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Curbing Short-Termism in Corporate America: Focus on Executive Compensation

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INTRODUCTION

Short-termism—defined as judging company performance over a brief time period—has recently come under a barrage of criticisms from multiple sources—business groups, think tanks, academics and lawyers.[1] The emphasis on short-termism is said to be destructive to American businesses—discouraging corporate executives from investing in long-term projects and sustainable growth, while encouraging them to inflate reports of quarterly earnings.

The critics of short-termism argue that rapid trading by shareholders of public companies is heavily pressuring company executives to focus on current earnings rather than long-term performance. According to these critics, such a short-term focus of corporate executives is exacerbated by the expanding rights of shareholders relative to directors and by the compensation rewards for brief increases in stock prices.

Yet, long-termism seems alive and well in important aspects of corporate America. Investors have gobbled up initial public offerings of fledgling companies with growing revenues and no profits—presumably on the belief that those revenues will translate into profits over the next decade. Similarly, public shareholders have highly valued shares of biotech companies, like Amgen and Genentech, which have been investing large sums in long-term drug development.

1 For example: The Aspen Institute Business & Society Program, "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management," 2009; Policy and Impact Committee of the Committee for Economic Development, "Restoring Trust in Corporate Governance: The Six Essential Tasks of Boards of Directors and Business Leaders," January 25, 2010; CFA Institute, "Breaking the Short-Term Cycle," July 2006; and Martin Lipton, "Takeover Bids in the Target's Boardroom," *Business Lawyer*, vol. 35, no.1 (November 1979), p. 101.

To better understand the arguments on these topics, it is necessary to move away from looking at the "average" institutional investor and move toward looking at three subsets of investors: dedicated, transient and quasi-indexers. Most of the damaging effects of short-termism derive from the behavior of "transient" institutional ownership. Thus, the first section of this paper will dissect the composition of trading by different types of public shareholders. It will then go on to evaluate the three most popular proposals to curb short-termism[2]:

» Altering the compensation arrangements of asset managers and corporate executives,
» Constraining the rapid trading of stocks by public investors, and
» Limiting the influence of institutional shareholders on corporate governance.

This paper will conclude that:

» The most effective way to curb short-termism would be to lengthen the time horizons in the compensation packages of asset managers and corporate executives,

» Other effective measures to curb short-termism would be to limit "empty voting" by investors not owning shares and to discourage companies from publically projecting their quarterly earnings,

» The proposals to constrain rapid trading, even if they reduced trading volume, would not significantly change the business plans of most corporations, and

» The benefits from most proposals to reduce the governance influence of institutional investors would be outweighed by the costs of undermining corporate accountability.

2 For a comprehensive review of proposals to curb short-termism, see Lynne Dallas, "Short-Termism, the Financial Crisis and Corporate Governance," *Journal of Corporation Law*, vol. 37, no. 2 (February 2012), p. 264.

TRADING PATTERNS OF EQUITY INVESTORS

The criticisms of short-termism are based on several trends over the last few decades: the expanded volume of equity trading,[3] the increase in stock turnover[4] and the shorter holding period of investors.[5] During the last few years, however, the trading volume[6] and turnover rate[7] for US stocks has decreased significantly.[8]

In any event, these data reflect *average* investor behavior. US institutional investors should be divided into three distinct categories on the basis of continuity of share ownership within a portfolio and size of stakes in portfolio companies. According to Professor Bushee, 61 percent of institutional shareholders were "quasi-indexers", 8 percent were "dedicated" investors and 31 percent were "transient investors."[9]

- "Transient" institutional investors hold well-diversified portfolios of publicly traded securities: they pursue short-term profits through high turnover of their portfolios and heavy use of momentum trading.
- "Dedicated" institutional investors have substantial investments in a relatively small number of portfolio companies; they hold a high percentage (often over 75 percent) of their portfolio shares for two years or more.
- "Quasi-indexers" fall between the two other categories of institutional investors; they have highly diversified portfolios of publicly traded securities, and also a high degree of ownership continuity since they seldom trade.

3 The average daily trading volume in NYSE-listed stocks rose from 2.1 billion shares in 2005 to 5.9 billion shares in 2009. See Securities and Exchange Commission, "Concept Release on Equity Market Structure," Securities Exchange Act Release No. 34-61358 (January 14, 2010), 17 CFR Part 242.

4 The average annual turnover for shares of NYSE-listed stocks has increased from 10 percent to 30 percent during the 1940-80 period to more than 100 percent in 2005. See CFA Institute, "Breaking the Short-Term Cycle," supra Note 1, at 11-12; NYSE, "Report of the New York Stock Exchange Commission on Corporate Governance," September 23, 2010, p. 12-13.

5 The average holding period for US stocks has fallen from seven years in 1960 to two years in 1992 to less than eight months in 2007. See Yvan Allaire and Mihaela Firsirotu, "Hedge Funds as Activist Shareholders: Passing Phenomenon or Grave-Diggers of Public Corporations?," Working Paper (March 2007), p. 3.

