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

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Abstract: We argue that a fundamental reason for the short term perspective of corporate executives is the short term orientation of shareholders themselves and the financial markets that drive the performance benchmarks of CEOs. Although some shareholders are prepared to take a more long-term view they are generally not rewarded for their loyalty to the company. While lengthening stock option vesting periods and introducing claw-back provisions into CEO compensation contracts help induce a more long term orientation of CEOs, we argue that it is also necessary to reinforce this more long-term performance-based compensation with a better alignment between shareholders and CEOs horizons. One way of moving towards such an alignment is to introduce **L-Shares** (or **L-shares**). These shares provide an additional reward to shareholders that have held on to their shares for a contractually specified period of time, the **loyalty period**. The reward would be in the form of a warrant giving the right to purchase a pre-determined number of new shares at a pre-specified price and granted to loyal investors at the expiration of the loyalty period. This paper discusses how L-shares can be structured and distributed, how they may be valued and how they affect liquidity and control of the corporation.

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I] INTRODUCTION

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

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

loyalty to a company.

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

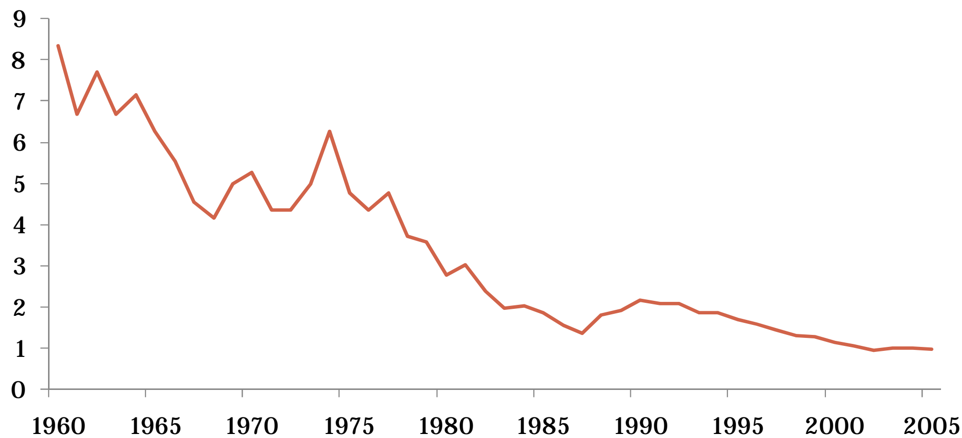
> "If you don't like the management sell your stock,"

which, interestingly, Benjamin Graham has qualified by adding:

> "….provided you can get a fair price. If you can't, do something about the situation."
> [Graham (1954) pp.]

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

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



Source: NYSE overview statistics

As a result of this shorter-term outlook of investors, equity markets in the U.S. impose a *momentous short-termist pressure* on corporate executives, all the more so that in the last three decades the universal and exclusive performance benchmark for CEOs, analysts, activist investors and independent directors has increasingly become the stock-price performance of the firm (see Gordon, 2007). Not only has the importance of the stock-based compensation-component in CEO pay steadily increased in the past thirty years (see Murphy, 1999 and Gabaix and Landier, 2008), but also the influence of independent directors and the pressure exerted by activist hedge funds (see Brav, Jiang, Partnoy, and Thomas, 2008).

The rise of stock-option based pay has been motivated by the need to align the interests of managers with those of shareholders (Jensen and Murphy, 1990 and Holmstrom and Tirole, 1993). The argument was that, since—by the widely accepted *efficient markets hypothesis* (Fama,

1970)—stock prices on average reflect the long-term fundamental value of the firm, this form of executive compensation would encourage CEOs to maximize the long term value of the firm. The focus on stock price as a central performance measure and the pressure exerted by corporate raiders and activist hedge funds had a similar motivation.

The recent history of bubbles and crashes, however, has if anything highlighted the limits of the efficient markets hypothesis, and has revealed the extent to which stock prices can in the short-run substantially deviate from long-term fundamental value. This history has given new credence to an alternative *speculative markets hypothesis*, dating back at least to John Maynard Keynes, and recently formalized by Harrison and Kreps (1978) and Scheinkman and Xiong (2003), which argues that due to differences of opinion and short-sales constraints, stock prices reflect both the (long-term) fundamental value of the firm and a (short-term) *speculative option value*, which is simply the value of the option to sell the stock to a more optimistic shareholder in the future.

