LOYALTY SHARES

ECGI ROUNDTABLE
HOSTED BY NYU SCHOOL OF LAW
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REPORT BY TOM VOS

On Friday 7 December 2018, the ECGI organized a roundtable in New York on loyalty shares, together with the NYU School of Law. The first ECGI roundtable on this topic was held on 18 June 2018 in Brussels (a report on this roundtable is available on the ECGI website:

https://ecgi.global/sites/default/files/events/ecgi_roundtable_report_on_loyalty_shares_by_tom_vos_0.pdf.

The Roundtable focused on loyalty shares as a legal solution for encouraging long-term ownership, a concept that is gaining traction in Europe with the support of the European Commission, and has also attracted interest in the United States. Loyalty shares that confer additional voting rights have a long tradition in France, were recently introduced in Italy, and are expected to be introduced in an ongoing reform of Belgian company law. In the U.S., loyalty shares with "tenure voting" or "time-phased voting" have appeared in a small number of companies and are included in the listing requirements for the newly proposed "Long Term Stock Exchange" (LTSE). Loyalty shares might also confer additional cash-flow rights to long-term holders rather than votes. This Roundtable critically examined these developments, with the goal of evaluating whether loyalty shares have a future in the U.S. and whether they should.

WELCOME AND INTRODUCTION

Edward Rock (NYU School of Law) opened the roundtable by briefly introducing the topic and the program for the day. He noted that "loyalty voting rights" have been around for some time in the United States, but have recently attracted more attention, especially from Silicon Valley, as dual class share structures have come under attack by investors; and also partially because time-phased voting rights play an important role in the Long-Term Stock Exchange (LTSE) project.

1. LOYALTY SHARES WITH TENURE VOTING - A COASIAN BARGAIN? EVIDENCE FROM THE LOI FLORANGE EXPERIMENT

Professor Marco Becht, Université libre de Bruxelles and ECGI

The first presentation was given by Marco Becht (Université libre de Bruxelles) on loyalty shares in France in the context of the Loi Florange. He began by distinguishing the concept of loyalty voting shares that offer extra cash flow to loyal investors (as proposed by Bolton & Samama) from "loyalty shares with tenure voting" (or "time-phased voting rights"), which is the topic of this roundtable. Becht explained that loyalty voting shares exist in France, the Netherlands and Italy and Belgium is introducing them in 2019. There are legal commentators who have argued that they are also available in the United Kingdom. They are also under consideration in Spain. He argued that they are mainly used as a control enhancing mechanism in family companies, and by the state in France.

In the French model of tenure voting, shareholders receive double voting rights if they have held the shares uninterruptedly for at least two years. "One share, one vote" used to be the default rule, but the Loi Florange changed this: starting from the end of the transition period (2 April 2016), loyalty shares became the default rule, unless shareholders opt out with a two thirds majority. Becht presented evidence that companies adopting loyalty shares at the IPO have high family ownership. In addition, the paper finds a small but statistically insignificant increase in IPOs with loyalty shares after the Loi Florange. Becht argued that this is contrary to what behavioral finance predicts – default rules are "sticky" due to the endowment effect. The finding is consistent with efficient contracting and the Coase theorem; default rules should not matter when transaction costs are small.

Becht also discussed the impact of the law reform on the stock of listed companies. There were 14 companies that did not reverse back to "one share, one vote". In 7 cases, there was no vote that proposed to retain the "one share, one vote" structure; Becht explained that in each of those cases, there was no point in having a vote, as a shareholder had a blocking minority of at least one-third. In 6 of the 7 other cases, where there was a vote, the vote failed because the French state was a dominant force. In the Renault case, the French state even bought and borrowed extra shares to reach a blocking minority.

Becht then presented evidence that the firm value (Tobin's Q) was unaffected by the Loi Florange, even for those companies that switched to loyalty voting shares; but that Tobin's Q is negatively affected both before and after the Loi Florange by state ownership. In addition, the paper found that the average holding periods of companies with and without loyalty shares are not significantly different, both before and after the Loi Florange.

Finally, Becht outlined the main differences of loyalty voting shares in comparison to dual class structures: (1) loyalty shares constitute a single class of shares, that is potentially available to all shareholders; (2) the extra votes are not perpetual and expire upon a sale; (3) the voting power depends on the holding periods of other shareholders; and (4) they are less transparent than dual class share structures.

