Short-termism and the Internal Organization of Issuers and Investors
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Tab 1: The Internal Arrangements and Compensation Practices of Institutional Investors
Behaving Like An Owner: Plugging Investment Chain Leakages

Jane Ambachtsheer, Richard Fuller, and Divyesh Hindocha

The theme of investing for the long term through engaged ownership is gaining profile. This article explores the implications of “behaving like an owner” and estimates its financial benefits. We follow the journey of $100 over 20 years under four different “leakage” scenarios. Downstream leakages are active management fees, manager transition costs, and excessive trading; upstream leakages are unwarranted M&A activity and misaligned incentive structures. We find that fixing these leakages can increase the size of savings pots by as much as 25% over a 20-year accumulation period. We also address the behavioral question, “If this is so self-evident, then why do presumably rational investors keep doing these irrational things?” We close with some thoughts on the behavioral changes needed to get institutional investors behaving as owners.

Keywords: Institutional Investors, Investment Costs, Investment Process, Long-Term Investing, Pension Funds, Short-Termism

Leakages and Behavioral Impediments to Long-Term Investing

There is a growing debate on the negative economic consequences of short-termism in institutional investing and the need for a longer-term approach to investments. An example is the recent workshop organized by Rotman International Centre for Pension Management and the Generation Foundation and attended by senior representatives of 40 major pension organizations ($4T in assets) from 12 countries. One of the key outcomes was a resolution to “Design and implement concentrated, long-horizon investment mandates and ensure that we have the necessary resources to implement them successfully” (Ambachtsheer and Bauer 2013).

That resolution fits nicely with our intent in this article, which is to show how institutional asset owners such as pension funds can generate and retain more wealth for their clients/beneficiaries. We do this by estimating the excessive friction costs along the current investment chain—leakages from investments that could be plugged. To illustrate the impact of these leakages, we look at what happens to a prospective pensioner’s $100, invested in public equities over 20 years, under four different investment “journeys.”

These leakages are not generally the result of mistakes or oversights that can just be “corrected” by the rational investor; they serve a purpose in the present configuration of the investment system. So plugging them requires institutional investors to think and behave differently and to change the environment that gives rise to those leakages. Given the systemic nature of these changes, we can expect two things: first, change will not be easy (otherwise it would have happened already); and, second, should change be achieved, it will ripple through the entire investment chain, affecting every participant along the way.

Leakages: Downstream and Upstream

There is evidence to suggest that we may be entering a period of investment returns that are modest by historical standards, what has come to be called a low-return world. So today more than ever should we be interested in minimizing unnecessary investment friction costs or leakages. We can look these costs in several ways, but it is helpful to make a distinction between “downstream” and “upstream” leakage.

- **Downstream leakage** occurs in the financial services industry—the investment chain that extends from asset owner (often a pension fund or insurance company)
through to asset managers and associated service providers, such as investment consultants. Downstream costs are tangible, measurable, and under the asset owner’s control; they include stock turnover, transition activity, and investment management fees.

- **Upstream leakage** occurs at the corporation or enterprise level. Looking upstream allows us to explore how and why companies behave as they do, and how they create or destroy wealth. We also include market regulation (e.g., rules on share trading, disclosure, and taxation), which can strongly influence how companies behave. Upstream costs are generally beyond the control of the investor (e.g., mergers and acquisitions); they tend to be diffuse and hard to quantify (e.g., complex remuneration design, excessive risk taking). Consequently, there is little direct incentive to fix these problems, partly because they are “free rider” issues (i.e., they are the responsibility of “everyone and no one”).

Upstream and downstream friction costs are intimately related. However, the distinction is helpful in understanding the characteristics of these costs. It is also useful in structuring our different scenarios for the performance of a saver’s $100 and in thinking about how these costs are best reduced.

### Downstream Friction Costs

**Turnover**

Friction costs are usually double edged. They may arise from activities that are important in generating value, but these same activities may become an unrewarded cost when not monitored and constrained. In this section we explore excessive trading in greater detail and consider what investors may do to limit it.

Stock turnover is a key element of portfolio management. Even with passive management, there will be some turnover as periodic rebalancing takes place to track the index. At the other extreme is high-frequency trading, with stock-holding periods counted in seconds. So a distinction must be made between “necessary turnover” and “excessive turnover.”

Our concern here is excessive turnover in the context of a strategy’s objectives. For the purpose of the study described here, we define excessive turnover as anything above 30% stock turnover per annum.6

The issue of excessive turnover has recently received considerable attention in the context of the long-term investment thesis. These discussions have three main themes:

- Excessive turnover is a friction cost (via brokerage and other fees) that must be covered by investment returns.
- Asset managers who trade stocks to gain marginal advantage over the short term forgo an opportunity to create value by investment “stewardship” in the form of constructive engagement with companies to create long-term value.
- Excessive turnover by investors is damaging to the efficiency of markets, as momentum trading (herding) drives volatility.

Reducing turnover involves behavioral change. It requires investors to believe that they are holding the right stocks; it also requires monitoring, engagement, resourcing, and corporate communications to give them confidence to continue to hold those stocks. The framework used to consider and measure risk is also relevant, as the prevailing practice of relative performance leads to a focus on “tracking error” and drives turnover. To promote functional behavior, the Kay Review calls for a strategy shift from “exit” (the characteristic behavior of a market trader) to “voice” (the behavior of a long-term owner; e.g., Kay 2012, ch. 1, cl. 1.31).

To capture the cost of excessive trading, we assume an active manager level of turnover of 70%, and we estimate costs associated with turnover at 0.40% per annum.7 We also assume that a long-term investment approach would reduce turnover for active managers from 70% to 30%.

**Manager Transitions**

Another significant friction cost is represented by the hiring and firing of asset managers. This process is most relevant to the outsourced asset management model adopted by most small and medium-sized pension funds. Transition costs arise in at least three ways:

- Administration costs arise from transferring to a new manager and the liquidation or transition of stock. The new manager will not generally want the stock that the old manager had acquired, or not in the same proportions. Often, a professional transition manager will be appointed.
- Asset owners can make poor choices when they decide to replace asset managers. A period of underperformance may merely reflect cyclical related to the manager’s investment style, rather than a permanent turn for the worse. It is very often the case that the removal of a manager precedes an uptick in performance (see, e.g., Mercer 2011).
- Consultant fees to undertake a new search will also contribute to the cost of changing managers.

Reducing the frequency of unnecessary manager transitions requires greater confidence in the managers selected by the asset owner, monitoring managers more effectively, and communicating concerns in more productive ways. These behavioral shifts would reduce reliance on disposable agents in an environment where trust is in limited supply. It would be replaced by productive collaboration, with higher degrees of trust validated by effective monitoring.
To capture the cost of unnecessary manager transitions, we assume that transitions currently occur at five-year intervals, and we assume a cost of 0.4% on active returns each time a transition occurs. We further assume that asset owners who adopt a long-term investment framework will reduce transitions from once every five years to once every seven years.

**Manager Tenure and Fees**

The Kay Review identifies time frames as fundamentally important to performance contract design:

> The interests of beneficiaries are largely interests in long-term absolute performance. The concern of asset managers and the basis on which they are monitored by many asset holders and by advisers to asset holders and retail investors is short-term relative performance. This misalignment of incentives creates a number of problems. (Kay 2012, 41)

We would add that:
- extending tenure increases the business stability of asset-management organizations, which should reduce operating costs such as expenses related to business development, and this should be reflected in reduced fees; and
- “partnership-like relationships” between asset owners and asset managers should reduce the number of overall managers used, which should increase manager scale and have a beneficial impact on fees.

Greater business stability should reduce the cost of doing business for asset managers, and these savings can then be passed to asset owners. In our calculations, we assume that a more productive relationship with asset managers will reduce active management fees from 0.65% to 0.45%.

**Upstream Friction Costs: Investment Returns**

Assessing how investment returns might improve through the adoption of a long-horizon investment framework is perhaps the most challenging and uncertain part of the study described here. We believe it also has the biggest potential payoff for asset owners. Woolley (2010, 122, 136) estimates that corporate earnings could be raised by 1% per annum after inflation and that investment returns could increase in the range of 1.5 percentage points per annum, lowering volatility at the same time. So in this section we are interested in the corporations in which asset owners invest and in why the senior managements and boards of these organizations behave as they do.

We begin by looking at how investment managers interact with companies. In a long-horizon investment framework, active asset managers will have lower turnover and more concentrated holdings, while passive managers will place greater weight on engaging with their investee companies. This exchange has economic value. It manifests itself in matters such as governance (board nominations), alignment (executive remuneration), and strategy (mergers and acquisitions) all key areas that can drive or destroy economic value. On the corporate side, however, boards and managements align their behavior with their perception of what investors want; if they see a trading mentality, that is what they will respond to. Many have the view that the “owners” have been largely absent (see AICD 2011).

Other actors in the investment chain also reinforce and amplify short-termism. For example, merger and acquisition activity often destroys value rather than creating it. This outcome is driven by a convergence of interests between external advisors, who derive fees from transaction activities, and executives within companies, who rationally seek to maximize the outcomes of misaligned remuneration structures. Asset owners could question such practices, but those questions are far less likely to be asked when the owners are effectively market traders and have abstained themselves from such discussions.

All these practices foster short-termism, exemplified by the tyranny of quarterly earnings so-called quarterly capitalism whereby companies focus on meeting short-term market expectations, very often at the expense of long-term value creation. Government activity also plays a role here. A strong assumption of market efficiency has led to a strong emphasis on information and market disclosure, and less emphasis on market failures and how to correct those failures. This is now changing: the introduction of Stewardship Codes in the United Kingdom, the European Union, and elsewhere; the taxation of financial transactions to slow down churn (Tobin taxes); and measures to reinforce good governance, transparency, and integrated reporting are all good examples.

The central point of all this is that if asset owners acted more like real owners; if regulation focused on mitigating market failures and encouraging long-term ownership and capital allocation behaviors; if companies were empowered to resist the short-termism of quarterly earnings, material improvements in long-term value creation and preservation become real possibilities. We noted above that Woolley (2010) estimates improved company performance would flow through to an improvement in investment returns of 1.5 percentage points per annum. Our more modest working assumption is that if companies and owners, with regulators as facilitators, act as long-term investors, there will be an increase in global equity returns of 0.5–0.75 percentage points per annum.
What Happens to $100 Over 20 Years?

With our operating assumptions in place, the next step is to look at what happens to a saver’s $100 over a 20-year period in four different journeys. Table 1 summarizes all of the assumptions for each.

For all four journeys, the $100 is invested at the beginning of the period and we assume no further contributions. We believe the “impact” assumptions developed above and summarized in Table 1 are realistic over a 20-year investment horizon.

The four journeys are as follows:

- **Journey 1 – Passive Investment**: This is the simplest journey, based on 100% passive investment. In practice, investors will want to think closely about approaches to passive investing, including alternatives to market cap indices such as fundamental weighted, equal weighting, and ESG options, as there are several fundamental items to consider.

- **Journey 2 – Active Investment**: We assume 100% active management using a simplistic, single-manager approach. We have claimed a modest amount of alpha (1%), but the cost of pursuing that alpha, in the form of turnover, transition costs, and management fees, extinguishes this excess return versus a passive alternative.

- **Journey 3 – Addressing Downstream Leakages**: We assume serious attempt to address the downstream leakages in the financial services sector. We acknowledge the inherent challenges of active management and have shifted to a core/satellite approach, with 60% of the portfolio allocated to passive management and 40% to more enlightened approach to active management via a concentrated and diversified structure. This helps enhance the active management expectations (to 1.25%). Active management fees are lowered from 0.65% to 0.45%:
  - On the passive side, while we may see some scope for fee reduction by aggregation creating larger pools of assets (economies of scale), we also prefer alternative forms of indexation that may cost more.
  - For active management, turnover is reduced to 30%.
  - For both active and passive, it is expected that economic benefit will also be derived from longer-term, more stable relationships between asset owners and asset managers, leading to both reduced business costs for the asset manager and reduced transition (and related) costs for the asset owner.

Table 1: Assumptions for Each of the Four Journeys

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Start value, $</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Annual contribution, $</td>
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<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Passive proportion of assets, %</td>
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<td>0.00</td>
<td>60.00</td>
<td>60.00</td>
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<tr>
<td>Active proportion of assets, %</td>
<td>0.00</td>
<td>100.00</td>
<td>40.00</td>
<td>40.00</td>
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<td>Passive global equity returns, %</td>
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<td>5.00</td>
<td>5.00</td>
<td>5.75</td>
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<td>Active outperformance, %</td>
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<td>1.25</td>
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<tr>
<td>Passive turnover, %</td>
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<td>10.00</td>
</tr>
<tr>
<td>Active turnover, %</td>
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</tr>
<tr>
<td>Turnover cost, %</td>
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<td>0.40</td>
<td>0.40</td>
</tr>
<tr>
<td>Transition rate, interval</td>
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<td>7 years</td>
</tr>
<tr>
<td>Transition cost, %</td>
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<td>0.40</td>
<td>0.40</td>
</tr>
<tr>
<td>Passive management fees, %</td>
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<td>0.10</td>
<td>0.10</td>
</tr>
<tr>
<td>Active management fees, %</td>
<td>n/a</td>
<td>0.65</td>
<td>0.45</td>
<td>0.45</td>
</tr>
</tbody>
</table>
Journey 4 – Addressing Upstream and Downstream Leakages: Here we add a significant change in investment focus upstream in the investment chain, leading to an uplift in aggregate company earnings because of a web of actions related to long-term ownership (e.g., extended dialogue between asset owners and companies; a shift away from damaging short-termism and an increased capacity to pursue long-term value creation; more concentrated and long-term holdings by owners; and some regulatory changes to reduce churn in the system). An additional 0.75% of broad equity market returns results. Active returns remain at 1.25%, although one could argue for a positive impact here also.

In Journeys 3 and 4, asset managers are expected to increase their level of engagement. This will come at a cost, but the cost savings from aggregation of assets, increased smart beta in the active space, improved relationship stability, and fewer transitions are sufficient to absorb this additional expense. The expectation for increased engagement also justifies our reluctance to push passive management fees below 10bps.

Figure 1 indicates the return enhancement potential of a long-term investment approach that addresses both upstream and downstream leakages. Note, for example, that Journey 4 produces 25% more wealth than Journey 2.

**Figure 1: Impact of Leakages: Four Journeys of $100 over 20 Years**

<table>
<thead>
<tr>
<th>Journey 1</th>
<th>Journey 2</th>
<th>Journey 3</th>
<th>Journey 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>$256.16</td>
<td>$250.35</td>
<td>$270.65</td>
<td>$312.18</td>
</tr>
</tbody>
</table>

Downstream Implications for Behavioral Changes in Investment Practice

Much of the literature on long-term investing assumes that the benefits of a longer-term approach to investing are self-evident, that such an approach has no or little downside, and that there is, in fact, a decrease in risk. There is a growing body of evidence supporting this view. However, the actual implementation of a long-horizon investment program is far from straightforward; profound changes in investment practices and behaviors are required.

With respect to downstream implications, we made four assumptions about the relationship between the asset owner and asset managers:

1. More patience in asset management relationships, with manager transitions or turnover from every five years to every seven years. For example, the average turnover for products rated A in Mercer’s Global Equity, Core universe is 15% per annum.
2. A reduction in active management fees through the use of enlightened active management, more effective use of active managers, longer tenure, and greater aggregation of assets.
3. Reduction of stock turnover in active management.
4. Increased expectations with regard to stewardship activity.

Achieving such relationships requires different thinking, different tools, and modifications to the principal/agent relationship. It must become more porous, and take on some of the characteristics of partnership.

Three practical implications are:

1. Investment management agreements (IMAs) need to change to provide greater alignment between asset owners and asset managers. Performance must be measured and payment made over a longer period, such as a five-year rolling measurement period.
2. Transparency on the part of the asset manager is needed to reinforce trust. This is part of the tradeoff for longer-term mandates.
3. The asset owner needs to develop a new way of understanding and evaluating manager performance capacity as well as performance (e.g., emphasize qualitative over quantitative factors, expand the quantitative factors monitored [e.g., corporate ROEs, investment income vs. relative stock price performance]).

See Box 1 for the views of 250 experienced investment professionals on actually implementing the changes.
Upstream Implications for Behavioral Changes in Investment Practice

We now turn to the relationship between institutional investors and the companies they invest in. Recall that we assumed above that a long-term increase in average global equity returns from 5.0% to 5.75% is plausible. What are the behaviors that would enable this to happen? In short: stop doing counterproductive things and start doing beneficial things.

Counterproductive things include excessive reliance on quarterly capitalism. Resisting this requires a multifaceted approach that draws on all participants in the system. Asset owners must review asset managers’ performance over the longer term and commit to addressing such crucial matters as reform of executive remuneration models. Companies must build more stable ownership bases and shift their communication emphasis from the sell side to the buy side. Regulators must support measures that enable these shifts.

Beneficial things include quality interactions between asset owners and corporations. For such interactions to occur, asset owners must understand corporate value creation and the company must know that they do. Where funds are invested passively, we must shift to a paradigm where the ownership is active.

Again, we see three practical implications in this paradigm shift:

1. A structured means of engaging investee corporations to understand company strategies aimed at creating long-term value
2. The requisite resources in asset owners and asset managers to interact with companies and evaluate information in this framework
3. Clearer understandings between companies and owners (e.g., clarity on what is and what is not acceptable in terms of the levels and designs of executive remuneration schemes)

Do we have the tools necessary to achieve this paradigm shift? In our view, the answer is mostly yes, but we have some way to go.

The Free-Rider Problem

This article presents a case for longer-term investment strategies as a means to achieve higher and more stable long-term returns for pension funds and their beneficiaries.

However, despite the beneficial impacts described here, there are also costs associated with implementing these long-horizon strategies (e.g., time spent engaging with companies, time spent with regulators, and time spent with asset managers). Also, someone must pay for the special expertise necessary to understand what corporate information is required and to understand the strategic direction (good or bad) that investee companies may be heading in.
While there may be a net benefit to the asset owners that ultimately bear these costs, it will not be as great as that obtained by their peers who do little or nothing. This is the classic free-rider problem. We believe, however, that it is clearly in the interests of pension funds (and therefore consistent with fiduciary duty) to improve the system for all participants for the longer term. In this context we also note that an evolving understanding of fiduciary duty, an evolution in thinking that more explicitly incorporates a longer-term and intergenerational perspective, offers the opportunity for this approach to become more widely acknowledged as best practice (see Hawley, Johnson, and Waitzer 2011).

Seven Key Questions for Pension Funds to Consider

If asset owners conclude that long-term investing is of value, they must provide the spark to make it happen. To that end, we pose seven key questions they should ask themselves. These questions are equally relevant to asset owners with internal investment functions and those that outsource this function.

Downstream Questions
1. **What are the levels of active and passive turnover in our portfolio?** What is the rationale for the level of turnover? What is the average concentration of stocks held by active managers?
2. **What is the level of manager terminations in the last decade for our fund?** How frequently do we review asset managers? What is the average tenure of our managers? How are these managers performing post-termination?
3. **What is the process for review, including qualitative and quantitative factors?**
4. **What is the process for engaging with asset managers?** How well do we know them, and what are their capabilities? How do we retain and use knowledge gained from manager interviews? To what extent is this our own view, and to what extent is it the view of a consultant?

Upstream Questions
5. **How do we (or our asset managers) engage with companies?** Is there a clear plan and understanding of what is effective engagement, in terms of the investment thesis? What results have been reported?
6. **Would we be prepared to support companies that do not provide quarterly earnings guidance?**
7. **Is our fund willing to expend resources to improve the long-term efficiency of markets overall?** If so, what is the best approach to achieving this? Do opportunities for collaboration exist?

We believe that investment consultants also have a key role to play in this transformation process. For example, they could:
- integrate stewardship considerations more fully into how passive managers are assessed;
- pilot new ways to measure the performance of asset managers;
- assess the detailed portfolio characteristics of long-horizon investment mandates and associated portfolio construction opportunities;
- analyze the reasons for turnover when assessing a strategy; and
- conduct global projects to understand how best to promote constructive dialogue and long-term relationships between investors and companies (see Mercer 2013b).

Serving the Interests of Savers

Our focus on investment system leakages in this article does not imply that we should cease to work on creating better investment strategies and investment processes across a whole range of areas to improve pension returns. Nor do we advocate reducing friction costs at the expense of moving to market-cap passive, selecting managers based purely on turnover statistics and fees, or retaining managers when there are good reasons to terminate them.

We do, however, believe that a focus on leakages serves the best interests of ordinary people saving for their retirement years. That is, many savers and their agents, the asset owners, may not be accumulating pension pots at the rate they could be. We have shown above that asset shortfalls as high as 25% are plausible over a 20-year investment period, largely due to behaviors and processes that are suboptimal but are rational in terms of the current configuration of the system.

In summary, we make two main points:
1. A more productive economy (with higher better gross returns for all), requires investment processes that incentivize longer-term thinking and reduce short-termism. Part of the solution is greater, more effective engagement of asset owners with companies.
2. Better investment outcomes for individual savers require smarter investment strategies and a reduction in friction costs. We have concentrated on the latter in this article, but the former warrants significant focus as well.

Asset owners are in the best position to be catalysts for the kinds of changes we propose. Asset owners can send powerful signals for change rippling through the investment supply chain. What sort of asset owners? Pension funds come foremost to mind, but other large investors such as endowment funds, insurers, and mutual funds can play important roles too. These actors are of critical importance in serving the interests of savers and of the broader economies in which they live.
Endnotes

1. We are grateful to David Zanutto, Director of Consulting for Mercer Investments Canada, for his thoughtful and challenging comments on an earlier version of this paper. The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer’s ratings do not constitute individualized investment advice. Information contained herein has been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently, and therefore makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability for any error, omission, or inaccuracy in the data supplied by any third party.

2. The issue of short termism in the investment process has long been a preoccupation of economists and thinkers about finance. Haldane and Davies (2011) include a wonderful comment from William Stanley Jevons’s preface to The Theory of Political Economy published in 1871, making the point that the complaint is hardly new. However, it is fair to say that this matter has received a lot of recent attention. See, for example, the work of the Marathon Club (2007) and, even more recently, the significant contribution of the Kay Review (Kay 2012), as well as such industry publications as the white paper “Sustainable Capitalism” (Generation IM 2012) and Mercer’s briefing paper “Loyalty Shares and Incentivizing Long Term Shareholders” (Mercer 2013b). On short termism we may also borrow a pithy definition from the CFA Institute (2012, 2): “Short termism refers to the excessive focus of some corporate leaders, investors, and analysts on short term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long term value creation.”

3. The term “friction costs” here relates to the cost of doing business and is not necessarily pejorative. These costs may be mandated by regulation (e.g., audit costs or the costs related to disclosure), or they may be discretionary (e.g., the services of investment banks for companies, or the services of fund managers and asset consultants for pension funds).

4. A brief word on terminology: a “saver” is an individual who places retirement funds with an institution; an “investor” is an entity that invests in equities it may be the pension fund, or it may be asset manager acting as an agent for a pension fund (however, as we will argue, pension funds in relative terms have a critical role in the system); “pension fund” is used interchangeably with “superannuation fund”; “asset owner” is a term increasingly used for institutions acting as fiduciaries in relation to savers (such as pension funds), although these organizations are not actually the beneficial owners. “Asset managers” (or “investment managers”) are engaged to implement a specific mandate on behalf of asset owners. For the purposes of our illustration, the investment managers are assumed to be external, but some asset owners have internal investment management, particularly in larger schemes.