6 NYSEData.com Factbook, "Consolidated Volume in NYSE-listed stocks," http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=3139&category=3, accessed January 2014.

7 NYSEData.com Factbook, "NYSE Group Turnover," http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=2992&category=3, accessed January 2014.

8 The holding period for US investors has remained roughly constant during the last few years. See Black Rock Investment Institute, "Means, Ends and Dividends: Dividend Investing in a New World of Lower Yields and Longer Lives," March 2012, p. 7.

9 Brian Bushee, "Identifying and Attracting the 'Right' Investors: Evidence on the Behaviour of Institutional Investors," *Journal of Applied Corporate Finance*, vol. 16, no.4 (Fall 2004), p. 30-31.

The crucial point is that most of the damaging effects of short-termism derive from the behavior of "transient" institutional ownership—and not from "dedicated" institutions or "quasi-indexers." Here are a few examples of empirical research showing the significant differential impact on corporate behavior of "transient" investors versus other investor types:

» When the ownership of publicly traded companies is dominated by "transient" institutions, these companies are more likely to cut research and development expenses to meet short-term earnings targets than companies dominated by "dedicated" institutions and "quasi-indexers."[10]

» "Transient" ownership is highly correlated with the likelihood of accrual errors and financial restatements by public companies, but neither is strongly associated with a high degree of ownership by "dedicated" institutions.[11]

» Aggregate institutional ownership is significantly correlated with material weakness in internal controls at public companies, but this significant correlation is mainly attributable to "transient" institutional ownership.[12]

In short, while average trading volumes in the U.S. stock market have increased and average holding periods have substantially decreased over the last few decades, most of these changes were attributable to "transient" institutional investors. Such "transient" investors trade heavily on technical factors like market momentum, rather than company fundamentals,[13] so they put pressure on the daily stock prices of public companies. However, the majority of public company shares are owned by more stable institutional investors, with lower trading rates and longer holding periods. Such institutions are less interested in short-term trading profits and more focused on monitoring long-term performance of public companies.[14]

In evaluating the various proposals to curb short-termism, we should target the problematic behavior of "transient" investors and avoid hampering the legitimate activities of more stable investors.

10 Bushee, supra Note 9, at 307.

11 Laura Yue Liu and Emma Yan Peng, "Institutional Ownership and Accruals Quality," in *American Accounting Association 2006 Annual Meeting*, Washington DC, August 6-9, 2006; N. Burns, S. Kedia, and M. Lipson, "Institutional Ownership and Monitoring: Evidence from Financial Restatements," *Journal of Corporate Finance*, vol. 16, no. 4 (January 2010), p. 443.

12 Alex P. Tang and Li Xu, "Institutional Ownership and Internal Control Material Weakness," *Quarterly Journal of Finance and Accounting*, vol. 49, no. 2 (Spring 2010), p. 93.

13 Alfred Rappaport, "Economics of Short-Term Performance Obsession," *Financial Analyst Journal*, vol. 61, no. 3 (May/June 2005), p. 65-66.

14 X. Chen, J. Harford and K. Li, "Monitoring: Which Institutions Matter?" *Journal of Financial Economics*, vol. 66, no. 2 (November 2007), p. 279.

Therefore, in evaluating the various proposals to curb short-termism, we should target the problematic behavior of "transient" investors and avoid hampering the legitimate activities of more stable investors.

LENGTHENING THE TIME HORIZON OF EXECUTIVE COMPENSATION

The most effective way to promote a long-term approach in corporate America is by changing prevalent compensation arrangements. To reduce systemic risk in the financial system, all the financial regulators have now identified certain incentive-based compensation as exposing large financial institutions to "excessive" risks, and proposed to prohibit the use of such arrangements in such institutions.[15] After a general discussion of bonus deferrals and measurement periods, this section will evaluate the compensation arrangements of the senior executives at public companies and asset managers.

A. BONUS DEFERRALS AND MEASUREMENT PERIODS

Since the financial crisis of 2008-2009, many public companies and investment managers have increased the portion of the cash bonuses (awarded to their senior executives) that is deferred for several years. Some of these deferrals are now required by bank regulators. Others have become common practice in various industries. In most cases, deferrals of cash bonuses are combined with provisions that allow firms to "claw back" a deferred bonus if certain adverse events occur.

Under the Sarbanes-Oxley Act (SOX), the CEO or CFO must reimburse a public company for any bonus or incentive compensation received on the basis of misconduct resulting in its material non-compliance with SEC financial reporting rules.[16] Similarly, firms may usually claw back a deferred bonus if the relevant executive is later found to have engaged in illegal or unethical activities. Firms may also establish procedures to claw back bonuses if an apparently profitable deal subsequently blows up.

Thus, bonus deferrals and associated claw backs are an effective way to encourage a longer perspective than one year. The combination penalizes executives who create successes in one year which, over the next few years, turn out to be failures or based on inaccurate numbers.