As Michael Lewis has vividly described, a speculator like himself during the technology bubble, might purchase a stock, as he did with *Exodus Communications* at the end of 1999 simply because :

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

When differences of opinion are pronounced and persistent (that is, when *optimists* and

pessimists fundamentally disagree about a stock) the speculative option value may represent a substantial fraction of the stock price, so much so that stock-price movements have little relation with changes in fundamental value. Under these circumstances an exclusive focus on share price as a performance measure may produce highly destructive short-termist pressure on publicly traded firms. The speculative behaviour described by Michael Lewis only focuses on short-term price-movements; it is mainly concerned about *market sentiment* or other investors' psychology, and as such it is divorced from any effort to discover long-term fundamental value or the effects of a CEO's decisions on the value of the firm. [2]

Worse still, as Bolton, Scheinkman, and Xiong (2006) show, during speculative bubbles both shareholders and managers may have an interest in pursuing short-termist strategies that inflate the speculative option value by fuelling even larger differences of opinion. Stock-based CEO compensation then provides incentives to CEOs to pursue short-termist strategies to *pump and dump* the company's stock. In particular, their analysis implies that CEO short-termism may not be caused by poor governance, but may actually be encouraged by short-term oriented shareholders. These predictions have been partially corroborated in the recent study of risk-taking and executive compensation in U.S. banks and other financial companies by Chen, Hong and Scheinkman (2009). They show that higher stock-based (residual) CEO compensation was correlated with greater risk-taking, but also that it was

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

unrelated to any governance failures. Simply put, CEOs were financially induced to take greater risks and they did not take these risks against the wishes of their shareholders.

The financial crisis has starkly brought to light these short-termist incentives of stock-based CEO pay in financial institutions, and in response to the crisis there has been a shift in CEO incentives towards more long-term performance, by putting in place longer vesting periods and instituting claw-back provisions. However, shareholders' short-termist orientation remains unchanged, and the recent trend towards longer term CEO compensation can only be a small counterweight to this market pressure. Indeed, as many a CEO can attest it is not easy to resist the entreaties of an activist hedge fund to pursue a particular corporate transaction, which is anticipated to result in a short-term boost in stock price, with arguments that the transaction risks undermining the long-term strategic position of the company.

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

This is why we propose a middle course: *loyalty shares* (L-shares) which reward buy-and-hold

investors by granting them a call-option, or warrant, if they have held their shares for a pre-specified loyalty period (say, two years).[3] These loyalty warrants (L-warrants), which can be offered by listed companies indiscriminately to all shareholders, would be especially attractive to those shareholders seeking more long-term buy-and-hold investments. Currently, such shareholders have little choice but to invest in regular common stock and receive rewards that are essentially independent of the length of time they hold the shares. These buy-and-hold shareholders are moreover at a disadvantage relative to more speculative traders, who can cash in on a speculative option, or respond more quickly to news and "exit" before the buy-and-hold shareholders.

We believe that *L-shares* would go some way towards redressing this imbalance between long-term and short-term investors. In particular, they would attract long-term non-speculative investors, by providing a reward to those shareholders who have held their shares for a pre-specified period of time, and they would repel day-traders, momentum investors, and other short-term speculators. They would also encourage a more long-term valuation outlook, as those shareholders seeking to obtain the loyalty reward would have to make an assessment as to the company's value at the expiration of the loyalty period.

There are already a few examples of such types of shares, but at this point it is fair to say that

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3 The reward can also take the form of a special dividend or greater voting rights. We believe that a call-option has additional benefits over a dividend payment, but the key point is to introduce rewards for long-term investors whichever form they take. Note also that we shall repeatedly refer to an example with a two-year loyalty period. There is obviously nothing magical about the two-year period. The loyalty period could be much shorter (a week; a month) or longer depending on the particular circumstances of a corporation and the objectives of long-term investors.

they are rather uncommon. One early example is the case of *Michelin* in 1991, which has granted L-shares (in the form of a warrant) following a dividend cut to compensate the most loyal shareholders for this loss in income. Specifically, Michelin granted one call-warrant for every 10 shares held on December 24th 1991. The call-warrant was exercisable at a four year horizon (December 31rst 1995) at an out-of-the-money strike price of FRF 200, compared with a share price of about FRF 115 at the time of the announcement. The CEO of Michelin motivated the L-shares at the time by saying:

> "Long-term oriented shareholders, who hold on to their shares during the difficult but critical time the company is facing [will thus be rewarded]"

In addition, all the shareholders who held on to their shares for the two year period between 1991 and 1993 were rewarded with an extra warrant.

