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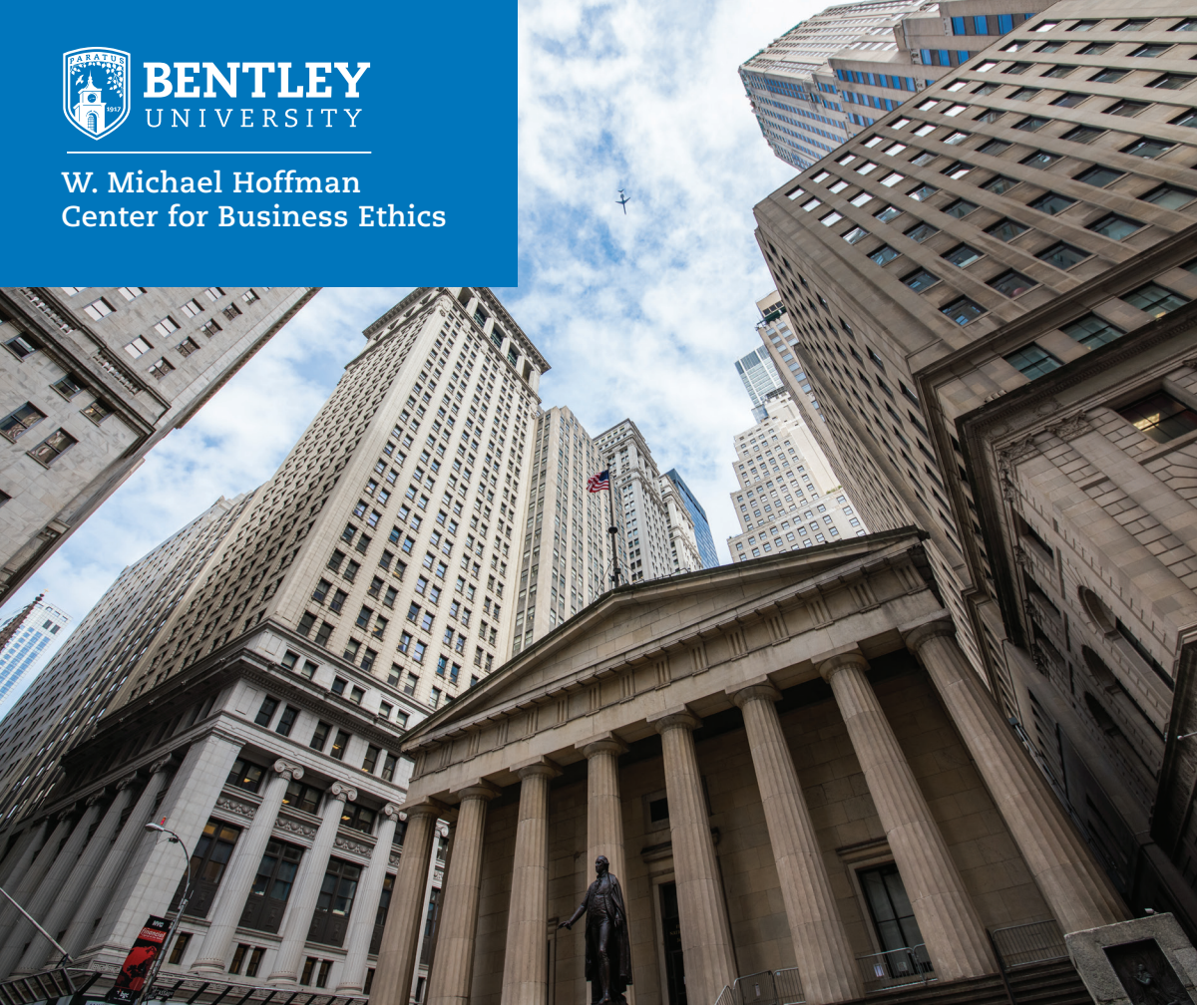
W. Michael Hoffman Center for Business Ethics



Verizon Visiting Professorship in Business Ethics

Executive Compensation and the Ethics of Misguided Incentives

Peter S. Cohan
Lecturer of Strategy, Babson College

William D. Cohan
Best-selling Author and Financial Journalist

November 6, 2018

BENTLEY UNIVERSITY is a leader in business education. Centered on education and research in business and related professions, Bentley blends the breadth and technological strength of a university with the values and student focus of a small college. Our undergraduate curriculum combines business study with a strong foundation in the arts and sciences. A broad array of offerings at the Graduate School of Business emphasize the impact of technology on business practice. They include MBA and Master of Science programs, PhD programs in accountancy and business and selected executive programs. The university is located in Waltham, Mass., minutes west of Boston. It enrolls approximately 4,200 full-time undergraduate students, 1,000 graduate and 24 doctoral students.

THE HOFFMAN CENTER FOR BUSINESS ETHICS at Bentley University is a nonprofit educational and consulting organization whose vision is a world in which all businesses contribute positively to society through their ethically sound and responsible operations. The center's mission is to provide leadership in the creation of organizational cultures that align effective business performance with ethical business conduct. It endeavors to do so by applying expertise, research, and education and taking a collaborative approach to disseminating best practices. With a vast network of practitioners and scholars and an extensive multimedia library, the center offers an international forum for benchmarking and research in business ethics.

Through educational programs such as the Verizon Visiting Professorship in Business Ethics, the center is helping to educate a new generation of business leaders who understand from the start of their careers the importance of ethics in developing strong business and organizational cultures.