5. On a low return world see Woolley (2010, 121) but also see, more generally, Dimson et al (2013).

6. Woolley (2010, 123) also points to >30% turnover as indicating “excessive” turnover; subsequently, in a recent speech (Woolley 2013), he has called for pension funds and foundations that exceed this level of turnover to lose their tax free status.

7. See, e.g., IRRC and Mercer (2010, 7), which puts average asset manager turnover at just over 70% but records around “20% of strategies falling into the ≥100% turnover end of the spectrum.”

8. All these points are reflected in the Kay Review in one form or another. Woolley (2010, 138) adds an interesting one: “Do not pay performance fees. Trying to assess whether a manager’s performance is due to skill, market moves or luck is near impossible. Also performance fees encourage gambling and, therefore, moral hazard. If funds cannot resist paying them, performance should be measured over periods of several years.”

9. See Dimson et al. (2012), who puts the engagement impact of ESG engagement at 4.4% one year abnormal returns for successful engagement, 1.8% for all engagements, and zero (no negative impact) for unsuccessful engagements. See also Junkin and Toth (2010), who identify a positive impact for engagement (2.4% above benchmark on an annualized basis) and notes that the engagement approach has been instrumental in halting the “rapider erosion of performance results” at the company level.

10. Stephen Covey (1989) famously made this point in The 7 Habits of Highly Effective People.

11. An interesting finding of this report, completed by Mercer for the Australian Institute of Company Directors, was that companies almost invariably thought of the “shareholder” as an asset manager, while the pension fund rarely rated a mention (AICD 2011, 5). See also Monks (2013).

12. There is a considerable body of evidence on this point: see Christofferson et al. (2004) and, more recently, Christensen et al. (2011), citing earlier studies that place the failure rate of mergers and acquisitions between 70% and 90%.

13. “Say on pay” developments across markets in recent years have created the opportunity for owners to more fully address this issue and have facilitated increased engagement; however, owners have rarely used this tool to voice dissent.

14. See, e.g., Haldane and Davies (2011, 14) on excessive discounting of future cash flows: “This is a market failure. It would tend to result in investment being too low and in long duration projects suffering disproportionately. This might include projects with high build or sunk costs, including infrastructure and high tech investments. These projects are often felt to yield the highest long term (private and social) returns and hence offer the biggest boost to future growth. That makes short termism a public policy issue.” Further, in a survey conducted by Graham, Harvey, and Rajgopal (2005), approximately 80% of managers indicated that they would sacrifice net present value positive projects and cut expenditure directed at supporting long term value creation to avoid missing quarterly targets.

15. This ground is well covered in Generation IM (2012) and Haldane and Davies (2011). In this context see also the UK Stewardship Code (Financial Reporting Council 2012); the EU “Action Plan” (European Commission 2012); the work of the International Integrated Reporting Council (IIRC 2013); and the work of the Sustainability Accounting Standards Board (SASB).

16. See DB Climate Change Advisors (2012), which covers similar ground and comes to much the same conclusions.

17. Various attempts to redraft IMAs have met with limited degrees of success see, e.g., the International Corporate Governance Network’s Model Mandate Initiative (ICGN 2012).

18. In this context we also note the considerable potential of the Integrated Reporting (<IR>) initiative, which seeks to address the limitations of current accounting based reporting and, in particular, value in relation to company strategy and intangible factors (e.g., people, natural resources, intellectual capital, market, and regulatory context) or, to quote the International Integrated Reporting Council, “An integrated report is a concise communication about how an organisation’s strategy, governance, performance, and prospects lead to the creation of value over the short, medium and long term” (IIRC 2013, 8).
References


References (cont’d)


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The mission of the Rotman International Centre for Pension Management (Rotman ICPM) is to be an internationally-recognized, high-impact catalyst for fostering effective pension design and management. Its four primary tools to achieve this goal are the funding of objective and transformative research, the organization of interactive, action-oriented discussion forums, the publication of a readable journal relevant to professionals in the pensions and related fields, and the delivery of the globe’s leading governance education program for Board members of pension and other long-horizon investment institutions.

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The Big Idea

FOCUSING CAPITAL ON THE LONG TERM

Big investors have an obligation to end the plague of short-termism.

by Dominic Barton and Mark Wiseman
Since the 2008 financial crisis and the onset of the Great Recession, a growing chorus of voices has urged the United States and other economies to move away from their focus on “quarterly capitalism” and toward a true long-term mind-set. This topic is routinely on the meeting agendas of the OECD, the World Economic Forum, the G30, and other international bodies. A host of solutions...
have been offered—from “shared value” to “sustainable capitalism”—that spell out in detail the societal benefits of such a shift in the way corporate executives lead and invest. Yet despite this proliferation of thoughtful frameworks, the shadow of short-termism has continued to advance—and the situation may actually be getting worse. As a result, companies are less able to invest and build value for the long term, undermining broad economic growth and lowering returns on investment for savers.

The main source of the problem, we believe, is the continuing pressure on public companies from financial markets to maximize short-term results. And although some executives have managed to ignore this pressure, it’s unrealistic to expect corporate leaders to do so over time without stronger support from investors themselves. A crucial breakthrough would occur if the major players in the market, particularly the big asset owners, joined the fight—something we believe is in the best interests of their constituents. In this article we lay out some practical approaches that large institutional investors can take to do this—many of which are already being applied by a handful of major asset owners.

The Intensifying Pressure for Short-Term Results

One of us (Dominic Barton) previously wrote about the need to “fight the tyranny of short-termism” (see “Capitalism for the Long Term,” HBR March 2011), and over the past few years both our organizations have been monitoring the debate on short-termism. Early in 2013 McKinsey and the Canada Pension Plan Investment Board (CPPIB) conducted a McKinsey Quarterly survey of more than 1,000 board members and C-suite executives around the world to assess their progress in taking a longer-term approach to running their companies. The results are stark:

- 63% of respondents said the pressure to generate strong short-term results had increased over the previous five years.
- 79% felt especially pressured to demonstrate strong financial performance over a period of just two years or less.
- 44% said they use a time horizon of less than three years in setting strategy.
- 73% said they should use a time horizon of more than three years.
- 86% declared that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation.

What explains this persistent gap between knowing the right thing to do and actually doing it? In our survey, 46% of respondents said that the pressure to deliver strong short-term financial performance stemmed from their boards—they expected their companies to generate greater earnings in the near term. As for those board members, they made it clear that they were often just channeling increased short-term pressures from investors, including institutional shareholders.

That’s why we have concluded that the single most realistic and effective way to move forward is to change the investment strategies and...
approaches of the players who form the cornerstone of our capitalist system: the big asset owners.

Practical Changes for Asset Owners

The world’s largest asset owners include pension funds, insurance firms, sovereign wealth funds, and mutual funds (which collect individual investors’ money directly or through products like 401(k) plans). They invest on behalf of long-term savers, taxpayers, and investors. In many cases their fiduciary responsibilities to their clients stretch over generations. Today they own 73% of the top 1,000 companies in the U.S., versus 47% in 1973. So they should have both the scale and the time horizon to focus capital on the long term.

But too many of these major players are not taking a long-term approach in public markets. They are failing to engage with corporate leaders to shape the company’s long-range course. They are using short-term investment strategies designed to track closely with benchmark indexes like the MSCI World Index. And they are letting their investment consultants pick external asset managers who focus mostly on short-term returns. To put it bluntly, they are not acting like owners.

The result has been that asset managers with a short-term focus are increasingly setting prices in public markets. They take a narrow view of a stock’s value that is unlikely to lead to efficient pricing and collectively leads to herd behavior, excess volatility, and bubbles. This, in turn, results in corporate boards and management making suboptimal decisions for creating long-term value. Work by Andrew Haldane and Richard Davies at the Bank of England has shown that stock prices in the United Kingdom and the United States have historically overdiscounted future returns by 5% to 10%. Avoiding that pressure is one reason why private equity firms buy publicly traded companies and take them private. Research, including an analysis by CPPIB, which one of us (Mark Wiseman) heads, indicates that over the long term (and after adjustment for leverage and other factors), investing in private equity rather than comparable public securities yields annual aggregate returns that are 1.5% to 2.0% higher, even after substantial fees and carried interest are paid to private equity firms. Hence, the underlying outperformance of the private companies is clearly higher still.

Simply put, short-termism is undermining the ability of companies to invest and grow, and those missed investments, in turn, have far-reaching consequences, including slower GDP growth, higher unemployment, and lower return on investment for savers. To reverse this destructive trend, we suggest four practical approaches for institutional investors serious about focusing more capital on the long term.

1 Invest the portfolio after defining long-term objectives and risk appetite. Many asset owners will tell you they have a long-term perspective. Yet rarely does this philosophy permeate all the way down to individual investment decisions. To change that, the asset owner’s board and CEO should start by defining exactly what they mean by long-term investing and what practical consequences they intend. The definition needs to include a multiyear time horizon for value creation. For example, Berkshire Hathaway uses the rolling five-year performance of the S&P 500 as its benchmark to signal its longer-term perspective.

Just as important as the time horizon is the appetite for risk. How much downside potential can the asset owner tolerate over the entire time horizon?
And how much variation from the benchmark is acceptable over shorter periods? Short-term underperformance should be tolerated—indeed, it is expected—if it helps achieve greater long-term value creation. Singapore’s sovereign wealth fund, GIC, takes this approach while maintaining a publicly stated 20-year horizon for value creation. The company has deliberately pursued opportunities in the relatively volatile Asian emerging markets because it believes they offer superior long-term growth potential. Since the mid-2000s GIC has placed up to one-third of its investments in a range of public and private companies in those markets. This has meant that during developed-market booms, its equity holdings have underperformed global equity indexes. While the board looks carefully at the reasons for those results, it tolerates such underperformance within an established risk appetite.

Next, management needs to ensure that the portfolio is actually invested in line with its stated time horizon and risk objectives. This will likely require allocating more capital to illiquid or “real” asset classes like infrastructure and real estate. It may also mean giving much more weight to strategies within a given asset class that focus on long-term value creation, such as “intrinsic-value-based” public-equity strategies, rather than momentum-based ones. Since its inception in 1990, the Ontario Teachers’ Pension Plan (OTPP) has been a leader in allocating capital to illiquid long-term asset classes as well as making direct investments in companies. Today real assets such as water utilities and retail and office buildings account for 23% of OTPP’s portfolio. Another believer in this approach is the Yale University endowment fund, which began a self-proclaimed “revolutionary shift” to nontraditional asset classes in the late 1980s. Today the fund has just over 35% in private equity and 22% in real estate.

Finally, asset owners need to make sure that both their internal investment professionals and their external fund managers are committed to this long-term investment horizon. Common compensation structures like a 2% management fee per year and a 20% performance fee do little to reward fund managers for long-term investing skill. A recent Ernst & Young survey found that although asset owners reported wanting annual cash payments to make up only 38% of fund managers’ compensation (with equity shares, deferred cash, stock options, and other forms of compensation accounting for the rest), in practice they make up 74%. While many institutions have focused on reducing fixed management fees over the past decade, they now need to concentrate on encouraging a long-term outlook among the investment professionals who manage their portfolios. CPPIB has been experimenting with a range of novel approaches, including offering to lock up capital with public equity investors for three years or more, paying low base fees but higher performance fees if careful analysis can tie results to truly superior managerial skill (rather than luck), and deferring a significant portion of performance-based cash payments while a longer-term track record builds.

Unlock value through engagement and active ownership. The typical response of many asset owners to a failing corporate strategy or poor environmental, social, or governance practices is simply to sell the stock. Thankfully, a small but growing number of leading asset owners and asset managers have begun to act much more like private owners and managers who just happen to be operating in a public market. To create value, they engage with a company’s executives—and stay engaged over time. BlackRock CEO Laurence Fink, a leader in this kind of effort, tells companies not to focus simply on
winning over proxy advisory firms (which counsel institutional investors on how to vote in shareholder elections). Instead, says Fink, companies should work directly with BlackRock and other shareholders to build long-term relationships. To be clear, such engagement falls along a spectrum, with varying levels of resources and commitment required (see the sidebar “The Equity Engagement Spectrum”). But based on their in-house capabilities and scale, all asset owners should adopt strategies that they might employ individually or collaboratively.

Some asset owners are large enough to engage on their own by formally allocating dedicated capital to a relationship-investing strategy. This could involve taking a significant (10% to 25%) stake in a small number of public companies, expecting to hold those for a number of years, and working closely with the board of directors and management to optimize the company’s direction. For smaller asset owners, independent funds like ValueAct Capital and Cevian provide a way to pool their capital in order to influence the strategies of public companies. The partners in such a coalition can jointly interact with management without the fixed costs of developing an in-house team.

Engaging with companies on their long-term strategy can be highly effective even without acquiring a meaningful stake or adopting a distinct, formal investment strategy. For example, the California Public Employees’ Retirement System (CalPERS) screens its investments to identify companies that have underperformed in terms of total stock returns and fallen short in some aspect of corporate governance. It puts these companies on its Focus List—originally a published list but now an internal screen—and tries to work with management and the board to institute changes in strategy or governance. One recent study showed that from 1999 to mid-2013, the companies targeted through the Focus List collectively produced a cumulative excess return of 12% above their respective industry benchmarks after five years. Other studies have shown similar results, with companies doing even better in the first three years after going on the Focus List. Interestingly, the companies CalPERS worked with privately outperformed those named publicly, so from 2011 onward, CalPERS has concentrated on private engagement.

Despite the evidence that active ownership is most effective when done behind the scenes, there will inevitably be times when public pressure needs to be applied to companies or public votes have to be taken. In such cases, asset owners with sufficient capacity should go well beyond following guidance from short-term-oriented proxy advisory services. Instead they should develop a network with like-minded peers, agree in advance on the people and principles that will guide their efforts, and thereby position themselves to respond to a potentially contentious issue with a company by quickly forming a microcoalition of willing large investors. Canadian Pacific Railway is a recent example where a microcoalition of asset owners worked alongside long-term-oriented hedge funds to successfully redirect management’s strategies.

Transparency makes such collaborative efforts easier. In the United Kingdom, major institutions are required to “comply or explain” their principles of engagement under the UK’s Stewardship Code. Elsewhere, big asset owners and managers should also publish their voting policies and, when a battle is joined, disclose their intentions prior to casting their votes. Smaller asset owners or those less interested in developing in-house capabilities to monitor and engage with companies can outsource this role to specialists. Hermes Equity Ownership Services, for example, was set up by the BT Pension Scheme in the UK to provide proxy voting and engagement services.

### The Equity Engagement Spectrum

Asset owners are developing a range of approaches to engaging with companies in which they have equity investments. As the size of their stake rises, they move from monitoring and coalition building to acting like owners, often with board representation.

<table>
<thead>
<tr>
<th>OWNERSHIP STAKE IN COMPANY</th>
<th>ONGOING ENGAGEMENT</th>
<th>ACTIVE OWNERSHIP</th>
<th>RELATIONSHIP INVESTING</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;2%</td>
<td>• Continuously monitors companies, with a mix of active and reactive engagement</td>
<td>• Owns a meaningful position in a handful of companies</td>
<td>• Takes a significant minority ownership</td>
</tr>
<tr>
<td>1–5%</td>
<td>• May build microcoalitions with other investors</td>
<td>• Usually remains below the 5% threshold for public disclosure of holdings</td>
<td>• Often has board seats</td>
</tr>
<tr>
<td>&gt;10%</td>
<td>• Often does not pursue any additional investment beyond an index-weighted holding</td>
<td>• Tries to build microcoalitions with other investors</td>
<td>• Works collaboratively with management on long-term strategy</td>
</tr>
</tbody>
</table>

Source: McKinsey & Company and Canada Pension Plan Investment Board

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services to 35 global asset owners that together have some $179 billion under management.

Finally, to truly act as engaged and active owners, asset owners need to participate in the regulation and management of the financial markets as a whole. With some exceptions, they have largely avoided taking part publicly in the debates about capital requirements, financial market reform, and reporting standards. Some of the biggest players in the game are effectively silent on its rules. As long-term investors, asset owners should be more vocal in explaining how markets can be run more effectively in the interests of savers.

3 Demand long-term metrics from companies to change the investor-management conversation. Making long-term investment decisions is difficult without metrics that calibrate, even in a rough way, the long-term performance and health of companies. Focusing on metrics like 10-year economic value added, R&D efficiency, patent pipelines, multiyear return on capital investments, and energy intensity of production is likely to give investors more useful information than basic GAAP accounting in assessing a company’s performance over the long haul. The specific measures will vary by industry sector, but they exist for every company.

It is critical that companies acknowledge the value of these metrics and share them publicly. Natura, a Brazilian cosmetics company, is pursuing a growth strategy that requires it to scale up its decentralized door-to-door sales force without losing quality. To help investors understand its performance on this key indicator, the company publishes data on sales force turnover, training hours per employee, sales force satisfaction, and salesperson willingness to recommend the role to a friend. Similarly, Puma, a sports lifestyle company, recognizes that its sector faces significant risks in its supply chain, and so it has published a rigorous analysis of its multiple tiers of suppliers to inform investors about its exposure to health and safety issues through subcontractors.

Asset owners need to lead the way in encouraging the companies they own to shift time and energy away from issuing quarterly guidance. Instead they should focus on communicating the metrics that are truly material to the company’s long-term value creation and most useful for investors. In pursuing this end, they can work with industry coalitions that seek to foster wise investment, such as the Carbon Disclosure Project, the Sustainability Accounting Standards Board, the investor-driven International Integrated Reporting Council, and most broadly, the United Nations–supported Principles for Responsible Investment.

But simply providing relevant, comparable data over time is not enough. After all, for several years, data sources including Bloomberg, MSCI, and others have been offering at least some long-term metrics—employee turnover and greenhouse gas intensity of earnings, for example—and uptake has been limited. To translate data into action, portfolio managers must insist that their own analysts get a better grasp on long-term metrics and that their asset managers—both internal and external—integrate them into their investment philosophy and their valuation models.

4 Structure institutional governance to support a long-term approach. Proper corporate governance is the critical enabler. If asset owners and asset managers are to do a better job of investing for the long term, they need to run their organizations in a way that supports and reinforces this. The first step is to be clear that their primary fiduciary duty is to use professional investing skill to deliver strong returns for beneficiaries over the long term—rather than to compete in horse races judged on short-term performance.

Executing that duty starts with setting high standards for the asset owner’s board itself. The board must be independent and professional, with relevant governance expertise and a demonstrated commit-
ment to a long-term investment philosophy. Board members need to have the competencies and time to be knowledgeable and engaged. Unfortunately, many pension funds—including many U.S. state and local government employee pension plans—are not run this way; they often succumb to short-term political pressure or lack sufficient expertise to make long-term investment decisions in the best interests of beneficiaries.

However, successful models do exist. For example, the New Zealand Superannuation Fund is overseen by a board of “guardians” whose members are selected for their experience, training, and expertise in the management of financial investments. The board operates at arm’s length from the government and is limited to investing on what it calls “a prudent, commercial basis.” The board is subject to a regular independent review of its performance, and it publishes its progress in responding to the recommendations it receives. Two other exemplary models are the Wellcome Trust, a UK-based global charitable foundation, and Yale University’s endowment fund; each delegates strategic investment implementation to a committee of experienced professionals.

Professional oversight needs to be complemented by policies and mechanisms that reduce short-term pressures and promote long-term countercyclical performance. These could include automatic rebalancing systems to enforce the selling of equities during unsustainable booms, liquidity requirements to ensure there is cash available to take advantage of times of market distress, and an end to currency hedging to reduce the volatility of short-term performance. Such policies need to be agreed to in advance of market instability, because even the best-governed institutions may feel the heat during such periods.

A case in point is Norges Bank Investment Management (NBIM), which invests Norway’s revenue from surplus petroleum (more than $814 billion) in the country’s global government pension fund. In 2007 the Ministry of Finance and NBIM set a long-term goal: to raise the equity content of the fund from 40% to 60%. Yet when the financial crisis hit, NBIM lost over 40% of the value of its global equity portfolio, and it faced significant external pressure not to buy back into the falling market. Its strong governance, however, coupled with ample liquidity, allowed it to continue on its long-term path. In 2008 it allocated all $61 billion of inflows, or 15% of the fund’s value, to buying equities, and it made an equity return of 34% in the following year, outperforming the equity market rebound. In similar circumstances a few years later, NBIM kept to its countercyclical strategy and bought into the falling equity market of mid-2011, turning an equity loss of nearly 9% that year into an 18% return in 2012.

A final imperative for the boards and leadership of asset owners is to recognize the major benefits of scale. Larger pools of capital create more opportunities to invest for the long term by opening up illiquid asset classes, making it cost-effective to invest directly, and making it easier to build in-house engagement and active ownership capabilities. According to analysts such as William Morneau, the Ontario Ministry of Finance’s pension investment adviser, these opportunities are often cost-effective once an asset owner has at least $50 billion in assets under management. That suggests that savers, regulators, and board members of smaller asset owners should be open to these institutions pooling assets or even merging.

**Large asset owners can be a powerful force for instituting balanced, long-term capitalism that ultimately benefits everyone.**

**Leading the Way Forward**

Today a strong desire exists in many business circles to move beyond quarterly capitalism. But short-term mind-sets still prevail throughout the investment value chain and dominate decisions in boardrooms.

We are convinced that the best place to start moving this debate from ideas to action is with the people who provide the essential fuel for capitalism—the world’s major asset owners. Until these organizations radically change their approach, the other key players—asset managers, corporate boards, and company executives—will likely remain trapped in value-destroying short-termism. But by accepting the opportunity and responsibility to be leaders who act in the best interests of individual savers, large asset owners can be a powerful force for instituting the kind of balanced, long-term capitalism that ultimately benefits everyone.
Will The New Shareholder-Director Exchange Achieve Its Potential?

Posted by Carl Icahn, Icahn Enterprises, on Thursday February 13, 2014

Editor’s Note: Carl Icahn is the majority shareholder of Icahn Enterprises. The following post is based on a commentary featured today at the Shareholders’ Square Table.

The recent announcement of the formation of the Shareholder-Director Exchange, a new group that aims to facilitate direct communication between institutional shareholders (namely, mutual funds and pension programs) and non-management directors of the U.S. public companies they own, has been accompanied by a flurry of articles regarding the purposes and possibilities of this new group. From my perspective, the Shareholder-Director Exchange has tremendous potential to help improve corporate governance and performance in this country.

Today, over 70% of the shares of U.S. public companies are owned by large institutional shareholders, and for many years these shareholders have been sleeping giants with respect to corporate governance. They have often elected to “vote with their feet” (by selling shares in underperforming companies) rather than using their votes and their voices to push companies to make the often difficult changes necessary to improve performance. However, more recently some institutional investors have been taking note of, and adding their support to, various criticisms of corporations that have been raised by activist shareholders in proxy fights and precatory solicitations. Indeed, the formation of the Shareholder-Director Exchange is consistent with the observations of Mary Jo White, Chairwoman of the Securities and Exchange Commission, who recently made the following statements:

“Over the years, shareholders have become increasingly engaged with the companies in which they invest in order to influence boards and management. Much of this increased engagement can be traced to campaigns that used shareholder proposals to address corporate governance practices that were viewed as entrenching management and preventing growth, such as supermajority voting, classified boards and anti-takeover devices.”
“The nature of the practices and objectives associated with shareholder engagement is changing. More and more, investors have become comfortable with being called an 'activist' in part because of the support they have received for their goals and, in some cases, even the tactics that they use.…[T]here is widespread acceptance of many of the policy changes that so-called 'activists' are seeking to effect.”

