of institutional corruption are particularly acute when executive compensation is based primarily on “objective” accounting measures such as profits and cash flow. Companies can easily “manage” or game these measures by deciding how to accrue expenses, recognize revenues, and account for assets on their balance sheets. For example, before its bankruptcy, the investment bank Lehman Brothers used undisclosed transactions to disguise the assets reported on its balance sheet and paint a misleading picture of its true financial condition. (See more on this is below.)

The short-term perspective embedded in accounting measures of performance and operating budgets is reinforced when the system for compensating executives fails to provide penalties when investments or other activities produce losses. Adding outsized bonuses to no-risk stock options and large rewards without symmetrical losses when failures ensue produces a truly toxic situation: personal opportunism combined with short-term risk-taking and little regard for long-term effects.

Law school professors Lucian Bebchuk (Harvard) and Jesse Fried (Berkeley) have noted the problems created by this pattern of executive pay:

First, managers may take actions that boost the stock price in the short run even if such actions would destroy value in the long run. For example, executives may enter into transactions that improve the current bottom line but create large latent risks that could cripple the firm in the future. Second, managers may engage in financial manipulation or other forms of “window dressing” that do not build firm value, merely to pump up short-term prices. In both cases, executives receive higher pay even though they fail to build firm value. And in the first scenario, executives receive more pay even though they destroy firm value. Thus, rewarding executives for short-term results not only fails to serve the goal of encouraging executives to improve firm performance—it can actually work in the opposite direction.²⁸

These huge compensation numbers may help explain why leading financial institutions, such as Citigroup and Goldman Sachs, tolerated conflicts of interest with clients in their trading operations, and gamed financial reporting rules. The high levels of compensation may have helped convince executives to interpret conflicts of interest in the most favorable light.

Performance measurement and reward systems have also been a common source of short-termism beyond Wall Street, adding fuel to the fire of gaming and other forms of institutional corruption. Perhaps the most carefully documented example of the potential perversity of such systems is the case of Enron, documented in my book on the social pathology of Enron’s collapse.²⁹ (See more on this below.)

CEO Turnover

Since 1998, the job tenure of CEOs of large U.S. companies has become precarious. Research by Steven Kaplan shows that from 1992 to 2007, annual turnover of CEOs—both internal (board driven) and external (through takeover and bankruptcy)—amounted to 15.8 percent of the broad population surveyed. The means average tenure was less than seven years. After 2000, annual CEO turnover rose to 16.8 percent, for an average tenure of less than six years.³⁰ Other studies based on different samples of firms and time periods show even higher rates of CEO turnover.

In an earlier study, Kaplan and Bernadette Minton found that CEO turnover was significantly related to three measures: the performance of a firm’s stock price compared with that of the industry as a whole; industry performance relative to the performance of the overall stock market; and the overall performance of the stock market. As Kaplan and Minton speculate, shorter CEO tenures, along with stronger links among job security, stock performance, and higher levels of CEO pay, may have created a greater incentive for CEOs to manipulate earnings—that is, to game accounting rules of the game.³¹

Consistent with these observations is the idea that managers tend to place less weight on outcomes that occur after their employment ends than on those during their expected tenure. This management myopia intensifies short-termism throughout the enterprise.³²

The Stock Market

This category includes two closely related sources of short-termism. The first is the preoccupation of managers of investment funds and other institutional investors—who now own

60–70 percent of U.S. equities—with the near-term earnings of companies in their portfolios, rather than indicators of long-term value, such as research quality, innovation rates, customer retention, and even market share. According to many scholars and experienced observers, these investors put significant pressure on corporate boards and executives to deliver short-term gains in stock price, at the expense of balanced, long-term investment, prudent risk management, and integrity, because their modus operandi involves beating composite short-term indexes and peer investors.³³

The result is a rising turnover rate of equities held by both purportedly long-term investment funds and institutional investors. That is, these players maximize profits by continually “rebalancing their portfolios.” Take, for example, a study of stock turnover commissioned by the Investor Responsibility Research Center, and conducted by Mercer Consulting.³⁴ This study examined 991 strategies of self-professed “long-only” equity fund managers across geographic regions and styles from June 2006 to June 2009. The researchers found an average annual portfolio turnover of 72 percent, with some 20 percent of funds recording more than a 100 percent turnover within a 12-month period.

The Investment Company Institute has also reported a 60 percent average annual turnover in investment funds over the past decade, with peaks of 70 percent before the 2002 market crash and after 2008. Although these two studies relied on different methodologies, these rates are significantly above the 50 percent in 1990 found by the Employee Benefit Research Institute.

Looking at longer sweep of history, Andrew Haldane of the Bank of England reports that the average holding period for U.S. equities across all investor groups has dropped from seven years in the 1970s to about seven months over the last 40 years.³⁵ And the World Bank reports that the turnover ratio for the U.S. stock market (the total value of shares traded divided by the average market capitalization) rose from 182.8 in 2006 to 348.8 in 2009—almost doubling in just four years.³⁶ In fact, the annual rate of equity turnover for many hedge funds, which now account for nearly half of all stock trades, can reach 1,200 percent.

There is little doubt that much of this increase reflects the rapidly declining costs of trade in equities and the corresponding rise of “hyperspeed” traders, who may hold stock for only a few seconds. These traders, who now account for as much as 70 percent of all trade in U.S. equities—have zero interest in an investment’s long-term value.³⁷ Thus the market resembles a top-of-the-line gambling casino, where gamblers—many with access to easy credit—play numerous high-speed games of chance with immediate payouts or losses.³⁸ Many of these gamblers (money managers) are themselves subject to short-term performance metrics, so it is no surprise that pressure builds to focus solely on the here and now.

The second source of short-termism in this arena is the *response* by managers of public corporations to the diminished time horizons of professional investors. These executives essentially collude with investors in the pursuit of short-termism by offering quarterly “earnings guidance”: their best guess regarding how much the company will earn over the next three months.³⁹

This practice became more common after Congress passed the Private Securities Litigation Reform Act of 1995. That law effectively protected executive and their companies from legal liabilities stemming from statements about projected performance. Many more public companies have since adopted this practice, following others that had provided informal earnings

guidance for years.⁴⁰ Thus companies that offer opportunities in the casino—by going or remaining public—know what’s expected of them: deliver a payout by meeting near-term earnings forecasts, or see defecting gamblers hammer their share price.⁴¹

Many companies argue that this practice improves communication with financial markets, raises share prices, and reduces their volatility. However, a 2006 McKinsey study examined some 4,000 companies with revenues greater than \$500 million, of which about 1,600 provided earnings guidance at least once from 1994 to 2004. The researchers found no evidence that frequent earnings guidance affects valuation multiples, or reduces the volatility of share prices.⁴² Frequent guiders did not receive superior valuations in the marketplace—regardless of the year, industry, or size of the company.

Indeed, the only significant effect that McKinsey observed was an increase in trading volumes when companies begin issuing earnings guidance. That increase could simply reflect the rise of hyper-traders and hedge fund managers with little interest in companies’ long-term prospects. On top of the management time required to prepare such reports, McKinsey concluded that the entire process “can be a powerful incentive for management to focus excessive attention on the short term; to sacrifice longer-term, value-creating investments in favor of short-term results; and, in some cases, to manage earnings inappropriately from quarter to quarter to create the illusion of stability.”

Academic research and professional opinion confirms these findings. In a 1992 study for the U.S. Council on Competitiveness, Harvard Business School Professor Michael Porter defined management myopia as underinvestment in projects that create long-term value, such as R&D, to meet short-term goals, such as beating earnings forecasts. Using this definition, Mei Cheng, K.R. Subramanya, and Yuan Zhang showed in 2005 that companies that offer earnings guidance often invest significantly less in R&D than companies that offer such guidance only occasionally. Companies offering frequent guidance also had significantly lower long-term growth rates.⁴³

These findings are also consistent with a survey of 400 corporate managers published in 2005 showing that “that almost four out of every five respondents indicated that they would decrease discretionary spending on such areas as research and development, advertising, maintenance and hiring in order to meet short-term earnings targets. More than half of the respondents said they would delay new projects, even if it meant sacrificing value creation.” The goal, of course, was to avoid punishment by the securities market—in the form of lower stock prices and cuts in management compensation—for failing to hit a quarterly target.⁴⁴

Hundreds of companies—including Coco-Cola, Alcoa, AT&T, Clear Channel Communications, Mattel, PepsiCo, and Sun Microsystems—stopped issuing quarterly earnings guidance. However, some of these same companies have resumed the practice, probably to counter their image as troubled, and to sustain the interest of analysts and institutional investors. Still, the surveys by McKinsey and the National Investor Relations Institute clearly reveal that most senior executives believe that pressure from Wall Street for short-term performance is a huge problem hurting companies.