Jeffrey Moriarty, PhD
Interim Director, Hoffman Center for Business Ethics and Professor and Chair, Department of Philosophy, Bentley University

Robert E. McNulty, PhD
Director of Programs, Hoffman Center for Business Ethics, Bentley University

Until now, every monograph in this series has begun with an introductory reflection by W. Michael Hoffman, the founder of the Hoffman Center for Business Ethics. On November 6, 2018, true to form, Dr. Hoffman went to the stage to welcome the speakers whose talk appears in this monograph. Sadly, soon thereafter, he was diagnosed with a grave illness from which he was unable to recover. The work of the Center continues, and for that reason, this introductory comment is being co-authored by Prof. Jeffrey Moriarty, Interim Director of the Hoffman Center for Business Ethics and Dr. Robert McNulty, the Center's director of programs.

The lecture on the following pages was given by Peter Cohan and William Cohan, two brothers who both work in the areas of business and finance — Peter as a lecturer of strategy at Babson College and William as a financial journalist and author. Each, in his own way, has dedicated his career to educating others on the nature and methods of business as well as the risks and remedies. Although their careers have proceeded along related but parallel tracks, this lecture constituted a rare point of intersection. William opened the lecture with a compelling argument that the key factor leading to the economic crisis of 2008 was a misguided system of incentives that rewarded executives in the financial sector for engaging in wildly risky investments with other people's money. To this, Peter proposed a logical solution — an alternative incentive system in which rewards follow from acting in accordance with with a set of ethical principles as well as achieving business outcomes.

Both the analysis and remedies suggested appear to be on target. They also point to the tension at the heart of business ethics between the desire for profit maximization and personal enrichment and the desire to conduct business in a way that seeks to do what's best for all stakeholders. Is it realistic to expect businesses to be ethical? Generally, businesses today are more conscious and committed to ethics than in generations past. Here's the rub: we are no longer living in a world of shopkeepers and family farms. We live in a transnational economy in which the impact of transnational companies is pervasive and powerful. When things go badly, the impact can be catastrophic.

William and Peter Cohan have raised an alarm and suggested a response. Have they been heard? We can ill afford to sit back and hope for the best.

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Peter Cohan (on left) and William Cohan responding to questions during the Verizon Lecture in Business Ethics given to students, faculty, staff, and friends at Bentley University.

Peter S. Cohan

Lecturer of Strategy
Babson College

Peter Cohan is a Lecturer of Strategy at Babson College, where he also teaches Foundations of Entrepreneurial Management. He has published numerous articles and 14 books, the most recent of which is: *Scaling Your Startup: Mastering the Four Stages from Idea to $10 Billion*.

William D. Cohan

Best-selling Author and
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William Cohan is a *New York Times* best-selling author and journalist and a special correspondent at *Vanity Fair*. He has worked with several major financial firms. His first book, *The Last Tycoons: The Secret History of Lazard Freres & Co.* won the 2007 FT/Goldman Sachs Business Book of the Year award.

(From left) Gregory K. Miles, Director, Office of Ethics and Business Conduct, Verizon Communications, Peter Cohan, Lecturer of Strategy, Babson College, W. Michael Hoffman, PhD, founding Executive Director of the Center for Business Ethics and Hieken Professor of Business and Professional Ethics at Bentley University, William Cohan, best-selling author and financial journalist, and Paul S. McGovern, Manager of Affirmative Action and Equal Employment Opportunity, Verizon Communications

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William D. Cohan

Thank you, for your kind introduction, Dr. Hoffman. I am pleased to be speaking here with my brother, Peter.

For 10 years, I have been arguing that the compensation system on Wall Street is the primary reason we had the 2008 financial crisis. It usually goes nowhere, but I thought I would share the idea again today.

I like to say I have the greatest job ever. Now that I'm no longer an investment banker, I've spent nearly the last 15 years writing books about Wall Street and other matters. I wrote a book about the Duke lacrosse scandal and am writing my new book about the rise and fall of a company called GE that now is based in Boston. I have a great gig and I enjoy it. I can work from where I want and do what I want. I don't have a boss, which is something I worked very hard to achieve because I don't like bosses.

Another thing is I get to talk to many interesting people. This year was the 10th anniversary of the financial crisis, and in connection with that, I had the opportunity to talk to Hank Paulson, the former CEO of Goldman Sachs who went on to be the United States Secretary of the Treasury during the 2008 financial crisis. One of the books I wrote was

William D. Cohan delivering the Verizon Lecture in Business Ethics.

about Goldman Sachs. He was very helpful to me in the writing of that book as well as my book about the fall of the investment bank Bear Stearns. As such, I have often tested my theory out on Hank Paulson, who as a CEO of Goldman Sachs was in a position to know something about compensation systems on Wall Street, and as the Treasury secretary during the 2008 financial crisis, he was in a position to know something about what caused it. After extensive research into the causes of the financial crisis, the explanation that keeps presenting itself to me is this issue of incentives. I brought this up with former Secretary Paulson recently in an interview I did with him for *Barron's*, and he couldn't have disagreed with me more. He told me, "We're deluding ourselves." What I think he meant was, "You're deluding yourself, Bill, if you believe that the Wall Street compensation system — excessive as it is and was — caused the crisis." Therefore, while he does not agree with me, I am here to tell you that I disagree with him. That's my prerogative because I am a journalist, and I can write pretty much what I want based on my research and reporting, both of which I take very seriously.