It is, of course, incumbent upon institutional shareholders to be responsible stewards of the funds they manage, and the Shareholder-Director Exchange has the potential to create an open path for these shareholders to engage in meaningful dialogue with the directors who oversee their investments. However, as highlighted by Kenneth Squire, publisher of The Activist Report, there are some troubling aspects of the 10-point protocol for engagement that was released by the Shareholder-Director Exchange. For example, I see no reason why a director should consider a shareholder’s voting history when deciding whether or not to hear that shareholder’s concerns. No shareholder should ever be penalized for exercising their inherent right to vote how they see fit.

Nevertheless, the formation of the Shareholder-Director Exchange is in and of itself a positive development if for no other reason than to stand in stark contrast to the hawkish approach that has for years been championed by firms, such as Wachtell, Lipton, Rosen & Katz LLP (“Wachtell Lipton”) and Goldman, Sachs & Co., who have made fortunes from corporate conflicts by spreading the implementation of entrenchment devices, like the poison pill and staggered board. Just recently Wachtell Lipton promoted a new entrenchment scheme whereby incumbent directors unilaterally amend a company’s bylaws to disqualify certain individuals from challenging their positions on the board—a move that was widely criticized and quickly discredited.

Despite the emergence of a sea change in support for shareholder engagement, Martin Lipton, a founding partner of Wachtell Lipton, continues to champion his most pernicious invention—the poison pill (which, in a bit of Orwellian double-speak, is named the “shareholder rights plan”). Just recently, in The Wall Street Journal, he referred to the poison pill as “an essential tool for boards fulfilling their duties in the interests of stockholders.” But the notion that the poison pill—which has been the subject of massive shareholder and academic criticism—is a tool to fulfill duties to shareholders is totally misguided. The effect of the poison pill is to disproportionately shift power

1 Over the years, commentators have argued, among other things, that poison pills: (i) diminish shareholder value by discouraging or thwarting takeover offers before they are made, instead of fostering negotiations with bidders that result in higher premiums; (ii) are simply a pretext for delaying tactics intended to stifle bids; (iii) depress a company’s stock price and promote poor corporate governance; and (iv) serve only to entrench, and deprive shareholders of the right to replace, boards and management (i.e., individuals whose primary source of income is derived from the company may have incentives to maintain a pill in place, even in the face of a value-creating offer, if they fear they would not have a continuing role at the company). See 2009 Governance Background Report: Poison Pills (RiskMetrics Group, September 24, 2009).
to management and away from shareholders, and the ongoing reduction of the trigger point for poison pills (which began at 20% and has recently been reduced to 10% and even 5% at certain companies) results in a tremendous chilling effect on shareholder involvement, as it prevents shareholders from building stakes sizable enough to justify conducting (at their own expense) the costly, time-consuming campaigns necessary to unseat and replace inept management and directors.

Another value-destroying tactic in vogue with members of the Business Roundtable and legal and financial advisors of entrenched management and boards is the allegation that shareholder activists are all "short-term" investors. According to these folks, all of the corporate world’s ills can be laid at the feet of the mythical and evil “short-term” investor, while incompetent management teams and passive shareholders who ignore the fiduciary duties they owe to their own investors are exalted and assumed to be benevolently focused on “long-term” growth and prosperity. Although this baseless attack has been exposed by commentators as a mere public-relations technique, it continues to be used to defend boards and management teams.

Let me be clear—we do not buy securities with the intention of agitating for a quick “pop” and then “flipping” them for a speedy profit. Certainly this does happen on occasion when, for example, prices rise irrationally. But in reality, the opposite is true—we focus on the long-term. The holding period for many of our investments spans several years (and sometimes even decades). For examples, just see our investments in the following companies—

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2 See Charles Nathan, Debunking Myths about Activist Investors, The Harvard Law School Forum on Corporate Governance and Financial Regulation, March 15, 2013 (“[T]he fact that activist investors understand IRR math does not make them slaves to short-term results. Many activist investors have advocated strategies that require significant time to implement. Moreover, most activist investors understand that there is an unpredictable time frame between an initial proposal for a change at the target company and acceptance and implementation of the change. Whatever the reasons, many activist investors have undertaken investments with durations measured in years not months.”); and Steven M. Davidoff, A Label for Activist Investors That No Longer Fits, The New York Times, July 9, 2013 (“Maybe it’s time to drop the rhetoric of short-term versus long-term shareholders. Instead, let’s just call it what it is. A disagreement over what direction and risk the company should take — with the hedge funds sometimes being right.”).

3 For one thing, we do not enjoy paying short-term capital gains tax rates.
<table>
<thead>
<tr>
<th>COMPANY</th>
<th>HOLDING PERIOD</th>
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<tr>
<td>American Casino &amp; Entertainment Properties</td>
<td>From 1997 To 2008 11 Years</td>
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<tr>
<td>American Railcar Industries</td>
<td>From 1984 To Present 30 Years</td>
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<td>American Real Estate Partners (now Icahn Enterprises)</td>
<td>From 1990 To Present 24 Years</td>
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<td>Federal-Mogul</td>
<td>From 2001 To Present 13 Years</td>
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<td>Forest Laboratories</td>
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<td>Hain Celestial Group</td>
<td>From 2010 To 2013 3 Years</td>
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<td>Mentor Graphics</td>
<td>From 2010 To Present 4 Years</td>
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<td>Motorola</td>
<td>From 2007 To 2012 5 Years</td>
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<td>National Energy Group</td>
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<td>Navistar International</td>
<td>From 2010 To Present 4 Years</td>
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<td>PSC Metals</td>
<td>From 1998 To Present 16 Years</td>
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<td>Take Two Interactive Software</td>
<td>From 2008 To 2013 5 Years</td>
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<td>Tropicana Entertainment</td>
<td>From 2008 To Present 6 Years</td>
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<td>Vector Group</td>
<td>From 1999 To 2012 13 Years</td>
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<tr>
<td>Viskase Companies</td>
<td>From 2001 To Present 13 Years</td>
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<td>WebMD Health</td>
<td>From 2011 To 2013 2 Years</td>
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<tr>
<td>WestPoint Home</td>
<td>From 2004 To Present 10 Years</td>
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<tr>
<td>XO Communications</td>
<td>From 2001 To Present 13 Years</td>
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We perform extensive financial and legal analyses prior to making any investment because our view is generally that we will not buy a single share of stock unless we are willing to own the entire company. A great recent example of that is CVR Energy, Inc. ("CVR"), where we started with a relatively small position but ended up acquiring the company. Today, CVR is an operating subsidiary of Icahn Enterprises L.P. ("IEP"). Based on the current trading price of CVR’s stock and the distributions since we acquired control, we have a gain of approximately $1.6 billion on our purchase of CVR.
Although our holding periods would generally place us in the “long-term” camp, we nevertheless evaluate each of our investments on a daily—sometimes hourly—basis. We do not sit on our hands and pray that boards and management teams will do the right things for shareholders. When we see things like mismanagement, poor capital allocation, wasteful spending and excessive compensation, we do not throw up our hands and sigh that our only remedy is to “vote with our feet.” We hope that the Shareholder-Director Exchange, and its direct shareholder/director dialogue, will provide institutional shareholders with an alternative to voting with their feet when they are not happy with an investment.

We believe that both the change of attitude by large institutional shareholders regarding ineffectual boards and the formation of the Shareholder-Director Exchange is due in large part to the fact that “activists” have had a strong and positive impact on the companies they invest in and have often produced outsized returns for investors. A recent study that was conducted at IEP showed that if an investor invested in every one of the 20 companies at which our designees became directors over the last 5 years and sold when those designees left the board (or continued to hold if our designee stayed on the board), the investor would have earned an annualized return of 28%, compared to only 2% if an investor invested the exact same way in the hedge fund index. Another IEP study showed that an investor in IEP who bought in 2000 and sold at today’s current price would have a 1,684% total return on equity, which would equate to an annualized return of 22.7%, compared to an annualized return of only 3.4% for the S&P Index. I believe that the primary driver of IEP’s results since 2000 is the fact we have been activists throughout the entire period.

Additionally, Professor Lucian Bebchuk at Harvard Law School studied approximately 2,000 interventions by activists occurring during the period from 1994 to 2007, and he concluded that activist interventions are typically followed by a five-year period of improved operating performance. (The study is discussed on the Forum here.) Professor Bebchuk thus refutes by empirical evidence those naysayers who allege (based on their self-interested, anecdotal observations) that activism only achieves short-term profit at the expense of long-term corporate improvement. Professor Bebchuk has confirmed, as we have always asserted, that activism forces lackluster boards and management teams to adopt and implement actions that lead to long-term corporate success.

Large institutional investors are now realizing that it is almost self-evident that if management teams and boards are held accountable for their actions it will not only enhance shareholder value but will also make companies more productive and competitive. I believe that U.S. public companies are finally beginning to understand the impact of the changes in shareholder sentiment, and I encourage members of the Shareholder-Director Exchange to use their unique
and powerful positions to promote good corporate governance practices, including the elimination of entrenchment devices (especially poison pills with low share ownership triggers, which are particularly troubling), and the elimination of corporate waste and excess.

I have made a lot of money identifying poorly run companies and getting them back on track. It is not rocket science, but it requires finding the right directors and managers and keeping them focused on performance. Hopefully those participating in the Shareholder-Director Exchange will carry this philosophy forward, making U.S. public companies more profitable for all investors, thereby creating new employment opportunities and helping to fund the pension programs of retirees. That is the great potential of the Shareholder-Director Exchange—if our large institutional shareholders actively exercise their power to improve the companies they own and reverse the negative effects caused by years of management and board isolation from the influence of owners (i.e. if all shareholders take an interest in their investments and become “activists”), I believe the entire economy will reap the benefits.
Tomorrow's Value

Achieving long-term financial returns: a guide for pension fund trustees
Introduction

The most fundamental duty of a pension fund trustee is to ensure that the best possible benefits are paid to the right people at the right time. This involves managing the cost-effective transformation of retirement savings into pension payments. As a pension fund trustee you are responsible for shaping investment strategies to achieve financial returns for beneficiaries. But how long-term are those returns?

In the face of current crises, your role as a pension fund trustee has become more important and, many would say, more challenging.

All too often attention is focused on the asset manager and others in a very complex system with multiple intermediaries and many behavioural pressures. If the system is to work and the interests of beneficiary are to be advanced we need to focus on those responsible for the stewardship of the scheme – the trustee or equivalent.

This guide will provide you with practical support in your role. This is a time of opportunity, as well as of challenge. In securing the long-term interests of beneficiaries, it is important to protect the interests of savers and to secure the long-term interests of people, profitable companies and the planet. Linked to this is a view of value, supported by evidence, which is fit for purpose and which will support the judgements you reach.

This guide covers and brings together a number of complex and related arguments – they are too important to be left to the experts! We argue that:

- a new view of value is needed and provide the evidence for it
- behavioural pressures on trustees must be recognised and challenged
- fiduciary duty, properly understood, reinforces this view of value.
We believe trustees should therefore be encouraged to ensure that ‘Tomorrow’s Value’ is reflected in the mandates for which they are responsible.

Five key principles frame and run through the guide:

- arrangements made for pensions must meet two key goals, affordability and payment certainty – trustees need to meet and to balance short- and long-term considerations
- trustees need to understand value as integrating a number of factors over the long-term – rather than mainstream or environmental, social, and governance (ESG) factors, the challenge is how to embed ESG and other considerations into a new mainstream view
- trustees bear ultimate responsibility for the effective governance of the pension scheme, ensuring that it achieves its mission in a cost-effective manner
- the responsibility of pension fund trustees must be applied according to principles of good governance – trustees need to delegate to their executive
- trustees should be good stewards – supporting companies that create value over the long-term. This does not however mean ‘picking winners’.

The guide is supported by an agenda and a resource for boards that want to take this forward with asset managers and other suppliers.

We are sure this guide helps you and other key players to understand why and, more importantly, how to promote long-term value creation in practice.

Tony Manwaring
Chief executive, Tomorrow’s Company
We are very pleased to welcome and to be associated with the Tomorrow’s Value guide for pension fund trustees. We believe the associated agenda will provide trustees with practical guidance on how to best deliver long-term financial value within their own pension schemes. This includes setting up a process, and an excellent range of questions to ask themselves and their suppliers. We are confident that this work will ensure progress is made towards the overarching goals to which we all subscribe.

The Principles for Responsible Investment (PRI) was established eight years ago by a global group of asset owners who believed that much more needed to be done to promote responsible investment which looks to the long-term. That initial vision has since blossomed, and PRI signatories now number over 1,200, representing assets of over $34tn. We have come a long way since those early days, but the global financial crisis only highlights how much work there is left to do.

PRI supports a wide range of initiatives across the world, and we applaud the work of Tomorrow’s Company which has focused on long-term success – for business, investors, and savers – for many years.

We encourage pension fund trustees to engage with this work. They are the guardians of workers’ capital, a phrase which rightly highlights the nature of the assets under their stewardship.

Fiona Reynolds, Managing Director, Principles for Responsible Investment
Pension Funds – Key facts

The 13 largest pension markets held $29,754bn worth of assets at the end of 2012, representing an 8.9% rise compared to the 2011 year-end value.

The US has the biggest pension market (56.6%). Japan is the second largest (12.5%) and the UK is third largest (9.2%).

In 2012, 89% of pension assets in the UK were held by private sector companies. In Canada, this figure was 43%. Methodology does not provide an estimate for 2013.

By 2018, nearly all workers in the UK will be automatically enrolled into a workplace pension scheme.¹

UK state pension deficit £7.1tn (2010, still lower than EU average – ONS).²

UK private sector final-salary schemes deficit £244.7bn at the end of December 2012 (January 2013 – PPF).

There are over 6000 defined benefit schemes in the UK.³

Different asset classes

At the end of 2012 the average global asset allocation of the seven largest markets was 47.3% equities, 32.9% bonds, 1.2% cash, and 18.6% other assets like alternative investments and property.

In 2013, the UK continued to have above average equity allocations at 45% (although down from 61% in 2002), 37% invested in bonds, 1% in cash and 17% in other assets like alternative investments and property.⁴
The guide focuses on the United Kingdom and on English Law. To keep the guide a readable length, we decided to focus on one jurisdiction rather than a number of jurisdictions superficially so as to include practical actions to implement the principles identified. Other jurisdictions will be able to achieve similar results, by applying the same principles while working within the remit of their legal system.

Though the guide focuses on pension fund trustees, these principles are also applicable to all other players in the investment chain.

We use a number of terms throughout the guide, agenda and resource – what we mean by these is as follows:

- **fundamental beliefs** – trustees should be clear about their fundamental beliefs and what factors they take into account when considering long-term financial objectives and investment related risks

- **board mandate** – Trustee Boards should have a shared clarity of the most fundamental principles of their own mandate, which helps them to formalise their strategic intent in relation to values, standards, performance outcomes and key issues of risk and forward development

- **Statement of Investment Principles (SIP)** – SIP can, in principle, provide much of this information. However, they may often be completed without the Board being clear about their own mandate

- **mandates to suppliers** – on the basis of shared clarity about fundamental beliefs, the mandate and SIPs, this will better frame the parameters of the mandates given to their suppliers.
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Achieving long-term financial returns: a guide for pension fund trustees

Tomorrow’s Value

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Executive summary

It is time to form a new and integrated view of value. One that is intergenerational, takes into account economic, social and environmental factors, and is measured using both financial and non-financial indicators. This is what we call long-term financial value. It is a view that considers the time horizons of both new and mature pensions and whether the pension arrangement is likely to achieve its stated goal. This guide aims to support pension fund trustees in forming and implementing this view.

The short-term view of value which underpins the current pension fund system is arguably unfit for purpose. It makes it challenging for pension fund trustees to ensure that their fund works in the best interests of its savers to deliver a high quality and low-cost pension.

Post-war growth was fuelled largely by economic drivers of value and securing financial returns. Social and environmental issues were largely seen as constraints, ‘a price to be paid’.

The context has changed, compounded by general global volatility and uncertainty. This is re-shaping how value will be created in the future. It is now necessary to consider how to create long-term financial value. This is value that goes beyond the estimated financial returns of an asset and considers its resilience in the context of a changing business environment.

It is now more important than ever to take into account strategic risk factors which might have a material impact on future returns. This includes social, environmental, cultural, and behavioural factors, all operating over the long-term.

The current view of value is marred by behavioural pressures that affect all key players in the investment chain. This myopic view has resulted in inconsistent performance by funds in recent years, whether through speculation in equities, bonds or commodities.
The fundamental frameworks which inform understanding and behaviours are no longer fit for purpose. The short-term economic view of value, sustainability, and a responsible approach to investment all too often sit in a separate universe. This makes it difficult to go beyond the short-term and to allow for more long-term investment strategies which would take broader factors into account.

Through our discussions with pension fund trustees, we observe that these pressures are at times further reinforced by the belief that there is no evidence to support long-term investment and by a lack of understanding of trust law principles and fiduciary duty. A narrow interpretation of case law and narrow legal advice are common, with a fear of incurring liability. All of this steers pension fund trustees away from making more long-term investment choices.

We argue that we need to go beyond current compartmentalised measures of success such as ESG, Responsible Investment (RI), Socially Responsible Investment (SRI) as well as mainstream views of value. Discouraging compartmentalisation will mean that every asset will be viewed in an integrated and complete way, recognising that value lies in all perspectives and how they interrelate.

This guide sets out how pension fund trustees can better fulfil their role and in doing so reset the system.
How this guide works

What is the fiduciary duty and how does it reinforce this new view of value? How to strengthen the use of the mandate as an important tool to achieve long-term financial value?

Pages 36 to 48

What can a pension fund trustee do to minimise the risk of value erosion because of these pressures? How would the ideal system flow?

Page 33

How do current pressures along the investment chain impact on behaviour, and how does this impact implementing a broader view of value?

Pages 28 to 32

What evidence is there that moving away from traditional perceptions of value makes business sense and maximises returns? Who is working towards this new view of value?

Pages 22 to 26

Why is there a need for a new view of value? Why forming this view matters? What has been the evolution of value? What is Tomorrow’s Value – achieving long-term financial value?

Pages 14 to 21

How can pension fund trustees achieve long-term financial returns for their funds?

Pages 28 to 32

What is the fiduciary duty and how does it reinforce this new view of value? How to strengthen the use of the mandate as an important tool to achieve long-term financial value?

Pages 36 to 48

If you are a defined contribution scheme trustee, how does this apply to you? What are the developments in the area?

Pages 50 to 52

What can pension fund trustees do to minimise the risk of value erosion because of these pressures? How would the ideal system flow?

Page 33

How do current pressures along the investment chain impact on behaviour, and how does this impact implementing a broader view of value?

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What evidence is there that moving away from traditional perceptions of value makes business sense and maximises returns? Who is working towards this new view of value?

Pages 22 to 26

Why is there a need for a new view of value? Why forming this view matters? What has been the evolution of value? What is Tomorrow’s Value – achieving long-term financial value?

Pages 14 to 21

How can pension fund trustees achieve long-term financial returns for their funds?
Pension funds traditionally have long-term investment horizons as they face the challenge of funding liabilities many decades ahead. Although day-to-day investment decisions have been largely outsourced to asset managers and equities are a smaller part of most portfolios, pension funds continue to have an ongoing interest in the health of companies through their corporate bond holdings and sponsor covenant. More thought is also being given to investments in non-traditional asset classes such as infrastructure and private equity – both long-term investments requiring increased consideration of extra-financial issues.

Pension funds therefore continue to collectively own a significant share of the economy and will do so for many years to come. Funds also understand that the assets they own and oversee can play an important role in determining the future society member’s face, and thus the real value of their retirement income.

Given the increasing range of challenges which require the focus of trustees, the National Association of Pension Funds (NAPF) supports efforts to put the stewardship agenda into a context which can be embraced by funds in a simple but effective fashion. The NAPF has produced various tools for trustees to utilise in meeting its Principles for Stewardship Best Practice, and encourages funds to:

- develop an investment policy which includes an appropriate understanding of stewardship objectives and extra-financial risks within investment decisions
- select managers considering how they approach stewardship and whether this is aligned to the fund’s own policy
- structure the awarded mandates to enable accountability for stewardship activities, encourage a strong focus on the appropriate time-horizon, and establish an alignment of interest between manager and client.

We would encourage pension fund trustees to consider how they can make best use of The Tomorrow’s Value: achieving long-term financial returns and accompanying agenda to enable further consideration of this important agenda.

Joanne Segars, Chief Executive, National Association of Pension Funds
We are now in a better position to form a new view of value, one that will provide the resilience needed for continued success. But value is entrenched by a complex investment chain and is marred by systemic behavioural pressures. When understood, these can be overcome.

We can then embrace a view of value that is integrated and long-term – where performance is measured using financial and non-financial indicators against clear investment goals, taking economic, social, environmental and behavioural factors into account to generate superior and long-term risk adjusted financial returns.
Foreword

The Marathon Club was formed to stimulate institutional funds to be more long term in their thinking and actions, and to place a greater emphasis on being responsible and active owners.

A fundamental issue arising from earlier research and discussions between Club members is how best to overcome the apparent barriers to long term investing, particularly in an environment where funds face deficits and funding problems.

The Marathon Club has received a wide range of responses to the consultation paper it issued in March 2006. This dialogue has greatly assisted us in developing the guidance contained in this document. This is not put forward as a simple solution to the problem nor as a common approach for all funds. However, it is clear that a successful approach to long term investing rests primarily on the mindset of trustees and their beliefs, and on how the investment process is structured, implemented and managed. There is also a heavy responsibility placed on those who advise funds and on those who manage the investments to deliver long term investing.

The Marathon Club plans to research in more depth some of the components expressed in this guidance. In the meantime, I hope you find this document helpful in developing your investment approach and strategy.

Peter Scales, Chairman
Marathon Club
Spring 2007
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Executive Summary

This note seeks to provide practical guidance to trustees and their advisers on behaviour consistent with a long-term approach to investing. In the Introduction we note the problems and causes of short-termism identified by Myners and others. We explain what a long-term approach to investing means – an emphasis on capital protection and return over one or more business cycles of at least five years, underpinned by deep fundamental research including understanding long term threats and opportunities – and why pension funds should approach investment in this way. We also identify 6 key components of a long-term mandate.

We explain firstly why trustees’ investment beliefs are a fundamental component, which affect all others. We propose that trustees’ beliefs should be formally recorded as a standing guide, which should incorporate the trustees’ attitude to risk, preferred sources of return, and views on investment styles, governance and ethical issues. We give an example of a beliefs document in Appendix A.

The Marathon Club recommends that clear objectives for risk and return should be set, based on the trustees’ beliefs and long-term goals, and we list some suggestions. Objectives should be communicated clearly to advisers and investment managers.

