Loyalty-Shares: Rewarding Long-term Investors

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I] INTRODUCTION
The recent history of bubbles and crashes, and especially the financial crisis of 2007-09, provides fresh evidence of the extent to which stock prices can deviate from firms’ long-term fundamental value over prolonged periods of time. In light of this evidence it is increasingly recognized that an exclusive focus on quarterly earnings and on share price as performance benchmarks may give rise to highly destructive short-termist incentives for publicly traded firms. Speculative behaviour in stock markets generally focuses on short-term stock-price movements. It is mostly concerned with anticipating and taking advantage of changes in market sentiment or investors’ collective psychology, and as such it is largely divorced from any effort to discover firms’ long-term fundamental value. As a result of the short-term outlook of speculators, which has been enhanced by advances in information technology and the concomitant higher frequency of stock trading, equity markets are imposing greater and greater short-termist pressures 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 become the stock-price performance of the firm.

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Following the crisis of 2007-09 there have been some efforts to correct short-termist incentives of company executives by lengthening the vesting periods for executive stock-options and by introducing claw-back provisions, mainly in the financial sector. But these efforts remain largely futile as long as shareholders themselves only focus on corporate short-term performance.

Box 1: Average holding period

- Calculated roughly as the ratio of the average of the total market value of the shares outstanding at the start and at the end of the year and the value of shares traded in any given year (as an adaptation of Haldane 2011), the average holding period was globally less than one year in 2008 and the average holding period has considerably decreased in the U.S. (this trend is global and every major Exchange is concerned).

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

- This measure of short-termism might be distorted by the rapid rise of high frequency trading (HTF) in the mid-2000s as HFT firms are believed to account for a significant part of all trading volume. Note, however, that the average holding period had already fallen below two years in the mid-80s, so that this measure still suggests a dramatic shortening of stock holding periods for the typical shareholder. A survey by Mercer and the IRRC Institute (2010) focusing on long-only equity strategies shows that nearly two-thirds of the 900 strategies studied had a turnover higher than expected, with some strategies recording more than 150-200% higher turnover than anticipated. The average annual turnover of the sample was 72% (which equates to an average holding period of 16.6 months). This figure is similar to the findings by Cremers, Pareek and Sautner (2012), who have identified a 20 months holding period for pension funds and endowments (that is significantly less than for long-term investors like Berkshire Hathaway, with a 48 month average holding period).
Even if CEO stock options only vest two or three years after they have been granted, CEOs remain largely concerned with quarterly performance, as they are aware that they can be dismissed long before their options vest if shareholders are unhappy with their reported quarterly performance. As a result CEOs continue to boost short-term earnings at the expense of long-run value maximization.

It is worth emphasizing that CEO short-termism is generally not the result of a governance failure, but is associated with well-governed companies, who in effect reward their CEOs for meeting the short-term objectives of their shareholders (see e.g. Cheng, Hong and Scheinkman, 2010, and Becht, Bolton and Roell, 2011). One shareholder constituency that has particularly severe short-termist biases is the institutional investor community comprising mutual funds and pension funds. This is unfortunately the largest investor base for publicly traded companies, nowadays holding collectively over 60 or 70% of publicly traded stocks. This constituency is structurally short-termist, as fund managers are directly or indirectly (through money flows in and out of the funds they manage) rewarded for meeting market index performance benchmarks over the short run (see e.g. Chevalier and Ellison, 1999 and Vayanos and Woolley, 2008). In addition, a greater and greater proportion of institutional investors simply implements passive asset-class-allocation investment strategies. All in all, the reality of financial markets today is that a smaller and smaller fraction of shareholders cares about long-run performance and is informed about any individual firm’s fundamental long-term value.

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. According to their study, 78% of managers “would give up economic value in exchange for smooth earnings” and “55% of managers would avoid initiating a very positive NPV project if it meant falling short of the current quarter’s consensus”. Confirming the survey evidence of Graham, Harvey and Rajgopal (2005), the study by
Asker, Farre-Mensa, and Ljungqvist (2013), which compares the investment behavior of listed and unlisted US firms with otherwise similar characteristics, finds that listed firms substantially underinvest and are less responsive to new investment opportunities than their unlisted counterparts. Using a different methodology, Alti and Tetlock (2013) also find strong evidence of overconfidence and extrapolation biases in financial markets, which give rise to investment distortions. Finally, shareholder extrapolation biases have also been found to result in greater risk taking by firms with a short-term investor base in Brochet, Loumioti and Serafeim (2012). Their study reveals that the companies with a more short-term oriented shareholder base (as revealed from conference call transcripts with analysts and investors) tend to have higher equity betas, and they suggest that the higher equity betas can be explained by companies being pressured to take more leverage in an attempt to meet the market’s unrealistically high earnings growth expectations.

If publicly traded firms can succumb to the short-termist pressures of equity markets, what can be done to overcome the excessive short-term orientation of financial markets? Policy-makers and commentators’ reactions to the accumulating evidence of market short-termism has ranged from outright denial (all the evidence can be reconciled with the efficient market hypothesis), or benevolent skepticism (there are both instances of ‘short-termism’ and ‘long-termism’, meaning that the market ‘overvalues’ the long-term prospects of some firms), to calls for radical action to curb the excesses of financial market speculation (increase capital-gains taxation on realized short-term capital gains, introduce a financial transactions tax, etc.).

Our view is that short-termism of financial markets is a major concern, but that solutions to correct this bias cannot be seen only in terms of regulatory intervention. The market itself has an important role to play in inviting contractual solutions to short-termism where they are most needed. We also believe that while the disease and its origins are being diagnosed more and more accurately, what cures are available (that are better than the disease) is still far from obvious. The time has thus come for some experimentation, on a small scale to begin with, to explore some possible solutions.