Nevertheless, the measurement period for bonus performance remains one year in most firms. This is simply too short—as executives may make a fortuitous decision, or be in the

15 Section 956, Sarbanes-Oxley Act of 2002. The federal regulators of banks and other financial institutions have proposed rules requiring the report of incentive-based compensation arrangements by a "covered financial institution" to its primary regulator and prohibiting certain such arrangements if they expose that institution to inappropriate risks. Incentive-Based Compensation Arrangements, 76 Fed Reg. 21 (April 14, 2011).

16 Section 304(a), Sarbanes-Oxley Act of 2002, 107th Congress, Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002.

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right place at the right time. To reward superior skill, rather than luck, the bonuses of corporate executives and investment managers should be based on their performance over the last three years.

B. COMPENSATION OF CORPORATE EXECUTIVES

The compensation term of many corporate executives is too short. The average duration until senior corporate executives were entitled to receive their pay was 1.18 years, according to a recent study.[17] In that study, executive pay consisted of salary, cash bonus, stock options and restricted share grants.

Stock options, in particular, have been criticized as encouraging executives to manipulate short-term earnings and stock prices.[18] After options vest, company executives have an incentive to push up the company's share price for a few days—so they can exercise their options and immediately sell their shares. However, this incentive can be fundamentally altered by requiring company executives to retain most of their shares obtained through options for several years or until they retire. Company executives should be allowed to sell a limited number of such shares to cover their taxes due on exercising these options.

Since the financial crisis, many companies have shifted from stock options to restricted share grants. But time-vested shares do not provide a strong alignment between executives and shareholder interests. If the stock price declines, the executive still receives substantial economic gain from the share grant. By contrast, the company's shareholders have lost economic value due to the stock price decline.

To achieve better alignment of shareholder and executive interests, companies should grant restricted shares that vest only if certain performance conditions are met.[19] These conditions could include, for example, increasing earnings per share or cash flows by specific percentages over 3 years. If these performance conditions are met and the restricted shares vest, executives should be required to hold the shares for several years or until retirement—except for shares necessary to meet current tax obligations.

17 Radhakrishnan Gopalan et al, "The Optimal Duration of Executive Compensation Theory and Evidence," Working Paper, April 10 2010, http://www.olin.wustl.edu/docs/Faculty/PayDuration.pdf, accessed January 2014.

18 See Dallas, supra Note 2, at 357.

19 Performance vested shares also have substantial tax advantages over time-vested shares. See section 162(m) of the Internal Revenue Code.

C. COMPENSATION OF ASSET MANAGERS

Commentators have criticized the investment industry for thinking "in relatively short periods of time, a month or a quarter."[20] Although the bonuses of some portfolio managers are based on one-year performance, bonuses in most large asset management firms are based on a combination of performance over the most recent 1, 3 and 5 years—with the heaviest weighting on 3 years. A focus on performance beyond 3 years seems unrealistic given the fast-changing nature of securities and the time horizons of many clients of asset managers.

By contrast, the incentive fees of mutual funds do not encourage short-term risk taking.

To discourage portfolio managers from taking excessive risk to boost short-term results, many asset management firms use risk-adjusted measures of performance. For example, portfolios with leverage will tend to do much better or worse than non-leveraged portfolios. Similarly, portfolios dominated by volatile stocks will rise higher in up markets, and fall lower in down markets, than portfolios comprised mainly of stable stocks.

Incentive fees can also encourage short-termism depending on their design. The typical incentive fee for a hedge fund manager is 20 percent of net realized capital gains each year—with no direct penalty for realized losses. Instead, the manager does not receive any incentive fee unless the hedge fund's returns over time exceed an aggregate high-water mark such as 6 percent or 7 percent per year.

Such an incentive fee design does encourage a hedge fund to try to hit "home runs" in the short run. If the hedge fund realizes a big capital gain in the first year or two, then the manager receives a large incentive fee. On the other hand, if the hedge fund realizes big capital losses in the initial few years, the manager is not likely to earn an incentive fee, and can respond by deciding to return the fund's assets to its investors.

By contrast, the incentive fees of mutual funds do not encourage short-term risk taking. A mutual fund is allowed to charge an incentive fee only if it is symmetrical and measured against a broad-based index.[21] For instance, if the management fee of a mutual fund increase from 0.5 percent to 0.55 percent when the fund outperforms the S&P 500 by 10 percent, the management fee of that mutual fund must decrease from 0.5 percent to 0.45 percent when the fund underperforms the S&P 500 index by 10 percent.

20 Andrew Clearfield, "With Friends Like These, Who Needs Enemies? The Structure of the Investment Industry," *Corporate Governance*, vol. 13, no. 2 (March 2005), p. 118.

21 Securities and Exchange Commission, Rule 205-3, Investment Advisers Act (April 1, 2012), 17 CFR 275.205-3.

CONSTRAINING THE RAPID TRADING OF STOCKS

To constrain the rapid trading in U.S. stocks, critics of short-termism have proposed that such trading be penalized by transaction taxes, and that extended stock holding periods be rewarded by additional votes. Commentators have also proposed more disclosure to investors about the costs of short-term trading.