Appropriate selection of investment managers depends upon determining how each candidate’s approach best fits with the trustees’ long-term investment beliefs and objectives, together with the establishment of clear mandate parameters. The Marathon Club recommends that trustees ensure that sufficient time is taken to select the right manager. We highlight the advantages of site visits to gain in-depth knowledge of a manager’s philosophy and culture. In Appendix B, we set out the likely attributes of a long-term investment manager.

We believe that alignment of trustee and manager objectives for the long-term is best achieved through individual managers owning a stake in their business and through the manager’s co-investment. We support the wider use of appropriately structured performance fees.

In building and managing a long-term relationship between trustee and manager, the Marathon Club places greater emphasis on the content, rather than the frequency, of review meetings. The emphasis of periodic reviews should be on testing the continuity of or changes to philosophy, process, systems, people and internal compensation, and why the manager owns the stocks he does, rather than on quarterly performance. We give examples of possible reports in Appendix C.

Implementation of these recommendations requires strong governance and leadership by the trustees, to control strategy and objectives consistent with their beliefs and to withstand the short-term ups and downs of the wider investment market which long-term investing necessarily entails. Trustees therefore need to communicate their beliefs, objectives and strategy clearly and should ensure transparency in implementing strategy and in monitoring outcomes.

The Way Forward requires trustees and advisers to work together to implement these recommendations and to develop a long-term approach appropriate to each set of trustees’ circumstances.
“We have a large pool of long-term capital, but do we invest it with a sufficiently long-term view?”

Paul Myners, Review of Institutional Investment, 2000

Introduction

Paul Myners’ remarks echo a concern that is shared by many observers within and without the global investment industry. An obsession with short-term outcomes can result in investment choices which may damage or thwart the long-term development of the wider economy, a healthy corporate sector and the financial performance of investment portfolios.

The corporate sector is continually being influenced by the need to satisfy analysts’ quarterly earnings expectations. Moreover, active fund managers, when selecting potential investments for their portfolios, are keenly aware that their clients – not least the pension funds of the companies that are being evaluated in this short-term manner – are assessing their performance on a quarterly basis. This obsession with short-term performance measurement is deep-rooted in the investment system and is reflected in a fixation with quarterly earnings guidance, deviations from consensus earnings forecasts, and a focus on a narrow set of performance statistics. The danger, to both investors and the companies in which they invest, is that pursuit of such short term goals may jeopardise long term growth opportunities.

These obstacles to long-term investment – focus on quarterly performance, over-use of stock market indices, and measurement of long term liabilities on a short term basis – have been well documented in various studies. Recognising this, some commentators have recently advocated that companies should give less frequent earnings guidance and shift focus towards longer-term indicators of the health of a business, while investors’ attitudes should also change to take a longer term view.

While the need for a change in investors’ behaviour has been recognised, the Marathon Club has seen little in the way of proposals as to how it might be accomplished. This guide is intended to help fill that gap - to inform institutional investors and their investment managers of the key elements of long-term investment and to provide advice on successful implementation of a long-term approach. This guidance has been prepared primarily for those people directly involved in making decisions on how the assets of pension funds, charities and endowments are invested. We refer to these decision makers collectively as “trustees”. 
Why invest long-term?

Generally pension funds and endowments must meet their obligations to members and beneficiaries over a long period. Even the most mature pension fund will likely have expected future liabilities which span more than 30 years. The investment objectives of trustees for the assets invested to fulfil their long-term obligations should recognise and complement this. Broadly speaking, trustees can seek to make money in two different ways: they can endeavour to take advantage of short-term opportunities, effectively to “win” against other investors, or they can seek to nurture genuine economic growth in which they can participate. In the first instance, both winners and losers will emerge as a result of market participants trading against each other. In the second, trustees will be winners if they allocate capital efficiently to businesses within the economy.

Peter Drucker summarised the case for long-term management as follows:

“…by definition, pensions are long-term. Pension fund management therefore requires long-term strategies for true performance. It is an axiom proven countless times that a series of short-term tactics, no matter how brilliant, will never add up to a successful long-term strategy”.

Peter F. Drucker, The Pension Fund Revolution

Any investment represents an interest in the ability of a business to generate cash flow. This cash flow is ultimately the source of return to investors, in the form of interest, dividends or capital gain. Long term investors are concerned with not only the current return generated by a business but also the capital it must invest to survive, grow and meet future threats.

The contribution of income generation and reinvestment to the total return from equity and bond markets is often overlooked. A study by Brandes Partners shows that, over rolling 20 year periods from 1926-2003, the income component averaged over 60% of total return for UK and US equities.

Recognising the importance of income generation, the essence of a long-term approach should be to seek investments in businesses that have strong earnings potential. To protect against loss of capital, it is important to analyse these businesses carefully to be satisfied that returns are sustainable over a long period of time. Success with this approach requires a deep understanding of the business, its strengths and weaknesses, its capital requirements and risks. Above all, trustees will want to avoid the misallocation of capital which commonly arises from market bubbles.

The Marathon Club defines long-term investment as a fundamental, research-oriented investment approach that assesses all risks to the business and which has a focused discipline of seeking positive returns over the long-term business cycle.

The important elements of this definition are:

• an emphasis on protecting capital and seeking a positive real return over a business cycle, which is typically five years or more;

• thorough research around the fundamentals of a company including the impact of the wider economy, industry structure and trends, quality of management and competitive strength;
• a proper assessment of all risks, including threats due to the competitive environment, the factors of supply and production, labour, technology, regulation, political and economic stability, governance, environmental, social and reputation costs.

The Marathon Club recognises that the elements of this approach are neither new nor unique. It does believe however that true long-term investment will likely be resource intensive and require particular care in the selection and monitoring of investment managers to ensure that they have the skill, depth of knowledge, experience and, most importantly, mind-set required to really understand the long-term prospects and risks of different business sectors.

The long-term approach of allocating capital based on a fundamental understanding of a business is applicable to a wide range of asset classes that are suitable for trustees.

This financial perspective is consistent with a broader view of the responsibilities of trustees as the ultimate owners of the assets they hold – in particular the equity shares of limited companies, and physical assets, such as property, which they may hold directly or indirectly. One of the central tenets of this guidance – that corporate executives respond to the signals sent by investment managers, who in turn respond to the incentives and boundaries set by the primary investors – applies to both financial and what may seem, at least at first sight, to be non-financial considerations. While the Myners Report is primarily concerned with the institutional aspects of investment, it is inherent in its thinking that the decisions taken by trustees - or in some instances the decisions they do not take – are influential in defining the capital marketplace, and ultimately the shape of the broader economy.

This guidance note is not intended to make a case for a particular social or political agenda, but the concept of 'socially responsible investment' is relevant. In the short-run promoting a certain ethical code, making certain environmentally-sensitive investments, may be viewed as incurring inadequately remunerated costs. But in the long-run such issues impact the firm's licence to operate and/or demand for its goods and services, so what appears as a cost in the short-run can produce genuine shareholder value in the longer-term, given the change in the commercial environment that has been created. Accordingly trustees need to weigh narrow short-term sources of advantage against the long-term impact of their decisions, conscious or unconscious. In this context decisions include broad investment allocation, the holding of individual assets and the exercise of ownership rights through voting policies, not just the timing of buying and selling. Trustees need to ensure that their ownership rights are exercised by investment managers with long-term benefits in mind.
Trustees can allocate capital to businesses within the economy at different stages of their life cycle - introduction, expansion, maturity, revival or decline. In each stage, businesses offer various forms of participation in their economic growth in which trustees can participate, as exemplified below.

- Venture capital investment in companies at early stages of their formation;
- Equity and fixed income investment in companies during their growth and maturity phases;
- High yield fixed income investment, typically in the late maturity phase;
- Distressed debt and private equity in companies that are in decline or recovery.

There is a strong rationale for a disciplined long-term approach to investment across a wide range of asset classes, in recognition of the long-term nature of funds’ obligations.
Is a long-term approach only suited to pension funds which are well funded and supported by a financially strong sponsor? The implication of this question is that funds which are not well funded and which have weak sponsors could not adopt the mindset of a long-term investor, because they cannot accept the short-term volatility in asset values that may arise from a long-term strategy.

Clearly there is a link between the trustees, the sponsor and the regulator in the environment in which pension funds are managed. The financial position and regulatory requirements of individual funds or their sponsors will influence the assessment of risk, which impacts upon trustees’ choice of asset classes, asset allocation and management of liabilities. However, these considerations should not detract from the need for long-term investment thinking within each asset class.

The Marathon Club considers that the issue trustees need to consider when deciding whether or not to employ a long-term approach to each asset class is their time horizon and not the financial position of the fund or the sponsor. The reasons for this view are:

- The risk implications for a pension fund, with respect to its liabilities, of investing in a particular asset class are broadly similar regardless of how the asset class is managed. The risk level associated with investment in equities, for example, will be considerably higher than investing in long-term government bonds that are a closer match for the liabilities. But the level of risk associated with managing the equities with a short or a long-term approach will be within a narrow margin. Thus, the selection of different asset classes has a much greater bearing on managing the risk with respect to pension fund liabilities than the form of management.

- A long-term approach, as defined by the Marathon Club, with its emphasis on preservation of capital and absolute return, should imply less downside risk than a short-term approach.

- The Marathon Club believes, like Peter Drucker, that a series of short-term approaches is unlikely to generate the desired return.

To the extent that a fund has a short-term horizon, it will need to divest assets in the short-term to fulfil its obligations. This should be reflected in its asset allocation: a fund in this position will need to invest in assets that it can sell easily and bear little liquidity risk, e.g. government or investment grade corporate bonds.
In contrast to some observers of the investment industry, the Marathon Club does not believe that merely extending the formal term of investment management contracts will lead to a long-term approach. The components of a long-term approach highlighted in the definition proposed by the Marathon Club have to be embedded within the philosophy and process of the investment management organisation. Crucially, for such an approach to be successful and not abandoned mid-course, trustees must buy into the beliefs that underpin this definition.

Central to a long-term approach are the trustees’ own investment beliefs. Trustees should endeavour to articulate their beliefs before venturing into long-term investing. Furthermore, the leadership and governance of the trustee or investment board has an important influence in forming, implementing and sustaining these beliefs. Implementation is achieved through setting clear investment objectives, ensuring appropriate manager selection and alignment of financial interests and through managing the long-term relationship.
How should managers be remunerated to align their behaviour with long term objectives?

The separation of interests of asset owners and their managers leads to an agency problem for owners. Though managers act as agents of owners, their objectives are not necessarily aligned with the owners. It could be argued that the *ad valorem* fee structure that is common in the industry encourages a long-term approach, because growth in fees comes from growth in asset values. However, the linkage is not sufficiently strong in itself. In addition, full alignment of interests requires alignment not only between investor and investment manager but also with the employees of the investment manager.

This may be why the best long-term investment performance is often found in boutique investment houses, where the investment manager has also invested its own money. The following excerpt from the third quarter newsletter of Eagle Capital Management Inc illustrates the point:

> “In ancient Rome, when a bridge was completed, the architects and engineers who had initially designed it stood beneath the structure as the first carriages drove over. If the design was faulty, the bridge would collapse and they would be crushed. THAT is an incentive which aligns behaviour with client interest.”

The Marathon Club strongly supports co-investment as probably the clearest and strongest mechanism for gaining alignment of interests.

The use of performance fees is more complex. There is an advantage to using performance fees only if it will change the investment manager’s behaviour in the way intended.

If the investment manager does not have, at the outset, beliefs about the advantages of long-term investing which are already embedded in its investment management style and processes, what assurance is there that performance fees will change those beliefs and processes? The danger of an inappropriate performance fee structure is that it may encourage excessive short term risk taking, for example to meet an impending three or five year goal. In addition, many investment managers say that performance fee structures will not change their behaviour, and only a relatively small proportion of their mandates have such structures. Only a minority of trustees appear to be encouraging them.

The Marathon Club supports the wider use of performance fee structures, suitably tailored to each case.

The likely components of any performance fee structure might be:

1. A base fee, which might most appropriately be calculated to cover the manager’s basic costs (excluding any performance related costs within the manager) plus a small margin.

2. Performance related fees, designed initially to bring total manager remuneration towards the level of a “normal” basis point fee for the asset class on the achievement of an agreed return.

3. A ratcheting effect, so that reward might progressively increase with out-performance of various “hurdles”, subject to a ceiling or absolute cap.

Design of the fee structure will require negotiation with the investment manager and must be consistent with the levels of risk the trustees wishes the manager to take. The better the performance – not simply the higher the market – the higher will be the performance fee.
One feature that has been used to discourage trustees’ change of managers for reasons solely to do with short-term performance is a sliding scale redemption charge. The redemption fees progressively reduce over the term of the mandate and may be fully withdrawn after some specified period. However, exemptions to the sliding scale redemption fees need to be built in and to include trigger events for review of the mandate which are non-performance related.
Relationship with the investment manager and monitoring

What is measured and monitored will have an influence on the relationship between trustees and investment managers. The quarterly monitoring process, with a focus on performance relative to an index has become the norm in the investment industry and has been blamed for promoting short-term behaviour by investment managers.

The Myners Review recommended that “pension funds should provide fund managers with clarity about the period over which their performance will be judged”, so as to reduce uncertainty for managers.

The Marathon Club considers that it is the focus and content of the review meeting that has greater bearing on manager–trustee behaviour, than either the frequency of review or the lack of clarity around the term of the contract.

The content and conduct of review meetings can help build mutual trust between trustees and their managers. When trustees simply focus on performance without intimate knowledge of the process they are likely to encourage short-term behaviour. If the ongoing reviews inform the trustees of the investment manager’s decision making process, so that they can assure themselves that the philosophy and process they bought into initially is intact, this will engender a relationship of trust. In long-term investing, the purpose of the ongoing review should be to help the trustees determine that they are still on track to achieve their long-term objectives.

Frequency of review meetings

In the early stages of a mandate, trustees and the investment manager may feel that it is necessary to meet frequently, e.g. quarterly. The regular pattern of meetings is best determined only when a good dialogue and understanding of the investment strategy and approach has built up between trustees and the manager. The depth of preparation and discussion for a formal review of a long-term investment mandate is likely to require a commitment of time such that an annual review cycle may be more appropriate, once the relationship is established.

Regardless of the cycle of formal review meetings, trustees can obtain quarterly reports from their in-house staff or investment consultant on the manager’s performance and organisation.

Agenda and preparation

Trustees should set the agenda for the review meeting and agree the format of reports from the manager. Trustees need to be sufficiently briefed in order that they can ask pertinent questions. Investment advisors and internal staff have an important role in helping to set the agenda and prepare trustees for the review meetings.

Trustees also need to decide who they wish to see in the review meeting. Ultimately the portfolio manager is best placed to give an understanding of the investment portfolio. Yet, this practice can distract portfolio managers and therefore must be considered when deciding the frequency and location of the manager review meetings.
Contents of a review meeting

The Marathon Club recommends that a review meeting covers the following:

1. **Changes to investment philosophy, process and systems.** Trustees should encourage the manager’s skills, allowing subtle adjustments to keep pace with evolving markets. In contrast, reactive changes to an investment process following a period of underperformance would be grounds for concern.

2. **Changes to organisation ownership, general management and key staff compensation, particularly co-investment;**

3. **Continuity in key personnel;**

4. **Major client acquisitions and losses;**

5. **Regulatory issues;**

6. **Adherence to process and performance**

It is, perhaps, inevitable that trustees will continue to look at the return and compare this to an index or the performance of comparable managers in order to get some sense of the context of their manager’s performance. The Marathon Club advocates that the emphasis of the review ought to be on testing that the process and the development of assets within the portfolio conforms to the underlying philosophy or investment beliefs. The focus must not be on price-based, short-term performance measures. Such measures are an inappropriate way to decide whether to retain or change managers under a long-term approach.

“The compared with their predecessors, modern investors concentrate too much on annual, quarterly, or even monthly valuation of what they hold, and on capital appreciation and depreciation generally; and too little either on immediate yield or on future prospects and intrinsic worth.”

Keynes 1938

The indicators for the portfolio review would be most helpful if they are based on the way the manager manages money and should be developed with input from the manager, at the final stage of manager selection.

Trustees should check whether the individual characteristics of the portfolio are consistent with the overall investment process, e.g. in terms of the number of holdings, concentration, type of holdings (small, large, growth or value oriented), turnover, themes, valuation characteristics (price-to-earnings, yield, manager’s valuation, etc.) or fundamental characteristics (return on equity, operating margins, sales/earnings growth rates, etc.). Trustees should be able to test how new purchases conform with the investment philosophy and security selection process and how sales conform to the sell discipline.

From a snapshot of the portfolio, trustees should identify a very small number of holdings, possibly new purchases or holdings that are out of favour with the market, for a more detailed discussion. A case-by-case
analysis, as shown in Appendix C, can be the most insightful part of the monitoring process as it will help the trustees understand how the process is being applied, the depth of research and see the output of the investment philosophy.

As already described above, trustees should agree the metrics with the investment manager which will be used for evaluating the portfolio at the final stage of the manager selection.

The type of metrics agreed upon will vary according to the preferences of the trustees and the way the investment manager is managing the money. Some examples of the types of measures that could be relevant for monitoring long term mandates are provided in Appendix D.

**Termination of a Manager**

A mandate should be terminated if, based on a review process described above, the trustees conclude that the portfolio does not reflect the investment philosophy and process or that changes to the organisation or key individuals are such that the philosophy and process will not be deliverable in the future.

Trustees will generally need to be more tolerant of managers appointed for a long term mandate who may encounter occasional bumps in the road (experiencing periodic performance decrements in anticipation of a major pay-off).
The way forward

The Marathon Club believes that trustees of endowments and pension funds must fundamentally re-consider the way they invest.

This paper argues that a long-term approach is ideally suited to investors who have a long time horizon. A change of mindset is needed for investors to think of success in investing as participation in the growth of enterprises within the economy at various stages of their life-cycle. This is different from the widely followed approach of perceiving success as outperforming market indices over short periods of time.

The Marathon Club recognises that the change in mindset needed is significant. It cannot be achieved without the cooperation of all participants in the investment chain – trustees, investment managers and investment advisors. The role for each is clear:

- **Trustees must devote time to establish their investment beliefs and express their need for long-term investment in seeking advice;**
- **Investment advisors must raise trustees’ awareness of a long-term approach through advice, discussion with and training of trustees.**
- **Investment managers must be prepared to offer investment products with a long-term approach, which includes appropriate pricing structures and reporting.**

Some might argue that there is insufficient supply of long-term investment products. We believe that the supply will follow demand. If trustees, supported by their consultants, ask for long-term approaches to investment and question managers on their approach, the products available will expand. This Guidance Note should help trustees to specify their need for long-term investment and create such a demand.
The Incentive Bubble

Outsourcing pay decisions to financial markets has skewed compensation and, with it, American capitalism. by Mihir Desai
THE PAST THREE decades have seen American capitalism quietly transformed by a single, powerful idea—that financial markets are a suitable tool for measuring performance and structuring compensation. Stock instruments for managers and high-powered incentive contracts for investors have dramatically altered the nature and level of incentives and relative rewards in our society, on both sides of the capital market.

In 1990 the equity-based share of total compensation for senior managers of U.S. corporations was 20%. By 2007 it had risen to 70%. Meanwhile, the investment management industry has been transformed by the rise of private equity firms and hedge funds, both of which prominently feature market-based compensation as the basis of their supposed virtue. The norm at these funds is the “2 and 20” rule, whereby compensation is tied to the size of assets being managed (the 2%) and to managers’ performance as measured by the financial markets (the 20%, or “carried interest”). As detailed below, the rise of the alternative-assets industry has altered behavior through much of the financial sector. Financial-markets-based compensation has become the norm in modern American capitalism.

This transformation would be welcome if it served to structure incentives and rewards appropriately—indeed, nothing is more important for a market economy than the structure of incentives for managers and investors. Unfortunately, the idea of market-based compensation is both remarkably alluring and deeply flawed. The result has been the creation of perhaps the largest and most pernicious bubble of all: a giant financial-incentive bubble, or
FIB. (“Bubble” acknowledges the unsustainability of market-based compensation, and the acronym reminds us of the intellectual flaws underlying this idea.) These changed incentives and rewards have contributed significantly to the twin crises of modern American capitalism: repeated governance failures, which lead many to question the stewardship abilities of American managers and investors, and rising income inequality.

The allure of financial-markets-based compensation stems from its connection to powerful narratives about entrepreneurship and the virtues of “sweat equity.” The translation of this intuition to managerial and investor compensation has proceeded without consideration of the differences in settings and the potential for distorted incentives. Moreover, those that monitor managers (boards of directors) and investors (largely state and corporate pensions funds) have readily outsourced performance evaluation and compensation to markets in order to avoid their obligation to make tough decisions and in order to rationalize the excessively optimistic assumptions undergirding the solvency of their funds. The combination of a foundational myth and absent monitors over the past two decades gave rise to harmful incentives, asymmetrical payoffs, and windfall compensation levels.

Remedying these distorted incentives and restoring faith in the fairness of American capitalism will require that we pop the financial-incentive bubble by exposing the intellectual flaws behind it, restructuring compensation contracts and separating legitimate investment activities from systemically important financial institutions.

It has become fashionable to bash capital markets and financial institutions. The purpose here is not to pile on. Indeed, the clear consensus in academic research today is that well-functioning financial markets and institutions play a vital role in economic growth by ensuring the most efficient allocation of capital. More broadly, managerial and investment talent may be the most important ingredients in modern capitalism. Such talents should be richly rewarded when they are evident.

The point here is more specific: Financial markets cannot be relied upon in simple ways to evaluate and compensate individuals because they can’t easily disentangle skill from luck. Widespread outsourcing of those functions to markets has skewed incentives and provided huge windfalls for individuals who now consider themselves entitled to such rewards. Until the financial-incentive bubble is popped, we can expect misallocations of financial, real, and human capital to continue. The misplaced incentives are simply too powerful.

THE IDEAL
The promise of financial-markets-based compensation can best be illustrated by the dynamics of entrepreneurial firms. Most start-ups begin with entrepreneurs owning large chunks of their companies. Over time other funders come in, diluting the entrepreneurs’ stake. The most successful of these start-ups go public, creating significant wealth for both entrepreneurs and funders. This is the story of our most innovative firms, from Google to Genzyme. Entrepreneurs and funders are given appropriate incentives and are rewarded handsomely for their sweat equity—for taking risks and creating valuable products. All this seems just as it should be.

The appeal of this model has led to the use of financial-markets-based compensation at large corporations and investment firms. Mature corporations without large shareholders may become bloated with perquisites or preoccupied by empire building that satisfies managers rather than shareholders—the classic principal-agent problem. Here, financial-markets-based compensation seeks to align financial markets cannot not evaluate individuals because they can’t easily disentangle skill from luck.
IDEA IN BRIEF

American capitalism has been transformed over the past three decades by the idea that financial markets are suited to measuring performance and structuring compensation.

Stock-based pay for corporate executives and high-powered incentive contracts for investment managers have dramatically altered incentives on both sides of the capital market.

Unfortunately, the idea of compensation based on financial markets is both remarkably alluring and deeply flawed: It seems to link pay more closely to performance, but it actually rewards luck and can incentivize dangerous risk taking.

This system has contributed significantly to the twin crises of modern American capitalism: governance failures that cast doubt on the stewardship abilities of U.S. managers and investors, and rising income inequality.