A more recent example of an L-share is *L'Oreal*'s offer of a *Loyalty bonus* to registered shareholders (proposed at the Annual General Meeting of April 16th, 2009), which grants a 10% incremental dividend to all shareholders having held registered shares for at least two years, up to a limit of 0.5% of nominal capital per shareholder. A third example is *Air Liquide*, who offered both a dividend and share bonus to all the shareholders having kept their shares for at least two years. A few more examples can be found in demutualized U.K. life insurance companies and building societies. Thus for example, *Standard Life* 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.

Finally we note that several leading commentators have recently spoken out in favor of such types of shares. Most notably, John Bogle wrote in a recent op-ed in the *Wall Street Journal* (2010):

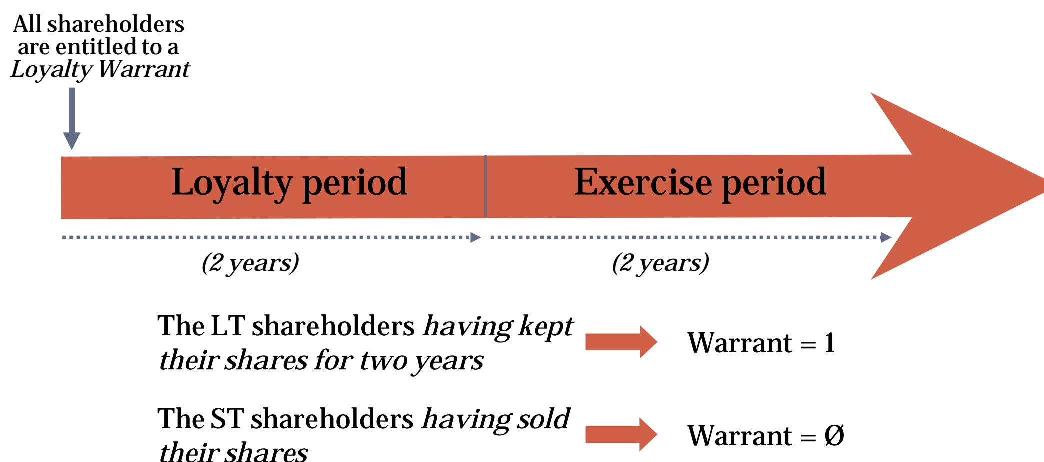
“In addition, policy makers ought to be considering structural changes that would enhance the role of investors and diminish the role of speculators. For example, granting longer-term (say, two- to five-year holders of stock) extra voting rights and/or a higher dividend; a federal transfer tax on securities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

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

II] L-SHARES: HOW WOULD THEY WORK?

The best structure in our view for a loyalty share (L-share) is a call-warrant attached to each share that is exercisable at a fixed time-horizon (say, two years) and at a fixed exercise price. The main difference with an ordinary warrant is that the right to exercise the warrant is only obtained if the holder of the L-share holds the share for the entire length of a pre-specified "loyalty period". If the L-share is sold before expiration of the loyalty period the right to the warrant is lost. In other words, the warrant attached to an L-share is not transferable. In this respect the L-share is similar to an executive stock option, which is also not transferable and also only vests after a fixed period of time.

The figure below provides an illustration of how an L-share could be structured.



An important feature of the L-share is, thus, that it is solely the behavior of shareholders that

determines the ultimate ownership (or not) of the L-warrants. In this example all shareholders are equally treated at the time of the offer. It is only their trading behavior that induces an ex-post difference in their treatment. Those shareholders who hold the L-share until the end of the loyalty period are granted a warrant that is exercisable over a pre-determined period (two years in the example). Once they are granted the warrant they can trade it, but prior to the expiration of the loyalty period no trade is possible. The mere trade of an L-share cancels any right to a future warrant in this example.