It is in this spirit that we make a modest proposal, which is to amend the standard common-stock contract by introducing a financial reward for long-term investors. While far from perfect, a simple
and concrete way of identifying a long-term investor is as a buy-and-hold investor — what we shall refer to as a *loyal investor* in an undisguised allusion to Albert O. Hirschman’s classic book on governance, *Exit, Voice and Loyalty* (1970).

A basic tenet of classical investment theory is that passive long-term investors ought to continuously rebalance their portfolio over time so as to maximize their inter-temporal risk-adjusted return. In contrast, a ‘value investor’, who seeks out stocks that are undervalued in the short-run and holds onto them until the market eventually catches on, is a more active buy-and-hold investor. Such an investor is valuable to any firm that is suffering from a market misperception about its long-run fundamental value, whether she engages with management or not. An investor clientele that is loyal to the firm, by refusing to choose the easy ‘exit’ option in response to the slightest negative market whim, ought to be wooed by firms as it provides valuable stability to management and employees. Our proposal, thus, is to attract such an investor clientele by offering a *loyalty reward* to buy-and-hold investors. As we explain in detail below our favored reward is in the form of a loyalty warrant granted to all shareholders, which vests only after a pre-determined loyalty period has expired (say, three years).

By offering such loyalty shares (or in short *L-shares*) firms may be able to correct some of the short-termist biases they are exposed to. They would not only attract a more long-term investor base and repel day-traders, momentum investors, and other short-term speculators, but they would also induce investors to study the firm’s long-term prospects more. Indeed, prospective buy-and-hold investors seeking to obtain a loyalty reward will want to estimate the present value of this reward, which would involve an assessment of the firm’s likely stock price at the time when the reward vests. In short, L-shares would encourage a more long-term outlook and thus help correct financial markets tendency to just focus on the short-term bottom line.

We view this as a simple proposal, limited in scope, that may be suitable for some, if not all, publicly traded firms. It is a proposal with very limited negative unintended effects. It might not deliver much, but it also won’t cause much harm. Firms may experiment at first with relatively small loyalty rewards and revise the contract in light of how it performs. They can scale up the rewards or
abandon them entirely. While the costs of experimenting with this solution are minimal, the benefits however could be substantial. We now turn to a detailed analysis of how L-shares could be structured, which firms they may be most suitable for, which potential weaknesses underlie the concept and how they might be addressed.

II] L-SHARES: HOW WOULD THEY WORK?

The design of loyalty 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 that the right to exercise the warrant is conditional on holding 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. Once, the warrant is granted, however, it can be traded. In sum, all shareholders would be entitled to the same reward and therefore would be treated equally. Whether a shareholder ultimately receives the L-warrant or not is entirely driven by her behavior. Thus, the loyalty reward as such does not give rise to a dual-class share structure.

The strike price of the warrant may be set in different ways depending on circumstances. It could be for example: 1) a simple ‘at-the-money’ call, with the price given by the market price of the L-share at the time it is granted; 2) the minimum of the stock price at the time the L-share is granted and the lowest of the prices over the loyalty period; 3) a strike price that is calculated at the time of expiration of the loyalty period to be equal to the average stock price over the loyalty period. The latter two formulations would correspond to look-back options, the last one being akin to a so-called *Asian Look-back Call Option*.

A potential advantage of allowing for adjustments in the strike price to reflect changes in stock prices over the loyalty period, is that the warrant’s value may then be less affected by price drops
over the loyalty period. In other words, the L-warrant is then less likely to be out-of-the-money at the time of expiration of the loyalty period. Thus, if the firm’s goal is to retain a long-term oriented, loyal, shareholder base in a bear market it can achieve this by adjusting the strike price in this way. But there is also an argument for making no ‘look-back’ adjustments at all: this warrant structure would ensure that greater market discipline is imposed on management. Poor performance leading to a significant stock price decline would result in out-of-the-money L-warrants and thus would not lock in shareholders. This may be seen as a desirable feature if greater market discipline on management is valued.

Conceivably, the firm may even want to offer L-warrants that are initially far out of the money as a way of signaling to its shareholders its ambition (or confidence) that the share price will rise to the point where the L-warrants will be in the money by the end of the loyalty period. The precise terms a firm sets for its L-shares will generally depend on the intentions the firm wants to convey to the market. This signaling (or communication) dimension of loyalty rewards is possibly the most important aspect for the first firms who decide to rely on such rewards. Will the introduction of these rewards be perceived as a brilliant innovation that strengthens the firm’s reputation as a ‘game-changer’, or will it be seen as a last-ditch attempt to stem the flow of investors out of a losing business? Just as with any new share offering, the timing of introduction of loyalty rewards and the market context are thus likely to be critical for the successful reception of L-shares.

How would L-shares be distributed? For a company that is already publicly traded, the simplest approach would be to announce that all shareholders are granted an L-warrant per share. Alternatively, the firm could issue L-shares through a rights issue. But L-shares could also be privately placed if a strategic investor is targeted. For a privately held firm contemplating an IPO, the loyalty warrants could be offered along with the shares floated. If the goal is to achieve as broad a loyal shareholder base as possible then the IPO agreement could allow for warrants being granted to all shares at the expiration of the lock-up period.
We have described only the simplest possible form of L-share: a share with a one-time warrant.
attached, which *vests* at the expiration of a given loyalty period. Such a share makes most sense if the goal of the firm is mainly to delay a dividend payment or to secure a temporary alliance with a strategic partner. However, if the firm’s objective is to secure a more permanent loyal shareholder base then—following a practice similar to that adopted by *Air Liquide*—the L-share could be structured to allow for recurrent grants of loyalty warrants at the expiration of each loyalty period, or conceivably even grants of new L-warrants with overlapping loyalty periods (for example a three-year overall loyalty period with new L-warrants granted every six months).