Said another way, there are returns that one can generate by doing little, and managers and investors shouldn’t be compensated for those returns. A rising tide lifts all boats, so managers should only be compensated for “excess returns.”

In order for these pay mechanisms to be successful, managers and investors should be rewarded only for success beyond what would normally be generated. Said another way, there are returns that one can generate by doing little, and managers and investors shouldn’t be compensated for those returns. A rising tide lifts all boats, so managers should only be compensated for “excess returns.”

At a start-up, that is not hard. We don’t worry much that the wealth Larry Page and Sergey Brin generated for themselves by launching Google is undeserved. The vast majority of entrepreneurs fail or achieve only middling success. The same is true for the funders of their ventures. Clearly, fads and bubbles occasionally provide enormous returns, but we don’t attribute the success of our best entrepreneurs to pure luck.

Measuring “excess returns” more generally, however, is difficult, and requires establishing the “normal” return for an activity. In most cases we view the normal return as what would have been generated by undertaking an activity of comparable risk—and measuring risk appropriately helps us assess how much of the return is truly skill based and how much is luck based. Someone running an oil company when the price of oil is skyrocketing doesn’t need a lot of skill to earn high profits. So how do we measure the skill of a manager or an investor in that company when the price is skyrocketing?

Modern financial theory has developed some fairly elegant concepts, represented by the Greek letters alpha and beta, to help solve this problem. A company’s exposure to market risk or other relevant risk factors dictates the expected or normal return. Companies that move opposite to or only a little with the market aren’t required to generate returns as high as those of companies that move very much with the market. Beta represents the amount of risk a company presents to an investor because of how it moves with the market. Alpha represents any return earned by a company or an investor greater than what is expected in light of the beta of a stock or an investment strategy—the amount in excess of what is caused by a rising tide.

The precise decomposition of returns into those associated with luck rather than skill, into expected returns and excess returns, into beta and alpha, is what financial-markets-based compensation demands.

THE UGLY REALITY OF MANAGERIAL COMPENSATION

Almost all current financial-markets-based compensation departs significantly from the demands described above. Ideally, top-level managers would receive company stock as compensation but any returns associated with the broader market or with their industry would be subtracted. In other words, stock compensation would be indexed to remove price appreciation arising from market returns. The manager of that booming oil company should receive pay reflecting the return of his company less
the returns of comparable firms in the industry. That would provide an appropriate incentive for high performance and would measure the true incremental value the manager provided.

Indexed stock compensation has been exceedingly rare in the United States. The rapid spread of stock options over the past two decades resulted in large windfalls for managers because no effort was made to subtract average performance during a period of remarkable returns in asset markets. Moreover, wide varieties of misbehavior have been traced to incentives created by the “cliffs” in most compensation packages: strike prices and vesting dates. Reaching for extra earnings by cutting small corners when such large amounts were at stake was inevitable. The corporate governance crises of the past 15 years had many roots; large stock option grants and the distorted incentives they provide loom large among them.

It is tempting to rationalize these arrangements by saying that they ensure an alignment of managers and shareholders: Managers win only when shareholders win. But the reality is far more complicated, because managers can dictate the timing and levels of market-based compensation. Indeed, the past 15 years have witnessed mediocre stock market returns for long-term investors, remarkable levels of managerial compensation via financial-markets-based compensation, and repeated corporate governance crises tied to the ill-conceived managerial incentives created by these instruments. Changes in the structure of incentive contracts have begun—but managers’ sense of entitlement will erode only slowly.

THE UGLIER REALITY OF INVESTOR COMPENSATION

The effects of financial-markets-based compensation on the investment management industry are less well understood and even more profound. Extraordinary asset returns in the late 1990s, the growing savings of baby boomers, and low interest rates in the early 2000s provided the perfect conditions for the rise of alternative assets. Pension funds had grown accustomed to—perhaps addicted to—double-digit returns. Cheap leverage and novel strategies allowed private equity and hedge funds to promise those returns. University endowments and foundations supplied intellectual cover for this growth by blessing the rise of private equity and hedge funds as new, uncorrelated “asset classes,” providing a free lunch for investors. Every new asset class demanded an allocation, so entire industries were baptized as critical pieces of a prudent investment strategy for pension funds and foundations. By 2007 even 130-30 funds, which short 30% of their assets, were being touted as a new asset class. Funds of funds grew up to provide another layer of intermediation and fees in an effort to find skillful alternative-asset managers—“alpha generators.”

A centerpiece of this transformation of the investment management industry has been an incentive structure that provides investment managers with significant returns via carried interest—or a share of returns as measured by financial markets. The logic was alluring to investors: Take my $100, turn it into $120, and I’ll happily pay you $4 for the outsize return. Performance would be manifest in financial markets and thus would be real and verifiable. This logic, combined with the allure of a new asset class, sustained the transformation of the investment-management industry.

That logic, however, is deeply flawed. Most obviously, the 20% return in this example might not represent alpha, given the opportunity cost of capital for the investment. At a minimum, one might consider a crude hurdle rate meant to approximate that opportunity cost. If returns exceeded the hurdle rate, incentive fees would kick in. Most private equity funds have an 8% hurdle rate, but rates vary dramatically in the hedge fund industry, including 0%.

These incentive contracts make limited, if any, efforts to measure risks, and so returns cannot be measured accurately either. The entire premise of financial-markets-based compensation is that returns are extraordinary only after the risks undertaken have been accounted for. Crude hurdle rates are obviously insufficient. But simple comparisons with market returns—benchmarking—are also misleading. As my colleague Erik Stafford and the Princeton economist Jakub Jurek have shown, hedge funds as an asset class superficially appear to outperform market benchmarks, thereby justifying their compensation contracts. But this conclusion is naive. Accounting for both the strategies that hedge funds actually employ and the risks they undertake leads Stafford and Jurek to conclude that hedge funds destroy value given the risks they are undertaking.

This conclusion is remarkably damning, and it extends to the private equity industry, which overall has underperformed a simple strategy of borrowing money and using it to buy a diversified portfolio of midcap stocks. Only the leading 20% of funds mean-
ing fully outperform naive market benchmarks. Of course, none of this should be particularly surprising. Various analyses have shown that individual managerial skill in financial markets is exceedingly rare. But the use of leverage and opaque strategies has allowed the alternative-assets industry to suggest the opposite.

A deeper problem in these incentive contracts is the effect on investors’ risk taking. Imagine that you are a young hedge fund manager given such a contract along with potential investors who flock to stellar returns. The strategy is clear for anyone with a limited horizon: Undertake risks that may generate outsize returns and transform yourself into a star manager who accumulates funds rapidly. If the gambles fail, highly attractive returns are still available at your old job.

In short, we have come to evaluate and compensate managers on both sides of the capital market as if the market could precisely disentangle skill from luck. Professional sports provide a common and convenient metaphor for business and financial managers. But distinguishing skill from luck is relatively simple in sports. The success of Roger Federer or LeBron James comes almost exclusively from aptitude, hard work, skill, and expertise, with only an infinitesimal amount of luck involved. We pretend that we can assess managers and investors with the same precision through financial markets, when in reality that ideal level of measurement is unobtainable and current compensation arrangements don’t even try to approximate it very seriously.

We might not worry about all of this if market-based compensation resulted merely in payments to individuals who are skilled at marketing themselves while not actually adding any financial or social value. Indeed, we reward such individuals all the time in product markets. But the fact that both sides of the capital market have become captive to the financial-incentive bubble is highly problematic for three reasons.

First, the inefficient risk taking engendered by these incentive contracts has widespread consequences for the allocation of capital in our society. Indeed, as detailed below, the recent financial crisis is the latest and largest manifestation of the disruptions a financial-incentive bubble can create. Significant spillovers arise when individuals are given such asymmetric incentives to pursue risk. Second, talent will continue to be misallocated in our economy as long as outsize rewards are available in certain professions. Third, the surge in income inequality that troubles many people today can be traced to windfalls for managers and investors and the rise of alternative assets. As a result of these generous contracts, the top 0.1% of the income spectrum is dominated by executives and financial professionals.

**LINKS TO THE FINANCIAL CRISIS**

Absent regulators, irresponsible intermediaries, and oblivious homeowners were all important agents in creating the financial crisis, but the transformation of investment banks into risk-hungry institutions was central to it—and that transformation is connected to the growth of financial-markets-based compensation. At a basic level, the appetite for risk by managers of investment banks can be linked to the rise of compensation structures that provided them with highly asymmetrical incentives. Large balance sheets, easily obtained leverage, and incentive structures that provide enormous benefits from rising stock prices will surely lead to more risk taking. The deeper connection between the financial crisis and financial-markets-based compensation stemmed from the rise of the alternative-assets industry.

From 1998 to 2006 hedge funds, funds of funds, and private equity funds grew by more than 25%
a year, and the prime brokerage and banking businesses of investment banks came to rely on them for revenue. They generated significant transaction volumes and were price insensitive. But soon these funds, such as Citadel and Blackstone, were encroaching on the investment banks’ core, most-profitable businesses—syndicated loans, market making, and proprietary trading. These funds were also unburdened by the relatively low-profit business of dealing with large numbers of customers. Alternative-assets managers soon became the largest clients and the largest competitors of traditional investment banks.

Talent quickly migrated from investment banks to hedge funds and private equity. Investment banks, accustomed to attracting the most-talented executives in the world and paying them handsomely, found themselves losing their best people (and their best MBA recruits) to higher-paid and, for many, more interesting jobs. Why service clients on the sell side when you can earn more and enjoy being courted on the buy side?

Observing the remarkable compensation in alternative assets, sensing a significant business opportunity, and having to fight for talent with this emergent industry led banks to venture into proprietary activities in unprecedented ways. From 1998 to 2006 principal and proprietary trading at major investment banks grew from below 20% of revenues to 45%. In a 2006 Investment Dealers’ Digest article chronicling the rise of alternative assets and the resulting transformation of Wall Street, one former Morgan Stanley executive said, “I felt like we lost more people to hedge funds than to other investment banks.” She said that extravagant hedge fund compensation—widely envied on Wall Street, according to many bankers—was putting upward pressure on investment banking pay, and that some prop desks were even beginning to give traders “carry.” Banks bought hedge funds and private equity funds and launched their own funds, creating new levels of risk within systemically important institutions and new conflicts of interest. Another executive quoted in the article noted that “a given party is often at the same time a competitor, a counterparty, a partner, and a customer in all different parts of the organization.”

By 2007 the transformation of Wall Street was complete. Faced with fierce new rivals for business and talent, investment banks turned into risk takers that compensated their best and brightest with contracts embodying the essence of financial-markets-based compensation. The rise of alternative assets created pressure throughout the investment management world to retain talent and to produce alpha, as these funds promised to do. The quest for higher returns led investors of all types to search for new securities that would provide the proverbial free lunch, especially in the low-interest-rate environment of the early 2000s. Intermediaries obliged by repackaging loans. The real estate bubble and the securitization fad could not have exploded without complicit investors. Indeed, the premise of the alternative-assets industry—that alpha is there for smart people to get—has become a defining belief among investment managers. The reality is far more prosaic: Markets are roughly efficient, talent is remarkably scarce, and alpha is extremely hard to measure.

**THE WAY FORWARD**

The skills of managers and investors are among the most precious capabilities in our market economy. Accordingly, they should be richly rewarded. But they are extremely rare, and assessing them is a complex, multifaceted process requiring judgment. Contracts that control for risk and market perfor-
mance can easily be constructed with mathematical formulations. Unfortunately, the translation into practice over the past two decades has been highly incomplete and naive, sometimes consciously so. The remarkable windfalls to managers and investors of all types have given rise to a sense of entitlement that burdens us still and that will be hard to reverse. Recognizing the intellectual flaws in these developments is a necessary—but only the first—step in rectifying the skewed rewards and incentives that have contributed to repeated economic instability and the growth of income inequality.

Three superficially attractive responses to these developments should be resisted. First, it is tempting to respond that markets will self-correct against these excesses, so little action is required. Such complacency overlooks the profound conflicts of interest that characterize modern capitalism. Commodity will not solve the problem of pension funds that fail to monitor the investment managers they hire, given the monopolistic position of those funds. Similarly, competition from new alternative-assets managers will not solve the problem,

HOw to Burst the Bubble

Boards of directors (charged with monitoring executive compensation) and pension funds, foundations, and endowments (charged with monitoring investors’ compensation) have been happily complicit in inflating the financial-incentive bubble instead of restraining it. To rectify the bubble’s skewed incentives and rewards,

Board Members Must:

STOP outsourcing evaluation and compensation to financial markets and do the difficult work of assessing CEO performance

ABANDON the notion that managers will do well only when the stock does well

SUPPORT the turn toward restricted stock and vesting based on longer-term accounting metrics

Pension Funds, Foundations, and Endowments Must:

STOP allowing existing assets to be repackaged as “new” ones

STOP expecting alternative assets to magically cure insolvent pension plans

QUESTION the appropriateness of active and outsourced investments, given the limited evidence of managerial quality

REEVALUATE the advisability of paying consultants to find skillful managers

RENEGOTIATE incentive fees toward a significantly longer term with better performance and risk assessment

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because self-interested managers will happily adopt the incentive schemes that provide their brethren with windfall gains. Markets are powerful, but they are not a panacea when monopolies are present and when agents aren’t serving their captive principals.

The best way forward requires spotlighting the ultimate enablers of the financial-incentive bubble. Would-be monitors of managers and investors have been happily complicit in growing the financial incentive bubble instead of restraining it. Their stance can be traced to the plausible deniability provided by outsourcing evaluation and compensation to financial markets. Instead of actually assessing a CEO’s efforts in a subjective way that might subsequently be proved wrong, board members can fall back on the notion that managers will do well only when the stock does well. Assessing CEO performance is a difficult, time-consuming, far from foolproof process. Why not simply let the market do it?

Similarly, the heavy use of alternative assets and funds of funds allows pension fund and endowment managers to point the finger at others when returns are poor. A few additional layers of fees are a small price to pay for shifting that responsibility. More pointedly, managers seeking to boost earnings have come to rely on optimistic assumptions about pension assets that can be rationalized only by accessing new asset classes. And alternative assets provide the illusory hope that underfunded pension plans can be made whole again by simply changing asset allocations. A great irony of the current configuration is that universities and pension funds—representatives of some of the interests most deeply disturbed by recent economic disruptions and the rise in income inequality—have been absent monitors and, as significant capital providers, enablers of the financial-incentive bubble.

Monitors must begin to wrest control back from managers and investors to rectify the skewed incentives and rewards of the financial-incentive bubble. Managerial compensation has already made some advances: The turn to restricted stock and vesting based on longer-term accounting metrics is best practice at some leading corporations today. Board members must continue the move toward subjective, longer-term, accounting- and finance-based measures of compensation. Judgment must replace the mindless outsourcing of decision making to markets and compensation consultants. Compensation for the best managers may remain as high, but the form it takes should change dramatically.

Pension funds, foundations, and endowments must question anew the suitability of the diversification model they have followed and the compensation contracts provided to their asset managers. First, “new” assets can’t be simply repackaged, leveraged existing assets. Second, alternative assets can’t be expected to magically provide the excess returns that will cure insolvent pension plans. Third, foundations and funds of modest size should question whether active and outsourced investment is appropriate, given the fees and limited evidence of managerial quality. Fourth, if investor quality is as scarce as the evidence suggests, and traditional tools for measuring it are suspect, the advisability of paying additional fees to a fund of funds or a consultant to find skillful managers should be reevaluated. Indeed, pension fund consultants have played a critical role in ratcheting up compensation by benchmarking the incentive contracts of all funds to those earned by truly good investment managers, as if the right incentive scheme were enough to ensure exemplary performance. Finally, and most important, the largest capital providers should, as some have begun to, renegotiate incentive fees toward a significantly longer term with better performance and risk assessment. Alpha is neither easily captured nor easily
measured, and investment practices should reflect that basic reality.

The role of alternative assets in the financial sector deserves special attention, given their influence on systemically important institutions. That investment activities should be separated from intermediary activities, as suggested by the Volcker rule and others, is a basic but still unheeded lesson from this financial crisis. The financial-incentive bubble led institutions into risk taking and into severe conflicts of interest where customers were often competitors and where notions of fiduciary responsibility quickly seemed antiquated.

**THE FRAVING** of the compact of American capitalism by rising income inequality and repeated governance crises is disturbing. But misallocations of financial, real, and human capital arising from the financial-incentive bubble are much more worrisome to those concerned with the competitiveness of the American economy.

An economy can be only as strong as the allocation mechanisms that ensure that capital of all types moves toward its highest social use. When risk is repeatedly mispriced because investors enjoy skewed incentive schemes, financial capital is being misallocated. When managers undertake unwise investments or mergers in order to meet expectations that will trigger large compensation packages, real capital is being misallocated. And when relative compensation is as distorted as it has been by the financial-incentive bubble over the past several decades, one can only assume that human capital is being misallocated, to a disturbing degree. Awakening our monitors to their responsibilities and to the flaws of market-based compensation provides the best hope for correcting these misallocations and strengthening the U.S. economy for the challenges of this century.

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Tab 2: Arrangements for Encouraging Long-Term Shareholder Loyalty
L-Shares: Rewarding Long-term Investors

by

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Abstract: We argue that a fundamental reason for the short term perspective of corporate executives is the short-term orientation of shareholders and financial markets that drive the performance benchmarks of CEOs. In our view, long-term committed shareholders can provide substantial benefits to the company they invest in and although some shareholders are prepared to take a more long-term view, they are generally not rewarded for their loyalty to the company. We believe that because they are a scarce resource and provide benefits to the company and other shareholders that have all the features of a public good, long-term shareholders need to receive financial incentives. While lengthening stock option vesting periods and introducing claw-back provisions into CEO compensation contracts help induce a more long-term orientation of CEOs, we argue that it is also necessary to reinforce this more long-term performance-based compensation with a better alignment between shareholders and CEOs horizons. Our proposal for moving towards such an alignment is to introduce Loyalty-Shares (or L-shares). These shares provide an additional reward (usually under the form of an extra-share or extra-dividend) to shareholders if they have held on to their shares for a contractually specified period of time, the loyalty period. The reward we propose, which we believe would be a more optimal solution in many cases, is in the form of a warrant giving the right to purchase a pre-determined number of new shares at a pre-specified price and granted to loyal investors at the expiration of the loyalty period. This paper discusses how L-shares under the form of loyalty warrants can be structured and distributed, how they may be valued and how they may affect liquidity and control of the corporation.

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1 We are grateful to Dominic Barton, Marco Becht, Max Von Bismarck, William Bratton, Robbert Eccles, Ron Gilson, Edward Greene, Denis Gromb, Roger Guesnerie, Huang Haizhou, Olivier Hubert, Jin Liqun, Peter Knight, Jacques de Larosière, Stefan Lundbergh, Anna Pinedo, Augustin de Romanet, Howard Rosenthal, Joseph Stiglitz, Ernst-Ludwig Von Thadden and James Wolfensohn for many helpful comments. We also thank Alice Balagué, Elina Berrebi, Lucile Fournereau, Timothée Jaulin, and Kambiz Mohkam, for excellent research assistance. The views expressed in this paper are those of the authors and do not necessarily reflect the position of the Crédit Agricole Group.

I] INTRODUCTION

In his classic essay on the governance of organizations, *Exit, Voice and Loyalty*, Hirschman (1970) distinguishes between two different responses to a governance crisis by members of an organization (e.g. shareholders of a company). One is “exit”, which in the case of a firm means that an individual shareholder sells her shares before the crisis becomes fully apparent to others. The other is “voice”, which means that the shareholder holds on to her shares, gets involved, and attempts to resolve the crisis. Getting involved may range from simply voting against management at shareholder meetings to mounting a full-fledged proxy contest. Obviously, “exit” is the path of least resistance. But it is also the path least likely to bring about a good resolution to the crisis. The “voice” response is likely to be personally costly to the activist shareholder, while bringing uncertain rewards in the distant future, which moreover are shared equally by both active and passive shareholders.

As Hirschman’s analysis emphasizes, “loyalty” to the organization is the critical variable that can tip the balance away from the easy “exit” option in favor of the “voice” strategy, which is individually more costly but likely to be collectively the better response for the organization. We argue however that loyalty can be gained more easily if it is rewarded. Some shareholders may be intrinsically loyal to their firm. This is especially true for founding shareholders who take pride in the success of their firm, and for owners of family businesses, who want to preserve the firm for future generations. But for the typical shareholder, there is no real sense of loyalty to a company.

It has been common to pit the market-based governance practices of the U.S. and the U.K., which favor liquid equity markets and hostile takeovers, against the bank-based and block-holder governance model of Japan and Germany, which favor governance by large controlling shareholders (see e.g. Coffee, 1991, Roe, 1994, and Franks and Mayer, 1995).² Institutional investors in the U.S.

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² In his recent report, John Kay (2012) takes up this observation and argues that public equity markets currently encourage “exit” (the sale of shares) over “voice” (the exchange of views with the company) as a means of engagement, replacing the concerned investor with the anonymous trader: “Only the analysis can acquaint investors with the long-term prospects of a company, and only as a result of analysis will companies receive relevant signals from the market about the direction of the business. Effective value discovery is necessary to the utility of either voice or exit as mechanism of performance enhancement.” He further notes that: “The structure of the industry favours exit over voice, and gives minimal incentives to analysis and engagement.”
are also often described as following the simple Wall Street Rule:

“If you don’t like the management sell your stock,” an adage which, interestingly, Benjamin Graham has qualified by adding: “…provided you can get a fair price. If you can’t, do something about the situation.” [Graham (1954) pp.]

Alas, Benjamin Graham’s important caveat is generally ignored by most institutional investors. Not only do these investors sell rather than get involved in companies facing governance crises, but also they appear to hold stocks for shorter and shorter periods. As the chart below highlights there has been a secular trend towards shorter and shorter holding periods of stocks by investors, and therefore a concomitant secular increase in secondary-market trading. This dramatic shortening of the average holding period of stocks is a reflection of the shorter and shorter-term outlook of the average stock-market investor in the U.S.

**Average Holding Period for a stock on the NYSE (years)**

![Graph showing average holding period for a stock on the NYSE over time.](image)

*Source: NYSE overview statistics*

As a result of this shorter-term outlook of investors, equity markets in the U.S. impose a *momentous short-termist pressure* on corporate executives, all the more so that in the last three decades the universal and exclusive performance benchmark for CEOs, analysts, activist investors and independent directors has increasingly become the stock-price performance of the firm (see

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3 See Appendix I for further evidence on the shortening of the average holding period of stocks.
Gordon, 2007). Not only has the importance of the stock-based compensation-component in CEO pay steadily increased in the past thirty years (see Murphy, 1999 and Gabaix and Landier, 2008), but also the influence of independent directors, proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis, and the pressure exerted by activist hedge funds (see Brav, Jiang, Partnoy, and Thomas, 2008).

The rise of stock-option based pay has been motivated by the need to align the interests of managers with those of shareholders (Jensen and Murphy, 1990 and Holmstrom and Tirole, 1993). The argument was that, since—by the widely accepted efficient markets hypothesis (Fama, 1970)—stock prices on average reflect the long-term fundamental value of the firm, this form of executive compensation would encourage CEOs to maximize the long term value of the firm. The focus on stock price as a central performance measure and the pressure exerted by corporate raiders and activist hedge funds had a similar motivation.