The essence of my thesis is this: The compensation system on Wall Street rewards people to take big risks with other people's money. People are very simple; they do what they are rewarded to do. For instance, some of you may be familiar with the fact that one of the proximate causes of the financial crisis was the widespread sale of "subprime mortgages." Wall Street collected up large numbers of these mortgages, many of which should never have been written in the first place, and packaged them up into securities. These mortgage-backed

securities were then sold as good investments everywhere. When it was discovered that those mortgage-backed securities actually weren't very good investments and that Wall Street was using them as collateral for short-term loans to finance its own business, quite simply, Wall Street ran out of money. They literally could no longer meet their obligations as they became due, meeting the very definition of bankruptcy. That's why one Wall Street firm after another went bankrupt and out of business unless it was rescued by the federal government as Bear Stearns was — which, amazingly, was the first time that ever happened.

The reason Wall Street bankers, traders, and executives did this is because that is what they were rewarded to do. They were rewarded to find mortgages, package them up into securities, get the rating agencies to give them a AAA rating even though they were not, and then to sell them as investments globally. When your life, your salary, and bonus depends on doing a certain thing, that's exactly what you're going to do. That's not a surprise, either. I was rewarded for 17 years to advise CEOs on mergers and acquisitions. I was only paid if companies did the deals that I suggested or I was asked to advise on the deals that they wanted to do. If they did not do deals or if I did not come up with good ideas that they took, I did not get paid. It was the same thing with traders, executives, and bankers. It was their responsibility to buy mortgages, bundle them into mortgage-backed securities, and sell them as investments all over the world. When you are rewarded to do a certain thing, you're going to do it. In fact, while we are sitting here having this very nice conversation this afternoon, the armies of people on Wall Street are still getting rewarded to take big risks with other people's money.

It is important to understand this wasn't always the case. In fact, it was not the case for the first 200 years of Wall Street's existence. Before becoming the iconic place it is today, Wall Street really was just named after a wall that was built in lower Manhattan to protect the Dutch, who were then in charge of New Amsterdam, from what they perceived as threats from the Native Americans to whom the land actually belonged. The Dutch were especially worried about retaliation from the Native Americans because they had massacred a significant number of them in New Jersey. Interestingly enough, they first built this wall only to protect themselves where Wall Street is now in lower Manhattan. Over time, people would congregate in front of the wall and engage in trade. When the British took the city over from the Dutch and renamed it New York rather than New Amsterdam, they took down the wall and what was left was this street called Wall Street. Ships would come in on the East River bringing raw materials. People there would work on those raw materials, and create finished goods, which would then go out on ships on the Hudson River. This then became a very efficient trading system.

It took a while for Wall Street to become a place where stocks and bonds were traded and securities firms were formed. It started with a bunch of small, private, undercapitalized partnerships. The only capital that was given to these firms was by the very people who were the partners of these firms. Quite literally, there was a Mr. Goldman and a Mr. Sachs; there were three Lehman brothers, there was a Smith and a Barney, there was a Morgan and a Stanley, there was a JP Morgan, and there were the three Lazard brothers. These were actual people, who put their actual capital into these firms, putting their entire net worth at risk. This was before people created something called limited

liability corporations. Therefore, not only did they put at risk the capital that they had invested in these firms, but they also put at risk all the money that they had taken out. Their apartments in Manhattan, their art collections, their houses in the Hamptons — all of those things were at risk. These were partnerships where one wrong move would cause these partners to lose all their money, so Wall Street was a very dangerous place. Of course, people often forgot the dangers and still had all of their money at risk. Their incentive in the olden days was just to create pre-tax income. If they make enough pre-tax income, that pre-tax income could be distributed to the firm's partners, and they could all live a very nice life. Goldman Sachs will be celebrating its 150th anniversary next year, and Lazard Frères is even older than that. However, sometimes the companies didn't make it. Lehman Brothers didn't make it. Bear Stearns didn't make it.

In an earlier time, the CEO of Bear Stearns, Ace Greenberg, would talk to the new recruits who came to Bear Stearns. He would hold up what was called a tombstone ad. Wall Street banks would place ads in the Wall Street Journal after doing a big underwriting, such as for the Ford IPO or a General Electric debt deal, for example. These were called tombstone ads, in which were listed all of the underwriters for these securities. Mr. Greenberg would say to the new recruits, "Here's the ad of all the firms that participated in this underwriting. In 10 years, half of these will be gone, and in another 10 years, another half of those firms will be gone. But, we at Bear Stearns, we will still be around because of the way we do business." Well, of course, he was wrong. Bear Stearns went down the tubes in 2008. Wall Street has always been a dangerous place, but the motivation for the people who worked in these private partnerships was to create pre-tax profitability. To do this, they had to make sure that their partners did not go rogue or do stupid things that might result in the loss of money and cause their partnerships to go out of business.