Under such an arrangement, new shareholders over time can also become loyal shareholders, so that the fraction of loyal shareholders at any time remains stable. As with executive and employee stock ownership programs, the firm could also put in place a share repurchase program to undo the increase in share ownership resulting from the exercise of L-warrants. Obviously, how the firm corrects for the growth in outstanding shares will depend on the situation it faces.

**III] BENEFITS AND USES OF L-SHARES**

The structure of the loyalty reward we propose has a number of attractive features. It provides higher rewards to *buy-and-hold* shareholders in turbulent times, as the value of the L-warrant increases with volatility. At the same time the L-warrant does not hinder exit or undermine liquidity when it is most needed. If the company is mismanaged its share price will languish and the L-warrant will be out of the money so that shareholders will not face any penalty if they sell their shares at that point. We now turn to a more detailed discussion of some of the benefits and uses of loyalty rewards.

*Rewarding costly long-term monitoring by a large shareholder*

Block-holders and activist shareholders provide a “public good” to all shareholders when they monitor management and intervene to correct inefficient managerial policies. These shareholders shoulder most of the costs of these activities, but spread the benefits to the entire shareholder base. They are, however, prepared to engage in costly monitoring and interventions only if their own rewards exceed the costs. Unfortunately, successful activism often requires sustained involvement
over a long period of time. In addition, the results of the intervention may only become apparent after a few years. Thus, activist shareholders may only be able to reap the rewards of their interventions after a substantial amount of time has elapsed. This time lag between the costly intervention and the return from the intervention requires compensation, which L-shares are well suited to provide. Indeed, L-shares would allow the firm to discriminate between ordinary (short-termist) shareholders, who do not require special compensation, and interventionist shareholders, who must be compensated for both their costly monitoring and the illiquidity of their equity holdings until the effects of their intervention become visible and can be capitalized.
Box 3: L-Shares to reward monitoring

Consider a firm operating over two time-periods. At time $t = 0$, the firm’s stock price is dragged down by the uncertainty around its future solvency. The firm has 1000 shares outstanding and a debt liability of $D = 900$ to be repaid at time $t = 1$. Investors believe that the firm’s stock may be worth either $1.35$ per share, with probability $2/3$, or $0$ with probability $1/3$ at $t = 1$. That is they believe that the firm’s assets are worth $V = 2250$ with probability $2/3$ and $V = 800$ with probability $1/3$, in which case the firm would go bankrupt at $t = 1$ (since $V < D$). Investors are therefore willing to hold their shares at time $t = 0$ at a price per share no higher than $0.9$. The firm, however, will fail immediately unless the firm’s stock price is at least equal to $1$ at $t = 0$.

Now, long-term investors can monitor the firm’s management at a cost of $0.05$ per share, and through their ‘due diligence’ they can discover how profitable the firm will be in $t = 1$. Should they discover that shares are worth $1.35$ per share it is clearly efficient to let the firm continue until time $t = 1$. But, in the absence of any monitoring by long-term investors the share price will be no higher than $0.9$, too small to allow the firm to continue until time $t = 1$. Long-term investors are only willing to incur the monitoring cost if they can recoup it through a capital gain.

If the firm issues only common stock, then long-term investors can never hope to recoup their due diligence cost. Either they purchase the stock at price $0.9$ before incurring the due diligence cost, in which case they make an expected loss per share equal to their due diligence cost of $0.05$. Or they first incur their due diligence cost and then bid for shares when they learn that they will be worth $1.35$ at $t = 1$. But then the share price is bid up to $1.35$ and again they lose their due diligence cost.

If, however, the firm has issued L-shares then it is possible to discriminate in favor of long-term investors and allow them to recoup their due diligence costs. Suppose that short-term investors sell their shares at the end of the first period, and that long-term investors hold their shares until time $t = 1$. Suppose also that the L-shares grant a warrant (with parity $2$ and strike price $1.2$) to anyone holding the shares until time $t = 1$ with an ex-ante value$^*$ at $t = 0$ of $w = 0.5*2/3*(1.35-1.20) = 0.05$. Long-term investors obtain a reward that recoups the monitoring cost $0.05$.

This example illustrates that L-shares can serve the role of disproportionately rewarding investors who are willing to incur costs to find out what the long-term fundamental value of the firm is likely to be. Even if this information leaks out through their trades, long-term investors will still be able to recoup their information acquisition costs as the value of the information they produce is worth more to them (because of the loyalty reward) than to short-term investors.

$^*$ A simple way of pricing the warrant has been adopted in this discrete framework. It does not take into account any correction for dilution (to this end, one would need to know the proportion of long-term investors). See Box 7 for a more thorough discussion on pricing in a continuous-time framework using a classical Black-Scholes style warrant pricing formula.
Postponing a costly dividend payment or stock repurchase

In times of financial stress, firms in need of cash may want to temporarily suspend a costly dividend payment, or postpone a planned stock repurchase. Firms are generally loath to cut dividends, as the likely reaction by the market to an announced dividend cut is a sharp decline in stock price. However, as the example of the dividend cut of Florida Power and Light (FPL) in 1994 illustrates, when the economic logic behind the dividend cut is sound and when the change in dividend policy is communicated well to the market then the decline in stock price may only be temporary. One notable feature of FPL’s dividend cut policy was to accompany the announced cut with a partially offsetting stock repurchase, which had the effect of dampening the negative price reaction but also, unfortunately, undid the cut to a large extent. An alternative, more logical, approach could have been to substitute a dividend payment with an L-share offer, which would have simply moved the payment to shareholders later in time, in a state of the world when the firm was in better shape.