After Becht's presentation, Emiliano Catan (NYU School of Law) offered some comments and questions for further research. For example, he pointed out that this is mainly a story of the French state using its power as a government to increase its power as a shareholder. He also offered possible methodological refinements. Tobin's Q could have been tainted before the date of the Loi Florange by public announcements, and there could be a confounding effect because the Loi Florange contained other provisions than only loyalty voting shares. Further research could control for firm fixed effects and check the parallel trends assumption. There are also some problems with Tobin's Q as a measurement for firm value, but it would be difficult to establish the right date for an event study. Finally, measuring average holding periods of all shareholders is actually too crude of a measure, as we would only expect a change for larger blockholders.

Michelle Edkins (BlackRock) also commented on the paper. She questioned the motivations behind the introduction of the Loi Florange, as subsequent actions by investors with time-phased voting rights suggest it is more a control mechanism than a means to encourage long-termism. Edkins also noted that funds managed by BlackRock would normally not be able take up loyalty voting rights: first, because the clients are the real – and usually the registered - owners of the shares; and second, because the registration and deregistration processes are lengthy, which reduces liquidity for clients. There are also some "proxy plumbing problems", which could perhaps be solved by blockchain, but this is not yet the case.

One of the other participants compared the situation in France with the one in Italy: in Italy, loyalty voting rights are mainly used by companies with a controlling shareholder with around 40%, where short-termism is no problem. Institutional shareholders cannot benefit from loyalty voting rights in practice. Therefore, it is hard to see how loyalty voting rights foster long-termism.

The debate then turned to securities lending, which participants concluded would be impossible if a shareholder wants to benefit from loyalty voting rights. They argued that this would make it difficult for index funds to use loyalty voting rights, as it would be a competitive disadvantage for them not to have securities lending.

Most participants agreed that loyalty shares in Europe are mainly a control enhancing mechanism used by insiders, but with a better PR story than dual class structures. According to Becht, the advantage of loyalty shares is that there is only one class, which facilitates index inclusion, and that insiders cannot sell their shares; the disadvantage is that the system is less transparent. However, some participants argued that a different technology, such as blockchain, could empower institutional investors to take up loyalty voting rights.

2. WILL TENURE VOTING GIVE CORPORATE MANAGERS LIFETIME TENURE?

Professor Wei Jiang, Columbia University and ECGI

Wei Jiang (Columbia University) first discussed some of the arguments and the empirical evidence that suggested that short-termism is a problem. She also outlined the possible causes and solutions to short-termism, before turning to tenure voting, and specifically how it affects the likelihood of a pro-management outcome in a proxy contest. The model developed in the paper assumes that it is easy for outside shareholders to register for loyalty voting rights. The model classifies the different investor types according to their long-term/short-term horizon, their pro-management bias and their conformity to proxy advisors. It then models the likelihood of a dissident winning a proxy contest, given different levels of share ownership of management and institutional shareholders, and given different types of tenure voting.

The paper concludes that when corporate management holds a large block of 20-30%, tenure voting will ensure that managers will almost always win a proxy contest against dissident. The overall benefit of tenure voting to managers is tempered with the increase in ownership of outside long-term institutional shareholders (who enjoy tenure voting as well). At lower level of management ownership, long-term institutional shareholders are driving the outcome of the proxy contest, and if they hold a significant stake, the benefit of tenure voting to management is modest. In conclusion, assuming that institutional investors can benefit in practice from tenure voting, tenure voting can only ensure lifetime control at high managerial ownership levels, in contrast to dual class share structures.

Scott Luftglass (Fried Frank) commented on the paper by Jiang. He first pointed out that there are relatively few companies in which management owns 20-30% of the company's stock, as the model assumes. Rather, it is much more common (relatively speaking) for there to be a 20-40% shareholder in the form of a private equity sponsor, which the model and the paper do not address. Secondly, he noted that proxy contests are not the only moment where shareholders exercise their voting rights, whereas the paper focuses only on proxy fights. Finally, he argued that the strategy of investors may change because of loyalty voting rights, and thus it is challenging to draw comfort from analyses based on investor's prior historical behavior, which was influenced by the status quo (i.e., non-loyalty share) regime: for example, hedge funds may go more long-term to benefit from tenure voting, as they did with appraisal litigation; or investor-friendly institutional investors may become more unfriendly, because of increased leverage due to increased, loyalty voting rights.