That was the system and it was perfectly aligned with their incentives. They took prudent risks because it was their own money. However, that began to change in 1970, when a firm named Donaldson, Lufkin & Jenrette, known to us on Wall Street as DLJ, decided to do something different — they wanted to go public. They decided that they wanted to take other people's money into the partnership, have a stock that traded publicly, and get access to other people's financing. At the time, this was against the rules of the New York Stock Exchange (NYSE). If you wanted to be a member of the NYSE as an investment bank, you could not have outside investors, unless the NYSE approved of those investors. The NYSE didn't want these firms to go public because they didn't want the incentives to be misaligned with the interests of their clients. Essentially, during the first 200 years of the NYSE, this prevented all Wall Street firms from going public. That all changed when DLJ came along, and the partners, Mr. Donaldson, Mr. Lufkin, and Mr. Jenrette, decided they wanted to go public for seemingly good reasons; they wanted to pay out their retiring partners, and they wanted to give new partners some incentive — stock options to help grow the firm. For this, they were going to need access to cheap capital. In 1969, they decided to challenge the NYSE rules during a time when the country couldn't have cared less that a firm named DLJ was trying to change the NYSE rules. The country was engulfed in protests over the Vietnam War, and its attention was elsewhere. In 1970, DLJ got the NYSE to change its rules and it became the first

Wall Street firm to go public. It raised about $12 million, which is minuscule by today's standards, but nearly 50 years ago, it had the effect of changing the way Wall Street financed and compensated itself.

Consequentially, Wall Street companies went from having a partnership culture where the emphasis was on creating pre-tax profits and taking prudent risks with their own money so they didn't lose everything that was built up over the years to becoming businesses that rewarded their executives and employees for taking extravagant risks with other people's money. That was the effect that DLJ going public had. Soon thereafter, in 1971, Merrill Lynch went public, and then firm after firm followed. In 1985, Bear Stearns went public. In 1986, Morgan Stanley went public. In 1999, after fierce internal debate, Goldman Sachs went public. Even the firm I worked at for a long time, Lazard, which was once proudly a private partnership owned by one French banking family, decided that in 2005, it too would go public.

All of this naturally resulted in a massive cultural change on Wall Street from prudent risk-taking to a bonus culture where people were rewarded for taking big risks with other people's money. Suddenly, bankers, traders, and executives were rewarded for generating as much revenue as they possibly could. It changed the way Wall Streeters behaved forever. I know that personally because I worked there for 17 years under a bonus culture. Wall Street became an army of people with the sole job of generating as much revenue as they possibly could, year in and year out, all with the aim of getting for themselves big bonuses. What was once a prudent culture became a swing-for-the-fences culture.

The cheap capital to which Wall Street gained access allowed for many innovations. In the 1980s, we started to see securitization. We saw the creation of the junk bond market, the derivatives market, and what I called the democratization of capital. Even the credit cards that we just take for granted, are essentially unsecured lines of credit worth thousands of dollars of money that can be spent on anything you want without any permission from a bank. All of that was the result of Wall Street innovations that came about because these firms' capital went through the roof, and made them able to attract the best and the brightest who wanted to make as much money as they possibly could. Literally, they were able to attract rocket scientists to come to work on Wall Street.

In the years leading up to 2008, Wall Street's rocket scientists figured out that they could take mortgages that were issued to people all over the country, collect them, package them up, and make securities out of them. It was an incredible innovation at the time. It allowed people who never had a mortgage before to gain access to the mortgage market, which allowed them to buy their first home. For others, it allowed them to purchase their second or third home. It also created a huge bubble in the housing market, with Wall Street bankers driving up the mortgage market, desperate for these mortgages to be packaged up into securities that were then sold off as investments all over the world. Because these bankers would reap huge bonuses after the mortgages had been repackaged and sold as securities, they had no accountability for what they were doing. Their concern was how to get a bigger bonus.

Before I turn it over to my brother, Peter, I want to leave you with a couple of thoughts. I've been writing about this for 10 years but nobody on Wall Street wants to change the compensation system

because people on Wall Street are among the most risk-averse people on the planet. Where else can you go to make the kind of money they make without putting up any of your own capital? You can use other people's money to sell products where you have no accountability for your behavior and still get a big bonus. Therefore, you have risk-averse people, who know they are on a gravy train. They are continuously encouraged to resist changing the system and having the accountability needed, despite the financial crisis, which they had a big role in causing.

One of my favorite examples is a person named David Miller who works at Credit Suisse and created a product called a dividend recapitalization loan, and sold five billion dollars' worth of these dividend recapitalization loans to many resorts in the West, like the Yellowstone Club, which is a famous resort in Montana. Miller would pitch entrepreneurs something to the effect of, "I'll give you a loan of $400 million. You can take it out and put in your pocket in the form of a dividend." He did this over and over again with many resorts, ultimately having Credit Suisse issue $5 billion dollars' worth of these loans, then syndicated them, and sold them off to investors around the world. But every one of these companies to which he made these loans went bankrupt. All $5 billion of these loans were lost and the creditors of these companies took over these resorts. And Miller, who was responsible for this, kept being promoted. During the years when he was making these loans, he received approximately $23 million in bonuses. He's still at Credit Suisse, is still being promoted, and is still lending huge sums of money every year, all without any accountability. What needs to be done on Wall Street is to change the compensation system to make people accountable once again for their behavior. As was the case when Wall Street was comprised of private partnerships, these firms need to be held accountable for their bad behavior so that they can lose as much as their full net worth for the things that they do wrong. As I see it, this is akin to the difference between a chicken and a pig at a breakfast of ham and eggs: The chicken is interested but the pig is committed. Once again, we need Wall Street bankers, traders, and executives committed to their behavior and accountable for what they do. They should not be rewarded for taking big risks with other people's money that serve their own purposes of receiving big bonuses, while not serving our purpose as the American public, who rely on the capital that they provide.