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Box 4: The Michelin Case

By 1991, Michelin’s balance sheet had been weakened by an increase of debt since the acquisition of Uniroyal Goodrich in a deal worth $1.5 billion (among which Michelin assumed $810 million in debt). Michelin, which had recorded a $4.8 billion loss in 1990 cut its dividend program but decided to grant L-shares (in the form of a warrant) to compensate loyal shareholders for this loss of income. Specifically, Michelin granted a warrant for every 10 shares held on December 24th 1991. The call-warrant was exercisable at a four-year horizon (December 31st 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. In addition to the free warrant, Michelin proposed a “fidelity bonus” to all the shareholders who held on to their shares for the two year period between 1991 and 1993 with the same characteristics (parity, maturity, etc.) and with two conditions: the warrant could be exercised only by those shareholders who would have held on to their shares for the two years (without any interruption) and who did exercise the classic warrant.

This highly innovative move by Michelin was motivated by its management at the time as a way of saving precious cash reserves during a difficult period and of compensating and rewarding those shareholders who would remain loyal to the firm during the difficult transition period. 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]”
Securing a strategic alliance

In practice strategic investments often involve lock-up provisions for a period of time or early redemption penalties. L-shares can be seen as achieving the same objective with a “carrot” as opposed to a “stick”. Granting L-shares to a strategic investor when the firm is going through a period of financial stress is also a way of signaling to the market the strength of the investor’s commitment and his belief in the ultimate turnaround of the company. Thus, when Warren Buffet made a critical equity investment (which had some characteristics resembling an L-share) in Goldman Sachs in the midst of the financial crisis he was able to send a strong message to the market that he believed that Goldman Sachs would pull through. Ironically, an unintended aspect of the TARP equity injections in the largest financial institutions during the crisis (namely, the warrants granted to the government) also had L-share characteristics. While the U.S. treasury’s concern was mainly to disguise the size of the equity stakes the government was taking in some of the banks, the effects of the warrant grants was similar to those of an L-share investment.

Facilitating a share issue

Book-building, under-pricing and flipping are integral parts of the equity offering process. Firms and underwriters’ main concerns with IPOs are typically to generate enough interest in an issue, without excessive under-pricing and flipping. During an IPO the last thing the issuer wants to see is shareholders getting in and out just to make a quick profit from the under-pricing. Interestingly, L-shares could be an effective response to those concerns. Buy-and-hold investors would be more willing to subscribe to an L-share issue, thus reducing all these concerns in one stroke. An interesting precedent for such an offering is the former mutual insurance company Standard Life issue which offered a form of loyalty share to all its mutual shareholders between its IPO and the first anniversary of the IPO. The parity of the L-share was 1 for 20.
IV] THE EFFECTS OF LOYALTY SHARE ISSUES ON THE MARKET

In this section we discuss the likely effects of the introduction of loyalty rewards on the market for the company’s stock, focusing on valuation, liquidity and volatility in particular. This discussion is based both on our own analysis and on feedback we received from other scholars as well as a number of asset managers and corporate issuers.

Transfer of Wealth from short-term to long-term investors

It is possible that the introduction of loyalty rewards could result in a transfer of wealth from short-term to long-term shareholders. This effect follows directly from simple Modigliani and Miller logic, if one assumes that aggregate equity value is a given constant amount that is unaffected by the introduction of L-shares. In the example illustrated in Box 2 the value per share before any loyalty reward is introduced is $100, and the value of the loyalty warrant to long-term shareholders is $2. Suppose that there are 10 shareholders, so that the total capitalization of the firm before a loyalty reward is introduced is $1000. Suppose, in addition, that this total value remains constant after the

Box 5: ESG Factors, Integrated Reports, Fundamental Financial Analysis and the Proper Shareholder Basis

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. Moreover, Eccles, Ioannou and Serafeim (2011) have highlighted that “sustainable companies” significantly outperformed in the long-run their counterparts which have not pursued these policies.

In that perspective, more and more companies are implementing integrated reports in order to deliver a more complete picture of business value to the investors. But this long-term perspective has to match with the right shareholder basis as, otherwise, companies are carrying the risk of implementing strategies (and communication) that does not fit with their investors’ time horizons. Corporates could therefore combine integrated reports and L-Shares in an attempt to align as much as possible the different interests in a long-term perspective.
introduction of the loyalty warrant. Then if all 10 shareholders are buy-and-hold investors they are all getting the $2 reward, which essentially comes out of their pockets, so that their shares continue to be worth $100 each. Similarly, if all 10 shareholders are short-term investors none of them gets the $2 reward, so that again each of them can sell their shares at the price without any loyalty reward of $100. But suppose now that one of the 10 shareholders is a buy-and-hold investor, while the remaining 9 are short-term holders. Then the loyal shareholder gets the $2 reward, which is paid out by the firm, so that the value of each share drops to $99.80. In this situation there is a transfer of 20 cents from the nine short-term shareholders to the loyal shareholder, who ends up with a total value for her investment of $101.80.