A. TAXING SECURITIES TRANSACTIONS

Several economists have recommended that the United States impose a tax on stock transactions in order to reduce stock trading volume. In the view of these economists, a securities transaction tax would increase market efficiency by decreasing "speculative" trading not based on company fundamentals.[22] By contrast, other commentators have expressed concerns that a securities transaction tax would reduce the market's liquidity and hamper some value-adding trading.[23] Commentators have also pointed out that a portion of a securities transaction tax may be paid indirectly by individual beneficiaries of pension funds, who are not "transient" investors.[24]

This paper will not attempt to assess the ultimate merits of a securities transaction tax. Rather, it will point out two practical constraints on implementing such a tax in a manner that helps curb short-termism. First, for a securities transaction tax to apply to "transient" investors and not to stable investors, the tax would have to be limited to matched buys and sells within a relatively brief time period—such as one week, one month or one year. Such a matching requirement would necessarily entail complex design features that would be challenging to administer. For example, if a pension fund held 1,000,000 shares of IBM for 3 years, and then bought and sold 200,000 shares within 3 months, would that 200,000 shares sold be matched against the pension fund's recent or long-term holdings in IBM stock? [25]

Second, and more importantly, a securities transaction tax can be effective only if adopted at the same time by all countries with credible trading markets. If not, most stock trading will quickly migrate to the trading markets *without* a securities transaction tax. Such migration

22 Joseph Stiglitz, "Using Tax Policy to Curb Speculative Trading," *Journal of Financial Services Research*, vol.3 (1989), p. 101; Lawrence Summers and Victoria Summers, "When Financial Markets Work Too Well," Journal of Financial Services Research, vol.3 (1989), p. 261.

23 Paul G. Mahoney, "Is There a Cure for 'Excessive' Trading?," Virginia Law Review, vol. 81, no. 3 (April 1995): 713.

24 Mark Kleinman, "EU Tax To Have €50 bn Impact on Pensions," Sky News, November 16, 2013, http://news.sky.com/story/1169256/eu-tax-to-have-50bn-impact-on-pensions, accessed January 2014. This article references a study by the consulting firm Oliver Wyman for the Association of Financial Markets in Europe.

25 The proliferation of derivatives on individual stocks and stock indices creates special problems for applying this matching requirement. For instance, suppose a "transient" trader buys 1,000,000 shares of IBM and holds them for more than one year. In the interim, however, the "transient" trader employs a variety of derivatives to effectively sell 800,000 IBM shares. How would the securities transaction tax be applied in this situation?

happened soon after Sweden enacted a financial transaction tax in 1986; most securities trading quickly moved from Sweden to markets in other countries.[26]

The prospect of trading migration and other potentially adverse effects on local markets have led to considerable opposition to a financial transaction tax.[27] And there is no reason to believe that Singapore or Shanghai will adopt a tax for trade on their stock exchanges. Ironically, if Congress were to enact a tax on stock trades within the US, "transient" institutions would probably move their trading to stock markets in foreign countries with much less disclosure of short-term transactions than the US.

B.REWARDING LONG-TERM STOCK HOLDERS

Instead of penalizing short-term stock trading, other commentators have suggested that long-term shareholders be rewarded by lower taxes or more voting power. The suggestions for lower taxes revolve primarily around better treatment of capital gains and losses for investors who hold their shares for many years. For instance, during the late 1990s, Massachusetts had in place a declining tax rate on capital gains (down to zero) for asset sales based on how long the assets had been held.[28] Conversely, opponents, of short-termism have suggested that Congress do away with the current $3,000 limitation on personal deductions for net capital losses on long-term stock holdings.[29] But I have not seen a systematic analysis of whether either suggestion, if adopted as federal law, would result in a material reduction of short-termism.

Ironically, if Congress were to enact a tax on stock trades within the US, "transient" institutions would probably move their trading to stock markets in foreign countries with much less disclosure of short-term transactions than the US.

On shareholder voting, the SEC adopted a rule allowing certain shareholders to nominate one or two directors to be elected to a company's board and to be included in the company's proxy card. The SEC gave that nomination right only to shareholders who had held that company's shares for at least three years. But that rule was vacated by the court due to insufficient SEC consideration of the rule's effect on competition and capital formation.[30] Since the SEC has not re-proposed

26 European Commission, "Impact Assessment of a Proposal for a Council Directive on a Common System of Financial Transaction Tax and amending Directive 2008/7/EC," European Commission Staff Working Paper 28.9.2011 SEC(2011) 1102 Vol. 1, p. 8-9.

27 "Europe's Financial Transaction Tax: Bin It," *The Economist*, February 23, 2013.

28 U.S. Congress, "Taxpayer Relief Act of 1997, HR 2014 (105th)," Pub. L. 105-34, 11 Stat. 787 (August 5, 1997).

29 The Aspen Institute Business & Society Program, "Overcoming Short-Termism," supra Note 1, at 3.

30 Securities and Exchange Commission, Securities Exchange Act Release No. 33-9136 (August 2010); *Business Roundtable* v. SEC, 647 F. 3d, 1144 (D.C. Cir. 2011).

that rule, we will have to wait to see whether, under state laws, public companies will allow their shareholders to nominate directors.