The strike price of the warrant may be set in different ways depending on circumstances: 1) it could be 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) it could be the minimum of the stock price at the time the L-share is granted and the lowest of the price over the loyalty period; 3) it could also specify 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*.

The main 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.

The precise terms the firm would set for its L-shares will generally depend on the fraction of shareholder value the firm intends to allocate to loyal shareholders and on the intentions the issuer wants to convey to the market. Thus, for example, a straight at-the-money call option could *signal* the firm's belief that it does not expect its stock price to fall and that therefore it is not necessary to include any look-back feature into the L-warrant. Indeed, as the strike price of the warrant will be disclosed to the market, it may be seen as a signal of what the issuer knows about the long-term value of its shares. Therefore, the determination of the strike price is likely to be an important decision for the firm.

As we have highlighted, an important feature of our proposed structure for L-shares is that they offer greater *buy-and-hold* incentives for shareholders in turbulent times. In particular, as the value of the warrant increases with volatility, L-shares become more attractive other things equal when stock price volatility increases. Buy-and-hold incentives are thus strengthened just in times when they may be most needed.

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 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. The main technical difficulty with distributing L-shares is that the company must put in place a system to track ownership of its shares through the loyalty period, to be able to determine which shareholders are loyal and which are not. We describe in detail how the company can do this, while preserving shareholder anonymity in section VI.2 below.

So far we have described only the simplest possible form of L-share: a share with a one-time warrant attached that *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 may 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 two-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. One important problem for the firm under a more permanent loyalty arrangement, however, is how it would address the dilution of share ownership that could result from repeated exercises of L-warrants. As with executive and employee stock ownership programs, the firm may then want to 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. If the firm has many growth opportunities and is engaged in a large capital expenditure program then it makes sense to let the number of shares outstanding grow with the size of the firm. If, on the other hand, the firm has reached maturity then it may be desirable to maintain a target earnings-per-share ratio and therefore to engage in a sterilizing share repurchase program.

The table below summarizes the different structures for L-shares depending on the objectives of the issuer.

	New L-Shares *	Existing L-Shares with a Warrant	
		One Shot	At Maturity roll-over
Rewarding a Costly Monitoring			✓
Postponing a Costly Dividend		✓	
Securing a Strategic Investor		✓	
Facilitating a Share Issue	✓	✓	

** In the Case of an IPO*

This table can be read as follows: starting from the second row, if the objective is mainly to postpone a dividend payment then an L-share with a *one-shot warrant* seems most appropriate. If the firm is contemplating a more permanent change in *dividend policy* then an L-share with recurrent grants of warrants (together with a share repurchase program) of a value proportional to the dividend payments that the firm is eliminating seems more suitable.

Similarly, the continued commitment of a large activist shareholder or a strategic partner may also require recurrent grants of warrants.

III] BENEFITS AND USES OF L-SHARES

Besides inducing shareholders to take a more long-term perspective in broad terms, L-shares may also be helpful instruments for more specific transactions the firm might contemplate. We briefly touch on these more specific uses in this section.

III.1. 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 (see e.g. Bolton and Von Thadden, 1998). 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 long period of time. This time lag between the costly intervention and the return from the intervention requires compensation, which L-shares are well suited to provide efficiently. 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.

III.2. 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 (see Soter and Evanson, 1996) . 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 mostly undid the cut. An alternative, more logical, approach could be to substitute a dividend payment with an L-share offer, which would simply move the payment to shareholders later in time, in a state of the world when the firm is in better shape.

This is exactly what *Michelin* did in 1991, when it offered shareholders a classic out-of the money warrant, exercisable in two years in exchange for a dividend cut. More precisely, the warrant could be exercised only by those shareholders who would have held on to their

shares for the two years (without any interruption). 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.

III.3. Securing a strategic alliance

Short of a sale or a full merger deal, any strategic long-term investment could be enhanced by a grant of L-shares to the strategic investor. This would strengthen the strategic partner's long-term commitment, while maintaining the partner's ability to trade its' shares in the event of a liquidity shock. 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". L-shares may also support a more 'flexible' long-term commitment by focusing on the benefits of staying loyal to an ultimately successful venture without imposing an unduly severe penalty on the L-shareholder for leaving a sinking enterprise. Indeed, if the firm is mismanaged and as a result underperforms, the underlying share price will decline, so that the L-warrants will be 'out-of-the-money' and worthless. Nothing would then stop the L-shareholder from selling her shares before the commitment period expires.