The size of the transfer and whether it occurs at all in equilibrium depends, of course, on the behavior of shareholders and on each shareholder’s ability to accurately predict whether she will be more or less loyal than the average shareholder. If all shareholders can tell for sure whether they are able to hold the share for three years or not, then all that will happen in equilibrium is that the 9 short-term shareholders will sell their shares to 9 other buy-and-hold shareholders for the initial price of $100 and there is no transfer. At that price loyal shareholders are just indifferent between holding the stock or not and short-term shareholders are better off selling. More generally, the introduction of the loyalty reward is likely to simply result in a trade between the most loyal shareholders, who are buyers, and the least loyal shareholders, who are sellers, and the equilibrium price will then simply reflect the expected value of the stock to the most loyal shareholders.

Thus a transfer of wealth between short-term and long-term shareholders will only occur if the short-term shareholders over-estimate their ability to remain loyal or the long-term shareholders under-estimate the probability that they will be able to hold the stock for the entire loyalty period.

But there is likely to be value creation resulting from this re-composition of the shareholder base towards more long-term oriented shareholders. Interestingly, those who ought to be able to appropriate this added value are the initial shareholders, who introduce the loyalty reward. And they ought to benefit irrespective of whether they are short-term or long-term oriented. The former benefit by selling their shares at a profit to long-term shareholders, and the latter simply by holding
on to their shares. Overall, the introduction of loyalty rewards ought to induce a shift towards a longer horizon for all shareholders. Buy-and-hold shareholders will focus on the reward they are hoping to receive at the end of the loyalty period and short-term investors will ask themselves how much the shares together with the loyalty reward are worth to the long-term shareholders they sell to with prior to the inception of the L-shares.

One specific transfer issue of potential concern is when a controlling (long-term) block-holder stands to benefit from the introduction of L-shares. Could this be a simple way for the controlling shareholder of expropriating minority shareholders? In other words, could this be just another related-party transaction? If minority shareholders are able to sell their shares to other long-term investors then there ought to be no transfer. All the introduction of L-shares would bring about is a uniform long-term shareholder base. But, suppose that for some reason there are no other long-term shareholders willing to buy the L-shares. Then the introduction of L-shares could indeed result in a positive transfer from minority short-term shareholders to the controlling long-term shareholder. Moreover, it is possible that in such a situation the only motive for introducing L-shares could be to engineer such an unwarranted transfer. Obviously, in this situation the whole purpose of loyalty rewards would be abused. This is why we suggest that in companies where there is a large controlling stake it may be desirable to require that there should not only be shareholder approval but also that a majority of the minority shareholders must approve the introduction of L-shares.
Box 6 : Wealth transfers, Financial Transaction Tax or Loyalty Shares?

As a debate over a Financial Transaction Tax rages, L-Shares could provide an appropriate alternative

The original idea for a Tobin Tax in the 1970s was to slow foreign exchange markets by throwing in “some sand.” It was believed increasing the cost of speculative transactions would mean that prices could better reflect fundamental and encourage long-term thinking.

The Financial Transaction Tax to be implemented under enhanced cooperation by 11 Eurozone member states is, under the initially proposed rates (0.1% on the face values of shares and bonds and 0.01% for derivatives), expected by the Commission to deliver revenues of 30-35 billion euros a year. Two of its stated core objectives are “(to) ensure that the financial sector makes a fair and substantial contribution to public revenues” and “(to) support regulatory measures in encouraging the financial sector to engage in more responsible activities, geared towards the real economy.”

If a Financial Transaction Tax (FTT) already exists in many countries such as Taiwan, South Korea, Hong Kong or the United Kingdom, the current project is unprecedented by its scope (the “resident principle” was adopted to limit avoidance of the tax) and faces fierce opposition.

Such a tax does not target per se the traditional buy side but nor does it reward them for the positive impact they can play on the market and on the real economy through thorough fundamental analysis and careful due diligence.

Where the buy side with a long-term horizon would be the beneficiaries over a transfer channeled by the State

One key effect of the introduction of L-shares is a possible transfer of wealth from short-term to loyal shareholders. If the introduction of L-shares induces value creation through a more long-term outlook, then this value creation will also be shared by short-termist shareholders.

To this regard, loyalty shares would go a long way toward encouraging the financial sector to engage in more responsible activities while avoiding the many potential drawbacks of a FTT. Moreover, one can argue that the ultimate beneficiaries would be asset owners,

At a time when most asset managers struggle to seek Beta, L-shares could help increase long-term managers’ returns. Note however that the opportunity provided by the FTT debate gives the buy side a quasi unique bargaining power to embrace a product that both has the power to decrease the cost of capital of the companies they invest in and increase returns.

Market Liquidity

Another concern with a Loyalty-share program is that the greater incentives to buy and hold during the loyalty period might lead to a substantial reduction in underlying liquidity of the stock. It is probably safe to predict that the introduction of L-shares will have a negative impact on trading at least during the loyalty period. Partly that is the point of L-shares. Given that there is too much stock trading anyway and too much short-term speculation this cannot be an entirely bad development.

Having said this, there are at least two important countervailing effects that mitigate this concern for reduced liquidity. First, dynamic hedging of the L-warrants by traders will increase liquidity of the underlying stock. That is, once the L-warrants vest and are tradable, or in anticipation of the vesting of the warrants, liquidity is generated by the traders of the warrants who will seek to hedge their option position by holding an offsetting replicating portfolio, which combines proportions of debt and the underlying stock. Second, the warrants only have real value if the underlying share price increases. Therefore, the potential reduction in liquidity would only occur in the event of an increase in share price, that is to say, when the reduced liquidity is not too much of a problem.