More broadly, there are proposals to give long-term shareholders of public companies more votes per share than short-term shareholders. However, giving 3 or 4 votes for every long-term share might result in small groups of shareholders gaining control of a public company without paying a control premium to the company's other shareholders. This result would be troublesome to advocates of corporate democracy and adverse to the rights of minority shareholders.[31]

By contrast, the practice of "empty" voting both promotes short-termism and undermines the core principles of corporate governance. "Empty" voting means that the shares voted at a company meeting are not actually owned by the investor on the meeting date. An investor may borrow the shares mainly for the purpose of voting at a meeting. Alternatively, an investor may purchase shares just before the record date, sell them soon thereafter, yet retain the right to vote for those shares on the meeting date.

Either alternative may be used by short-term traders trying to influence a critical shareholder vote. For instance, "empty" voting has been employed in proxy fights for director seats and contested votes for merger approvals.[32] Therefore, Delaware and other states should amend their corporate laws so that companies with local charters could disregard votes by transient shareholders who do not own the relevant shares at both the record and meeting dates.

Therefore, Delaware and other states should amend their corporate laws so that companies with local charters could disregard votes by transient shareholders who do not own the relevant shares at both the record and meeting dates.

C. MORE DISCLOSURE ABOUT SHORT-TERM TRADING

Critics of short-termism have called for more disclosure in a number of areas. For instance, these critics cite studies showing that investors, on average, do not attain higher returns by switching among funds. Therefore, these critics advocate more education for pension trustees

31 For proposals, see Dallas, supra Note 2, at 351. Long-term shares would lose their extra votes if sold to a new individual or institutional shareholder. However, a few long-term shareholders could garner enough votes to push through a merger with a related company.

32 "Empty" voting was utilized by investors contesting a 2012 proposal to consolidate two classes of shares at Telus, a large telecoms company in Canada, and opposing Mylan's proposed 2004 merger with King Pharmaceuticals.

and individual investors about the virtues of long-term investing.[33] Nevertheless, we should recognize that educational efforts in the past have not substantially altered the time horizons of most investors.

Similarly, commentators have suggested that mutual funds include their brokerage costs as part of their annual operating expenses in their summary expense table.[34] At present, a fund's portfolio turnover is disclosed in the financial highlights section of its prospectus and annual report, but the actual brokerage costs are harder to find. Although fund shareholders should be given more detailed and salient information about the brokerage costs incurred by their mutual funds, such incremental information seems unlikely to induce a substantial change in the turnover rate of funds or their shareholders.

More controversial proposals pertain to the regulation and disclosure of short-selling: betting on the decline of a company's stock by borrowing shares and selling them. To some, short-selling symbolizes short-termism: investors making negative bets based on daily technical factors or issuing unduly pessimistic reports in support of their negative bets. To others, short-selling represents a fundamental critique of a company's performance or accounting; such short selling may extend for months or even a year.

To halt the steep decline of financial stocks during October of 2008, US regulators banned all short-selling in these stocks. While these bans did not halt the price declines in those stocks, they did increase their volatility and trading spreads.[35] After discontinuing these bans, regulators went on to adopt two sensible sets of rules, one designed to ensure that short sellers, when closing out their position, could actually deliver the relevant shares; and installing "circuit breakers," pauses in trading if a stock's price dropped sharply within a day.[36]

Currently, the SEC is studying whether and how to require real-time reporting of all short sales—either to the SEC only or the public. Such requirements could provide the SEC, and perhaps companies and other market participants, with a better understanding of the economic and voting interests on the negative side of a specific stock. But the SEC

33 CFA Institute, "Breaking the Short-Term Cycle," supra Note 1.

34 For example, see Jeff Schwartz, "Reconceptualizing Investment Management Regulation," *George Mason Law Review*, vol. 16 (2009), p. 521, 546-47.

35 Robert Pozen, Too Big to Save (Hoboken, NJ: John Wiley & Sons, 2009), p. 108.

36 On the requirement for short sellers to promptly purchase or borrow securities to deliver on short sales, see Securities and Exchange Commission, "SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency," SEC News Digest No. 2009-142 (July 27, 2009), http://www.sec.gov/news/digest/2009/ dig072709.htm, accessed January 2014; For the circuit breaker rule, see Securities and Exchange Commission, "Amendments to Regulation SHO," Securities Exchange Act Release No. 34-61595 (Feb 26, 2010), 17 CFR Part 242.

recognizes that real-time public reporting of short sales could lead to front running, and that any such reporting requirements should include exemptions, such as for bona fide hedging transactions.[37]

A parallel controversy surrounds the trigger point and timing of SEC filings by those acquiring substantial beneficial ownership of public companies. Under long-standing SEC rules, acquirers of 5 percent or more of the voting shares of a public company must file a 13D report within 10 days of reaching that 5 percent threshold. Corporate executives and their lawyers have argued that the 10-day filing window is obsolete—too long in light of today's fast-moving markets.[38] In their view, the 10-day window allows activist shareholders with short-term perspectives to covertly gain large footholds in a company's stock.