Thank you very much. I now turn it over to my brother, Peter, to take it from here.

Peter S. Cohan

Thank you very much, Bill.

While my brother Bill focused on a problem, I want to talk about what may be a solution that applies not only to Wall Street but corporations generally. Many of you may recall the company, Enron and, more recently, another company called "Theranos." I recently learned that the two companies are connected: The daughter of one of the vice presidents of Enron was Elizabeth Holmes, the founder and former CEO of Theranos, which collapsed after a major scandal.

Enron was an energy trading company that went bankrupt in 2001, and with it also brought down the accounting firm Arthur Andersen, as some of their partners decided it was okay to look the other way when Enron employed non-compliant accounting practices. Ultimately, that wiped out Arthur Andersen, the pensions of all the people who worked for Enron, and cost roughly $74 billion in losses. This led me to try to figure out if there were a way to rethink how capitalism works in this country.

My response was a book called *Value Leadership*. While the audience for this book was limited, the views expressed not long ago by Larry Fink, the CEO of Blackrock — the largest asset manager with over $6.3 trillion under management — reinforced some key ideas in my book. Mr. Fink announced earlier this year that he was going to hold the companies in Blackrock's portfolio accountable for corporate social responsibility. I was

Peter S. Cohan delivering the Verizon Lecture in Business Ethics.

impressed by this, but it is not clear how Blackrock is going to assess whether companies are acting in accordance with principles of corporate social responsibility.

Just as Professor Hoffman asked the question during his introduction, "Why does business exist?" Mr. Fink's comments led me to think again about the purpose of business. In a class this morning, I asked my students to describe what they see as the purpose of business. One of the students said the purpose of a business is profit. Others said businesses exist to benefit employees and customers. I focused the discussion on what Milton Friedman had to say about the purpose of a corporation. Friedman said that the purpose of a corporation is to maximize shareholder value. What does "maximize shareholder value" actually mean? That's a very interesting question because depending on the definition, maximizing shareholder value could be good or bad. Some people say maximizing shareholder value means that you are charging the highest possible price, having the lowest possible cost, maximizing your profits, and paying all the profits out to the shareholders in the form dividends and stock buybacks. If that is the purpose of the company, why do you need to pay CEOs tens of millions or hundreds of millions of dollars? Couldn't you just program that into a computer?

I was talking to somebody today in one of the classes, who said that their firm was managed by a group of about five investors. They fired the CEO and now the investors were managing the company. I thought, "Wow, that's very efficient." If that company can work without having a CEO, maybe we don't need CEOs anymore. What is the purpose of CEOs? However, maybe maximize shareholder value means something different. Maybe it means thinking about shareholders more and trying to have your stock price go up. If so, what is the mechanism that leads stock prices to go up? Any ideas?

(A member of the audience replied: "Earnings.")

Earnings? That's part of it. In my shorthand, I would express it as "beating and raising." Let me tell you what I mean by this. Every quarter, a company reports earnings as well as something called "guidance." Guidance is the forecast for the next quarter or for the next year on how much revenues and earnings are expected to grow. That's all there is to it. If a company reports that it beat the revenue growth rate, beat earnings per share growth rate and then raises its guidance, then its stock price will go up. However, if it misses on any of those things, the stock goes down.

Have any of you ever heard of Apple? Of course you have, and many of you are holding Apple products right now. Last week, Apple reported disappointing sales on their iPhone. Sales of the iPhone were not growing as much as they should have grown or as much as the company expected them it to grow. Nearly 60% of Apple's revenue is dependent on this one product, which was introduced 11 years ago. If you are a company and 60% of your business depends on a product that matures, it becomes harder to make money in that industry. How is the company going to survive if it depends on that one product? What does the company have to do? It has to reinvent itself and come out with new sources of growth.

I think CEOs who can come up with new growth vectors for their companies to sustain rapid growth create enormous value. If you happen to be the CEO of a company that has $200 billion dollars in revenue and you are able to get that

company to keep growing at over 20% year after year, the capitalist system should reward you. Can anybody think of any CEOs who do that? Jeff Bezos is one example of a CEO who has been able to do that. From what I can tell, the capitalist system has rewarded him pretty well because he's been able to invest in opportunities that have sustained the growth of the company. That is a very valid purpose and a very important way to increase the value of a company.

What I am proposing is a way of fixing the compensation system by linking compensation to a set of company behaviors that are related to values and principles. This starts with the idea that the company should not be trying to benefit shareholders solely. Rather, one needs to recognize an integration among an organization's different stakeholders. I'm sure you all know about the concept of stakeholders, but I am going to take a slightly different twist on this idea. The stakeholders of this company are not just the shareholders — they are the employees, the customers, and the communities in which the employees and the customers live.

Now let's connect this to another idea. Some of you may be familiar with the idea of the "loyalty effect." This is described in a book of the same name written by Fred Reichheld, who is a partner emeritus at Bain & Company. Reichheld argued that if you have employees who really want to serve customers and are happy working at the company that is reflected in their relationship with the customers. Moreover, the customers who remain loyal to the company and keep buying their products would have what is called a high Net Promoter Score. The Net Promoter Score follows from the idea that if customers are happy with a company, they will have a very high willingness to recommend it to other people. Customers, then, become a company's best salespeople. If a company has happy employees, they have happy customers, and they keep buying from the company.