Stock Price Volatility, Short-selling and the Costs of Borrowing Shares

If secondary-market liquidity is affected by the introduction of L-shares then so must volatility. Again, the effects of L-shares on volatility are likely to depend on the time window: whether the L-shares are in the loyalty period or in the exercise period. During the Exercise Period, L-shares ought to reduce volatility, as some long-term shareholders may sell their warrants to traders who, as explained above, are likely to manage the option in a delta neutral way (which involves taking counter-cyclical hedging positions). By doing so, traders will automatically contribute to a reduction in volatility.

During the Loyalty Period, volatility could increase slightly as a result of the reduced liquidity. Another reason why volatility may increase is that long-term investors may no longer be willing to enter share-lending transactions during the loyalty period should lending result their losing the right to the
L-warrant.

**Box 7: Pricing Loyalty-Shares**

Even though there is no precedent for the valuation of this instrument, the fair-value based pricing of L-shares ought to be straightforward as there exist similar instruments, such as executive stock-options (ESOs) that vest only after a pre-specified period of time and cannot be sold, that are routinely priced. Drawing an analogy with these options, the approach to valuation of an L-warrant could be that the L-warrant is worth the same as a classic warrant multiplied by the probability that the warrant vests at the end of the loyalty period. Like for the valuation of ESOs, the higher the forfeiture rate, the higher the rate of reduction in option value and the rate of reduction must also change depending on vesting period, the longer the vesting period, the more significant impact of forfeitures. Thus, a valuation formula along the following lines may be appropriate:

\[
\text{Fair value L-warrant} = \text{Call Option Model} \times \text{Occurrence Probability}
\]

\[
\text{With Call Option Model (vesting + maturity, spot, strike, dividend yield, interest rates, implied volatility).}
\]

\[
\text{Occurrence Probability} = \frac{\text{Stable Capital}}{\text{Total Float}} + \frac{\text{Turnover Capital}}{\text{Total Float}} \times \max(1 - (\text{Annual Turnover Rate} \times \text{Loyalty Period in Years}), 0)
\]

Where:

- Turnover Capital: is the estimated share of equity owned by short-term investors;
- Stable Capital: is the estimated share of equity owned by loyal shareholders;
- Total Float: is the total number of outstanding shares.

Annual turnover rate is the average historic turnover rate.

This pricing is similar to the one for executive stock-options in the sense that it takes into account at inception an estimate of the future behavior of shareholders (loyalty for the L-shares and turn-over before stock-options vest for executives).

With respect to L-shares, there may also be an interesting potential novel factor related to the correlation between the volatility of the underlying stock and the turnover of share ownership: the higher the volatility, the higher the turnover is likely to be. Therefore, in contrast to the classical positive effect of volatility on option value, a loyalty-warrant’s pre-vesting value could conceivably be lower for volatile stocks.

A more sophisticated pricing of L-shares, may also allow for the L-warrant price to go down if the share price goes down, as L-share owners are then more likely to sell their L-shares. The L-warrant would then be akin to a so-called *down-and-out* call-option.

In sum, although there would be no secondary market for L-warrants during the loyalty period, the valuation of these warrants can nevertheless be done using pricing methods similar to those applied to value executive stock-options, which are also not traded (see e.g. Hull and White, 2004).
V] IMPLEMENTING LOYALTY-SHARES

Any firm contemplating a loyalty reward for its shareholders will face a number of institutional implementation issues, ranging from the accounting and tax treatment of these rewards to the issue of how the firm keeps track of its loyal shareholder base. As we discuss below, none of these practical considerations are insurmountable.

Accounting treatment of L-Shares
As with any new financial instrument, L-shares obviously do not have a well-defined accounting treatment. Still, reasoning by analogy one may argue that grants of L-warrants are similar to dividend payments out of reported earnings. As such, loyalty rewards should therefore not affect the income statement. Thus, consistent with both US GAAP and with IFRS, the attribution of an L-share should have no impact on reported earnings per share. Moreover, under both US GAAP and IFRS, L-shares could be booked as equity instruments. It is likely that L-shares would be booked as IAS32 equity instruments under IFRS because the strike price and the number of underlying shares, which will be physically delivered, are both fixed. According to paragraph 16 of IAS32, the warrant should “be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments” to be recognized as an equity instrument. Failing these requirements could be detrimental, as L-shares may be considered as liability derivative instruments and thus would have to be re-valued at each reporting date, which would impact the income statement. Furthermore, L-shares also meet US GAAP equity instruments criteria: the strike price and the number of underlying shares are both fixed (ASC 815-40-15-7C), and there is no cash settlement alternative (ASC 815-40-25) since the underlying shares are already registered and the L-Share contract is a free-standing contract (ASC 815-40-15).

Tracking Loyalty
In Europe, the first step is to attribute a new ISIN code to all the initial holders of L-shares (call it, say, the L-ISIN code). Those shareholders who hold on to their L-shares until the expiration of the
loyalty period (who are identified by the L-ISIN number that has been attributed to them) would then receive the promised L-warrant. The second step is that the new shareholders, who acquire shares from initial L-shareholders who sold their shares before the loyalty period is over, would be assigned a different ISIN number (the one that identifies underlying common shares) by the custodian of the L-shares. With the switch in ISIN code, the right to the L-warrant cannot be transferred, so that ‘disloyal’ shareholders would automatically lose their right to a L-warrant if they trade before the loyalty period has expired. With this mechanism the issuer would be able to track loyalty and reward the long-term investors without compromising shareholder anonymity.

From a U.S. perspective, the simplest way of tracking holding periods in order to identify loyal shareholders would be for the company to retain the services of a transfer agent who would act as the issuer’s warrant agent. The retained transfer agent would maintain a register of warrant holders and would ensure that no transfers are executed until the end of the holding period, when the positions would be unblocked. Another approach might be to issue registered warrants where the warrants only become exercisable, and the underlying stock only becomes transferable, after a three-year holding period.