The SEC is soon expected to issue a concept release in response to a rulemaking petition to reduce the filing window under Section 13D from 10 to 2 days.[39] However, the petition has been severely criticized by other commentators.[40] They point out that the percentage of company shares acquired within the 13D filing window has stayed roughly the same over the last few decades. More broadly, these commentators believe that the 13D proposals are simply another anti-takeover defense for under-performing companies against activist shareholders.

ALTERING THE RELATIONSHIPS BETWEEN PUBLIC COMPANIES AND THEIR SHAREHOLDERS

In the prior part, we reviewed the proposals to limit short-term trading by investors. Most of these proposals, if adopted, would not dramatically reduce short-termism because corporate behavior is one step removed from daily trading volumes. For example, although "high frequency" traders buy and sell millions of shares per minute, they are not responding to financial performance or business plans of public corporations. Rather, such traders are trying to take advantage of fleeting anomalies in the pricing of securities or related derivatives. Thus, this next section will evaluate the proposals to alter the relationship between corporate executives and the shareholders of their companies. These proposals can be divided into two main categories—quarterly projections of corporate earnings by corporate executives,

37 For SEC studies on disclosure of short selling, see "SEC Seeks Public Comment on Short Sale Disclosure," Securities and Exchange Commission Press Release 2011-103, May 4, 2011 on SEC.gov website, http://www.sec.gov/news/press/2011/2011-103.htm , accessed January 2014.

38 Adam Emmerich et al, "Fair Markets and Fair Disclosure," *Harvard Business Law Review*, vol. 3, no. 1 (2013), p. 135.

39 David Katz et al, "Section 13(d) Reporting Requirements Need Updating," The Harvard Law School Forum on Corporate Governance and Financial Regulation (blog), April 12, 2012, http://blogs.law.harvard.edu/corpgov/2012/04/12/section-13d-reporting-requirements-need-updating/, accessed January 2014.

40 Ronald Gilson and Jeffrey Gordon, "Proposals to 'Reform' the 13D Rules: Getting it Precisely Backward," *The CLS Blue Sky Blog*, August 7, 2013, http://clsbluesky.law.columbia.edu/2013/08/07/proposals-to-reform-the-section-13d-rules-getting-it-precisely-backwards/, accessed January 2014.

and shareholder efforts to influence the leadership and strategies of these corporations. The second category includes a separate analysis of the role of activist hedge funds.

A. PROJECTING QUARTERLY EARNINGS

Critics of short-termism often point to the sharp decline in a company's stock price if its quarterly earnings are lower than Wall Street's estimates. This response to shortfalls in estimated quarterly earnings is indeed a troublesome aspect of short-termism; a company should not be judged by its performance over so brief a period.

Instead, to help curb short-termism, corporate executives should not publically announce their estimates of next quarter's earnings per share

It is bad to miss Wall Street's estimates of the quarter's earnings; it is more devastating to miss the quarterly projections by the CEO or CFO of the company. To avoid missing their own estimates, 80 percent of corporate executives were willing to forgo spending on research and development, while 55 percent were willing to delay projects with promising long-term prospects.[41] Instead, to help curb short-termism, corporate executives should *not* publically announce their estimates of next quarter's earnings per share.

Nevertheless, since 2006,[42] some corporate executives still fear that not issuing earnings guidance would hurt their company's stock price. These fears are not supported by a McKinsey study of 1,200 companies—comparing those giving quarterly guidance versus those that did not.[43] According to this study, there were no statistically significant differences between guiders and non-guiders with respect to valuation multiples, stock price volatility, and analysts following the company. Although trading volume initially dropped when a company abandoned earnings guidance, trading volume rebounded within a year.

To help focus Wall Street's attention on their long term priorities, corporate executives should disclose more about their business plans over the next decade, and whether they have been successful in carrying out these plans during the past. As Barton and Wiseman suggest, companies should publicly report on long-term metrics "like 10-year economic value added,

41 J. Graham, C. Harvey and S. Rajgopal, "The Economic Implications of Corporate Financial Reporting," NBER Working Paper No. W10550, January 11, 2005.

42 Before 2006, if a company stopped giving earnings guidance it was often interpreted as a sign that the company was in trouble. See S. Chen, D. Matsumoro and S. Rajgopal, "Is Silence Golden? An Empirical Analysis of Firms that Stop Giving Earnings Guidance," University of Washington Working Paper, Ocotber 2006. But that signaling effect has recently dissipated as more and more financially strong companies have stopped giving earnings guidance, or limited guidance to annual earnings within a broad range.

43 P. Hsiek, T. Koller and S.R. Rajan, "The Misguided Practice of Earnings Guidance,' *McKinsey Quarterly*, March 2006, http://www.mckinsey.com/insights/corporate_finance/the_misguided_practice_of_earnings_guidance, accessed January 2014.