Now, consider the flipside. If a company treats its employees badly, they want to leave. If they are unhappy at the company, they will also tend to treat the customers badly. The customers can't wait to get out of their contracts. In such cases, to get new customers and grow, the company has to spend more money on marketing. The company also will need to hire new employees to serve those customers. If a company makes both employees and customers miserable, they will leave, and the company enters what is called a doom loop. Companies need the opposite — they need to create strong loyalty among their employees and customers by giving them superior value in the things that they care about. In doing so, they can create an ever-growing stream of profitability. In this way, if a company has excess profit, it can take some of that and invest it in new growth opportunities. If you have covered your investments to support growth, some profits can be given to shareholders in the form of dividends, and some can be put into investments in the community.

However, I want to talk about something that really bothers me about corporate social responsibility, which is the idea of greenwashing or corporate social responsibility washing. By this is meant that a company may have a little department or organization on the side that "does" corporate social responsibility, but it is not deeply integrated into the business. It's not fundamentally tied to the way the company treats its employees and the way it treats its customers, partners, and other stakeholders.

A great example of this is Southwest Airlines. Even though I've only flown with

Companies should reward executives based on how well they follow seven Value Leadership *principles.*

them once, it is clear that people who work there really love to serve other people. I know this because many years ago when I was writing *Value Leadership*, I talked to the then chief operating officer of Southwest, Colleen Barrett, who told me the following story. She said there was someone who was interviewing for a job as a Southwest pilot. When he called to schedule a reservation to come down to the headquarters in Dallas for the interview, he was very rude to the person who was making the reservation. After he flew to Dallas, an HR staffer said to him, "Thanks for coming down, but we're not going to interview you." Why? Probably, he was a very good pilot, but he was not polite. He didn't care about other people — he wasn't nice. The company leaders want everyone — even pilots, who don't have frequent direct interactions with many passengers — to be people who care about other people and are not rude. They are very, very careful about the culture.

Another feature that I learned about the interview process was that they have group interviews and everybody in the group of approximately five or six people are interviewed for a job together. Everybody in the group gives a brief presentation. If you are one of the people giving a presentation and all you do is to concentrate on your own presentation, you are not going to get the job. On the other hand, if you are cheering on the other people who are giving the presentations, then you are much more likely to get the job or at least get to the

next level of interviews. Why? Because you showed that you care about other people. Southwest really screens very, very tightly to bring in only people who fit that culture of service.

As another example, one other thing that Southwest Airlines did was to organize an event with Ronald McDonald House. Ronald McDonald House is a place where families and parents go when their children are in the hospital. The CEO of Southwest went personally to a Ronald McDonald House and was serving food and drinks to the family members who were there. One of the pilots that I spoke with (not the one I mentioned earlier regarding the interview process) told me that he was staying at Ronald McDonald House visiting his son who was sick. The fact that the CEO of Southwest Airlines was personally serving people there was incredibly moving to him and incredibly motivating to the employees at Southwest Airlines generally. The pilot told me that really made him love being part of the company and extremely engaged with it. What I'm trying to tell you is that this is an example of corporate social responsibility that is not greenwashed. It is not fake. It is deeply integrated into the values of the organization and consistent with the way they want people to feel when they work at Southwest Airlines. The way they make customers feel is important because Southwest is a service business that happens to fly airplanes.

I want to leave you with a couple of ideas of how to integrate this into compensation. First, what I have expressed here is a framework for value leadership, which relates values like engagement to specific principles — things that companies ought to do. Engagement is a value. It means that the company wants its employees to be engaged because it values human relationships. Another fundamental value is trust. You need to have people trust you, and you need to be able to tell people what you're going to do and then you have to fulfill your commitments. All these different things are values that are related to principles, and those principles are related to activities. So, for example, the value of experimenting frugally means that you perform certain activities like growing organically, managing development risk and so on. According to the methodology described in my book, *Value Leadership,* these practices are then converted into a Value Quotient — a score for a company between zero and 100 that indicates how well they follow the 24 activities that underlie the principles of value leadership. What I am recommending is that compensation be tied to this score.

For example, this semester I asked my students to calculate Google's Value Quotient and they concluded that it was 88/100. They are 12 points short of a top score. If over time, the CEO of Google improves the score from 88 to 90 and 90 to 92, then he or she should be rewarded for that. The idea is to integrate value leadership by using the Value Quotient so that companies would actually improve on their activities linked to values. That would, therefore, improve the overall social responsibility along with the behavior of company leaders and the conduct of companies generally.

Thank you.

Q&A

Below are edited highlights of Peter Cohan and William Cohan's question-and-answer session with Bentley University students, faculty, staff, and guests.

QUESTION: *If you want to link CEO compensation to behaviors that create sustainable companies, it seems to me the important question is to ask what the process is. In my mind, the process requires strong board members, particularly the chair of the CEO Compensation Committee. How do you make that happen?*

PETER COHAN: My answer is that it's very hard to do this. The way that this would work is if a CEO has certain specific values and they initiated this process. I don't think it's something that the board can impose on a CEO. I also think it's something which is more likely to happen for a founder CEO, namely, somebody like Jeff Bezos or any of the founder CEOs who have started companies and taken them public and are now running them. They have much more say over the governance of the organization. If they thought that this was a good framework to use, and they used it and it worked, then I think it could create a snowball effect. Other companies would see that it was working, and they would get interested in it. Some other people would use it. If it were successful, it would grow more organically. I don't think it's something that would ever work if you tried to impose it from the board on down to a CEO. It would be very, very problematic, and I don't think it would be practical.