Short-term performance pressures—reinforced by protections of the Private Securities Litigation Reform Act—can easily lead executives to manipulate reports on a company’s revenues and accrued expenses.⁴⁵ A recent study by Francois Brochet, Maria Loumiotis, and George Serafeim examined the language of senior executives and investors during 70,042

quarterly conference calls devoted to the earnings of 3,613 public companies worldwide from 2002 to 2008. The researchers found a predictable relationship between calls where participants used language indicating short time horizons and efforts to manage earnings. The researchers also found that the short-termism of investors seemed to beget short-term behavior by executives—and that short-term-oriented companies tended to attract short-term investors.⁴⁶

Other deceptions are more complicated, shocking, and destructive, such as looting a firm's pension fund to fuel reported earnings. In 2005, for example, more than 80 percent of Lucent's pretax profit came in the form of noncash income from its flush pension plan.⁴⁷ In fact, earnings management—a classic case of lawful but corrupt behavior—is a central feature of institutional corruption in business today, and an important factor in the continuing decline in public perception of management authenticity.

The Impatient Self

Short-term incentives to game or pursue other lawful but corrupt behavior often appeal to our impatient self—the third powerful source of short-termism. Andrew Haldane, the Bank of England economist, has described the implications of this phenomenon for the practice of finance and the stability of markets.⁴⁸

Haldane reminds us that in the *Theory of Moral Sentiments*, Adam Smith spoke of a “two-self” model, defined by patience and impatience. Psychologists, philosophers, and, most recently, behavioral economists—such as Sigmund Freud, Isaiah Berlin, Richard Thaler, and Hersh Shefrin⁴⁹—developed Smith's concept of a double self into a model of the patient “planner” and the impatient “doer.”

Today brain imaging has given this model scientific support. Haldane cites research showing that while patient behavior is associated with the prefrontal cortex, which is involved in making plans and taking action, impatient behavior is associated with the limbic system, which appears to govern our emotional life and memory.⁵⁰ Thus, when we face difficult decisions, we are literally of two minds.

Haldane notes that impatience was no stranger to neoclassical economists such as Alfred Marshall, Irving Fisher, and Arthur Pigou. Writing over a century ago, Pigou, Haldane recalls, described the tendency of humans to discount long-term outcomes as a “defective telescopic faculty.”⁵¹ Economic research has since shown that such discounting is not only myopic but also inconsistent: managers' and investors' references shift as distant outcomes move closer to the present. That is, Smith's patient planner becomes a spontaneous doer when outcomes are within reach, and the long-term investor becomes a short-term gambler when assets can be cashed.

At the extreme, this condition spins into a form of addiction wherein a person seeks immediate gratification regardless of long-term consequences.⁵² Economists call this “hyperbolic discounting.”

Haldane argues that impatience leads to two adverse outcomes, “as people opt for jam today at the expense of a whole jam-jar tomorrow.” First, impatience can lead to undersaving and underinvestment, which retards the growth of both firms and economies. Second, overborrowing, in the form of consumer credit—the flip side of undersaving—moves tomorrow's spending to today. At the extreme, impatience expressed as overborrowing becomes a credit addiction, which, among investors, often spurs overtrading. Undersaving, overborrowing, and overtrading

are all aspects of short-termism, and their effects on financial and economic systems can be profound.

Strong, misplaced incentives can foster such shifts in time and risk preferences toward short-termism—and are arguably the source of the recent financial crisis. Add behavioral contagion and peer pressure that reinforces impatience and short time-horizons, and we have just about every condition in place for a full-fledged elimination of Adam Smith’s patient planner.

5. Examples of How Short-Termism Invites Corruption

If incentive systems, the capital market, and our impatient selves originate and perpetuate short-termism in public companies, then how does short-termism invite institutional corruption, such as the gaming of society’s rules of the game?

I have suggested that the combination of (a) monetary stakes in the success or failure of a transaction or organizational outcome that dwarf any personal risks, and (b) monetary payoffs based on short-term performance measures, create a huge incentive for executives to game society’s rules for immediate gain. Without claiming that large, short-term incentives *inevitably* lead to corrupt behavior, I argue an important relationship exists between distorted incentives and corrupt behavior.

As one compelling example, consider the case of Enron. Along with fraud, Enron pursued one of the greatest gaming strategies of all times. A gradual erosion of integrity and candor in response to several factors fueled this gaming and corruption. One was enormous pressure from creditors and shareholders to maintain profit growth, the company’s all-important credit rating, and the price of its overvalued stock. Other factors included large annual bonuses for energy traders—sometimes 5 to 10 times base salary; stock options for senior executives that encouraged excessive risk taking in the present, without accountability and financial penalties for poor results in the future; and a corporate culture wherein senior managers encouraged limits-testing and sometimes both tolerated and promoted deception.

Long before the company’s chief financial officer, Andrew Fastow, created the first of many off-balance-sheet partnerships and related financial transactions designed to bolster Enron’s reported profits and anemic cash flow, the company depended on its quarterly results to keep credit ratings and stock price up. When Enron’s profits declined in 1997, its cash flow looked weaker than ever, and its credit rating and stock price came under great pressure, the firm’s gaming of accounting and SEC rules escalated dramatically. Much of this gaming of short-term financial results was not incontestably illegal.

Enron had established itself as a world class gamer even before 1997. For example, its *rule-making* games centered on rewriting rules of the game related to the deregulation of electricity and the opening up of mark-to-market accounting to nonfinancial institutions. Both these practices enabled Enron to state earnings in a most favorable light to support its stock price.⁵³

After 1997, the company’s *rule-following* games included the use of off-balance-sheet partnerships to inflate quarterly and annual earnings, the reorganization of business structures to obfuscate line-of-business reporting, and the use of accounting techniques for asset sales to boost reported current earnings. Other such games include the use of “prepay” transactions to disguise the firm’s true end-of-year debt, and the use of opaque financial disclosure to support the company’s stock price. Reasonable parties differ on whether each instance of regulatory

influence and devious behavior was actually unlawful, based on varying readings of ambiguous rules and interpretations of Enron's intent. However, the company's propensity to cheat clearly rose with the stakes involved in missing short-term earnings and expectations for cash flow.

A more recent example of the links among the rule-following game, short-termism, and institutional corruption is the dressing up and obfuscation of short-term performance by Lehman Brothers in the years before its collapse. According to bankruptcy court examiner Anton R. Valukas, Lehman's use of undisclosed Repo 105 transactions enabled the bank to "paint a misleading picture of its financial condition."⁵⁴

In these transactions, Lehman swapped risky fixed-income assets for cash just before publishing quarterly results while promising to buy back the securities later. These transactions disguised the composition of Lehman's assets and enhanced its three-month reporting cycle. The goal: to avoid punishment in the form of a drop in stock price and cuts in executive compensation for failing to hit announced near-term results.

Valukas concluded that investors had credible legal claims against the bank's former CEO and finance chiefs, as well as Ernst & Young, its auditor, for misrepresenting the bank's true financial condition. Ernst & Young has argued that this maneuver did not violate accounting rules at the time. However, there is no controversy over the fact that these parties gamed the firm's short-term financial position to prevent a sudden breakdown in confidence among Lehman's creditors and shareholders. Given the huge adverse results certain to result from short-term failure, obfuscation of financial reality became Lehman's modus operandi. The relationship between large, short-term financial rewards or penalties and the gaming of corporate financial reporting—and institutional corruption—could not be clearer.

The Impact When Banks Became Publicly Held Corporations

Short-termism, at least on Wall Street, strengthened when traditional investment banking partnerships—in which partners share *all* gains and losses—began turning themselves into limited-liability, publicly owned corporations. That structure eliminated the personal liability of key employees for losses, in effect releasing them from the personal obligation to provide for their retired and next-generation partners.

Two key aspects of investment banks changed dramatically when they converted to publically held corporations. The first is investment policy. As Seymour Smidt explains, "As partnerships, [investment banks] were very conservative, since the money at risk was their own. When [the banks] converted to public corporations, the incentive to minimize investment risk no longer existed to the same extent since most of the money at risk belonged to the stockholders, not the investment bankers and traders who were making the decisions."⁵⁵ Ask yourself: Would U.S. investment banks have taken on such extraordinary leverage—as much as 20 to 30 times tangible capital—if they had remained partnerships?