R&D efficiency, patent pipelines, multiyear return on capital investments, and energy intensity of production".[44]

B. INSULATING DIRECTORS FROM SHAREHOLDER PRESSURES

For those critics who believe that shareholders are pressuring companies to take a myopic short-term approach, the remedy is obvious: reduce the influence of the shareholders and increase the powers of corporate boards. For example, Mitchell maintained that public shareholders "distort the behavior of corporate managers" by placing undue emphasis on short-term stock prices.[45] Therefore, Mitchell recommended that "shareholder rights should, ideally, be eliminated, and certainly not expanded or enhanced."[46] But Mitchell is lumping all public shareholders into one homogenous group. As explained above, there is a huge difference between the volatile trading patterns of transient shareholders and the more stable positions of dedicated institutions and quasi indexers.

Some critics of short-termism have taken aim at the role of corporate directors. According to one critic, directors should be *required* to act in the best long-term interests of their companies.[47] However, under the business judgment rule, directors already have broad *discretion* to take a long-term approach to company affairs. Unfortunately, in certain cases—Enron, WorldCom, Bear Stearns and Lehman Brothers—independent directors exercised this discretion by allowing management to pursue disastrous company policies. Instead, independent directors should devote a board meeting every year to evaluating their company's long-term strategy; at that meeting, they would scrutinize the long-term business plans of management as well as the assumptions built into such plans. Independent directors should also insist on longer time horizons in executive compensation arrangements, as discussed earlier in this chapter.

Other critics of short-termism believe that corporate directors need terms of more than one year in order to take a long-term view. For instance, Judge Jacobs of the Delaware Supreme Court has supported 3-year terms for corporate directors;[48] and Martin Lipton, prominent defense lawyer, has advocated a 5-year term for corporate directors.[49] But extending the

44 Dominic Barton and Mark Wiseman, "Focusing Capital on the Long Term," *Harvard Business Review* (January-February 2014), p. 44-51.

45 Lawrence Mitchell, "The Legitimate Rights of Public Shareholders," *Washington and Lee Law Review*, vol. 66 (2009), p. 1635, 1667-1670.

46 Mitchell, supra Note 45, at 1640, footnote 16. See also, Stephen Bainbridge, "Director Primacy and Shareholder Disempowerment," *Harvard Law Review*, vol.119, no. 6 (April 2006), p. 1735.

47 Nadelle Grossman, "Turning a Short-Term Fling into a Long-Term Commitment," *University of Michigan Journal of Law Reform,* vol. 43, no. 4 (Summer 2010), p. 905, 961.

48 Jack B. Jacobs, "Patent Capital: Can Delaware Corporate Law Help Revive It?," *Washington and Lee Law Review*, vol. 68, no. 4 (September 1, 2011), p. 1645, 1660-63.

49 Martin Lipton & Steven Rosenblum, "A New System of Corporate Governance: Quinquennial Election of Directors," University of Chicago Law Review, vol. 58, no. 1 (Winter 1991), p. 187, 229.

terms of directors means that their companies will be effectively insulated from takeovers—regardless of the company's performance.[50]

Of course, the critics of short-termism would support stronger anti-takeover protections as a way to encourage long-term company investment. However, the empirical studies on this issue show mixed results. Professor Mark Roe summarized the arguments and data:[51]

> Takeover protection has been one of the most prominent policy presumptions induced by those who see stock-market induced short-termism as a serious problem. If the prescription were on average correct, then isolating boards and management from takeovers would lead to higher R&D and other results. But although two studies are consistent with this view, as many or more studies do not find such increases following takeover protection. The most recent extensive studies on the issue find that patent and innovation decreases for firms incorporated in states that pass antitakeover laws relative firms incorporated in states that do not.

C. THE ROLE OF ACTIVIST HEDGE FUNDS

While generally supporting fewer rights for shareholders and more security for directors, critics of short-termism have focused particularly on the activism of hedge funds. These hedge funds actively solicit proxies from other shareholders to persuade a target company to adopt when they believe would be better company policies, such as selling lagging divisions or paying higher dividends to their shareholders.[52] Yet, some commentators blame activist shareholders for generally advocating "strategies with immediate payoffs at the expense of strategies with superior but distant profit."[53] Other critics note that incremental cash dividends may be financed by higher leverage on junk bonds.[54]

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50 The combination of a poison pill and a board with multiple-year tenure for directors will thwart most uninvited bids for control of public companies. See L. Bebchuk, J. Coates and G. Subramanian, "The Powerful Anti-Takeover Force of Staggered Boards," *Stanford Law Review*, vol. 54, no. 5 (May 2002), p. 887.

51 Mark Roe, "Corporate Short-Termism: In the Boardroom and in the Courtroom," *Business Lawyer*, vol. 68 (August 2013), p. 994 (footnotes omitted).

52 For example, Carl Icahn lobbied Apple to use some of its cash hoard to pay dividends to its shareholders. To help implement this new dividend policy, Icahn also tried to elect a few directors to the Apple board though less than a majority.

53 Natalie Mizik, "The Theory and Practice of Myopic Management," *Journal of Marketing Research*, vol. 47, no. 4 (August 2010), p. 594.