**Treatment of L-Shares in an M&A Transaction**

A firm having granted loyalty rewards to its shareholders may be faced with a number of important events during the loyalty period. Among the most important events are bankruptcy and a merger transaction. How should loyalty shares take account of such events? Consider first how L-shares ought to be adapted to an acquisition during the loyalty period. In this situation, the exchange of shares is not an individual decision of a shareholder and cannot be attributed to any lack of loyalty towards the company. It therefore makes sense to adapt the terms of the loyalty share to account for the unusual circumstances leading to the trade in shares. One possibility could be to accelerate the maturity of the loyalty period in the event of an acquisition offer on the company: then long-term shareholders would be able to exercise their L-warrants in advance of the acquisition. Another option is to simply cancel the loyalty reward in such an event. Whatever is the chosen design by the firm the general principle ought to be that the loyalty reward does not create an artificial barrier to an acquisition. The simplest way of achieving this is just to cancel the reward in the event of an offer.
during the loyalty period, but there could be other less drastic steps taken such as the acceleration of the loyalty award to the day of the acquisition offer.

Second, note that if an offer comes after the expiration of the loyalty period then there is no longer any risk of entrenchment, as all shareholders are then on an equal footing with respect to the acquisition. Finally, should the firm itself initiate an acquisition involving a share exchange, which would require shareholder approval, then it does not seem that the existence of L-shares creates any difficulties given that the shareholders of the acquiring firm do not need to trade their shares.

**Voting Rights of L-Shareholders**

Corporate governance is likely to be enhanced if more say is given to loyal shareholders, who care more about the long-term prospects of the corporation and are less likely to try to time equity markets to take advantage of a short-term speculative phase. It thus makes a lot of sense to also reward loyal shareholders with more control rights, as Dallas (2012) among others has proposed. Although we are not proposing rewards to long-term shareholders in terms of greater voting rights it is worth noting that even under the one-share-one vote terms we implicitly outlined above, loyal shareholders automatically stand to gain more control as they exercise their warrants. The question then is whether it is desirable to give long-term shareholders even more control rights. Our view is that the answer depends on the type of long-term investor the company is able to attract. If it is a large actively engaged investor it could make sense to also grant that investor more voting rights. If, on the other hand, long-term investors remain largely passive there may not be much of a gain from also giving them more voting rights.

**Disclosure Requirements for L-Shares**

Given that Loyalty-shares grant warrants at the expiration of a loyalty period that in all other respects are like ordinary warrants it makes sense to treat these warrants the same way as ordinary warrants in terms of disclosure. On the other hand, if the L-shares are granted in a restricted offer to a strategic investor then disclosure of the owner’s identity and stake would be required as soon as the owner’s stake exceeds the 5% ownership threshold.
**Tax Treatment**

There is only a special tax event if the warrant is granted at the end of the loyalty period and exercised. Otherwise there should be no tax deduction in the event that the warrant is not granted or exercised. The taxable capital gain on the shares from the exercise of the warrants should be the difference between the price at which the share is sold and the strike price. More specifically, under French tax law we could argue that the standard capital gain tax treatment should apply when the L-warrant is sold.

**Corporate Law Issues**

Under Delaware corporate law, L-shares could be issued through a subscription rights offering. All stockholders would be entitled to subscribe, for a *de minimis* amount (at least equal to the par value of the company’s common stock), for warrants that would become exercisable and transferable only upon satisfaction of the requisite holding period. The company’s board of directors would have to determine that there was a valid business purpose or benefit for the company’s stockholders as a result of undertaking the rights offering. The company would have to comply with the rules and regulations applicable to listed companies in connection with a rights offering, such as the requirement to publicly announce a record date (date by which an investor must possess stocks to be eligible to a warrant), and also prepare and file with the Securities and Exchange Commission a registration statement covering the warrants and the underlying shares represented by the subscription rights.

Under French and Dutch Law a company can grant loyalty dividends (*dividende majoré*) or additional voting rights that are subject to a minimum holding period (two-years or longer). The issuance of an L-warrant can be seen as legally equivalent to granting a loyalty dividend, but may be subject to shareholder approval. There is not always a specific reference to loyalty rewards in other countries’ corporate law but it seems plausible that the precedents of the U.S., French or Dutch laws will serve as a guide to the legal treatment of loyalty rewards in those countries.
**Decoupling and Arbitrage**

A question that often arises in discussions on L-shares is whether holders of the shares may be able to undo or ‘decouple’ the right to an L-warrant from the loyalty holding-obligation. And if so, whether their ability to arbitrage the L-shares defeats the purpose of L-shares altogether. Conceivably, holders of L-shares might be able to trade their shares forward, after the expiration of the loyalty period, and thus collect the L-warrant while still being able to cash in on their stock sale before the expiration of the loyalty period. Alternatively, an intermediary—such as a closed-end fund specializing in L-shares—might hold the L-shares, while allowing investors to engage in unrestricted secondary-market trades in the intermediary’s stock. In a frictionless financial market such schemes could undo L-shares, but then the worst possible outcome is just the status-quo.