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 important L-share characteristics. While the U.S. treasury's concern mainly was to hide the extent 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.

III.4. 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. To see this, consider the following simple example where the IPO valuation delivers a price of 99.5, and suppose that the L-warrant is worth 1, but long-term investors represent only about 50% of subscribers. Then the expected cost of the warrant to the firm is only 0.5, so that each share offered is worth 99.5 without the warrant, and 100 with the warrant (given that only 50% of subscribers are long-term shareholders). Then the L-shares could be offered at 100, giving long-term investors an expected value of 100.5

against a value for short-term investors of only 99.5. Short-term investors would then be slightly more reluctant to subscribe just to take advantage of the potential discount associated with the IPO valuation (everything equal they would incur a .50 cost), while long term investors would have an initial gift of 0.5. 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

Having outlined the main features and purposes of L-shares we now turn to the analysis of the likely effects of the introduction of L-shares on the firm's secondary market for common stock.

IV.1. Transfer of Wealth from short-term to long-term investors

A first key effect of the introduction of L-shares is a transfer of wealth from short-term to loyal shareholders, other things equal. This effect follows directly from simple *Modigliani and Miller logic*, if one assumes that aggregate firm value is a given constant amount that is unaffected by the introduction of L-shares. We illustrate this wealth transfer in a numerical example given in table A.

In this example the share price prior to the introduction of L-shares is set at $100 and there are 10 million shares outstanding. An L-share is introduced in the form of a rights issue granting every share a warrant worth $2 in present value at the expiration of the loyalty period. Now suppose that there are 10% long-term shareholders who hold the L-share until expiration of the loyalty period. Then by Modigliani and Miller, the incremental average value per L-share must be transferred from the value of common shares to maintain the aggregate capitalization constant. This means that mechanically the introduction of L-shares results in a stock-price decline of $0.2, so that the post-issue price of common shares is $99.8. The 10% fraction of loyal shareholders therefore extract a transfer of $1,800,000 from the 90% other short-termist shareholders.

By assuming that the firm's aggregate capitalization remains constant, this example obviously exaggerates the size of the wealth transfer. 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. Conceivably, the value creation induced by the longer term orientation may be so large that no cost is imposed on short-termist shareholders.

IV.2 Change in Ownership Structure

Inevitably, at the expiration of the loyalty period and following the exercise of the L-warrant the shareholder base will shift composition towards more long-term oriented shareholders. This shift is reinforced, if the company chooses to undo the share dilution following the

exercise of the warrants with a share repurchase program. The example in Table B illustrates the effect of a share repurchase program under the assumption that the L-warrants represent 10% of the firm's equity ex post (and 1% ex ante, before shareholders know whether they will be able to hold the shares until expiration of the loyalty period or not).

What this example illustrates is that, as the shares are repurchased from short-term shareholders, the share repurchase program will enhance the shift in ownership towards loyal investors. A practical question is when the repurchase should take place, in anticipation of or after the warrants are exercised? The issue is about price and cash management. If the repurchase is planned for after the warrants are exercised the firm will be uncertain about the price. If, on the other hand, the repurchase is upfront the price will be known but the uncertainty will be on the number of outstanding shares and consequently the firm's cash reserves, as the firm won't know whether the warrants will be exercised or not.

TABLE A: *Transfer of Wealth from short-term to long-term investors*

Terms of L-Shares

Maturity:	4 Years
Loyalty Period:	2 years
Strike:	At the Money
Parity:	10 for 1
Volatility:	27%
Div Yield:	1.75%
Interest rate:	2%
Price of the share:	$100
Price (for LT shareholder):	$2
Price (for ST shareholder):	$0
Expected value:	$0.20

Capital Structure

ST Shareholders:	90%
LT Shareholders:	10%

	***Short Term* Investors**	***Long Term* Investors**
Before L Share		
Number of Shares	9,000,000	1,000,000
% of the capital	*90%*	*10%*
Price	$100	$100
After L Shares		
Theroretical Value [1]	$2	$2
Value with Probability [2]	$0.2	$0.2
Value for the Owner	$0.0	$2.0
Price of the Share	$99.8	$99.8
Value for each Sharehold	$99.8	$101.8
Total Gain/Loss	-$1,800,000	$1,800,000