But, recent history of bubbles and crashes, and especially the financial crisis of 2007-08 have, if anything, highlighted the limits of the efficient markets hypothesis, and have revealed the extent to which stock prices can substantially deviate from long-term fundamental value. To be sure, this succession of bubble episodes around the world in recent years has given new credence to the alternative speculative markets hypothesis. This new approach, dating back at least to John Maynard Keynes, and recently formalized by Harrison and Kreps (1978) and Scheinkman and Xiong (2003), argues that due to differences of opinion and short-sales constraints, stock prices reflect both the (long-term) fundamental value of the firm and a (short-term) speculative option value, which is simply the value of the option to sell the stock to a more optimistic shareholder in the future. As Michael Lewis has vividly described, a speculator like himself during the technology bubble, might purchase a stock, as he did with Exodus Communications at the end of 1999 simply because:

“[he] figured that even if Exodus Communications didn’t wind up being a big success, enough people would believe in the thing to drive the stock price even higher and allow [him] to get out with a quick profit.” [Michael Lewis, 2002].

When differences of opinion are pronounced and persistent (that is, when optimists and pessimists
fundamentally disagree about a stock) the speculative option value may represent a substantial fraction of the stock price, so much so that short-run stock-price movements may have little relation with changes in fundamental value. Under these circumstances an exclusive focus on share price as a performance measure may produce highly destructive short-termist pressure on publicly traded firms. The speculative behaviour described by Michael Lewis only focuses on short-term price-movements; it is mainly concerned about market sentiment or other investors’ psychology, and as such it is divorced from any effort to discover long-term fundamental value or the effects of CEO’s decisions on the value of the firm.

Worse still, as Bolton, Scheinkman, and Xiong (2006) show, during speculative bubbles both shareholders and managers may have an interest in pursuing short-termist strategies that inflate earnings in the short-run and fuel the speculative option value. Stock-based CEO compensation then provides incentives to CEOs to pursue short-termist strategies to pump and dump the company’s stock. Importantly, their analysis implies that CEO short-termism may not be caused by poor governance, but may actually be encouraged by short-term oriented shareholders.

Other important short-termist biases have been emphasized in the behavioural finance literature. Building on Shiller’s (1981) finding that stock prices have historically been too volatile to be consistent with rational present discounting of future expected earnings, Barsky and DeLong (1993) show that the evolution of stock returns can be explained with a model in which shareholders are assumed to excessively extrapolate recent earnings growth. Several subsequent studies have confirmed the explanatory power of this excess extrapolation bias by shareholders, most recently Hirshleifer and Yu (2012) and Alti and Tetlock (2012).

Interestingly, Fuster, Hebert and Laibson (2011) suggest that the tendency to extrapolate short-term

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4 As Levisohn notes in a (2010) Wall Street Journal article, a company’s stock price or price-earnings ratio is less reliable as a measure of performance in periods when there is a lot of uncertainty and disagreement about future earnings. He also notes that in the post 2008-crisis high-uncertainty environment, as in previous periods like the great depression, investors tend to focus more “on global economic events” than earnings forecasts to determine whether a stock is worth holding (see “The Decline of the P/E Ratio” by Ben Levisohn, WSJ August 2010).

5 Interestingly, the recent study of risk-taking and executive compensation in U.S. banks and other financial companies by Cheng, Hong and Scheinkman (2012) finds that, while higher stock-based CEO compensation was correlated with greater risk-taking, it was unrelated to any governance failures. Simply put, CEOs were financially induced to take greater risks and they did not take these risks against the wishes of their shareholders.
earnings growth trends may not just be a behavioural bias of investors, but may be due to econometric forecasting methods which, in an effort to increase the robustness of short-term forecasts, tend to underweight long lags and therefore under-predict mean reversion of earnings in the long run.

Underpinning the short-termist pressure exerted by stock-markets is an entire eco-system that reinforces this predisposition. Thus for example, most asset managers’ performance and compensation is benchmarked against market indexes, which tends to discourage a long-term outlook by institutional investors. Moreover, a greater proportion of institutional investors simply pursues passive, broad asset-class-allocation investment strategies, which means that a smaller fraction of shareholders is informed about any individual firm and its fundamental long-term value.

The short-termist outlook of most institutional investors is all the more worrying in light of the growing share of institutional ownership of US publicly traded corporations. As Jacobs (2011) powerfully emphasizes:

“In 1951, individual retail investors owned over 75% of all outstanding corporate equities in the United States. By 1979, institutional investors as a group owned over 36%. Today, institutional investors, including public and private pension and retirement funds, mutual funds, and hedge funds control nearly 70%. Those institutional investors are managed by persons or firms whose compensation depends on generating short-term returns from the portfolio company shares under fund management. Those arrangements motivate these institutional investors to exert significant pressure on corporate managements and boards to deploy corporate assets and develop business strategies that will yield short-term profits, often at the expense of the long-term.”

The concern is not only that the majority owners of US corporations (as a group) are managed with an excessive focus on short-run performance, but also that the shrinking fraction of retail owners will be discouraged from making a more active long-term commitment to these corporations.

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6 While (pure) index funds were non-existent in 1980, they now represent around 15% of total mutual fund assets. If one also includes “closet indexers” among index funds, then this share rises to over 40% of total mutual fund assets (see Petajisto, 2010).
Another growing trend, which further absolves institutional investors from closely examining the businesses they hold in their portfolio, is the greater and greater reliance on proxy advisory firms. Since 2003, mutual funds are required to disclose how they are voting and the effect of this regulation has mostly been that funds rely on proxy advisors to determine how they should vote. As a result, the two large proxy advisors that dominate the proxy advisory market have become increasingly influential in rating corporate behavior. This means that corporations that seek to pursue innovative, long-term, off-the-beaten-track strategies are now facing a greater challenge in overcoming the potentially flawed ‘conventional wisdom’ based on superficial research that is spread by the proxy advisors throughout the institutional investor community.

What are the consequences of the stock market’s growing short-termist bias? In a nutshell: missed investment opportunities, greater risk, and more timid planning and innovation. As Graham, Harvey and Rajgopal, (2005) have shown, when it comes to managing reported earnings in an effort to artificially boost the firm’s stock price, managers are not just ready to engage in dubious accounting manipulation, but are also prepared to forego profitable investment opportunities, which would increase the long-run fundamental value of the firm. The extrapolation bias of short-termist shareholders also results in greater risk. Companies may be pressured to meet the market’s unrealistically high earnings growth expectations by taking on too much leverage, thus raising the equity beta of the firm. Brochet, Loumioti and Serafeim (2012) find evidence of this effect: they show that those firms with a more short-term focus and a more short-term oriented shareholder base (as revealed from conference call transcripts with analysts and investors) tend to have higher equity betas.

One of the bedrocks of long-term planning is the effort to identify and anticipate the long-term trends, which will bring about the fundamental changes to which the firm will need to adapt. It is, of course, far from obvious to spot these trends, but it has been suggested that environmental, social and governance performance measures (ESG factors) can be helpful leading indicators of important social, cultural and environmental changes to come. Thus firms that pursue a long-term, sustainability policy could be in a better position to anticipate social and environmental changes that
will affect the bottom line of their business in the long run. Stock markets, if anything, penalize firms that do well on ESG measures in the short run, as ESG policies tend to come at the expense of reported earnings. However, as Eccles, Ioannou and Serafeim (2011) have shown, those firms that have been able to overcome short-termist pressures and have implemented ESG policies have also significantly outperformed in the long-run their counterparts which have not pursued these policies.

Unfortunately, the majority of publicly traded corporations only pay lip service to ESG factors (for example, Eccles, Ioannou and Serafeim only have 90 “high sustainability” firms in their sample7) and most publicly traded firms tend to succumb to the short-termist pressures of equity markets. This is why more and more commentators in academia, in the investor and business community, and in policy circles have voiced concerns about short-termism in the aftermath of the great recession8. But, what can be done to overcome the excessive short-term orientation of the entire financial ecosystem?

One area that has been the focus of close attention in the wake of the crisis of 2007-08 is executive compensation, especially in the financial industry. There has been a recent shift towards longer vesting periods for stock options, the introduction of claw-back provisions, deferred bonus payments, and generally a more long-term oriented pay structure for executives in the financial industry. It is, however, less clear how much this shift has extended beyond the financial industry. It is also not completely obvious whether this move towards longer term pay will have the intended effect of reorienting managers’ outlook more towards the long term. As Laux (2011) argues, while longer vesting periods do encourage a more long-term orientation, the greater risk of option forfeiture in case of early dismissal, can actually induce managers to become more short-termist. This is especially of concern if the board of directors and the shareholder base remain biased towards short-term performance.

But even if the deferred compensation induces a more long-term stance, this effect will be limited if

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7 This number is admittedly extremely low since their study goes as far back as the 1980s. Nowadays, a substantially larger number of firms is paying attention to ESG factors.
the overall financial ecosystem remains short-termist. Accordingly, a number of proposals have been made to reduce the short-termist bias of public markets. Thus, Blood and Gore (2012) recommend that corporations stop offering short-term earnings guidance to analysts, as some major companies like Coca-Cola, IBM or Google have done, and instead communicate about their long-term strategies with investors (see Barton, 2011). Another proposal is to lengthen the terms served by directors on corporate boards and to space out elections of directors to, say, every five years (Jacobs, 2011).

But, the impact of these changes is likely to be limited if shareholders’ viewpoint remains short-termist. As Strine (2010) has observed:

“[I]t is jejune to demand that CEOs and boards manage for the long term when the stockholders who can replace them buy and sell based on short-term stock price movements, rather than the long-term prospects of firms. It is contradictory to demand managerial responsiveness to stockholders sentiment, and then criticize managers for failing to resist stockholder demands for riskier business strategies and more highly levered balance sheets.”

Hence, he argues that institutional investors, who collectively own over 70% of US publicly traded stocks, must also be induced to change their investment horizon. According to him, one way to promote a longer horizon outlook by institutional investors is to push proxy advisors to determine their voting recommendations from the perspective of a shareholder intending to hold the stock for at least five years.

Other proposals to lengthen shareholders’ investment horizon center on discouraging speculation and taxing short-term gains from speculation. The financial transaction tax recently approved by Germany, France, and other Euro-member countries is partly motivated by this aspiration to curb speculation. Similarly, the Aspen Institute (2009) proposal to change the current capital gains tax rules, which tax capital gains realized within a fiscal year as ordinary income, but apply only a 15% tax on all capital gains realized past the one-year threshold, to a regime where capital gains are taxed
on a sliding scale at a rate that is inversely proportional to the length of time a stock has been held, is also designed to discourage short-term speculation\(^9\).

Of course, a radical solution against potentially destructive short-termist market pressures could be to simply take the firm private. This has indeed been a key argument put forward by private equity funds to motivate their investment strategy. While this solution may be appropriate for some firms, it cannot, however, be generally pursued by all listed firms, for the simple reason that the overwhelming share of pension savings can only be tapped by firms listed on organized equity markets with a liquid secondary market for stocks.

While taxation of financial transactions, changes in the tax law governing capital gains are major interventions in capital markets, and delisting of a company’s stock is a radical step to escape the short-term exigencies of investors, a somewhat more cautious and controlled change that we propose in this paper is to modify the form of the common share contract typically offered to investors in stock markets to reward a longer-term orientation of investors. The change we propose is to offer investors what we refer to as *Loyalty-Shares* (or L-shares for short) which reward buy-and-hold investors with a free call-option, or warrant, if they have held their shares for a pre-specified loyalty period (say, three years)\(^{10}\).

These loyalty warrants (L-warrants), which can be offered by listed companies indiscriminately to all shareholders, would be especially attractive to those shareholders seeking more long-term buy-and-hold investments. Currently, such shareholders have little choice but to invest in regular common stock and receive rewards that are essentially independent from the length of time they hold the shares. These buy-and-hold shareholders are moreover at a disadvantage relative to more speculative traders, who can cash in on a speculative option, or respond more quickly to news and “exit” before the buy-and-hold shareholders.

\(^9\) See also Stiglitz (1989) for an early similar proposal along these lines.

\(^{10}\) The reward can also take the form of a special dividend or greater voting rights. We believe that a call-option has additional benefits over a dividend payment, but the key point is to introduce rewards for long-term investors whichever form they take. Note also that we shall repeatedly refer to an example with a three-year loyalty period. There is obviously nothing magical about the three-year period. The loyalty period could be much shorter (a week; a month) or longer depending on the particular circumstances of a corporation and the objectives of long-term investors.
We believe that L-shares would go some way towards redressing the current imbalance between long-term and short-term investors. In particular, they would attract long-term non-speculative investors, by providing a reward to those shareholders who have held their shares for a pre-specified period of time, and they would repel day-traders, momentum investors, and other short-term speculators. They would also encourage a more long-term valuation outlook, as those shareholders seeking to obtain the loyalty reward would have to make an assessment as to the company’s value at the expiration of the loyalty period.

There are already a few examples of such types of shares, but at this point it is fair to say that they are rather uncommon. One early example is the case of Michelin in 1991, which has granted L-shares (in the form of a warrant) following a dividend cut to compensate the most loyal shareholders for this loss in income. Specifically, Michelin granted one call-warrant for every 10 shares held on December 24th 1991. The call-warrant was exercisable at a four year horizon (December 31rst 1995) at an out-of-the-money strike price of FRF 200, compared with a share price of about FRF 115 at the time of the announcement. The CEO of Michelin motivated the L-shares at the time by saying: “Long-term oriented shareholders, who hold on to their shares during the difficult but critical time the company is facing [will thus be rewarded]” In addition, all the shareholders who held on to their shares for the two year period between 1991 and 1993 were rewarded with an extra warrant.
More recently, L’Oreal offered a Loyalty bonus to registered shareholders (proposed at the Annual General Meeting of April 16th, 2009), which granted a 10% incremental dividend to all shareholders having held registered shares for at least two years, up to a limit of 0.5% of nominal capital per shareholder (as defined in the article L232-14 of the French Commercial Code). Similarly, the French firm Electricité de France (one of the largest electric utility companies in the world) and the French bank Credit Agricole agreed to implement respectively Loyalty bonus and Preferential dividend schemes. These preferential dividends, both approved in May 2011, present exactly the same design as L’Oreal’s loyalty bonus. A different example is Air Liquide, which offered both a dividend and a share bonus to all shareholders who kept their shares for at least two years. Finally, a few more examples can be found in demutualized U.K. life insurance companies and building societies. Standard Life thus offered shareholders who would hold on to their shares after flotation for a pre-specified time period a one-time additional share for every 20 shares held.

Although there are so far only a handful of examples of shares rewarding long-term investors for their loyalty, several prominent commentators have recently spoken in favor of such types of shares, most notably, Vice President Al Gore who argues in favor of long-term investing strategies buttressed by loyalty-based securities (see, Blood and Gore 2012), and John Bogle who wrote:

“In addition, policy makers ought to be considering structural changes that would enhance the role of investors and diminish the role of speculators. For example, granting longer-term (say, two- to five-year holders of stock) extra voting rights and/or a higher dividend; a federal transfer tax on securities transactions; or a tax on short-term realized capital gains (say, shares held for less than six months), applicable to taxable as well as tax-exempt investors such as IRAs.” [John Bogle, January 18, 2010, Wall Street Journal]

In this paper we analyze a particular form of L-share, which attaches a call-warrant to a common share, that vests only if the shareholder continuously holds her shares for a specific period of time (whether directly or under a street name). We show how such shares can both induce greater shareholder loyalty and be attractive to more long-term strategic investors. We discuss how such shares could be structured: the length of the time period; whether the warrants should be renewable and recurrent; whether and how the company should engage in share repurchase programs to reduce
ownership dilution; how such shares should be treated in an acquisition, or in the event of a bankruptcy filing; what the consequences are for secondary market liquidity of both common and L-shares; whether L-shareholders get special board representation or not; what the accounting treatment of L-shares is likely to be; what the tax implications are for L-shares, etc.

The remainder of the paper is organized as follows. We begin by describing the proposed design for an L-share and how its features may be adjusted with respect to the issuing firm’s objective in Section II. We next examine in Section III the benefits and uses of the L-shares depending on the specific transactions the firm may contemplate. We then turn in Section IV to the analysis of the likely effects of the introduction of L-shares on the firm’s secondary market for common stock. We discuss the pricing of the L-shares in Section V, and the various institutional and contracting issues with their implementation in Section VI. Eventually, we compare different types of rewards for loyalty in Section VII and conclude in Section VIII.

II) L-SHARES: HOW WOULD THEY WORK?

The type of loyalty share (L-share) we propose is a reward in the form of a call-warrant attached to each share that is exercisable at a fixed time-horizon (say, three years) and at a fixed exercise price. The main difference with an ordinary warrant is, thus, that the right to exercise the warrant is only obtained if the holder of the L-share holds the share for the entire length of a pre-specified “loyalty period”. If the L-share is sold before expiration of the loyalty period the right to the warrant is lost. In other words, the warrant attached to an L-share is not transferable. In this respect the L-share is similar to an executive stock option, which is also not transferable and only vests after a fixed period of time.
Mercer seeks long-term shareholder rewards program from corporations

Corporations would award long-term shareholders “loyalty rewards” of extra dividends, warrants, and additional voting rights as incentives to overcome short-term earnings focuses of corporations and investors, according to a concept Mercer is developing with two other organizations.

“I think it is an ambitious idea,” said Jane Ambachtsheer, Mercer partner and global head of responsible investment, who is working on the project commissioned by Generation Foundation. The foundation is an advocacy arm of Generation Investment Management, whose chairman is Al Gore.

Corporations would encourage long-term ownership and build support for long-term strategic decision-making by offering shareholders such loyalty rewards for holding shares for a specified time.

Corporations could implement the idea without regulatory action, Ms. Ambachtsheer said.

The project organizers, currently in the fact-finding stage, plan to host in the first quarter of next year a series of round tables and individual meetings with representatives of corporate issuers, asset owners and investment management firms “to get feedback on the proposal (and feasibility) ... and on alternative ideas to cultivate more engaged ownership by investors,” Ms. Ambachtsheer said.

The group plans to release a draft report in June and a final report in fall, Ms. Ambachtsheer said.

The project seeks to address “quarterly capitalism,” Ms. Ambachtsheer said. It is a “problem executives increasingly cite as a need to respond to short-term pressures by the markets (causing) undue focus on quarterly earnings guidance and performance,” taking away from a longer-term strategic focus, Ms. Ambachtsheer said.

“Outside of France in particular, it is not a well-known concept,” Ms. Ambachtsheer said. L’Oreal Group and L’Air Liquide SA introduced loyalty rewards this year for longer-term shareholders, Ms. Ambachtsheer said. Only a handful of French companies offer loyalty rewards, she added.

Mercer, which is leading the project, is also collaborating with the law firm of Stikeman Elliott, which is providing legal perspective on the concept, Ms. Ambachtsheer said.

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Executive Summary

i In June 2011, the Secretary of State for Business, Innovation and Skills asked me to review activity in UK equity markets and its impact on the long-term performance and governance of UK quoted companies. The Review's principal concern has been to ask how well equity markets are achieving their core purposes: to enhance the performance of UK companies and to enable savers to benefit from the activity of these businesses through returns to direct and indirect ownership of shares in UK companies. More detail on the background to the Review, including its terms of reference and the Interim Report, can be found at www.bis.gov.uk/kayreview.

ii This final report details the findings of the Review. Overall we conclude that short-termism is a problem in UK equity markets, and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain. These themes of trust and incentives are central to this report. We set out principles that are designed to provide a foundation for a long-term perspective in UK equity markets and describe the directions in which regulatory policy and market practice should move. These high level statements are supported by specific recommendations that are aimed at providing the first steps towards the re-establishment of equity markets that work well for their users.

iii Given the systemic nature of the problems the Review has identified, our principles and recommendations are not limited to steps that Government should take, but are also addressed to regulatory authorities and key players in the investment chain. No single reform will provide the solution, but when implemented together, we believe our recommendations will help to deliver the improvements to equity markets necessary to support sustainable long-term value creation by British companies.

iv Our proposals aim to:

- Restore relationships of trust and confidence in the investment chain, underpinned by the application of fiduciary standards of care by all those who manage or advise on the investments of others
- Emphasise the central function of trust relationships in financial intermediation and diminish the current role of trading and transactional cultures
- Establish high level Statements of Good Practice for key players in the investment chain – Asset Holders, Asset Managers and Company Directors
- Address the disincentives to engagement by asset managers with investee companies that arise from fragmented shareholding and the perceived regulatory barriers that inhibit collective engagement, by establishing an investors’ forum for institutional investors in UK companies
- Improve the quality of engagement by investors with companies, emphasising and broadening the existing concept of stewardship
- Increase incentives to such engagement by encouraging asset managers to hold more concentrated portfolios judged on the basis of long-term absolute performance
- Shift regulatory philosophy and practice towards support for market structures which create appropriate incentives, rather than seeking to counter inappropriate incentives through the elaboration of detailed rules of conduct
- Tackle misaligned incentives in the remuneration practices of company executives and asset managers, the disclosure of investment costs, and in stock lending practices
• Reduce the pressures for short-term decision making that arise from excessively frequent reporting of financial and investment performance (including quarterly reporting by companies), and from excessive reliance on particular metrics and models for measuring performance, assessing risk and valuing assets.

The sources of short-termism – the erosion of trust and the misalignment of incentives.

v Chapters 1-5 of this report present our assessment of the main problems in equity markets.

vi Short-termism in business may be characterised both as a tendency to under-investment, whether in physical assets or in intangibles such as product development, employee skills and reputation with customers, and as hyperactive behaviour by executives whose corporate strategy focuses on restructuring, financial re-engineering or mergers and acquisitions at the expense of developing the fundamental operational capabilities of the business.

vii We observe a wide variety of examples of companies that have made bad long-term decisions, and consider that equity markets have evolved in ways that contribute to these errors of managerial judgment. We conclude that the quality – and not the amount – of engagement by shareholders determines whether the influence of equity markets on corporate decisions is beneficial or damaging to the long-term interests of companies. And we conclude that public equity markets currently encourage exit (the sale of shares) over voice (the exchange of views with the company) as a means of engagement, replacing the concerned investor with the anonymous trader.

viii UK equity markets are no longer a significant source of funding for new investment by UK companies. Most publicly traded UK companies generate sufficient cash from their day-to-day operations to fund their own corporate projects. The relatively small number of UK companies which access the new issue market often use it as a means to achieve liquidity for early stage investors, rather than to raise funds for new investment. We conclude that the principal role of equity markets in the allocation of capital relates to the oversight of capital allocation within companies rather than the allocation of capital between companies. Promoting good governance and stewardship is therefore a central, rather than an incidental, function of UK equity markets.

ix We chart the evolution of the structure of shareholding in UK equities. We find increased fragmentation, driven by the diminishing share of large UK insurance companies and pension funds and by the globalisation of financial markets which has led to increased foreign shareholding. This fragmentation has reduced the incentives for engagement and the level of control enjoyed by each shareholder.

x At the same time, there has been an explosion of intermediation in equity investment, driven both by a desire for greater professionalism and efficiency and by a decline in trust and confidence in the investment chain. The growth of intermediation has led to increased costs for investors, an increased potential for misaligned incentives and a tendency to view market effectiveness through the eyes of intermediaries rather than companies or end investors.

xi Bad policy and bad decisions often have their origins in bad ideas. We question the exaggerated faith which market commentators place in the efficient market hypothesis, arguing that the theory represents a poor basis for either regulation or investment. Regulatory philosophy influenced by the efficient market hypothesis has placed undue reliance on information disclosure as a response to divergences in knowledge and incentives across the equity investment chain. This approach has led to the provision of large quantities of data, much of which is of little value to users. Such copious data provision may drive damaging short-term decisions by investors, aggravated by well-documented cognitive biases such as excessive optimism, loss aversion and anchoring.
Asset managers – specialist investment intermediaries – have become the dominant players in the investment chain, as individual shareholding has declined and pension funds and insurers have responded to incentives (including demographic changes and regulation) to reduce their investments in equities. Asset managers typically play a key role in exercising the attributes of share ownership most relevant to company decision making: the right to vote and the right to buy or sell a given share.