What's more, many executives of the now-public investment banks—who became extraordinarily wealthy as they cashed in their shares during public offerings, and then diversified their financial holdings—would remain wealthy whatever happened.⁵⁶ One inevitable result was a greater appetite for institutional risk-taking. Another was diminished financial penalties for top bank executives if such risk-taking breached common sense or society's rules of the game.

The second aspect of investment banking that changed, closely related to the first, involves our old friend performance evaluation—especially the time horizon for measuring both individual and institutional performance. After virtually all major Wall Street banks converted from private partnerships to publicly owned companies, quarterly and annual metrics replaced longer-term considerations. In so doing, the banks effectively rejected Gus Levy’s famous dictum for Goldman Sachs: “We are long-term greedy!” The fact bankers and traders were no longer accountable for a firm’s long-term performance and viability spurred them to actively game industry rules and norms. Would the executives in charge of Citigroup’s CDO business have acted as they did if they had been partners, or on the partnership track, at a private bank, with all its obligations to past and future partners?

The Perverse Impact of Skyrocketing Executive Pay

When corporations use longer time periods for measuring and rewarding individual and group performance, executives have more time to manage the personal risks of short-term financial disappointments and pursue longer-term strategies, without having to resort to gaming and obfuscation to “look good.” Longer time periods for assessing performance also allow for “lookbacks” at, say, deterioration of mortgage products, assessments of a firm’s real economic performance, personal accountability for past performance, and clawbacks of bonuses by corporate boards of directors or other oversight bodies within firms.

Unfortunately, as noted, pay packages for CEOs of public companies have not emphasized the long term over the past two decades. Most CEOs and senior executives are still heavily compensated (as much as 80 percent) by stock options and grants based largely on annual rather than multiyear performance. With a booming (some say overpriced) stock market until the 2008 financial meltdown, and growing reliance on equity-based pay, compensation for senior executives has risen rapidly and created incentives to game the system.

Cash-bonus plans can be as perverse as stock options and stock grants in shortening decision makers’ time horizons. Businesses that pay cash bonuses before establishing the true profitability of a new venture, such as a long-term energy contract (as at Enron), or a multitiered mortgage-backed security (as at Fannie Mae), end up promoting rosy valuations of future profitability and encouraging the gaming of accounting rules for short-term gains, especially when companies cannot revoke such awards given underperformance or malfeasance. This combination of practices is a principal storyline in the mortgage banking fiascos as well as Enron—and perhaps the Citigroup case as well.

Like the *form* of executive pay or compensation structure, the *level* of pay can spur short-termism and institutional corruption. As the stakes and potential payoffs rise, so do the incentive to cheat or game society’s rules. This is one implication of Table 1. A similar scenario occurs in sports, where the most experienced referees—and sometimes extra referees—are called into action during high-stakes playoff games and matches to enforce agreed-upon rules and minimize shady practices, such as stealing signals sent from catchers to pitchers in baseball, making borderline impermissible blocks and tackles in football, and camouflaging fouls in basketball.⁵⁷

Despite the challenges of tracking the pay of top executives, we do know that it has skyrocketed, especially in financial services. According to *BusinessWeek*, CEO pay across all industries was 42 times average blue-collar worker pay in 1980.⁵⁸ By 1991, according to Lucian Bebchuk and Jesse Fried in their 2004 book *Pay Without Performance*, the average company

CEO received about 140 times the pay of an average worker. By 2003, this ratio was about 500:1.⁵⁹

Even if we cut the latter ratio in half—adjusting for the rise in stock options as a share of total compensation since the 1980s, and the 2,340 percent total return of the S&P 500 from 1980 to 2009 (for an annualized return of 11.24 percent)—the ratio of top executive pay to average worker pay in U.S. business would still be extraordinarily high. This is true in both absolute terms and compared with executive pay in other industrialized nations.

For example, the International Labour Organization recently reported that the ratio of salary plus bonuses of U.S. executives (not counting stock) to the average compensation per worker was 112:1, versus 82:1 in Germany and 55:1 in Australia, in 2007.⁶⁰ With such large personal payoffs at stake for top U.S. executives—especially those in the finance industry—it is easy to imagine that many self-interested executives try to find ways of gaming established rules of the game to drive up the price of their company’s stock and reap the short-term benefits.

The case of Fannie Mae provides more evidence. The company had a reputation for paying its senior executives very well. For example, James Johnson, CEO from 1991 to 1998, reportedly earned a total of \$100 million. The company based executive bonuses largely on annual growth in per-share earnings, so it was important to keep profits growing. As the Office of Housing Enterprise Oversight (OFHEO) discovered, and Gretchen Morgenson and Joshua Rosner reported in *Reckless Endangerment*, “You could predict what Fannie’s earnings-per-share would be at year-end, almost to the penny, if you knew the maximum earnings-per-share bonus payout.”⁶¹

If current earnings would not support the large annual bonuses that top managers had planned for themselves, they redid the math—a perfect example of institutional corruption. And, as Morgenson and Rosner explained, Goldman Sachs helped Fannie Mae boost its earnings by designing a mortgage-backed security that allowed Fannie to “better manage the recognition of income” by pushing \$107 million in income to future years. OFHEO concluded that this and similar transactions “had no significant purpose other than to achieve desired accounting results.” Fannie Mae, in other words, was managing its reported earnings to trigger short-term (annual) management bonuses.⁶²

6. Curbing Short-Termism and Institutional Corruption

Proposals for combating institutional corruption in both the public and private sectors tend to cluster around three reform mechanisms. These are *shaming*, which includes exposure and negative publicity; *collective action*, which suggests public demonstrations such as Occupy Wall Street, and coalitions that promote cross-party collaboration in Congress, such as No Labels; and *institutional reforms*, which could include public policies that regulate or otherwise influence company conduct and business policies that affect day-to-day operations.⁶³ I focus here on institutional reforms related to corporate governance and public policy that can have an immediate impact on short-termism and the institutional corruption it invites.

Most institutional reforms and countermeasures for short-termism are reasonably well known. The challenge is finding the courage and perseverance to implement them in the face of inertia and active resistance. Changes in public policy have not received as much attention.

The most obvious countermeasures start with corporate boards of directors. In the final analysis, short-termism exists because corporate governance practices allow it. To the extent that we have a short-termism crisis, we also have a corporate governance crisis.

Corporate boards and executives need to walk the talk of prudent fiduciary behavior, which means keeping their duty to protect shareholder value foremost in their minds day in and day out. The private-sector record of institutional corruption shows that this is simply not happening in many settings.

Such a change in attitude will help directors and other overseers purge incentives to game society's rules for short-term gain, such as the use of stock price as a principal measure of corporate performance. Some progress is occurring in this sphere, but much remains to be done. (See more on this below.)

A third remedy in the corporate governance domain concerns how firms communicate with the capital market. Although controversial, ending the practice of quarterly earnings guidance is critical to helping public companies resist short-term pressures from fund managers and other investors.

A fourth strategy for eliminating the curse of short-termism is dual-class ownership of public corporations. The New York Times Co., Washington Post Co., Ford Motor Co., Berkshire Hathaway, and Google have all adopted that ownership structure, which allows founders to control the company's future without depending on what others think.

The founders of Google justified its unusual capital structure during the 2004 initial public offering (and again during their 2012 secondary offering) as allowing managers to pursue a long-term, innovation-based growth strategy, and as making it harder for outside parties to take over or influence the company. Converting established public companies to a dual-share structure diminishes the rights of existing shareholders, so I will not discuss it further here, although it is a credible option for companies planning to go public.⁶⁴

On the public policy front, one of the most effective countermeasures is eliminating the short-term bias of the nation's approach to taxing capital gains. Neither business leaders nor policymakers have discussed this option widely. However, eradicating this bias could change the way companies conduct business—not only by curbing short-termism and institutional corruption, but also by spurring investment in companies' long-term competitiveness, thus creating jobs.

The next sections explore these options further.