But we do not have frictionless markets. Note first that under a forward trade in L-shares the counterparty to the forward trade will probably have to borrow the shares for hedging purposes. This will inevitably add a cost to the transaction, especially if long-term shareholders hoping to obtain a loyalty reward are unable or unwilling to lend their shares. Second, these trades could involve a counterparty risk, which would also discourage such trades. As for setting up an intermediary fund (to take uniquely advantage of the L-Warrant), it will be a great day for long-term investors and L-shares when such a fund becomes profitable, for it will mean that a substantial fraction of stock markets will be in the form of L-shares. The point simply is that while this is a theoretical possibility it will not be a concern for the foreseeable future.
Box 8: L-Shares and the other types of rewards for loyalty

There are already existing examples of mechanisms to reward patient investors:

- **Additional dividends:** L'Oréal offers a Loyalty bonus to registered shareholders which grants a 10% incremental dividend to all shareholders who have held registered shares for a continuous period of at least two years, up to a limit of 0.5% of nominal capital per shareholder. The French firm Electricité de France and the French bank Crédit Agricole both agreed to implement similar schemes.

- **Additional shares:** Air Liquide, offered both a dividend and a share bonus to all shareholders who kept continuously their shares for at least two years. 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. It is as well very common to find same kind of offers within privatizations in the UK or France.

- **Additional voting rights:** Aflac and The J.M. Smucker Company both have shares of the Company's Common stock entitled to one vote per share until they have been held by the same beneficial owner for a continuous period greater than 48 months, at which time they become entitled to 10 votes per shares.

L-shares obviously belong to the same family as the solutions mentioned above but deliver additional outcomes when considering the 4 criteria detailed below:

- **Liquidity:** one of the major concerns related to any rewards delivered to a specific class of shareholders is a possible related loss of liquidity. The warrants will lead to an additional liquidity due to the hedging activities of the traders (that will likely become the owners after the loyalty period).

- **Volatility:** none of the other solutions have an impact on volatility while the warrants will lead to a decrease of the volatility (through the hedging activities of the traders).

- **Alignment with management:** L-Shares can be perceived as stock-options delivered to long term investors and thus offering an additional alignment of interest with top management being the beneficiaries of stock-options as well.

- **CEO "retrenchment":** L-warrants are out-of-the-money when the firm continues to do badly and its share price declines. In that event, holders of L-shares have little incentive to hold on to their shares until expiration of the loyalty period, so that a change in control is easier to achieve for an activist shareholder buying shares in the secondary market. CEOs are more protected with the solutions which are less sensitive to a share price increase.

Moreover, we believe that a global tax treatment, dividend policies and voting rights can be used to reward patient investors but all have important drawbacks:

- **Tax treatment:** L-shares act as a tax at the firm level, so that investors cannot circumvent it.

- **Dividends:** a loyalty dividend rewards patient investors whatever the stock-price is, possible issue of CEO retrenchment and lack of alignment, does not reduce volatility, does not increase liquidity and in many countries does not benefit from a favorable tax treatment.

- **Voting rights:** long-term investors are not always using their voting rights (in contrast to more short-term activist hedge funds). It is therefore not obvious that more voting rights constitute a real incentive for long-term investors.

Last but not least, L-warrants also increase in value when the underlying stock is more volatile, thus providing a higher reward to long-term investors in more turbulent times, when a loyal shareholder base is more valuable to the firm.

<table>
<thead>
<tr>
<th>Extra Share</th>
<th>Extra Voting Right</th>
<th>Extra Dividend</th>
<th>L-Warrants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impact on Liquidity</td>
<td>Decrease (if stock price rises)</td>
<td>Decrease (constant)</td>
<td>Decrease (constant)</td>
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<tr>
<td>Impact on Volatility</td>
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<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Impact on Share Borrowing Cost</td>
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<tr>
<td>Better Alignment with Management (3)</td>
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<tr>
<td>CEO &quot;Retrenchment&quot;</td>
<td>Light</td>
<td>Possible</td>
<td>Light</td>
</tr>
</tbody>
</table>

(1) Due to the hedging of traders
(2) After the Loyalty Period
(3) Assuming the management is entitled to stock options
VIII] CONCLUSION

Loyalty-shares can provide one simple contractual innovation to help restore the balance between long-term investors and short-term speculators. The main advantage of our proposed approach is that it is up to the companies to decide whether they want to experiment with such loyalty rewards and how they want to tailor the rewards to best fit their individual situation. There are already some precedents of a few companies that have toyed with loyalty dividends (see Box 8) and these companies do not appear to have suffered from the introduction of this financial innovation. We would like to draw attention to these experiments and believe that with relatively small modifications loyalty shares could be an answer to the current short-termism of financial markets.

Our discussions with corporate issuers and asset managers indicate that there is interest in the idea of loyalty rewards and L-shares. The corporate issuers we have had discussions with agree that L-shares would help alleviate short-termist shareholder pressures, and long-term oriented asset managers would value receiving a reward for their loyalty. But, inevitably there are also some concerns and reservations. One often voiced concern is with entrenchment and the worry that L-shares would further entrench management. We have argued above that this concern can be addressed by designing the L-share in such a way that it does not deter disciplinary takeovers and the like. Another concern we have heard is that a reward for simply being a buy-and-hold investor does not address the issue of lack of engagement by shareholders. While engaged shareholders are likely to be buy-and-hold investors at least during their period of engagement, and therefore are likely to be beneficiaries of loyalty programs, not all buy-and-hold investors will be engaged. Thus, although L-shares cannot solve the problem of lack of engagement they do at least help in providing an indirect reward for engagement by rewarding buy-and-hold behavior. Finally, a major immediate obstacle that corporate issuers have repeatedly brought up is the issue of ‘signaling’. Just as with ordinary share offerings, issuers worry about the potential negative signal the granting of loyalty rewards sends to the market. They ask: won’t the market interpret this action negatively? And they suggest that the pioneers in launching loyalty shares will be market leaders who can take advantage of the market’s goodwill.
REFERENCES