(1) Without taking into account the probability

(2) Takes into account the probability. But only the Long Term investors will ge

TABLE A: ***Transfer of Wealth from short-term to long-term investors (continued)***

Short-term Shareholders

(90%)

$100

Drop in the amount of expected value of warrant : -$0.2

$99.8

Long-term Shareholders

(10%)

$101.8

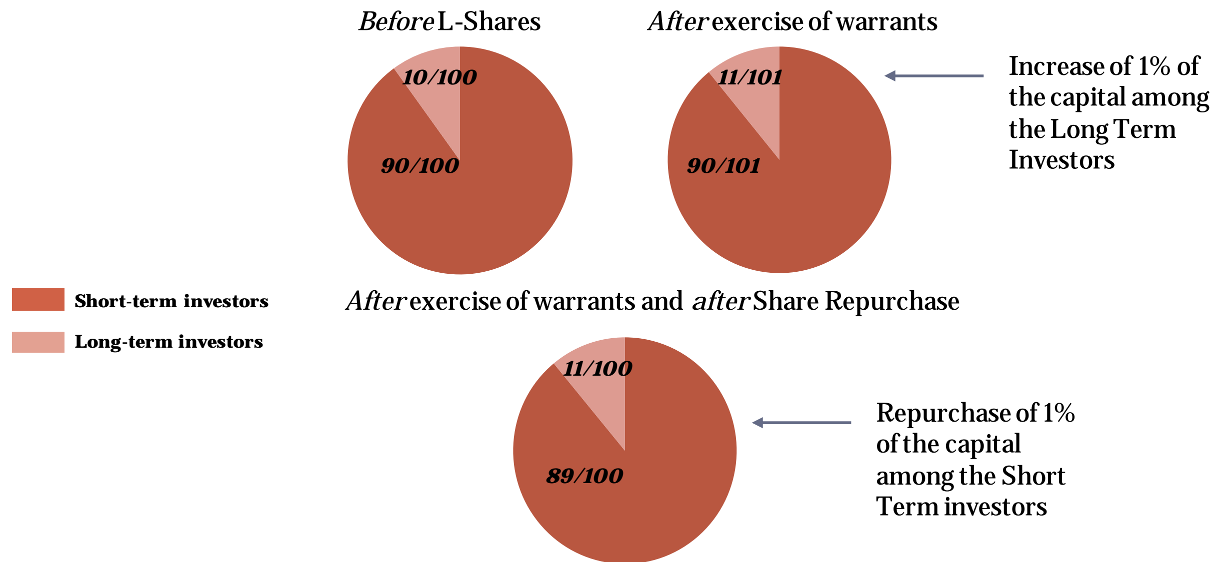
Rise in value of warrant: +$2

$100

Drop in the amount of expected value of warrant : -$0.2

$99.8

TABLE B: ***Change in Ownership Structure***

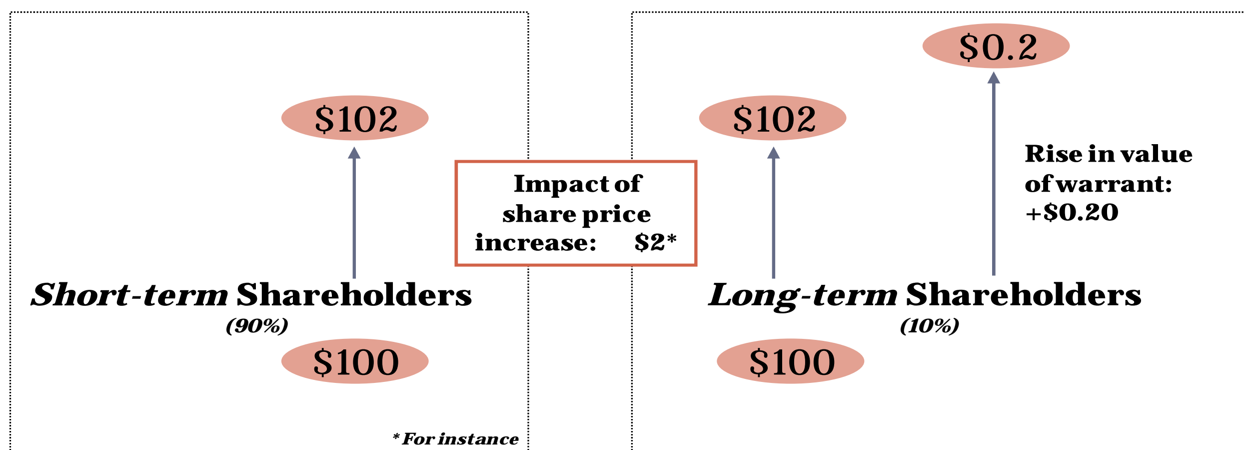


	Short Term Investors	Long Term Investors
Before L Share		
Number of Shares	9,000,000	1,000,000
% of the capital	*90%*	*10%*
% of the voting rights	*90%*	*10%*
After L Shares		
New Shares coming from L Warrants		100,000
Number of Shares	9,000,000	1,100,000
% of Capital and Voting Rights	*89.1%*	*10.9%*
After L Shares and Share Repurchase		
Share Repurchase (1)	100,000	
Number of Shares	8,900,000	1,100,000
% of Capital and Voting Rights (	*89.0%*	*11.0%*

(1) By construction, only the short term investors are selling their shares

(2) With the hypothesis that the warrants are exercised

TABLE C: ***How different Shareholders gain from a Share Repurchase Program***



	ST Investors	LT Investors	Stock-Option Holders
Dividend	+	+	
Share Buy Back	+	++	+

IV. 3 How different Shareholders gain from a Share Repurchase Program

A share buy back program affects different types of investors differently: long-term investors benefit more from the resulting share price increase than short-term investors, as they stand to gain both on the shares they own and on the warrants they receive at the end of the loyalty period. The example in Table C, in which the repurchase program is equal to the new shares issued following the exercise of the L-warrants (10% of the initial capital) illustrates this differential effect.

Long-term shareholders benefit more from the program than short-term investors, as they also receive a capital gain on the warrants. The share repurchase program also delivers a better alignment of interests between long-term shareholders and managers who own stock-options than a classic dividend payment. This is due to the fact that the dividend payment will not lead to an adjustment in the strike price (the strike price of the stock-options, or any classic options, is only adjusted in the case of an extraordinary dividend). In contrast, if the firm decides to repay shareholders through a share repurchase program—which would result in a share price rise—the resulting rise in share price will benefit executive stock-option holders (through an increase of value of their stock-options) as well as long-term share holders (through an increase of value of their shares and their L-warrants). This is thus another way of aligning the interest of managers with those of long-term investors (See Table C)