QUESTION: *You described Southwest Airlines as a company where people are happy at work, and that shows in their service. This brought to mind Walmart where it seems that the door-greeter is the only person that's happy to see you. However, they do fantastic business. I'm wondering how it works in those cases where you have companies like Walmart that perhaps don't have any competition, versus Southwest that is up against all kinds of competition. You also talked about the "democratization of capital." Can you explain further what that means?*

WILLIAM COHAN: We'll take it in reverse order. The democratization of capital is a fancy way of saying that Wall Street during an innovative burst that occurred in the 1980s — essentially after all these firms went public and had access to more capital — were able to attract the best and the brightest. Literally, rocket scientists would go there. Once upon a time, Wall Street was viewed as a backwater where you went if your uncle worked there and he could get you a job. You might start on the floor of the stock exchange running strips of paper back and forth. However, once they had more capital and became big global brands, they were able to attract the best and the brightest. Among them, there were literally rocket scientists who came up with many different products. If you think about what Mike Milken created in the high-yield market or Lou Ranieri created in the securitization market, or if you think about the derivatives market or even credit card, these innovations were all a way to give regular people access to capital in a way that had never occurred before. Previously, access to capital was usually the preserve of big corporations, really rich people, or lucky entrepreneurs. However, when you have a credit card in your pocket, that's like $20,000 of unsecured credit in your pocket. You can spend that on whatever you want; you don't have to get anyone's permission. Your only obligation is to pay it back on time if you feel like it, or, if you're kind of dumb, you don't pay it back and you have to pay interest charges at an exorbitant rate. That's what I mean by the "democratization of capital."

Mike Milken created the junk bond market and, for the first time in history, companies with below investment grade credit got access to capital. He created huge industries. As the Verizon guys will tell you, they created the whole cellular telephone industry on the backs of the junk bond market. Entrepreneurs got access to capital that they never had before. People were getting access to home mortgages who never could get them before because they were being sucked up off the balance sheets of local banks and packaged up into mortgage-backed securities. This was an incredible innovation. The securitization of credit card receivables, auto loans, and mortgages were great innovations. However, in my opinion, because of the rewards system, (or the "incentive system" or "compensation system") things slipped into excess. A great innovation is copied and essentially pushed to excess until it explodes. However, the basic idea of making capital available to companies with below investment grade credit and making capital accessible to everyday people in the form of credit cards, home mortgages, or car loans, led to an incredible explosion in capital in the 1980s that didn't exist before.

QUESTION: *Was it a bad thing?*

WILLIAM COHAN: No, it was a good thing, until Wall Street, in its infinite wisdom, seriatim wrecked one innovation after the

other. It wrecked the high-yield market by pushing it to excess. Then it wrecked the home mortgage market by pushing it to excess. However, once the excess is filtered out, the high-yield market — otherwise known as the "junk bond" market — is probably one of the most important financial markets that exists today. The market for home mortgages is hugely important. If you want to own a home, you basically need a mortgage if you can get one. We are a debt, consumer-oriented culture, and therefore, these innovations were brilliant. However, Wall Street greed pushed the innovation to excess without any carburetor on its behavior. No one was going to tell Mike Milken to stop making high-yield bonds available to people who shouldn't have them. No one was going to tell the bankers at Bear Stearns, Morgan Stanley, Goldman Sachs, or JP Morgan to stop issuing mortgages to people who they knew would never pay them back and then package them up into securities and sell them off around the world. The innovations are important and good and it's good that more people have access to capital who wouldn't otherwise have it. The bad thing is the compensation system that rewards bad behavior and the lack of accountability for that bad behavior.

PETER COHAN: Let me answer your questions about Walmart. There are a couple of things that come to mind. First, the culture of successful companies is usually not able to survive the passing of their founder. Sam Walton was a phenomenally successful entrepreneur. One of the most basic ideas that Sam Walton had was that the customer is the boss. Once Sam Walton was no longer CEO, the people who followed him were unable to live up to that. I remember taking my son into a Walmart to buy a video game many years ago. The games were in a locked case. Although there was a guy there who was supposed to unlock it, he was hiding behind boxes to avoid talking to me. I thought, "This place is just so horrible. How can this place possibly continue to exist?"

My first point is that after a company is founded and becomes huge, a new CEO may then come in and ruin it. That's step number one. Step number two is this. One of the reasons that Walmart is starting to get better is because of Amazon. This speaks to the point you were making before about Southwest having lots of competition. Now Walmart, which, of course, used to terrify all other retailers, is now being "Walmarted" by Amazon. Amazon is doing to Walmart what Walmart used to do to other retailers. Walmart has been a sleeping giant. They are waking up and doing things to try to respond to the threat that Amazon represents. I don't know whether it can ever get back to where it was when Sam Walton was the CEO. However, I also think that the threat of competition from a company like Amazon is definitely causing it to become more customer focused. Ultimately, we'll see if that works or not.

QUESTION: *You spoke about how firms were encouraged to take risks with other people's money, such as handing out mortgages to unqualified customers. What are the risks they're taking today with people's money?*

WILLIAM COHAN: Mark Twain said history doesn't repeat itself, but it does more or less rhyme. Since these firms went public, the rapidity and the virulence of the financial crisis that we've experienced has been like no other time in the nation's history because, I believe, the compensation system rewards bad

behavior. Where is the next bad behavior happening? It's probably not going to be in the mortgage market because people got that message. We had financial crises in 1987, '88, '89, up through '91 and '92. Really, these were a result, in large part, of many of the excesses in the junk bond market that Mike Milken created. We got that message; it's not going to be that way again.