Walking the Talk of Fiduciary Duty

A fiduciary is one who owes to another the duties of good faith, trust, confidence, and candor. Most industrial societies have legal standards for fiduciaries, including elected directors of public companies, who provide a modicum of protection to beneficiaries such as shareholders. Under U.S. law, corporate boards are deemed to owe fiduciary duties to both shareholders and the corporation.⁶⁵

Multiple sources set standards for directors serving in a fiduciary capacity. These include not only corporate law, which imposes liability, but also federal law and regulations, which can impose criminal sanctions (jail or fines) and civil sanctions (fines and other penalties); tort law

and common law, which can hold individuals liable for deficient conduct (by imposing damages); and aspirational standards, as reflected in the Model Business Corporation Act.

U.S. legal standards of fiduciary duty are quite low compared with the aspirational standards on which the law is based. This reflects the interest of courts in encouraging people with years of business experience and other professionals to serve in corporate oversight roles, and to in curbing judicial interference in business decisions. That means directors of public companies operate under weak legal pressure to sustain prudent fiduciary behavior, such as safeguarding a company's long-term interests and eliminating the ill effects of short-termism on the board and throughout the organization.

The record of spectacular collapses and near misses among leading financial institutions in 2007–08, and the accounting shenanigans during the past decade, are damning evidence of weak fiduciary oversight. Some boards of directors appear to easily forget that fiduciary prudence is the first line of defense against short-termism, cheating, and other forms of institutional corruption, and that remediation (and law enforcement) is at best reactive, not preventative.

Many directors of public companies cannot monitor and guide the long-term performance of their companies because they are out-of-touch with their prospects and problems. One McKinsey study conducted before the recent financial crisis found that half of 1,016 public directors surveyed across industries and geographic regions had no clear sense of their companies' current strategy. Only 11 percent claimed to completely understand the risks their companies faced.⁶⁶

In another survey by Colin Carter and Jay Lorsch in North America, continental Europe, and Australia, a majority of CEOs said they lacked confidence that their independent directors understood the company's business, regardless of the amount of time they spent on it.⁶⁷ Given those findings, it should not be surprising that many corporate directors lack a framework for managing for long-term competitive advantage and curbing the ill effects of short-termism.

The obvious remedy to this fiduciary and knowledge gap is better board governance processes, as recommended by the Committee for Economic Development and others.⁶⁸ Apart from the still-controversial requirements of the Sarbanes-Oxley Act of 2002, the most important improvements in board governance for curbing the curse of short-termism include:

- Adopting a five-to-seven-year time horizon for securing future growth.
- Setting aside enough time—often much more than the two days per month that directors of large, public U.S. companies typically spend, according to Korn/Ferry—to monitor business and financial plans, and to probe conduct that could put those plans in economic and moral jeopardy.
- Requiring directors to have substantial wealth invested and at risk in their companies, so the personal costs of failed oversight are high.
- Creating a more arm's-length relationship between directors and CEOs, and empowering nonexecutive chairs or lead directors to fully discuss short-termism and institutional corruption. These directors should have the authority to call routine meetings of nonemployee directors without the CEO present, and to evaluate the CEO and the board itself.

Better governance practices can help protect both the corporation and shareholders from the adverse effects of short-termism. To support these structural reforms, directors should commit to

shielding CEOs from unreasonable short-term pressures from capital markets—or, stated somewhat differently, to creating a safe harbor where CEOs can focus on creating sustainable, long-term value.

This commitment requires crafting and constantly reiterating a narrative of corporate purpose that goes beyond profit maximization for shareholders, as Johnson & Johnson, Novo Nordisk, and other public companies have done. For example, Novo Nordisk’s core purpose focuses on curing diabetes. Such articulations not only provide a valuable narrative that binds employees to important work, but also enable executives to balance short-term and long-term priorities given their institution’s core values and aspirations.

Terminating Quarterly Earnings Guidance

I see no compelling argument for why public companies that are actively followed by investment analysts should offer quarterly earnings guidance. If we are seriously interested in minimizing the ill effects of short-termism among operating managers and fund managers, that practice should end.

As noted, most surveys of managers’ attitudes and beliefs—and systematic analyses of actual managerial behavior and changes in share price—suggest that the benefits of quarterly earnings guidance are either overrated or nonexistent for most public companies, and that such guidance can be a costly diversion from longer-term value-creation.⁶⁹ The practice also invites the lawful but corrupt gaming of accounting rules and straight out misrepresentation of reported financial results.

Both the CFA Institute and the Business Roundtable have emphatically called on managers to end the practice. In 2007, the U.S. Chamber of Commerce publicly implored managers to stop providing quarterly guidance. And the 2011 summit of the Aspen Corporate Values Strategy Group, on “Combating Market Short-Termism,” also explored the benefits of moving away from quarterly guidance.⁷⁰ In fact, the keynote speaker recommended repeal of the 1995 Private Securities Litigation Reform Act, which protects executives and their companies from liability stemming from attempts to manage corporate earnings. That repeal would bring the practice of giving earnings guidance to a screeching halt. The evidence is convincing that the time for such a repeal has come.

For small companies with little coverage by analysts, and for companies not widely known by the media, the preferred course may sometimes be different. Recent research by Florian Eugster and Alexander Wagner shows that high-quality voluntary disclosures of corporate earnings, including quarterly guidance, can bolster the share prices of emerging companies.⁷¹ However, it is doubtful that this benefit trumps that of curbing short-termism in the stock market. And in any case, normal quarterly reports for all classes of public companies include significant information on performance.

Eradicating Perverse Incentives

One of the most effective leverage points for reorienting an organization to focus on its long-run health is restructuring financial incentives to reflect this commitment. Analysts have proposed many valuable routes for changing the time horizons and decision criteria of both managers of investment funds and corporate executives. Most of these ideas share elements of four principles:

- Employing longer time periods for measuring corporate and managerial performance and paying incentive-based awards.
- Including qualitative criteria when evaluating individual and institutional performance.
- Deferring a portion of annual incentive awards, so it can be clawed back given malfeasance or a significant reversal of corporate results.
- Basing the vesting of stock grants and options on longer-term metrics—such as several years of earnings in excess of the company’s (risk-adjusted) cost of capital—and extending the required holding period of exercised stock options.⁷²

Under the first three principles, companies would award incentive payments only after some or all risk outcomes are realized or better known. The fourth principle serves a compatible function by directly exposing holders of stock grants and options to the financial effects of risky outcomes. To reinforce long-term decision making, the vesting period could correspond to the time horizon of executives’ business strategies—surely longer than a year or two for most significant enterprises.⁷³

These principles should apply to managers of investment funds as well as public companies. Those funds could extend managers’ time horizons by linking bonuses to assets under management and client retention, rather than simply comparing short-term returns with some benchmark, and by paying out annual bonuses over three years. Such an approach is compatible with clawback provisions—introduced by the Sarbanes-Oxley Act and extended by the Dodd-Frank act—mandating that firms recoup bonus awards if short-term successes prove either unsustainable or unethically achieved.⁷⁴ Investment funds should also extend managers’ time horizons by linking bonuses to peer-group comparisons over a three-year period.

Clawback policies appear to be gaining some traction. By the end of 2009, 64 percent of the country’s 100 largest companies had begun requiring executives to return part of their pay under certain conditions, such as malfeasance—up from only 17.6 percent in 2006.⁷⁵ However, I have yet to see any evidence that a company has actually taken back funds based on these provisions.⁷⁶

Finally, as Lucian Bebchuk has suggested, “Limits should be placed on executives seeking to hedge their stock options and stock grants through derivative transactions.”⁷⁷ Hedging stock options weakens the connection between executive pay and long-term results, as an executive who buys a “put” option to sell his or her shares at the current price is effectively insured against declines in the stock price. That strategy should be universally prohibited.

Eliminating Short-Term Bias in Capital Gains Taxes

Short-termism results not only from firm-specific practices, but also from a critical economywide factor: a tax regime with a built-in, short-term bias.

The primary source of short-term bias in the U.S. tax regime is the treatment of so-called long-term capital gains on investments. According to the tax code, any gain accrued after more than 12 months is considered long-term. That means that the tax code treats 12-month investments exactly the same as 60-month investments, even though there is a world of difference in their impact on investment behavior and executive time horizons.

As most people know, taxes on capital gains vary with the seller's marginal income tax rate the year the assets are sold. If President Obama had let the Bush tax cuts expire on December 31, 2010, the long-term capital gains tax rate on individuals in the top two income tax brackets (with income greater than \$250,000) would have risen from 15 percent to 20 percent, for assets held longer than one year. Gains on "super-long-term" assets—those held for more than 60 months—would have been taxed at 18 percent for taxpayers in these top two brackets. Under the president's latest tax reform proposal, the capital gains tax would rise to 30 percent. Whatever the merits of such changes in enhancing revenue, they would move in precisely the wrong direction in encouraging long-term holding of financial and real assets.