54 Jose Gabilondo, "Leveraged Liquidity: Bean Raids and Junk Loans in the New Credit Market," *Journal of Corporation Law*, vol. 34, no. 2 (Winter 2009), p. 461-462.

In fact, activist hedge funds seem to fall in between short-term and long-term investors, with an average holding period of 2.5 years[55] or 266 days,[56] depending on the study's methodology. In either case, an activist hedge fund typically acquires a relatively small percentage of a company's shares. Therefore, the fund can be successful in effecting change only if it can garner the support of long-term institutional shareholders of the company.[57]

Like public shareholders, hedge funds are not a homogenous group; they have a broad range of strategies and time horizons. Not surprisingly, the empirical studies on interventions by activist hedge funds have mixed results. For instance, one study found positive stock returns at corporate targets of activism persisted for two years and another study found that improved operational performance lasted for five years after such interventions,[58] although a third study concluded that activists were better at extracting short-term concessions than long-term stock gains.[59] In terms of financing, one study found increased safety of debt in firms targeted by activist, while another study concluded that the bonds of target firms had a higher likelihood of being downgraded than peer firms.[60]

CONCLUSIONS

The clamor against short-termism in corporate America has been getting louder and louder. According to the critics, the significant increase in trading volume and annual turnover in the shares of public companies has put tremendous pressure on the senior executives of these companies to focus on quarterly profits. As a result, so the argument goes, U.S. public companies are not spending enough on research and capital projects necessary for long-term economic growth. To shift from a short-term to a long-term perspective in corporate America, the critics suggest a broad range of far-reaching measures—taxing securities transactions, reducing shareholder rights, and restructuring executive compensation.

As this paper has shown, the facts are more complex than the critics recognize. Most importantly, the short-term focus is primarily associated with "transient" institutional investors who constitute less than one-third of the U.S. shareholder base. Two-thirds of the base is comprised of "dedicated" institutions or "quasi-indexers" who take a more stable

55 William Bratton, "Hedge Fund and Governance Targets," *The Georgetown Law Journal*, vol. 95, no. 5 (2007), p. 1375-1433.

56 A. Brav, W. Jiang, and H. Kim, "Hedge Fund Activism: A Review," *Foundations and Trends in Finance*, vol. 4, no. 3 (2009) 185, 205.

57 Ronald Gilson and Jeffrey Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights," *Columbia Law Review*, vol. 113, no. 4 (May 2013), p. 863.

58 Brav, supra Note 56, at 222; Lucian A. Bebchuk, Alon Brav and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism," Columbia Business School Research Paper 13-66, 2013.

59 Bratton, supra Note 55, at 2.

60 Brav, supra Note 56, at 226 (citing opposing studies).

approach to investing. According to empirical studies, some activist funds push for quick results, while others lead the way to lasting corporate improvements.

Moreover, the causal relationship between higher transaction volumes and shorter corporate perspectives is not so strong. Rapid-fire trading by "transient" investors is usually based on technical factors and pricing anomalies, with little connection to a company's fundamentals or business plans.

Given the different time horizons among investors, we should be careful in assessing the costs as well as the benefits of the remedies proposed to counter short-termism. For example, the proposals to lengthen the terms of directors to 3 to 5 years might encourage them to take a longer term perspective, but such lengthy terms would effectively insulate poorly performing companies from shareholder accountability.

Other proposals, if adopted, would not seem effective in shifting the perspective of corporate executives from the short term to the long term. While a securities transaction tax in certain markets would certainly drive trades to less regulated markets, it seems doubtful that a securities transaction tax would alter the capital budgets of corporate executives. Although mutual funds should expand their disclosures on trading costs beyond annual turnover costs, such expanded disclosures are not likely to materially lengthen the time horizons of mutual funds or their portfolio companies.

The most effective measures to combat short-termism would alter the design of compensation for asset managers and corporate executives

The most effective measures to combat short-termism would alter the design of compensation for asset managers and corporate executives. Since the financial crisis, most firms defer a portion of cash bonuses for several years—a welcome development. Nevertheless, the measurement period for bonuses remains one year for most corporations. A one-year measurement period encourages people to try to hit home runs as soon as possible, instead of amassing singles and doubles over time. Therefore, the measurement period for the bonuses of senior executives and investment professionals should be based on their performance over the last three years.

The performance measures of portfolio managers should be risk-adjusted. That would discourage them from trying to achieve good short-term results by excessive leverage or risk taking. Corporate executives should be required to retain for several years—or until retirement—most of the shares obtained through options or share grants. That requirement would eliminate their incentive to boost the company's stock price for a brief period, so that they could quickly sell their shares for a big profit.

In addition, two other measures would help curb short-termism in corporate America. First, corporate executives should stop announcing their estimates of next quarter's earnings; such public projections only exacerbate Wall Street's focus on short-term performance. Second, state corporate laws should limit the ability of short-term investors to vote shares they no longer own; such "empty voting" is often used by transient institutions without any stake in a company's long-term performance.

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