We focus on the important, though not clear-cut, distinction among asset managers between those who “invest” on the basis of their understanding of the fundamental value of the company and those who “trade” based on their expectations of likely short term movements in share price. While some trading is necessary to assist the provision of liquidity to investors, current levels of trading activity exceed those necessary to support the core purposes of equity markets.

The appointment and monitoring of active asset managers is too often based on short-term relative performance. The shorter the timescale for judging asset manager performance, and the slower market prices are to respond to changes in the fundamental value of the company’s securities, the greater the incentive for the asset manager to focus on the behaviour of other market participants rather than on understanding the underlying value of the business.

But competition between asset managers on the basis of relative performance is inherently a zero sum game. The asset management industry can benefit its customers – savers – taken as a whole, only to the extent that its activities improve the performance of investee companies. This conflict between the imperatives of the business model of asset managers, and the interests of UK business and those who invest in it, is at the heart of our analysis of the problem of short-termism.

Regulatory policy has given little attention to issues of market structure and the nature and effectiveness of competition, instead developing detailed and often prescriptive rules governing market conduct, with substantial cost and limited success. Regulation should focus on the establishment of market structures which provide appropriate incentives, rather than the fruitless attempt to control behaviour in the face of inappropriate commercial incentives. We look forward to a future of less intrusive and more effective regulation, the product of a new emphasis on the incentives market participants face, and to the creation of trust relationships which can give savers and companies confidence that the equity investment chain meets their needs and serves their interests.

Chapters 6-12 of this report describe the reforms we believe are needed to ensure that equity markets support long-term corporate performance. The key principles and specific recommendations we advocate are set out below.
Kay Review Principles

1. All participants in the equity investment chain should act according to the principles of stewardship, based on respect for those whose funds are invested or managed, and trust in those by whom the funds are invested or managed.

2. Relationships based on trust and respect are everywhere more effective than trading transactions between anonymous agents in promoting high performance of companies and securing good returns to savers taken as a whole.

3. Asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest.

4. Directors are stewards of the assets and operations of their business. The duties of company directors are to the company, not its share price, and companies should aim to develop relationships with investors, rather than with ‘the market’.

5. All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client’s interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.

6. At each stage of the equity investment chain, reporting of performance should be clear, relevant, timely, related closely to the needs of users and directed to the creation of long-term value in the companies in which savers’ funds are invested.

7. Metrics and models used in the equity investment chain should give information directly relevant to the creation of long-term value in companies and good risk adjusted long-term returns to savers.

8. Risk in the equity investment chain is the failure of companies to meet the reasonable expectations of their stakeholders or the failure of investments to meet the reasonable expectations of savers. Risk is not short-term volatility of return, or tracking error relative to an index benchmark, and the use of measures and models which rely on such metrics should be discouraged.

9. Market incentives should enable and encourage companies, savers and intermediaries to adopt investment approaches which achieve long-term returns by supporting and challenging corporate decisions in pursuit of long-term value.

10. The regulatory framework should enable and encourage companies, savers and intermediaries to adopt such investment approaches.
Kay Review Recommendations

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.

2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.

3. An investors' forum should be established to facilitate collective engagement by investors in UK companies.

4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.

5. Companies should consult their major long-term investors over major board appointments.

6. Companies should seek to disengage from the process of managing short term earnings expectations and announcements.

7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.

8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund.

9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.

10. All income from stock lending should be disclosed and rebated to investors.

11. Mandatory IMS (quarterly reporting) obligations should be removed.

12. High quality, succinct narrative reporting should be strongly encouraged.

13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations.

14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.

15. Companies should structure directors’ remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.

16. Asset management firms should similarly structure managers’ remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.

17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.
specified period. This might be a general rule or one specifically applicable during takeover. We were persuaded that the introduction of such provisions by legislation or regulation would involve practical difficulties and would be unlikely to achieve the intended effect. The approach we have recommended – the development of stewardship – should in the long-term achieve that effect.

8.33 UK companies are already legally free to create different share classes with differential voting rights. Two notable recent US flotations – those of Google and Facebook – have involved such a structure, and it is less likely that the founders of these companies, who are anxious to maintain their influence on the distinctive character of their organisations, would have agreed to an IPO if such an arrangement had not been possible.

8.34 However multiple share classes are viewed with considerable hostility by UK institutional investors. The ABI, which led the historic opposition to these structures – a stance which led to the virtual elimination of dual class share structures amongst UK listed companies – told us that they remain strongly opposed. We consider this issue should be a subject of continued review and discussion. The challenge is to advantage engagement by committed shareholders without undermining protections for minority shareholders.

8.35 A number of respondents took the view that relationships between companies and shareholders would be more effective if shareholders took a part in the selection of chairmen and/or non-executive directors. They proposed the establishment of shareholders’ committees. A slightly different suggestion was that such a committee might provide a means of involving small shareholders more in the affairs of a company.

8.36 We think that the investors’ forum might provide a means through which companies could, and might in time be expected to, consult their main shareholders over chairmen and important non-executive appointments, in addition to the opportunities for such discussions which closer relationships between asset managers and companies would provide.

Recommendation 5: Companies should consult their major long-term investors over major board appointments.

8.37 When individual shareholders were predominant, analysts employed by stockbrokers played a major role in the assessment of company capabilities and performance. Their function was to provide research for salesmen who would use the material provided to them to encourage their clients to trade. As insurance companies, pension funds and unit trusts became more important as holders of UK equities, analysts directed their attention towards institutions. After Big Bang, most independent stockbrokers were acquired by large financial institutions. Analysts became employees of investment banks or other firms seeking corporate advisory and issuance business. There has always been a conflict of interest in the role of the analyst: the traditional function of equity analysis was to promote equity trading but, while that function remains, the more immediate conflict of interest faced by the equity analyst today comes from the need to maintain good relationships with the employer’s corporate clients.

8.38 Following the new economy bubble, which revealed instances of crass promotion by analysts in investment banks of stocks the analysts knew to have little or no value, and the Myners Report in 2001, attempts have been made in both the US and the UK to promote independent stock analysis. But these efforts have enjoyed limited success. We were told that it is difficult for independent firms to compete for talented staff with businesses which can cross-subsidise analysis from their issuance and corporate
advisory business, and also difficult to persuade asset managers to pay fees for research out of their own resources, rather than to ‘buy’ research access by directing dealing commissions, costs which can be charged to the funds under their management.

8.39 The analyst has always sought to provide news stories about the company which will arouse the interest of investors. As the relationships between analysts and companies have been more tightly regulated, the focus of analysts’ attention has increasingly been directed to the anticipation and interpretation of company statements. Analysts compete with each other to predict the content of an announcement, and the company will often join in this process by providing earnings ‘guidance’. Managing earnings expectations becomes a principal concern of the company’s financial officer and investor relations personnel. The exercise need have little, if any, connection to the underlying competitive capabilities of the business.

8.40 Several corporate executives described this process to us. We hear several statements of the kind ‘we found little interest in discussions of corporate strategy and developments, they were concerned with the numbers’. This dysfunctional process of earnings management and earnings guidance has not yet reached the scale achieved in the US, where a recent survey showed that 78% of respondent companies would be willing to reduce discretionary spending on research and development, advertising and hiring in order to meet earnings benchmarks\(^{32}\). But we believe it is important that the UK should not move any further in this damaging direction.

8.41 Looking forward, we see the sell-side analyst as a dispensable link in the chain of intermediation. Issuers will certainly wish to employ sales people, and these issuers will need to undertake their own research on their own behalf in preparing documentation for prospective buyers. But sales and due diligence are very different from research which, to be useful to investors, should involve an understanding on the competitive position of the company and the sources and sustainability of its competitive advantages. Most asset management firms now undertake their own analysis and employ their own analysts. Not only is it right that they should do so – this is the service for which they are paid – but the independent asset manager, unlike the securities issuer, is able to undertake research into the long-term capabilities of a company free of conflict of interest.

Recommendation 6: Companies should seek to disengage from the process of managing short term earnings expectations and announcements.

The power of short-term shareholders in widely-held public firms is widely blamed for "short-termism": directors and executives feel pressured to boost the short-term stock price at the expense of creating long-term economic value. The recent financial crisis, which many attribute to the influence of short-term shareholders, has renewed and intensified these concerns.

To reduce short-termism, reformers have sought to strengthen the number and power of long-term shareholders in public corporations. For example, the Aspen Institute has recommended imposing a fee on securities transactions and making favorable long-term capital gains rates available only to investors that own shares for much longer than a year. Underlying these proposals is a long-standing and largely uncontested belief: that long-term shareholders, unlike short-term shareholders, will want managers to maximize the economic pie created by the firm.

I recently posted a paper on SSRN explaining why this rosy view of long-term shareholders is wrong. In my paper, The Uneasy Case for Favoring Long-term Shareholders, I demonstrate that long-term shareholder interests do not align with maximizing the economic pie created by the firm – even when shareholders are the only residual claimants on the firm’s value. In fact, long-term shareholder interests might be less well aligned with maximizing the economic pie than short-term shareholder interests. In short, we can’t count on long-term shareholders to be better stewards of the firm simply because they hold their shares for a longer period of time.

The paper begins by considering a “non-transacting” firm – one that does not repurchase its own shares or issue additional shares before the long term. In this firm, I show, the conventional view is correct: long-term shareholders’ payoffs depend solely on the size of the economic pie. Accordingly, long-term shareholders will want managers to maximize the size of that pie. Short-term shareholders, on the other hand, may benefit from earnings manipulation and distorted investment decisions, actions that shrink the pie to boost the short-term stock price.

Most U.S. firms, however, are “transacting.” They buy and sell large volumes of their shares each year: approximately $1 trillion market-wide. In 2007, U.S. firms conducted $1 trillion in share
repurchases alone. The magnitude is staggering not only in absolute terms, but also relative to firms’ market capitalization. Over any given five-year period, the average U.S. firms buys and sells stock worth approximately 40% of its market capitalization.

In a transacting firm, I show, long-term shareholder interests become decoupled from the goal of maximizing the economic pie. I first consider a transacting firm that repurchases its own shares before the long term. In this repurchasing firm, long-term shareholder payoffs depend not only on the size of the economic pie, but also on the amount the firm pays to short-term shareholders selling their shares to the firm. For example, long-term shareholders benefit when managers conduct “bargain” repurchases—buybacks for at a price below the stock’s actual value.

Because long-term shareholders’ payoff in a repurchasing firm depends, in part, on the price the firm pays for its own shares, managers can benefit long-term shareholders in ways that reduce the pie. To begin, managers may distort capital-allocation decisions to maximize the value transferred to long-term shareholders through repurchases at a bargain price. In particular, managers may engage in “costly contraction”: diverting funds from valuable projects inside the firm to buy back sharply discounted shares.

In addition, managers serving long-term shareholders can (and in fact do) engage in price-depressing manipulation around repurchases. Once a firm decides to repurchase shares, long-term shareholders may benefit if managers expend corporate resources to lower the price before the repurchase. Such manipulation either increases the amount of value transferred to long-term shareholders (if the post-manipulation price is lower than the stock’s actual value) or reduces the amount of value transferred from long-term shareholders (if the post-manipulation price is still higher than the stock’s actual value).

I then consider the case in which the transacting firm issues additional equity. Now, long-term shareholders’ payoffs depend not only on the economic pie but also on the amount received from future shareholders buying stock from the firm. For example, long-term shareholders benefit when managers conduct inflated-price issuances (issuances at a price exceeding the actual value of the shares).

Because the payoffs to long-term shareholders in an issuing firm depend in part on the price at which the firm issues equity, managers can benefit long-term shareholders by taking steps that are pie-reducing. For example, when the stock price is high, managers may issue shares to finance additional investments even if these investments reduce the amount of value to be shared among all those owning shares before the long term arrives.
AOL’s acquisition of Time Warner in 2000, for $162 billion of stock, is a well-known example of long-term shareholders benefiting ex post from an issuance that destroyed economic value. The acquisition destroyed so much value that AOL and Time Warner were forced to part ways nine years later. Nevertheless, from an ex post perspective, AOL’s long-term shareholders undeniably benefited from the transaction; it enabled them to buy Time Warner’s valuable assets at an extremely cheap price. In 2009, their combined stakes in AOL and Time Warner were worth approximately 400% more than the AOL stake they would have held absent AOL’s acquisition of Time Warner.

In addition, whether or not the pre-issuance stock price is high, managers conducting issuances can benefit long-term shareholders by engaging in earnings manipulation and other actions that boost the short-term stock price but destroy economic value. If the post-manipulation price is high, more value is transferred to long-term shareholders. If the post-manipulation price is low (but higher than it would otherwise be), less value is transferred from long-term shareholders. Thus, the very same pie-reducing strategies that benefit short-term shareholders can also serve the interests of long-term shareholders, at least when the firm sells its own shares.

My purpose in this paper is to show that long-term shareholder interests, like short-term shareholder interests, are not aligned with maximizing the long-term economic value created by the firm. My analysis, by itself, cannot resolve the question as to whether long-term shareholder interests are better or worse aligned with maximizing the economic pie than are short-term shareholder interests. However, it does suggest that the case for favoring long-term shareholders – which is often based on a mistaken belief that long-term shareholders will seek to maximize the economic pie – is much weaker than it might otherwise appear.

The full paper is available for download [here](#).
Tab 3: The Internal Arrangements of Issuers
CPP Investment Board and McKinsey & Company: Global Survey Signals Short-Term Pressures on Business Leaders Are Mounting

New initiative seeks to enable a move to longer-term mindsets

TORONTO, ONTARIO--(Marketwired - May 22, 2013) - Speaking at the Institute of Corporate Directors annual conference, Mark Wiseman (President and CEO, CPPIB) and Dominic Barton (Global Managing Director, McKinsey & Company) called on business leaders to focus their thinking and actions on long-term value creation.

Announcing a joint initiative, entitled "Focusing Capital on the Long Term", Barton and Wiseman described short-termism as a central concern in today's global economy and discussed the pivotal role that corporate directors and institutional investors can take to foster long-term thinking and action.

As part of Focusing Capital on the Long Term, CPPIB and McKinsey conducted an international survey of corporate directors and CEOs, in order to understand their views on the need for long-term value creation and to identify the causes and risks of short-termism in the markets and in business:

- Sixty-three percent of business leaders indicated the pressure on their senior executives to demonstrate strong short-term financial performance has increased in the past five years.

- Seventy-nine percent of directors and senior executives said they felt the most pressure to demonstrate strong financial performance over a time period of less than 2 years. Only 7%
said they felt pressure to deliver strong financial performance over a horizon of 5 or more years.

- However, respondents identified innovation and strong financial returns as the top two benefits their company would realize if their senior executives took a longer-term view to business decisions.

- Yet, almost half of respondents (44%) said that their company’s management team currently uses a primary time horizon of less than 3 years when they conduct a formal review of corporate strategy. Seventy-three percent said this primary time horizon should be more than 3 years and 11% said the horizon should be more than 10 years. (i)

Recognizing that time horizons vary by industry and asset type, Barton and Wiseman introduced a new definition for long-term to set a common foundation for the initiative’s work: Long-term thinking goes beyond a product cycle, beyond the average tenure of directors or the CEO, and beyond a typical investment cycle.

Dominic Barton, Global Managing Director of McKinsey & Company, said:

"There is strong evidence, across the value chain, that long-term thinking creates enduring benefits for companies, their investors, and society while short-term thinking destroys value. Our aim is to move quickly to action to address the issue of short-termism and develop practical tools and approaches to help institutional investors and corporate directors execute long-term strategies."

Speaking about the challenge in moving to long-term mindsets, Mark Wiseman, CEO of CPPIB, said:

"We recognize the scale of the challenge in changing short-term attitudes and behaviours that have become all too ingrained in business, investment and society. We are not looking at an immediate fix to the problem of short-termism. This will take time, persistence and commitment from all involved. This initiative is focused on creating a roadmap for change."

**About the joint CPPIB and McKinsey initiative Focusing Capital on the Long Term**

In early 2013, the CPP Investment Board (CPPIB) and McKinsey & Company began a joint effort to set out the case for institutional investors and corporate boards to focus on long-term value creation. The initiative, *Focusing Capital on the Long Term*, was formally launched today at the 2013 Institute of Corporate Directors (ICD) National Conference. The ICD is the pre-eminent organization in Canada for directors in the for-profit and not-for-profit sectors.

With a mandate to contribute to the long-term sustainability of the Canada Pension Plan, a multigenerational fund belonging to the 18 million Canadians who are current and future beneficiaries, CPPIB has a compelling interest in driving a return to long-term fundamentals in the
investing and business worlds. Under the leadership of Mark Wiseman, CPPIB is committed to encouraging market participants to adopt longer-term perspectives.

Having witnessed the benefits of long-term thinking in Asian economies for more than 20 years, McKinsey's Dominic Barton has been a leading advocate of the need for long-term thinking and published a landmark article on the issue, "Capitalism for the Long Term," in the *Harvard Business Review* in 2011.

During 2013, CPPIB and McKinsey will continue to engage with leading institutional investors and corporate directors to identify structures and metrics that support longer-term behaviours and enhance long-term value creation. In 2014, they will release their initial recommendations and push for the adoption of behaviours and mindsets that will foster a significantly longer-term perspective across the investment industry and in the boardroom.

About CPP Investment Board

CPP Investment Board is a professional investment management organization that invests the funds not needed by the Canada Pension Plan to pay current benefits on behalf of 18 million Canadian contributors and beneficiaries. In order to build a diversified portfolio of CPP assets, the CPP Investment Board invests in public equities, private equities, real estate, infrastructure and fixed income instruments. Headquartered in Toronto, with offices in London and Hong Kong, CPP Investment Board is governed and managed independently of the Canada Pension Plan and at arm's length from governments. At March 31, 2013, the CPP Fund totalled $183.3 billion. For more information about CPP Investment Board, please visit www.cppib.com.

About McKinsey & Company

McKinsey & Company is a global management consulting firm dedicated to helping the world's leading organizations address their strategic challenges. With consultants deployed in more than 60 countries, McKinsey advises on strategic, operational, organizational and technological issues. The Canadian Practice was launched in 1968 and has offices in Toronto, Montreal and Calgary.

For more information, please visit us at www.mckinsey.com.

(i) McKinsey and CPPIB conducted a global survey of board members and executives using the McKinsey Quarterly survey panel. 1,038 people completed the survey: 71% were responding as a C-level executive, 29% as an independent Board member; 64% either work as executives, at or serve as board members for, privately held companies, 29% from publicly-listed companies; 34% are located in Europe and 30% are located in North America; 54% of respondents were from companies with revenues above $100m. All data quoted is for respondents from companies with revenues above $100m.
How should equity-based plans be designed to tie executive payoffs to long-term performance? This question has been receiving much attention from firms, investors, and regulators. We seek to answer this question in a study, Paying for Long-Term Performance, which is available here.

In our 2004 book Pay without Performance, we warned that standard executive pay arrangements were leading executives to focus excessively on the short term, creating perverse incentives to boost short-term results at the expense of long-term value. Following the financial crisis, there is now widespread agreement about that importance of avoiding such perverse incentives and of tying compensation to long-term results. There is much less agreement, however, on how this should be done. Building on ideas put forward in Pay without Performance, our study provides a detailed blueprint for structuring equity based compensation, the primary component of modern executive pay schemes, to tighten the link between pay and long-term results.

Here is a bit more detail about the content of our study: To improve the link between equity compensation and long-term results, the time when executives become free to unwind equity incentives should be separated from the time such incentives vest. Thus, vesting conditions should be accompanied by restrictions on unloading, and our study analyzes the optimal design of such restrictions.

We argue that it would be undesirable to require, as some commentators and reformers have proposed, that executives hold their equity incentives until retirement. Instead, we advocate that firms adopt a combination of grant-based and aggregate limitations on the unwinding of equity incentives. Grant-based limitations would allow executives to unwind the equity incentives associated with a particular grant only gradually after vesting, according to a fixed, pre-specified schedule put in place at the time of the grant. Aggregate limitations on unwinding would prevent...
an executive from unloading more than a specified fraction of the executive’s freely disposable equity incentives in any given year. Together, we suggest, these limitations would ensure that executives place sufficient weight on long-term results.

We also explain how executive compensation arrangements should be structured to prevent various types of “gaming” that work to increase executive pay at public shareholders’ expense and, in some cases, worsen executives' incentives: so-called “spring-loading” (using inside information to time equity grants); selling on inside information; and the manipulation of the stock price around equity grants and dispositions. We discuss how to control both gaming at the “front end,” when equity incentives are granted, and gaming at the “back end,” when equity incentives are cashed out.

Finally, we put forward the case for a broad adoption of anti-hedging provisions designed to ensure that executives cannot easily evade the proposed arrangements — both those that require executives to hold equity for the long-term and those that prevent gaming. Deploying arrangements that are desirable in theory will have little effect if they can be easily circumvented in practice. We therefore explain the importance of placing robust restrictions on executives’ use of any hedging or derivative transactions that would enable them to profit or at least protect them from declines in their company’s stock price.

Any comments on or reactions to our study, which is available here, would be most welcome.
Breaking the Short-Term Cycle

Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value
Much attention is currently directed at corporate executive compensation, but a more thorough approach to addressing short-termism requires appropriate incentive policies and practices for corporate executives, asset managers, analysts, and others.

Although the current median tenure for CEOs of Fortune 500 companies is approximately five years, the actions and decisions of these CEOs often have much longer consequences. To be properly structured, incentives should reflect the upside potential and downside risk of management actions and should align management interests with those of shareowners. One way companies can encourage long-term value creation is by basing the majority of executive compensation on long-term performance measures, even if such terms extend beyond the tenure of the executives themselves. (The definition of “long term” varies largely by industry, and therefore, incentive measures should reflect specific industry operating characteristics. Typically, in this context, long-term is considered to range from three to five years and should not be less than two years.)

Progress in long-term “pay for performance” is being made. In 2006, 57 percent of Business Roundtable companies indicated that the use of performance criteria has increased as a component of overall executive compensation. This is a notable increase from 49 percent in 2005 and 40 percent in 2004. Moreover, among the companies placing greater emphasis on performance, 20 percent use primarily long-term goals, 73 percent use a mix of long-term and short-term goals, and only 7 percent emphasize only short-term targets. The Panel’s recommendations seek to advance this progress.

