L-Shares: Rewarding Long-term Investors[1]

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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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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.

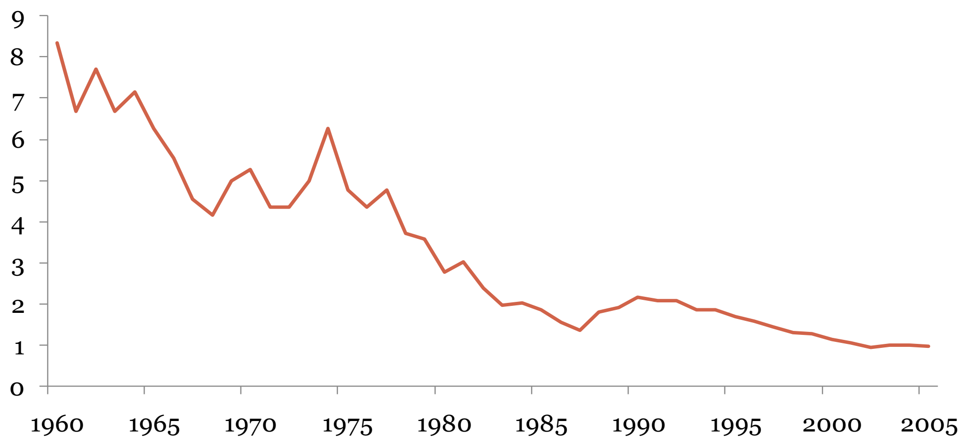
2 In his recent report, John Kay (2012) takes up this observation and argues that public equity markets currently encourage "exit" (the sale of shares) over "voice" (the exchange of views with the company) as a means of engagement, replacing the concerned investor with the anonymous trader: "Only the 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)[3]



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

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 Instititutional 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[4].

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[5].

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

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[6].

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.

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 sample[7]) 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 recession[8]. 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

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.
8 The Aspen Institute (2009), Barton (2011), Milton (2010) and Bachelder (2012) for examples of recent reports on short-termism.

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.

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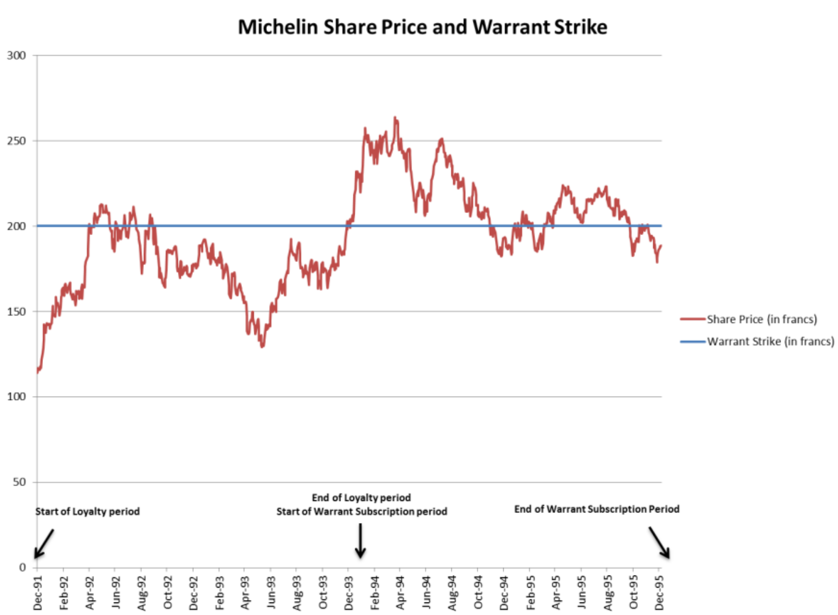
9 See also Stiglitz (1989) for an early similar proposal along these lines.

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.