Next, Jill Fisch (University of Pennsylvania Law School) offered her comments on the paper. She observed that the paper makes a timely contribution to the current policy debate over dual class stock. The paper's results confirm that loyalty voting shares can be seen as an intermediate solution between "one share, one vote" and dual class structures, as has been argued by Steven Davidoff Solomon. Fisch also pointed out that the results depend on the assumptions of the model. Here she made several suggestions to tighten the model, observing that dissidents or retail investors may actually own more than 10%; and that large asset management groups do not always vote all the shares that they manage uniformly. Finally, she argued that the model

appeared to focus on the contestability of control in election contests. She observed that shareholder votes are infrequent in election contests; most are settled and that, in addition, large institutional investors do not tend to follow ISS recommendations as closely in election contests.

3. PANEL: DO LOYALTY SHARES HAVE A FUTURE IN THE US? SHOULD THEY?

In the third part of the roundtable, the panel discussion, Michelle Greene (LTSE) began the debate by outlining how a long-term voting system, which shares characteristics with, but is also distinguished from loyalty shares could contribute to the goals of the LTSE. The goal of the LTSE is to solve the problem of short-termism, not to entrench management or prevent shareholder activism. Alternative voting structure ideas are only part of the proposed solution, the other solutions proposed by the LTSE include a board committee that is explicitly tasked with the long-term strategy, and more focus on and enhanced disclosure of long-term metrics, human capital, ESG, etc. So far, the LTSE has applied for recognition as an exchange with the SEC, but the application does not include these additional “long-term standards” because LTSE is taking a phased regulatory approach.

Greene then explained the details of LTSE’s voting structure as previously proposed in an SEC filing in 2018. Every shareholder would start at one vote per share, but shareholders could opt in through the existing direct registration system, with software designed by LTSE that would help to address potential concerns about any administrative burden. They then would begin to accrue 1/12 additional voting rights per month, up to a maximum of 10 voting rights per share over 10 years. According to Greene, a shareholder would be able to move in or out of the direct registration system within 1 to 3 days (in contrast to registering or deregistering one’s shares in France, which could take a few months). Shareholders would lose their accrued voting rights if they moved out of the registration system on a last-in-first-out basis. Greene characterized the proposed voting system of the LTSE as a more democratic alternative to dual class share structures, although such structures are not banned in LTSE’s proposal.

David Berger (Wilson Sonsini Goodrich & Rosati) then discussed why dual class shares became popular in Silicon Valley and beyond. According to Berger, the control of the U.S. public markets by a relatively small number of institutional investors and activist hedge funds has led the public markets to have a very different view than entrepreneurial founders about such things as how capital should be deployed, the relative view of acceptable risks for capital investments and corporate purpose. These differing views have led (at least in part), to (among other things), companies staying private longer as well as choosing alternative capital structures when they do go public so that the founders and other early investors can have a greater ability to make decisions on issues such as capital deployment and broader corporate purpose.

Berger then explained that following Google's IPO many of these companies adopted dual class structures. Such structures have generally worked well for many companies, and the limited empirical evidence to-date shows that such structures have also benefitted stockholders. In particular Berger cited a recent study from MSCI indicating that dual class companies have out-performed single class companies over a 10 year period. At the same time, companies remain open to consideration of alternative capital structures that would allow the board and management to have greater influence over such issues as capital allocation and social purpose, but thus far consideration of alternatives like tenure voting have been prohibited by the exchanges and/or regulators. As a result companies are left in the position of choosing between a governance system where the selection of directors (and thus direction of the company) is left to a limited number of institutional investors and activist hedge funds or where directors can be chosen by founders and others with a potentially better understanding of the company's business, needs, and purpose. Given this choice, Berger suggested that it should not be a surprise that many companies with strong founders who have a deep vision for the future of the company should choose a dual class structure when going public.

Next, Jim Rossman (Lazard) gave an investment banker's perspective. He argued that underwriters and US public markets have experience with taking companies public with all kinds of voting structures, including for example dual class structures and tracking stock. He believes that investors are willing to invest in a wide range of voting structures and that there is no "haircut" on the market price of these structures. He concluded that loyalty voting rights would not be a "big lift" in the US, given the depth of its markets and the experience of its actors.