National debate on the capital gains tax has so far centered on the tradeoff between tax revenues on the one hand and economic growth and jobs on the other. Advocates of higher tax rates argue that increased federal revenues are worth the risk of slower economic growth and modest job losses. Opponents argue that the expected revenue gains are meager, at best, and that the effects on the economy of reducing tax rates are substantial.

Economists have long debated how a higher or lower capital gains tax rate affects tax receipts, saving, investment, entrepreneurial activity, GDP growth, and jobs. However, little public debate has focused on how a significantly lower (or zero) capital gains tax rate would affect the time horizons of decision makers in the corporate and financial sectors. If a lower tax rate created a disincentive for short-termist behavior while increasing overall government revenues by boosting investment, hiring, and personal income, such a reform deserves broad public support.

Modeling in 2010 by Allen Sinai, president of Decision Economics, supports the economics underlying that approach. Sinai reports that "a reduction in the capital gains tax rate to 5 percent from 15 percent raises real GDP by 0.2 percentage points per year, lowers the unemployment rate by 0.2 percentage points per year, increases nonfarm payroll jobs by 711,000 per year, and raises productivity by 0.3 percentage points per year. Taken to its logical conclusion, these findings suggest that moving to a zero capital gains tax rate would have an even bigger effect."⁷⁸ The model also shows that higher capital gains taxes would not substantially reduce the deficit.

Some economists disagree with the methodology underlying Sinai's model. For example, two decades ago the Congressional Budget Office (CBO) examined eight analyses (including two by the CBO itself) of whether lower taxes on capital gains, in the form of exclusions from taxation for a portion of realized capital gains, would raise GNP by increasing savings and investment in the economy.⁷⁹

Five of the eight studies found that cutting taxes on capital gains was unlikely to increase savings, investment, and GDP much, if at all. Three studies found that cutting taxes on capital gains would increase GDP, so that additional tax revenue would offset initial losses. According to the CBO, the findings varied owing to different assumptions about how people would respond to changes in the return to savings, and how investors would respond to changes in the cost of capital.

One of the analyses the CBO reviewed was by Allen Sinai in 1990, who used the Sinai-Boston Econometric Model to simulate the economic effects of cutting taxes on capital gains. The CBO found that most of Sinai's estimates of the results of stand-alone cuts in capital gains

tax rates were well above those of other studies. Sinai's 1990 and 2010 studies seem to share a similar optimism about the growth effects of cutting the capital gains tax.

Modeling exercises always entail a myriad of assumptions and methodological choices. And no economist, to my knowledge, has published a study of the effects on tax revenue and GDP of a lower capital gains tax on assets held for 60 months or longer. Still, if a capital gains tax cut were neutral with respect to revenue and GDP growth, it would be worth considering because of its potentially positive effects on the time horizons of fund managers and corporate executives. In any case, the White House and Congress are apparently convinced of the positive economic effects of a lower capital gains tax rate.

President Obama inserted a provision in the Small Business Jobs Act, signed in September 2010, eliminating capital gains taxes on investments held by certain small businesses for more than five years. This temporary provision expired at the end of 2011, and the White House at one point considered asking Congress to make it permanent.⁸⁰ At least two candidates for the 2012 Republican nomination for president have recommended eliminating all taxes on capital gains, while a third would lower the top rate to 12 percent.

The White House admits that the economic impact of reducing the capital gains tax rate for small businesses is not yet known. This suggests a need for an "Allen Sinai-type" analysis of the impact of the Small Business Jobs Act on GDP and other aspects of the economy, as well as of the broader option of applying a zero tax rate to super-long-term (five years or longer) capital gains at all corporations.

A second analysis needs to explore the fact that a large percentage of investors are tax-exempt entities such as pension plans, individual retirement accounts, foundations, and endowments, which a change in capital gains rates would not affect directly. However, because most institutional investors invest large amounts in mutual funds, hedge funds, and other private equity funds, the short time horizons of the latter financial intermediaries could very well affect those of the institutional investors. For example, the greater the tax burden on short-term returns of these funds, the longer the horizon of these investors could become. Researchers need to investigate this potential outcome.

A third analysis should examine the impact of a lower tax on super-long-term capital gains on "carried interest" paid to partners of private equity funds, especially buyout and real estate funds. No legislative deal on capital gains tax reform can pass Congress without attention to this contentious matter.

Carried interest is a share of gains, typically 20 percent, that private equity funds (or any type of partnership) pay to their sponsors. A sponsor's share is taxed at the capital gains tax rate of 15 percent, rather than the income tax rate, which could be 35 percent. The same treatment applies to carried or profit interest in any type of partnership.

Some argue that carried interest should be taxed at the higher rate, because partnership managers are basically earning fees from their labor, like other workers who pay taxes at ordinary income rates. These critics also argue that the combination of this preferential tax rate, high borrowing following from cheap money, and the short time horizons of executives creates excessive risk-taking—and that the personal payoff from taking outsized risks dwarfs the cost of failure, especially in the finance industry. Finally, critics are concerned that compensation under

this seemingly preferential tax rate is excessive, even though carried interest is paid only from a fund's profits.

Supporters of the status quo counter that these fees are at risk, in that no one knows how much carried interest private equity funds will pay, and that compensation of partners should be considered returns on a risky investment—that is, a capital gain.⁸¹ Resolving these conflicting views will be difficult. However, as a recent *Wall Street Journal* editorial suggests, treating carried interest as regular income might be reasonable in the context of lowering the corporate tax rate to an internationally competitive level.⁸²

A fourth analysis should assess the nonfinancial benefits of eliminating the short-term bias of tax policy, which contributes to executives' short time horizons and promotes risk-taking and gaming behavior, such as that at Citigroup, in the absence of long-term accountability for business decisions.⁸³ This analysis needs to examine whether a zero tax on super-long-term capital gains would create a perverse incentive for firms to keep capital locked up in a plateaued investment.

One solution is to scale the capital gains tax, so that it gradually drops from 15 or 20 percent to zero over a five-year period. That would mean that the trade-offs between holding and selling an asset would be less stark in the middle years. Such a scale—would also mitigate the “Warren Buffet problem,” wherein a few wealthy individuals may decide to take a large proportion of their income in “undertaxed” capital gains, and thus end up paying proportionally less than most taxpayers. Under the suggested sliding scale, those who live off capital gains would still be paying taxes on all but the longest-term capital gains.

At the end of the day, whatever principles guide U.S. tax reform—simplifying the tax code, broadening the tax base, raising tax revenues, maintaining a progressive income tax, or ensuring an internationally competitive corporate tax rate—will need to consider the capital gains tax. This tax affects capital formation, innovation, and the corrosive effects of short-termism than any other element of our tax regime.

7. Conclusion

Will the corporate governance and tax reforms discussed here eliminate the kind of corruption that contaminated Citigroup's CDO-structuring operation by curbing the curse of short-termism? By themselves, probably not. Will these countermeasures reduce the probability of irresponsible behavior? Maybe.

To the extent that longer time horizons strengthen executives' fiduciary responsibility to the corporation and its stakeholders, and inform the compensation of fund managers and operating managers; to the extent that laws and company leaders eliminate the perverse practice of quarterly guidance; and to the extent that government can correct the short-term bias in capital gains tax policy, corporate culture will become dramatically more ethical and durable.

Today many of these structural underpinnings are missing from the U.S. business scene, despite myriad debates and legislative initiatives. The seedbed for institutional corruption is therefore richly endowed. The absence of horizon-stretching management systems and public policies has tended to fertilize rather than discourage lawful but corrupt behavior—such as the purposeful and often institutionally supported gaming of society's rules.

The inevitable result is diminished public trust in our leading business institutions, and persistent public calls for radical reform. While business leaders and policymakers have been cautious in implementing countermeasures to these ill effects, we must seriously consider them if we truly want to rein in the public and private costs of institutional corruption.