I had a column in the *New York Times* in August where I talked about the bubble growing in the debt markets. People forget about the debt markets. The stock market gets all the attention. The debt market is probably five times the size of the stock market. As I would describe it, people have been mispricing the risk of debt for the last 10 years. They've been paying too much to try to get a higher yielding debt instrument because the Fed has kept interest rates artificially low as part of "quantitative easing," which we don't need to get into. This has led to tremendous mispricing of risk.

When people invest billions and trillions of dollars at the wrong price, interest rates are a way to communicate price to the bond market. When interest rates are kept artificially low for so long by the Fed, the market loses its ability to properly price debt. When you misprice risk, you are creating a bubble, and this is creating a problem. I think this is going to come home to roost. We don't really know where and when but billions of dollars were lost when Toys "R" Us went bankrupt. Sears is going bankrupt and billions of dollars are going to be lost and never recovered. If it is sufficiently systemic, then the credit markets will freeze up and people won't get access to credit. Because debt and access to credit are the lifeblood of the capitalist system, this wonderful thing of democratization of capital may go away if we go into a recession.

QUESTION: *We know that CEO pay is going up and up and up while median pay within companies is not going up very much and there are disclosures starting to happen on the ratios. Do you think that those disclosures are going to help control CEO pay? Does it matter? What do you think the impact is going to be once the disclosures really start?*

PETER COHAN: I can talk about that. I wrote a story about a company that just disclosed that ratio, and I really don't think it's going to make any difference. I think people are not paying much attention to it. Boards have a process of setting compensation that involves looking at peer companies and finding out how they're compensating. For the most part, the methodology they use to come up with compensation is very opaque. You can't see it from reading the proxy material. One thing I noticed was that when they do disclose the ratio between the CEO pay and the median pay of the employees, you can compare it to all the peer companies. I did an analysis of one company and found out that it was dramatically underpaying its CEO. The problem is that that's only one factor. For three years in a row, the company had been missing its targets and so, not paying the CEO a big bonus made sense. Therefore, you have to look at it as a whole mosaic of many variables rather than just one statistic to decide if the CEO's salary is fair or unfair.

The ratio of CEO to median employee salary is an interesting statistic. It was interesting to see that the peer companies were paying their CEOs much more than the one I was studying. To make this data meaningful, you could compare the

Speaking at his last lecture, Dr. W. Michael Hoffman introduced members of the Bentley University community to Peter Cohan and William Cohan.

financial performance of the companies that were paying a higher ratio of CEO pay to median employee and see if there's a positive correlation between the ratio of CEO pay to employee pay and their financial performance.

The other thing that was interesting to me was that all the companies studied fudged the numbers in different ways. They all tried to take out certain numbers and add certain numbers in. Every company has a different way of doing it. Therefore, in some sense, the numbers are not comparable. It's hard to normalize them. That was just looking at one company and one industry. I saw an analytical complexity in actually making some use of those numbers.

QUESTION: *Peter, earlier you said that it would be interesting if companies started to move away from having CEOs. You also said that you want to see CEOs innovating more in their companies. Which would you prefer: To have companies start to move away from the CEO structure or to keep CEOs if they become more innovative, although still highly compensated?*

PETER COHAN: The second. Yes, I'd rather have all CEOs being incredibly good at innovating and investing in growth opportunities and having a company grow. Very few CEOs can actually do that effectively and I think one of the reasons is because they take over and they become caretakers of an institution that's been established by somebody else. The mindset of a CEO who is a caretaker is that they are afraid of risk and if they see a risk — if something looks risky —

they're going to analyze it to death and not do it. We have many tools that we teach in business schools designed to prevent risk-taking from happening, when, in fact, what we should do is to encourage people who are really good at embracing risk and differentiating between the good risks and the bad risks and having the courage to take good risks. If we had more CEOs that did that, I would not care how much money you paid them. I'd be happy to reward them very amply for creating growth.

WILLIAM COHAN: I think we live in the age of imperial CEOs and I think Peter's point about the big difference a CEO can make is just extraordinarily accurate. One may think that these companies are monolithic and that they're going to be around forever. I've written a lot about Sears and Eddie Lampert, the great hedge-fund guy, supposedly "the smartest guy in the room." He is a multi-billionaire who decides to buy the bonds of K-Mart, take it out of bankruptcy, and then two years later merged it with Sears. He's held onto it for 15 years and drove the company into the ground. It didn't have to be that way. He decided he was the smartest guy in the room. He decided he wasn't going to listen to anybody else. He was going to do it his way and throw his good money after bad and take down billions of dollars of creditors' money in the process, as well as other investors' money.

This is unfortunately repeated over and over and over again. It's the job of the board to officiate this, but most boards are in the pocket of the CEOs. It's the job of shareholders, but most shareholders are too afraid, even though they have incredible power to bring it up with the CEOs.

Occasionally, you get an activist investor in there who's not too smart by half, and can actually shake things up and make things happen. Supposedly, we live in the greatest capitalist society on Earth — one that supposedly has created more wealth and lifted more people out of poverty than any other country. Therefore, even though we have problems, things seem to be working pretty well. I don't want to get into politics right now, but let's hope that today we'll send a message about how it can work better.

Thank you.

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