A different class

Would giving long-term shareholders more clout improve corporate governance?

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The spectacular collapse of so many big financial firms during the crisis of 2008 has provided new evidence for the belief that stockmarket capitalism is dangerously short-termist. After all, shareholders in publicly traded financial institutions cheered them on as they boosted their short-term profits and share prices by taking risky bets with enormous amounts of borrowed money. Those bets, it turns out, did terrible damage in the longer term, to the firms and their shareholders as well as to the economy as a whole. Shareholders can no longer with a straight face cite the efficient-market hypothesis as evidence that rising share prices are always evidence of better prospects, rather than of an unsustainable bubble.

If the stockmarket can get wildly out of whack in the short run, companies and investors that base their decisions solely on passing movements in share prices should not be surprised if they pay a penalty over the long term. But what can be done to encourage a longer-term perspective? One idea that is increasingly touted as a solution is to give those investors who keep hold of their shares for a decent length of time more say over the management of a company than mere interlopers hoping to make a quick buck. Shareholders of longer tenure could get extra voting rights, say, or new ones could be barred from voting for a spell.

In the early 1980s shares traded on the New York Stock Exchange changed hands every three years on average. Nowadays the average tenure is down to about ten months. That helps to explain the growing concern about short-termism. Last year a task force of doughty American investors (Warren Buffett, Felix Rohatyn and Pete Peterson, among others) convened by the Aspen Institute, a think-tank, published a report called “Overcoming Short-Termism”. It advocated various measures to encourage investors to hold shares for longer, including withholding voting rights from new shareholders for a year.

An advisory committee in the Netherlands has proposed loyalty bonuses for long-term shareholders, such as increased dividends or additional voting rights after holding a share for four years. Likewise, Britain’s minister for financial services, Paul Myners, has suggested that short-term holders of shares should have inferior voting rights. Roger Carr, the chairman of Cadbury until it was taken over recently by Kraft, suggested earlier this month that investors who bought shares in a firm after it had received a takeover bid should not be allowed to vote on the offer.

The theory behind these proposals is that those who hold shares longer are more likely to behave like owners than those who trade frequently to bet on short-term movements in prices. Disenfranchising the punters would not only give investors an incentive to hang onto their shares for longer, the argument runs, but would also encourage those with voting rights to use them, as they would know their votes would be more likely to count in board elections and so forth.

Would it work? Happily, an experiment in dual classes of shareholders has long been under way in France, where shares often gain double voting rights after being held for a specified period—

usually two years, although sometimes as long as ten. A recent paper, “Disclosure and Minority Expropriation: A Study of French Listed Firms”, by Chiraz Ben Ali, an economist at the University of Paris Dauphine, found that the main impact of the dual-class structure was to increase the exploitation of minority shareholders (which tended to own the shares with weaker voting rights) by the controlling majority. Accounting practices, for example, tend to be much less transparent. Admittedly, France’s feeble safeguards for minority shareholders may be partly responsible for this result—but at the very least that suggests that extra voting rights are no cure-all.

Although no American firms have dual classes of shareholders, they do sometimes resort to another device designed to resist pressure to pursue short-term goals: “staggered boards”, in which only a minority of directors face re-election each year. According to Lucian Bebchuk of Harvard Law School, who has studied their impact, they are strongly associated with lower long-term returns.

Short-term vigour, long-term neglect

Equally, there is some evidence, albeit not conclusive, that short-term shareholders from activist hedge funds and the like can improve the performance of poorly run companies through brief campaigns to improve their strategy or management. As Colin Melvin, the boss of Hermes Equity Ownership Services, an advisory firm with activist leanings, points out, “Disproportionate voting rights can (and often do) serve to insulate management and make it less accountable to shareholders.” In short, the length of time that an investor holds a share does not tell you a lot about how much interest he will take in the management of the firm concerned. Many long-term index investors hold shares for years without taking the slightest interest in how the firms they invest in are run, let alone doing anything to improve matters. There is also a moral argument, of course, against depriving property-owners of their rights, no matter how seldom they make use of them.

The real issue is not how to encourage investors to keep hold of their shares for longer, but how to encourage more of them to take their duties as owners seriously, irrespective of the length of their tenure. Instead of creating multiple classes of shareholders, governments and regulators may want to think about how they define fiduciary duties in the financial realm. Better yet, the investing public, whose retirement savings have atrophied in the financial crisis thanks in part to the short-term way in which they were invested, may sort things out themselves, by demanding a longer-term perspective from the pension and mutual funds that they have entrusted with their money.