Paul Shim (Cleary Gottlieb) pointed out that while many investors consider "one share, one vote" a fundamental principle, in the end they are willing to invest in dual class companies. He predicted that the same would be true for loyalty shares. Shim also offered some criticism on the assumption that shareholders who have held their shares for a long period of time will continue to hold their shares for a long period, and argued that loyalty voting shares did not take this into account. Finally, he concluded that he was not convinced that loyalty shares are all that different from dual class structures. As a point of information Marco Becht asked if companies will be able to combine dual class with time-phased voting under LTSE's proposal and what the tenure status of the pre-IPO shareholders would be. Michelle Greene responded that under the previously-filed LTSE structure all shareholders would start with one vote per share irrespective of the length of their pre-IPO holding period but could go public with a dual class structure as they can on every other exchange.

David Klafter (Pershing Square) then discussed how loyalty shares could affect shareholder activism. They view loyalty shares as a control enhancing mechanism: it is not about a long-term versus short-term perspective, but rather about who gets to decide what is best in the long-term. He acknowledged that control enhancing mechanisms could protect innovation, but argued that they could also protect incompetency of the incumbents. Insulating management will also decrease the need for them to listen to new ideas from the outside, such as those from activists who have done a lot of research on the company. Finally, Klafter pointed out that loyalty shares are more opaque than dual class structures, as voting rights become more difficult to calculate.

Jim Rossman replied that the activism defense side attaches value to putting up "moats" around management, such as dual class structures and staggered boards. Michelle Greene replied that the proposed system designed by the LTSE would not put up moats around management, but around the long-term shareholders. Some participants argued, however, that the largest institutional investors, such as BlackRock, Vanguard and State Street, would not be allowed by regulators to take up their extra voting power, as there are already concerns that a small group of institutions has too much decision power.

After this discussion, Assaf Hamdani (Tel Aviv University) then raised some interesting academic questions and comments. He raised the question whether loyalty shares would only be used in the United States to entrench management and controlling shareholders, as in Europe, or whether they would be an "equal opportunity" control enhancing mechanism that would allow any shareholder with patience to get super-voting shares. He also characterized loyalty voting shares as a "time-phased anti-activist poison pill", although Michelle Greene argued that the LTSE is not anti-activism, but distinguishes between those activists seeking to extract short-term value and leave versus those promoting long-term value creation. Hamdani also raised the issue of whether the LTSE would end up with the less appealing companies, those who could not go public with a real dual class structure. Finally, he pointed to interesting open questions, such as whether sunset provisions should apply to loyalty voting rights, and what would be the impact on the fiduciary duties of directors.

Participants also engaged in an open debate on many related topics, including the relation of loyalty shares to other trends, such as the influx of venture capital, the increased ownership by institutional investors, and the increase in shareholder activism.

CONCLUSIONS

Marco Becht offered some brief conclusions of the roundtable. He contrasted the "technology" of loyalty shares in Europe, where the registration system makes it very difficult for institutional investors to register and thereby favors insiders, with the one developed by the LTSE that would make registration available to and easy for all shareholders and almost immediate. The reason for this discrepancy might be technological backwardness, but the necessary investment by the established exchanges in Europe could be motivated by the desire to favor insider blockholder control and to encourage family firm IPOs. Becht also pointed to the insights gathered from the calibration developed in the paper by Wei Jiang and how loyalty shares with tenure voting could potentially transform corporate control in the United States. Since the widespread adoption of loyalty shares on the main markets is unlikely it would be interesting to also see a simulation of the proposed LTSE experiment. It will be very interesting to see what will actually happen if the LTSE is established successfully. It will be a "live experiment" for practitioners and scholars alike. Becht concluded by thanking the NYU School of Law, the European Corporate Governance Institute, and the European Corporate Governance Research Foundation and its patrons for financial support.

About the European Corporate Governance Institute (ECGI)

www.ecgi.global

The ECGI is an international scientific non-profit association which provides a forum for debate and dialogue focusing on major corporate governance issues and thereby promoting best practice. It is the home for all those with an interest in corporate governance offering membership categories for academics, practitioners, patrons and institutions.

Its primary role is to undertake, commission and disseminate research on corporate governance. Based upon impartial and objective research and the collective knowledge and wisdom of its members, it can advise on the formulation of corporate governance policy and development of best practice. In seeking to achieve the aim of improving corporate governance, ECGI acts as a focal point for academics working on corporate governance in Europe and elsewhere, encouraging the interaction between the different disciplines, such as economics, law, finance and management.

The ECGI Roundtable Series

The ECGI Roundtable Series provides an engagement platform between ECGI Research Members and Institutional or Patron Members of ECGI. The topics are selected based on geographic relevance and the interests of the participating members. For queries about hosting or taking part in an ECGI Roundtable, contact Prof. Marco Becht, ECGI Executive Director.

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