Endnotes

- 1 E. Wyatt, “Citigroup to Pay Millions to Close Fraud Complaint,” *New York Times*, October 19, 2011
- 2 This quote from Citigroup’s offering circular appears in J.B. Stewart, “Few Avenues for Justice in the Case Against Citi,” *New York Times*, December 3, 2011.
- 3 I should add that Citigroup, as a matter of policy, did not regularly short positions on CDOs that it assembled. As a matter of fact, the bank reportedly as much as \$30 billion on its long positions during the subprime fiasco—much more than any other bank in the world.
- 4 E. Wyatt, “Promises Made, and Remade, by Firms in SEC Fraud Cases,” *New York Times*, November 8, 2011.
- 5 Some of this communication has turned out to be quite incriminating. According to the SEC complaint, “One experienced CDO trader characterized the Class V III portfolio in an e-mail as ‘dogshit’ and ‘possibly the best short EVER!’ An experienced collateral manager commented that ‘the portfolio is horrible.’” See U.S. Securities and Exchange Commission v. Citigroup Global Markets Inc. p. 19. Available at <http://www.sec.gov/litigation/complaints/2011/comp-pr2011-214.pdf>.
- 6 Quoted in Stewart, “Few Avenues for Justice in the Case Against Citi,” 2011, op. cit.
- 7 S. Pulliam, J. Eaglesham, and M. Siconolfi, “U.S. Plans Charges on Bond Fraud,” *Wall Street Journal*, February 1, 2012.
- 8 Ibid.
- 9 See M.H. Baserman and A.E. Tenbrunsel, *Blind Spots: Why We Fail to Do What’s Right, and What to Do about It* (Princeton University Press, 2011), for a great review of relevant research, plus the authors’ analysis of why presumably good souls make bad decisions.
- 10 For a more complete discussion of private-sector institutional corruption, see M.S. Salter, “Lawful but Corrupt: Gaming and the Problem of Institutional Corruption in the Private Sector” (Harvard Business School Working Paper 11-060, 2010). See also L. Lessig, *Republic, Lost* (New York: Twelve, Hachette Book Group, 2011), pp. 16–17.
- 11 G.A. Akerlof and P.M. Romer, “Looting: The Economic Underworld of Bankruptcy for Profit,” *Brookings Papers on Economic Activity* 2:1993.
- 12 This argument is the converse of Lynn Paine’s that a longer-term time frame strengthens the overlap between financial self-interest and ethical behavior. See L.S. Paine, *Value Shift: Why Companies Must Merge Social and Financial Imperatives to Achieve Superior Performance* (New York: McGraw-Hill, 2004).
- 13 Barnard, the author of *The Functions of the Executive* (Harvard University Press, 1964), was president of New Jersey Bell Telephone Co. and the Rockefeller Foundation. Selznick, a sociologist and the author of *Leadership in Administration* (Harper & Row, 1957), was well-known for studies of leadership in business firms, the Tennessee Valley Authority, and political parties, including the Bolshevik Party. K.R. Andrews, the author of *Ethics in Practice* (Harvard Business School Press, 1989), was a distinguished professor at HBS, the editor of *Harvard Business Review*, and director of several of the nation’s most important industrial companies in the last third of the 20th century.
- 14 This group’s recent papers and proceedings reflect a growing interest in the link between short-termism and institutional corruption, as I define it. See, for example, “Overcoming Short-Termism” (Aspen Institute Business & Society Program, September 9, 2009), available at

<http://www.aspeninstitute.org/sites/default/files/content/images/Overcoming%20Short-termism%20AspenCVSG%2015dec09.pdf>.

- 15 P.M. Healy, “The Effect of Bonus Schemes on Accounting Decisions,” *Journal of Accounting and Economics* 7 (1985):85–107; D.I Bergstresse and T. Philippon, “CEO Incentives and Earnings Management,” *Journal of Financial Economics* 80 (2006):511–529; E. Goldman and S.L. Slezak, “An Equilibrium Model of Incentive Contracts in the Presence of Information Manipulation,” *Journal of Financial Economics* 80 (2006):603–626; and L. Peng and A. Röell, “Managerial Incentives and Stock Price Manipulation,” (Baruch College/City University of New York, 2009).
- 16 An excellent review appears in R. Sappideen, “Focusing on Corporate Short-Termism,” *Singapore Journal of Legal Studies* (2011):412–431, available at <http://ssrn.com/abstract=2002501>.
- 17 See, for example, M.J. Jensen and W.H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,” *Journal of Financial Economics* 3(4) (October 1976):305–360.
- 18 I am thinking here of work by Mahzarin Benaji and colleagues at Harvard University.
- 19 The 2011 report by the U.S. Treasury Department’s Financial Stability Oversight Council minces few words in describing the strong temptations to game the regulations developed to enforce the Volcker rule, as well as various techniques banks could use to mask prohibited trading. See Financial Stability Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds* (Washington, DC: January 2011).
- 20 D. Enrich and L. Stevens, “Deutsche Avoids Dodd-Frank Rule,” *Wall Street Journal*, March 22, 2012, available at <http://online.wsj.com/article/SB10001424052702303812904577295614224666918.html>.
- 21 Available at <http://www.edelman.com/trust/2011/>.
- 22 Kellogg School of Management, Northwestern University, available at http://www.kellogg.northwestern.edu/News_Articles/2011/financialtrust-wave10.aspx.
- 23 Leading researchers at Harvard Business School who have focused on this problem include W. S. Abernathy, R. H. Hayes, M.E. Jensen, R.S. Kaplan, K.A. Merchant, M.E. Porter, R. Simons, and W.W. George. See, for example, R.H. Hayes and W.J. Abernathy, “Managing Our Way to Economic Decline” *Harvard Business Review* 60(3) (1980):71; M.E. Porter, “Capital Choices: Changing the Way America Invests in Industry” *Journal of Applied Corporate Finance* 5 (1992):2; K.A. Merchant and W.A. Van der Stede, *Management Control Systems: Performance Measurement, Evaluation and Incentives* (New York: Financial Times/Prentice-Hall, 2003); and W.W. George, “Another View: Can Biotech Survive Icahn?,” available at <http://www.billgeorge.org/page/nyt-dealbook-another-view-can-biotech-survive-icahn>.

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Finally, see A Haldane, “Patience and Finance,” delivered at Oxford China Business Forum, Beijing, September

- 2, 2010, which explores behavioral drivers of short-termism in the financial markets, available at: <http://www.bankofengland.co.uk/publications/speeches/2010/speech445.pdf>; and N.P. Reppenning and R.M. Henderson, “Making the Numbers? ‘Short Termism’ and the Puzzle of Only Occasional Disaster,” HBS Working Paper No. 11-033, which provides another excellent summary of academic work and then models the apparently contradictory strategies of managing for short-term results and making long-term investments.
- 24 The validity and appropriateness of the assumptions underlying typical short-term compensation arrangements for U.S. executives are open to question. Do executives actually work more effectively when their monetary rewards are tied to the results they are trying to achieve? Do executives really control those results? Is there actually a functioning market for senior executive talent that requires performance-based pay? Are senior executives simply agents for owners—which would justify stock-based compensation (whose value may not relate to executive action at all)? For a strong case against the current paradigm, see J. Lorsch and R. Khurana, “The Pay Problem,” *Harvard Magazine*, May-June 2010, pp. 30–35.
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- 28 “Paying for Long-Term Performance,” Discussion Paper No. 658 (Boston: John M. Olin Center for Law, Economics, and Business, Harvard Law School), p. 6.
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- 30 S.N. Kaplan, “How Has CEO Turnover Changed?” *International Review of Finance* 12(1) (2012):57–87, available at <http://dx.doi.org/10.1111/j.1468-2443.2011.01135.x>.
- 31 S.N. Kaplan and B.A. Minton, “How Has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs,” Working Paper No.12465 (Cambridge, MA: National Bureau of Economic Research, August 2006), available at <http://ssrn.com/abstract=924751>, updated August 2008 and available at <http://faculty.chicagobooth.edu/steven.kaplan/research/km.pdf>.
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- 33 See S. Loescher, “Bureaucratic Measurement, Shuttling Stock Shares, and Shortened Time Horizons: Implications for Economic Growth,” *Quarterly Review of Economics and Business* 24 (1984):1–24; T. Johnson and R. Kaplan, *Relevance Lost: The Rise and Fall of Management Accounting*, (Boston: Harvard Business School Press, 1987); K. Froot, D. Scharfstein, and J. Stein. “Herd on the Street: Informational inefficiencies in a market with short-term speculation,” *Journal of Finance* 47(4) (1992):1461–1484; D. Barton, “Capitalism for the Long-Term,” *Harvard Business Review*, March 2011; H. Kaufman, *The Road to Financial Reformation: Warnings, Consequences, Reforms* (New York: John Wiley & Sons, 2009); B.W. Heineman, Jr, “Shareholders:

- Part of the Solution or Part of the Problem?," *Atlantic*, October 2009, available at <http://www.theatlantic.com/politics/archive/2009/10/shareholders-part-of-the-solution-or-part-of-the-problem/29188/>; The Conference Board, *The 2010 Institutional Investor Report: Trends in Asset Allocation and Portfolio Composition* (New York, 2010); S.C.Y. Wong, "Why Stewardship Is Proving Elusive for Institutional Investors," *Journal of International Banking and Finance Law*, July/August 2010:406; R. Lambert, "Sir Ralph's Lesson's on How to End Short-Term Capitalism," *Financial Times*, May 23, 2011:11; A. Haldane and R. Davies, "The Short Long," presented at *New Paradigms in Money and Finance?*, 29th colloquium of the Société Universitaire Européenne de Recherches Financières, Brussels, May 2011, available at <http://www.bankofengland.co.uk/publications/speeches/2011/speech495.pdf>; P. Bolton, J. Scheinkman, and W. Xiong, "Executive Compensation and Short-Termist Behavior in Speculative Markets," *Review of Economic Studies* 73(3) (2006):577–610; Q. Cheng and T. Warfield, "Equity Incentives and Earnings Management," *Accounting Review* 80(2) (2005):441–476; and B.W. Heineman, Jr., and S. Davis, "Are Institutional Investors Part of the Problem or Part of the Solution?," Yale School of Management and Millstein Center for Corporate Governance and Performance, available at http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/80235_CED_WEB.pdf.
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- 35 "Patience and Finance," paper delivered at Oxford China Business Forum, Beijing, September 2, 2010, available at <http://www.bankofengland.co.uk/publications/speeches/2010/speech445.pdf>.
- 36 See <http://data.worldbank.org/indicator/CM.MKT.TRNR>.
- 37 D. Barton, "Capitalism for the Long-Term," *Harvard Business Review*, March 2011.
- 38 Of course, there are other possible causes of short-term trading, such as volatile markets and turbulent macroeconomic conditions, and changes in the portfolio strategies of long/short funds, which buy shares only to offset temporary short positions.
- 39 A third, more speculative source of short-termism is the rise of hostile takeovers in the 1970 and 1980s, leveraged buyouts in the 1980s, and megabuyouts from 2005 to 2007. One claim is that the new owners force managers to focus more on short-term cash flow to pay down the debt used to finance the takeovers (this is correct) than on investing in R&D and other drivers of long-term competitiveness (this remains contested). Critics of these takeovers argue that the only way to reduce their debt-equity ratio is to raise retained earnings by investing in the long-term. However, the holding period of buyouts averages slightly more than five years—hardly a long-term commitment.
- 40 Academics have monitored this practice widely. See, for example, A. Rappaport, "The Economics of Short-Term Performance Obsession," *Financial Analysts Journal* 65 (2005):61. Rappaport observes, "Financial analysts fixate on quarterly earnings at the expense of fundamental research. Corporate executives, in turn, point to the behavior of the investment community to rationalize their own obsession with earnings. Short-termism is the disease; earnings and tracking error are the carriers." Quoted in R. Sappideen, "Focusing on Corporate Short-Termism," *Singapore Journal of Legal Studies* (2011), available at <http://ssrn.com/abstract=2002501>.
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- 43 M. Cheng, K.R. Subramanyam, and Y. Zhang, "Earnings Guidance and Managerial Myopia" (New York: Columbia Business School, November 2005), available at <http://ssrn.com/abstract=851545>.

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- 45 For an excellent discussion of earnings management, see P. Healy and J. Wahlen. “A Review of the Earnings Management Literature and Its Implications for Standard Setting,” *Accounting Horizons* 13(4) 1999):365–383.
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- 47 E.E. Schultz, *Retirement Heist: How Companies Plunder and Profit from the Nest Eggs of American Workers* (New York: Penguin, 2011), p. 97. Schultz is a Pulitzer Prize–winning *Wall Street Journal* reporter who has covered the so-called retirement and pension crisis for more than a decade.
- 48 Haldane, “Patience and Finance,” 2010, op. cit.
- 49 See R.H. Thaler and H.M. Shefrin, “An Economic Theory of Self Control,” *Journal of Political Economy* 89(2) (1981):392–406. Thaler and Shefrin argue that humans are innately biased toward the present moment and certain outcomes, even when a less certain future option is likely to be more valuable.
- 50 S.M. McClure, D. Laibson, G. Loewenstein, and J.D. Cohen, “Separate Neural Systems Value Immediate and Delayed Monetary Rewards,” *Science* 306(5695) (2004):503–507.
- 51 A.C. Pigou, *The Economics of Welfare* (London: Macmillan, 1920).
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- 53 Rule-making games are a prominent feature of the Dodd-Frank Act. Take, for example, the drafting of the Volcker rule (Section 619), which allows banks to invest only up to 3 percent of their “tangible common equity” (or capital) in hedge funds or private equity funds. During congressional debate, Massachusetts Senator Scott Brown, whose electoral campaign banking interests heavily supported, won a loosening of the bill’s provisions as a condition of his support. Specifically, the term “Tier 1 capital” was substituted for “tangible common equity” in the 3 percent rule, creating a technical loophole that boosted by 40 percent the funds that banks could legally transfer to hedge funds and private equity funds. This amendment significantly weakened the law’s intent.
- 54 United States Bankruptcy Court, Southern District of New York, *In re Lehman Brothers Holdings, Inc., et al.*, Chapter 11 Case No. 08-13565 (JMP), *Report of Anton R. Valukas*, vol. 3, p. 732 ff, available at <http://jenner.com/lehman/VOLUME%203.pdf>.
- 55 S. Smidt, “Comment on Proposed Incentive-Based Compensation Rules,” submission to Financial Stability Oversight Council, File Number 57-12-11 (Washington, DC, May 27, 2011), p. 6.
- 56 *Ibid*, p. 9.

- 57 See B.R. Scott, *The Concept of Capitalism* (Springer, 2011), for extensive discussion of this phenomenon and its underlying dynamics.
- 58 See D. Mattern, “CEO Pay Is Outrageous and It’s Undemocratic,” *Common Dreams*, June 30, 2001, available at <http://www.commondreams.org/views01/0630-04.htm>.
- 59 L. Bebchuk and J. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2004).
- 60 The ratio of average CEO salary plus bonus to the average compensation per worker was 187:1 for the United States, 148:1 for Germany, and 138:1 for Australia International Labor Association, *World of Work Report: Income Inequalities in the Age of Financial Globalization*. Available at <http://www.ilo.org/public/english/bureau/inst/download/world08>.
- 61 G. Morgenson and J. Rosner, *Reckless Endangerment* (New York: Henry Holt, 2011). This is a common phenomenon with pay systems that include “caps,” which are usually a bad idea because they inevitably lead to gaming behavior.
- 62 The SEC eventually sued Fannie Mae for accounting fraud. No conviction resulted, but the SEC and OFHEO announced in May 2006 that Fannie Mae had agreed to settle charges relating to misstatements in its financial statements from 1998 through 2004. In so doing, Fannie Mae accepted a permanent injunction and paid a \$400 million penalty.
- 63 Participants in a seminar at the Edmund J. Safra Center for Ethics at Harvard, where I am an active participant, use this categorization of reform mechanisms for institutional corruption.
- 64 Supporters of the dual-class ownership model argue that in the case of Google, the three executives who control two-thirds of the company's shares even though they actually own only one-third of the outstanding shares (Eric E. Schmidt, Larry Page, and Sergey Brin) probably do a better job of steering the company than individual shareholders and institutional investors such as insurance companies and pension funds.

These proponents also argue, on a more theoretical note, that the company’s dual-class ownership structure mitigates an agency-cost problem that arises when control over cash flow is separate from ownership. In the two-class model, the right to control cash flow coexists with an ownership right, although this does create an agency problem for non-controlling shareholders.

The problem, of course, with disproportionate voting power is that it opens the company to claims that such voting presents a significant danger to shareholders, by reducing the accountability of corporate officers and insiders. Dual-class companies also have more freedom than single-class companies to be less transparent in their voluntary disclosures. Successful fraud charges brought by shareholders and the SEC against top executives at Adelphia Communications and Hollinger International dramatically illustrate the danger of disproportionate voting power.