In January 2006, the SEC proposed new guidelines for executive compensation that would greatly enhance the disclosures U.S. listed companies must make concerning the compensation of their highest paid executives. Greater disclosure should allow asset managers and all investors to better understand whether corporate executive compensation packages provide the proper incentives to manage for the long term. The Panel encourages asset managers and institutional investors to develop rigorous processes for the thorough review of corporate executive compensation packages.

Similarly, evaluating the performance of asset managers against a quarterly benchmark is counterproductive to conditioning them as long-term investors. When asset managers are evaluated and compensated primarily on the basis of quarterly metrics, they may pressure companies into the same short-term thinking or increase volatility by regularly trading in and out of company securities in an effort to capture short-term profit. The Panel thus believes that a significant portion of incentive pay for asset managers should be measured by long-term (three to five years) metrics similar to those used at the companies in which they invest. To confirm this longer-term focus, asset management firms should provide investors with more information about their incentive structures.

**INCENTIVES AND COMPENSATION RECOMMENDATIONS**

1. **Align corporate executive compensation with long-term goals and strategies and with long-term shareowner interests.** Compensation should be structured to achieve long-term strategic and value-creation goals.

Although proposed SEC requirements on executive compensation will provide shareowners with greater transparency as to the components of management compensation, it is ultimately up to the companies themselves, their boards, and their shareowners to make sure that the interests of management are aligned with those of shareowners. All three panels identified executive incentives that focus disproportionately on short-term objectives as a key driver of short-termism.

Additionally, stock ownership guidelines should require all executives and directors to hold a meaningful amount of equity in the company at which they serve. “Meaningful” in this context can be defined as an amount that makes it economically material to the individual that a company succeed in the long-term.
2. **Align asset manager compensation with long-term performance and with long-term client interests.**

Evaluating asset managers quarterly almost ensures that many will fall short of the benchmark because of unpredictable short-term events, near-term stock market swings, and transaction fees that ultimately penalize returns to investors.

As much as possible, incentive pay for asset managers should be measured by long-term metrics in order to promote a long-term investment horizon. The Panel recommends that asset managers investigate ways to link asset manager pay to performance—in much the same way the Panel encourages corporations to rethink corporate executive pay to better reflect long-term performance. An example would be tying manager incentives to multi-year performance. By creating more transparent links between asset manager pay and long-term performance, asset management firms will help ensure fund shareowners that asset managers are paid for performance, not asset gathering.

Asset managers should also be encouraged to commit a *meaningful* portion of their own wealth to the funds they manage in order to tie their compensation directly to the wealth they create for fund shareowners.

3. **Improve disclosure of asset managers’ incentive metrics, fee structures, and personal ownership of funds they manage.**

Asset managers and investors have long called for more transparency from the companies they evaluate and in which they invest, especially in the areas of executive compensation. Similar incentive disclosures are severely lacking in the managed funds industry.

The Panel calls on asset management firms to more closely link incentive compensation to long-term performance. Because most investors in mutual funds have a long-term investment horizon, asset management firms should strive to provide investors with more information concerning asset manager incentive metrics and incentive structures. Greater transparency concerning the incentive structures of asset managers will go a long way toward reassuring investors that the interests of asset managers run parallel to their own.

Although hedge funds do not fall under the same regulatory rubric as mutual funds, hedge fund managers should strive to assure long-term investors (e.g., those that agree to lock up their funds for a prolonged period of time) that the fund managers are fairly compensated on the basis of long-term results through use of incentive fees and other methods of tying fees to long-term performance.

4. **Encourage asset managers and institutional investors to develop processes for ensuring that the companies in which they invest use effective, long-term, pay-for-performance criteria in determining executive compensation.**

The new SEC guidelines for executive compensation disclosures should provide all shareowners with better tools for evaluating whether corporate executive compensation packages properly link pay to performance and provide executives with the incentives to manage for the long term. The Panel encourages asset managers and institutional investors to closely examine corporate pay packages to ensure that incentive plans are aligned with the long-term interests of shareowners.
The Financial Reporting Council (FRC) today is consulting on its two-yearly review of changes to the UK Corporate Governance Code following earlier consultations on directors’ remuneration (October 2013) and risk management, internal control and the going concern basis of accounting (November 2013).

The UK Corporate Governance Code sets out good practice for UK listed companies on issues such as board composition and effectiveness, risk management, directors’ remuneration and relations with shareholders. The Code operates on a ‘comply or explain’ basis. It was established in 1992 and is usually reviewed by the FRC every two years with a full consultation on all proposed changes.

The proposed changes to the UK Corporate Governance Code are that:

- greater emphasis be placed on ensuring that remuneration policies are designed with the long-term success of the company in mind, and that the lead responsibility for doing so rests with the remuneration committee;
- companies should put in place arrangements that will enable them to recover or withhold variable pay when appropriate to do so, and should consider appropriate vesting and holding periods for deferred remuneration;
- companies should explain when publishing AGM results how they intend to engage with shareholders when a significant percentage of them have voted against any resolution;
- companies should state in their financial statements whether they consider it appropriate to adopt the going concern basis of accounting and identify any material uncertainties to their ability to continue to do so;
- companies should robustly assess their principal risks and explain how they are being managed and mitigated;
- companies should state whether they believe they will be able to continue in operation and meet their liabilities taking account of their current position and principal risks, and specify the period covered by this statement and why they consider it appropriate. It is expected that the period assessed will be significantly longer than 12 months; and
- companies should monitor their risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and report on that review in the annual report.
Commenting on the consultation, Stephen Haddrill explained:

“The role of the board is to ensure the sustained success of their company and exercise responsible stewardship on behalf of their shareholders. To do this effectively they need to understand and manage the risks to the future health of the company. The remuneration of executives on the Board must also incentivise them to put the company’s well-being before their own. These proposals, which reflect the views of investors and others on earlier consultations, are intended to encourage boards to focus on the longer-term, and increase their accountability to shareholders.”

Subject to the outcome of the consultation, which closes on Friday 27 June 2014, the proposed changes will apply to financial years beginning on or after 1 October 2014.

Notes to editors:

1. The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

2. Under the UKLA’s Listing Rules, all companies with a Premium Listing of equity shares are required to report on whether they have complied with the provisions of the UK Corporate Governance Code and, if not, explain to shareholders the reasons why they have not done so.

3. All press enquiries should be directed to: Peter Timberlake, Head of Communications on telephone: 020 7492 2397/ 07768 502332, or email p.timberlake@frc.org.uk. Or to Sophie Broom, Communications Executive, on telephone: 020 7492 2395/ 07771 808464 or email: s.broom@frc.org.uk
Curbing Short-Termism in Corporate America: Focus on Executive Compensation

Posted by Robert C. Pozen, Harvard Business School, on Thursday May 8, 2014

The protest against short termism in corporate America is rising. Business and political leaders are decrying the emphasis on quarterly results—which they claim is preventing corporations from making long-term investments needed for sustainable growth.

However, these critics of short termism have a skewed view of the facts and there are logical flaws in their arguments. Moreover, their proposals would dramatically cut back on shareholder rights to hold companies accountable.

The critics of short termism stress how much the average daily share volume has increased over the last few decades. Although this is factually correct, this sharp average increase is caused primarily by a tremendous rise in intraday trading.

Intraday traders should not significantly influence the decisions of corporate executives about their business plans or allocation of expenditures. These traders are not interested in corporate fundamentals; they are trying to exploit fleeting price differences among related securities markets.

The critics of short termism also are alarmed by the expanded role played by activist hedge funds, which press for changes in corporate policies or leadership. The critics allege that activist hedge funds want quick changes so they call sell out for quick profits.

However, the data do not support this homogeneous view of activist hedge funds. These funds deploy a wide diversity of strategies. On average, they hold their big positions for 1-2 years. On average, the corporate changes they get adopted have positive effects for 2-5 years.

To be successful, activist hedge funds must persuade other investors to support their programs for corporate change. Activist hedge funds hold a small percentage of a company’s shares; most are owned by institutional investors like mutual funds and retirement plans.
Looking carefully at the business plans and financial reports, these institutions have different views about long-term strategies depending on the circumstances. For example, institutional investors support long-term research programs of biotech firms that have shown they can deliver. But institutional investors do not support long-term plans for expansion or acquisitions that they believe are unlikely to succeed.

To combat the perceived threat from day traders and hedge fund activists, critics of short termism have proposed substantial reductions in the rights of shareholders to have a voice in fundamental corporate issues. Some critics of short termism have even suggested terms of 3 or 5 years for corporate directors. Such long terms, combined with ability to issue poison pills, would immunize poorly performing companies from takeovers.

Other proposals are more narrowly designed to address the adverse dynamics of short term trading. For example, the paper supports limits on “empty voting”—whereby an investor temporarily buys a lot of votes just before a shareholder meeting without actually owning a lot of shares.

Most importantly, the paper stresses the need to lengthen the time horizon for awarding executive compensation. The measurement period for cash bonuses and stock grants is usually the prior one year, yet a one-year measurement period encourages corporate executives and investment managers to take a short-term approach. If we want these executives and managers to have a longer perspective, we should base their cash bonuses and stock grants on their performance over the prior three years, not one year.

Similarly, executives and managers are generally allowed to exercise stock options and immediately sell the shares obtained. They can also sell all of their restricted shares as soon as they vest. These practices can lead to efforts to push up the stock price for a few days in order to realize short-term profits. To promote a long-term perspective, holders of stock options and restricted shares should be required to hold for a period of 3 to 5 years the shares they obtain through executive compensation programs.

Finally, the paper recommends that all public companies stop the issuance of earnings estimates for the next quarter—for instance, a company might say “we estimate the company will earn $1.23 per share next quarter.” Such projections of quarterly earnings just aggravate the tendency of many Wall Street analysts to focus on short term results. If corporate executives feel they have to provide earnings guidance, they should offer a broad range of earnings estimates for the next year instead of a specific EPS number for the next quarter.

The full paper is available for download here.
Rethinking Director Nomination Requirements and Conduct

Posted by Peter Atkins, Skadden, Arps, Slate, Meagher & Flom LLP, on Wednesday July 17, 2013

Editor’s Note: Peter Atkins is a partner of corporate and securities law matters at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden, Arps memorandum by Mr. Atkins, Richard J. Grossman, and Edward P. Welch; the full text, including appendix, is available here.

This post identifies and discusses a number of steps public companies may wish to consider regarding director nomination requirements and conduct in light of the heightened potential for arrival on the board of activist shareholder-nominated directors.

Background

**Increased Incidence of Nomination Proposals**: Based on publicly reported information published by Activist Insight,¹ during 2012 activist shareholders threatened to initiate or initiated 58 director election proposals, and in 45 of them succeeded in electing at least one director either in an election contest or by agreement with the target’s board. During the first quarter of 2013, activist shareholders are reported by Activist Insight² to have threatened to initiate or initiated 36 director election proposals and in an election contest or by agreement in 13 of them succeeded in electing at least one director. By way of comparison, in the first quarter of 2012, activist shareholders threatened to initiate or initiated only 18 director election proposals.

**Reaction of Investment Community**: Moreover, the activist call for adding shareholder-sponsored directors, typically less than a majority, to public company boards is receiving increasing support in the investment community.

**Need for Proactive Board Assessment**: With short slate election contests by activist shareholders becoming an increasing risk and reality for public companies, incumbent boards

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¹ Source: Shareholder Activism Review 2012.
should be taking a proactive approach to assessing the implications of this development and to determining what steps, if any, would be appropriate to take in response.

**Legitimate Subject for Board Consideration; Timing:** To be clear, this suggestion is not motivated by a knee-jerk bunker mentality that shareholder-sponsored directors are an automatic threat. Of course that is not the case. However, it would be equally incorrect to conclude that the arrival of an activist shareholder-sponsored director is an inherently positive event. The fact is that dealing with the phenomenon of activist shareholder director nominations is a perfectly legitimate subject for sitting boards to consider. As the body ultimately responsible for overseeing a company’s business and affairs, the board of directors should be interested in mitigating the risk of dysfunction that often results from directors representing specific interests rather than shareholders as a whole, that can lead to, among other things, a loss of confidentiality with respect to company information, including discussions among and views expressed by directors. The optimal time to focus on mitigating this risk is “on a clear day,” without the pressures and confusion about motives surrounding a threatened or pending election contest.

**Exercise Thoughtful Judgment:** Before addressing various issues, one point should be underscored—any nomination requirement or conduct rule to be applied to a proposed new director sponsored by an activist shareholder should be tested against the following question: Would we, the incumbent board, be prepared to apply the requirement or rule to ourselves and to new nominees proposed in the future by us? This is not to say that a “one-size-fits-all” approach to director nomination requirements and conduct is mandatory. However, if there is to be a difference in application, the board should be prepared to articulate a legitimate basis for it, grounded in proper corporate interests—and should be comfortable that the differentiation does not overstep the bounds of public policy that in Delaware protects the exercise by shareholders of their voting rights and imposes some limits on directors constraining other directors.

**Communication of Confidential Information to Sponsoring Activist Shareholder**

**The Information Conduit Risk**

**The Kalisman Decision:** In a recent decision (*Kalisman*), the Delaware Chancery Court declared that “When a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder’s representative, then the stockholder is generally entitled to the same information as the director.” This proposition appears to have

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originated in cases involving shareholder designation of a director pursuant to a contractual right or by a controlling shareholder. In Kalisman, however, neither was present. OTK Associates, LLC, the designating shareholder, owned 13.9 percent and was the largest shareholder of Morgans Hotel Group, a publicly traded company. Kalisman, a founding member of OTK, appears to have been invited on Morgans’ board following conversations with Morgans about OTK’s investment in it, but without any formal agreement. Accordingly, the Kalisman decision suggests that, at least in the absence of an appropriately imposed limitation, an activist-sponsored director (elected after conversations between the activist shareholder and the company with or without a formal agreement, or after a settlement of or a vote pursuant to an election contest) might be free to serve as a confidential information conduit to the activist sponsor. The Kalisman opinion would also require that the designee be “understood” to be acting as the shareholder’s “representative”—each of which determinations would seem to be factual in nature to be made on a case-by-case basis.

**Potential for Board Disruption:** The existence of a pipeline of confidential company information to an activist shareholder from its sponsored director would be genuinely disruptive to the effective functioning of a public company board, particularly in light of the Delaware rule recited in Kalisman that “A director’s right to information is ‘essentially unfettered in nature.’” Moreover, the confidential information flow likely would be quite unexpected by the company, given the normal proposition that once elected to the board, a director owes his or her fiduciary duties, including of confidentiality, to the company and shareholders as a whole.

**Remedial Steps to Consider**

**Ability to Impose Limitations:** Companies should fix this potential problem up front. In Kalisman, the court acknowledged that some limitations can be imposed, noting that “[a]ny dispute on this issue [of conveying information to a shareholder for whom the director acts as representative] is not yet ripe, because Kalisman has undertaken not to share privileged information with OTK….”

**Possible Fixes:** A number of fixes to the problem may exist. One would be for the board to establish in the company’s bylaws a director nomination requirement that, prior to being accepted as a nominee, each proposed nominee must confirm in writing, in form acceptable to the company, that she or he will abide by all policies applicable to directors from time to time, including policies defining and specifying the treatment of company confidential information. (Some public company advance notice bylaws for shareholder-sponsored director nominations contain a similar requirement.) Two, in conjunction with that requirement, the company would establish a confidentiality policy (or amend its existing one, if needed) specifically providing that,
without limiting the director’s confidentiality obligations under the policy or otherwise, the director will not disclose company confidential information to any shareholder that nominated the director to serve on the company’s board. Three, alternatively (or in addition), all proposed nominees would be required pursuant to a board-adopted company bylaw to represent and agree in writing, in form satisfactory to the company, prior to being accepted as nominees, that they are not acting and will not act as the representative of any particular stockholder or group of stockholders while serving as a director (other than as a member of a committee established by the board).

Communication of Confidential Information to Others

The Broader Information Disclosure Risk

_Breaches of Confidentiality Obligations:_ Another potentially difficult area of director conduct, that can be exacerbated when activist shareholder-nominated directors sit on a company’s board, is communication by them with the media, investors and others about confidential company matters, in breach of fiduciary duties, company policies and/or express agreements. Particularly in situations where the nominee becomes a director in the context of an activist shareholder initiative (e.g., proposing the company put itself up for sale, spin off certain operations or return capital to shareholders), or where subsequent to election the activist shareholder starts such an initiative, the activist shareholder-sponsored director may be more vulnerable than other board members to private inquiries seeking information and, even if not contacted, may want to express himself or herself.

Remedial Steps to Consider

_Use of Situation-Specific Reminders:_ Most companies have codes of ethics and/or confidentiality policies that would prohibit such communications by directors. Nonetheless, they sometimes occur, including by non-shareholder-sponsored directors. Accordingly, companies should consider adopting a policy/practice of providing targeted reminders to all directors when problematic situations arise, as a means of reinforcing on a situation-specific basis both the existence of the prohibitions and the seriousness of a breach. (Certain other useful reminders can be provided at the same time, including regarding the company’s policy with respect to responding to media, shareholder and other inquiries, and to whom and when such inquiries should be reported within the company.) One mechanism for implementing this type of reminder might be a memorandum from the general counsel to the board, perhaps to be countersigned by each director. A model reminder memorandum is set forth on Appendix A (modified from a document used in a takeover election contest situation).
Resignation in Event of Intentional Confidentiality Breach: A more severe potential remedial step would be to require the shareholder-sponsored director nominees (or all nominees) to submit a resignation up front, the effectiveness of which is conditioned on a finding by a court of competent jurisdiction that the director intentionally disclosed confidential company information to a third party in breach of the director’s confidentiality obligations to the company under law and/or any policy, code, agreement or understanding applicable to the director. Such a conditional resignation is contemplated by Section 141(b) of the Delaware General Corporation Law. This remedial step would tie together with the confidentiality policy provision discussed above in connection with the Kalisman case.

Requirements for Acceptance of Shareholder-Nominated Directors

Prevalence of Advance Notice Bylaws: Many public companies have adopted bylaws requiring advance notice of shareholder-proposed directors. Over time, in response to increased efforts by hedge funds and other shareholder activists to take positions in and influence target companies, advance notice bylaws have become vehicles for requiring, as preconditions for acceptance of the nominees, various disclosures, representations and agreements by both nominees and shareholder sponsors.

Potential Areas for Enhancement: Companies should consider (a) the process for informing potential shareholder nominee sponsors and nominees regarding what disclosures, representations and agreements will be required of them and (b) what additional disclosures, representations and agreements, if any, might be appropriate.

Process Requirements

Improved Decision-Making About Requirements—A Two-Step Process: As to process, advance notice bylaws today provide for a one-step submission process, with all required material submitted with the notice of nomination, based on forms of questionnaires and disclosures, representations and agreements provided beforehand. However, some disclosures, representations and agreements might be better framed if the company knew, before providing its requirements, the identity of the sponsoring shareholder and of the nominees, and much of the information that otherwise would be obtained through required disclosures to the company at the time of submission of a nomination. Accordingly, in order to make more informed decisions about how precisely to frame the disclosures, representations and agreements to be required in a

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4 Whether such a resignation can be irrevocable is an open question under Delaware law. However, even if revocable, for a director who cared about his or her reputation, including for integrity, it seems doubtful he or she would actually revoke the resignation (which would amount to the director publicly reneging on his or her prior agreement to accept automatic resignation if, but only if, found by a court to have breached his or her confidentiality obligation to the company).
particular case, companies may wish to consider adopting a two-stage advance notice process. The first stage would expressly require identification of the proposed nominees and their shareholder-sponsor, and the concurrent submission of completed preliminary questionnaires by those parties, made available to them through the company's secretary. This would seem easily manageable within the timing for advance notice of shareholder-sponsored director nominations provided by most advance notice bylaws.

**Reservation of Right to Require More:** Another process point to consider is to reserve explicitly the right to require additional disclosures, representations and agreements even after shareholder-sponsored nominations have been submitted. Developments may occur both in applicable law and in awareness of relevant facts and circumstances during the course of an election contest, and it would seem prudent for the company to preserve the flexibility to respond to any such developments.

**An Important Caveat:** One caveat should be kept in mind. Attempts to manage the shareholder-sponsored nomination process may at some point be challenged as improperly interfering with the right of shareholders to nominate directors. Accordingly, care should be taken in structuring and applying both the two-stage process and the reservation of rights suggested above so that each separately and the advance notice requirements taken as a whole are supportable as rationally tied to legitimate company interests as determined by the informed business judgment of the board.

**Other Requirements**

**Review Other Precedents:** As to additional disclosures, representations and agreements, a number of public company advance notice bylaws for shareholder-sponsored director nominations contain a broad array of disclosure, representation and agreement requirements as a predicate for acceptance of a shareholder-sponsored nominee. (See, for example, the bylaws of Pfizer Inc., The Allstate Corporation and Verizon Communications Inc.) These are useful reference points for assessing the adequacy of a company's advance notice bylaws in this era of shareholder activism.

**Focus on Independence:** One noteworthy provision in some companies’ advance notice bylaws is the reservation of the right to require a proposed nominee to furnish such additional information as the company may reasonably require to determine the eligibility of the proposed nominee to serve as an *independent* director or that could be material to a reasonable shareholder's understanding of the proposed nominee’s independence. On its face, preserving the right to request such information about an activist shareholder’s proposed director nominee seems
plainly in the interest of shareholders as a whole. The issue may well go beyond whether the activist shareholder nominees would be independent for purposes of serving on the company’s audit, compensation or nominating committee. For example, in the context of an election contest linked to an activist shareholder proposing a course of action for a company that its board has rejected, the independence of the shareholder activists’ director nominees in reviewing that course of action as a director is likely to be an important election issue—and this independence issue may require understanding the nominee’s direct and indirect business and personal relationships with the activist shareholder sponsor and its affiliates. The formulation set forth in the first sentence of this paragraph provides flexibility to probe the full reach of “independence” depending on the facts and to decide when to make a request. At the same time, care should be taken to apply this flexibility in a reasonable manner.

**Negate Special Director Compensation:** Another area of recent focus is activist hedge funds providing special compensation arrangements to their director nominees if, after being elected, the activist’s program is successfully accomplished. These arrangements are quite troubling as a matter of director independence, overall corporate governance and board dynamics. They seem well within the prerogative of a board to negate through a provision in an agreement required to be submitted by the nominee as part of a shareholder-sponsored director nomination. Such agreement would represent that there are no such special arrangements in connection with the nomination and commit that there will be none going forward. It should be noted that a number of advance notice bylaws require disclosure that would encompass such arrangements, but do not affirmatively require that there are none and will be none. This disclosure approach may well be sufficient as a practical matter to curb the use of special compensation arrangements, given the likelihood that, once disclosed, they will constitute an attack point against and detract from the activist shareholder’s campaign and nominees.

**Conclusion**

As noted, we believe that in this era of heightened shareholder activism, particularly as manifested by the increased use by shareholder activists of election contests in support of their nominees, incumbent boards should proactively consider whether and, if so, what and how additional director nomination requirements and conduct rules should be explored and adopted, with a view to enhancing the protection of shareholders as a whole. Some particular suggestions in this regard are noted above.

At the same time, informed and balanced board judgment should be exercised and documented to mitigate both the risk of successful legal challenge to such measures, predicated on claims of
breach of duty or public policy, and the risk of other adverse reactions, including from shareholder activists, other investors, proxy advisory firms and the media.