- 65 For an excellent discussion of the ambiguities of for whom corporate directors and managers are trustees, see C. Bruner, “The Enduring Ambivalence of Corporate Law,” *Alabama Law Review* 59(5) (2008):1385. Bruner reminds us that the clearest expression of this ambiguity is the fact that “corporate boards are deemed to owe fiduciary duties to shareholders and the corporation simultaneously.” He adds, “Favored though the stockholders may be, relative to other constituencies...the very fact that corporate law has not seen fit to elevate with either the ‘stockholders’ or the ‘corporation’ over the other suggests a deep ambivalence about the ends of corporate production (and an implicit rejection of both strict board-centric and strict shareholder-centric governance theories” (pp. 1425–1426). See also the opinion of the Delaware Supreme Court that corporate officers and directors “stand in a fiduciary relation to the corporation and its shareholders,” *Guth v. Loft*, 5A.2d 503, 510 (del. 1939).

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- 67 C.B. Carter and J.W. Lorsch, *Back to the Drawing Board* (Boston: Harvard Business School Press, 2004), p. 38.
- 68 See, for example, a policy brief from the Subcommittee on Corporate Governance of the Committee for Economic Development (CED), “Restoring Trust in Corporate Governance: The Six Essential Tasks of Boards of Directors and Business Leaders,” January 2010, by B. Heineman, Jr., CED trustee and former senior vice president and general counsel for General Electric.
- 69 For further analysis, see J. Fuller and M.C. Jensen, “Just Say No to Wall Street: Putting a Stop to the Earnings Game,” *Journal of Applied Corporate Finance* 22(1) (Winter 2010), available at <http://ssrn.com/abstract=1583563>. See also R.L. Martin, *Fixing the Game* (Boston: Harvard Business School Press, 2011).
- 70 This discussion was spurred by *Fixing the Game* (ibid), by R. Martin, Aspen Institute participant and dean of Toronto University’s Rotman School of Management. Martin recommends repealing legal protections that encourage earnings guidance and promote short-termism in business.
- 71 F. Eugster and A.F. Wagner, “When and How Is Voluntary Disclosure Quality Reflected in Equity Prices?,” Research Paper No. 11-25, Swiss Finance Institute, July 29, 2011, available at <http://ssrn.com/abstract=1879804>.
- 72 This is a very discriminating metric because a large proportion of public companies fail to earn their cost of capital on a sustained basis.
- 73 In his recent submission to the Financial Stability Oversight Council, S. Smidt argued for an even more radical policy: requiring executive officers of systemically important financial institutions to carry unlimited personal liability for their institution’s debts while they are active in its affairs, plus five years, with personal liability diminishing to 80 percent, 60 percent, 40 percent, 20 percent, and zero over the five-year period. In the event of death, a covered executive’s liability would drop to 50 percent of what it would have been (see note 39, supra).

This is obviously an attempt to return to the (effective) discipline of the old investment banking partnerships. While this proposal would certainly curb risk and short-termism, it could also severely limit investments that are not sure bets, which would effectively turn banks into risk-free public utilities. Is this the most effective path forward? Not if we want banks to continue to play an (inherently risky) intermediation role in global financial markets. With limited intermediation, liquidity would be dramatically curtailed, which would most likely reduce corporate investment and economic growth.

- 74 Section 304 of the Sarbanes-Oxley Act (SOX) requires public firms to have clawback policies. These policies allow the SEC to recoup certain payments to executives in the case of misconduct, such as after an accounting restatement owing to “material noncompliance” with financial reporting requirements. However, the SEC has used this provision very infrequently over the past 10 years. In most cases, the targeted executives had been convicted of criminal fraud.

The Dodd-Frank Act of 2010 instructs the SEC to develop a new clawback policy that triggers the provision under conditions similar to those of SOX: if a firm is required to restate its financial statements because of material noncompliance with financial reporting requirements. However, the Dodd-Frank approach differs from that of SOX in several important ways.

First, there is an excess pay provision, meaning that the company can recover from current and former executives any incentive-based compensation received during the “three-year period preceding the date on which the company becomes required to prepare an accounting restatement that is based on erroneous data.”

Second, recovery is possible under the new clawback rule even if there is no misconduct. And third, clawback is enforceable by the firm, whereas under SOX, on the SEC could enforce clawback. The SEC is still writing this rule.

Dodd-Frank does not otherwise address the ills created by short-termism embedded in executive pay and corporate governance practices. However, the Department of the Treasury (Office of the Comptroller of the Currency and Office of Thrift Supervision), Federal Reserve System, and Federal Deposit Insurance Corporation did issue guidance on compensation practices in banking institutions on June 21, 2010.

- 75 Research by D. Chun, CEO of compensation research firm Equilar, cited in a *Bloomberg Businessweek* special report on “Executive Pay Trends in 2010,” available at http://www.businessweek.com/managing/content/oct2009/ca20091013_224531.htm?chan=careers_special+report+---+pay+perks+benefits+2009_special+report+---+pay%2C+perks%2C+benefits+2009.
- 76 In their SEC filings of January and February 2012, Goldman Sachs and Morgan Stanley outlined their clawback policies in connection with agreements to end proxy fights waged by the office that runs New York City’s pension funds. This disclosure followed efforts in 2011 by New York City Comptroller John Liu to force the firms to strengthen their clawback policies. See L. Moyer, “On ‘Bleak’ Street, Bosses in Cross Hairs: Morgan Stanley, Goldman Clarify Clawback Policies,” *Wall Street Journal*, February 8, 2012.
- 77 L.A. Bebchuk, “How to Fix Bankers’ Pay,” *Daedalus* 139(4) (Fall 2010), available at <http://ssrn.com/abstract=1673250>.
- 78 See A. Sinai, “Cap Gains Taxation: Less Means More,” *Wall Street Journal*, September 21, 2010; and American Council for Capital Formation, “Capital Gains Taxes and the Economy” (Washington, DC), available at <http://www.accf.org/publications/139/capital-gains-taxes-and-the-economy>.
- 79 See “Effects of Lower Capital Gains Taxes on Economic Growth” (Washington, DC: Congressional Budget Office, August 1990), available at <http://www.cbo.gov/ftpdocs/77xx/doc7767/90-CBO-033.pdf>. Sinai’s conclusions also differ from those of L. Burman, a professor at Syracuse University and former deputy assistant treasury secretary. In *The Labyrinth of Capital Gains Tax Policy* (Washington DC: Brookings Institution, 1999), Burman claims that the evidence on whether lower capital gains taxes promote growth is murky.

A proposal in President Bush’s 1991 budget—to exclude a portion of realized capital gains from taxation—prompted these studies. The exclusion would have varied with the length of time an asset was held: 10 percent for assets held one to two years, 20 percent for assets held two to three years, and 30 percent for assets held for three or more years. These exclusions would not have applied to capital gains earned by corporations, or to works of art and other collectibles held by individuals.

- 80 Notably, the August 2010 report of the President’s Economic Recovery Advisory Board on tax reform did not address a reduction in super-long-term capital gains rates. Still, the report contained clues on what the president might have been considering. For example, he and his advisors were then talking about putting *capital* to work, which is different from simply putting *people* to work. This change in thinking could have opened the door to nontraditional tax treatment of truly long-term capital gains. Sadly, the president’s proposed budget for 2013 turned 180 degrees, recommending doubling the capital gains tax rate to 30 percent—precisely the opposite of what my preliminary analysis would suggest.
- 81 In a detailed defense of current tax treatment of carried interest, funded by the Private Equity Council, D. Weisbach of the University of Chicago Law School argues that the most accurate way to view a private equity fund is that it is raising capital, and then using it to make investments. Viewed this way, Weisbach argues, “anyone who makes an investment and holds it as a capital asset, even if made with third-party capital, receives capital gain or loss treatment on the investment.” This has been true for more than 50 years, and changing this provision “would require reexamining this basic premise of partnership taxation.”

Further, if the Internal Revenue Service were to treat holders of carried interest as receiving compensation income, then “we would have to distinguish service income from capital income,” which is not feasible in many contexts. See D.A. Weisbach, “The Taxation of Carried Interests in Private Equity,” originally published in *Tax Notes* 505 (August 6, 2007):116, and then in *Virginia Law Review* 94 (2008) :715.

83 *Wall Street Journal*, January 25, 2012.

83 One practical issue that such an analysis might address is whether the era of relatively low tax rates is over, no matter what their long-run benefits may be. Total taxes as a share of GDP are now 15 percent, in contrast to a historical share closer to 17 percent. Meanwhile U.S. government spending is 25 percent of GDP.