IV.4 Loyalty Shares and Market Liquidity

One concern with a Loyalty-share program is that the greater incentives for shareholders to stop trading their shares during the loyalty period might lead to a reduced underlying liquidity in the secondary market. However, against this reward to buy-and-hold shareholders, there are two important countervailing effects that mitigate this concern.

First, dynamic hedging of the warrants by traders would increase liquidity of the underlying stock in proportion to their delta neutral adjustments. 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, when this is not too much of a problem.

IV.5 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 be volatility. The effects of L-Shares on volatility could 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, the presence of L-shares should tend to slightly increase volatility. The reason is that some long-term investors (main actors in the share lending market) by lending their shares during the loyalty period will lose the right to the L-warrant, as a loan would count as a transfer of ownership. Therefore, to obtain a loan of a share from a long-term investor the borrower will either have to deliver the value of the L-warrants to their counterparties or to "manage the options", and therefore have a negative gamma position (requiring a counter-cyclical hedging position).[4] Note, in particular, that in this respect L-shares discourage short-selling as they increase the cost of borrowing shares.

4 At the opposite long term investors could think about monetizing their positions. But that would lead to operational issues (authorizations for OTC products, counterparty risk,…) and therefore reduce that impact.

V] PRICING LOYALTY-SHARES

Even though there is no precedent for the valuation of this instrument, the pricing of L-Shares ought to be straightforward as there exist similar instruments, such as executive stock-options that vest only after a pre-specified period of time, 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. Thus, a valuation formula along the following lines may be appropriate:

Fair value L-warrant = Call Option Model[5] * [*Stable Capital*/Total Float + *Turnover Capital*/Total Float* Max [100%-(Turnover Capital annual Roll-Over * Loyalty Period), 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.

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).

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5 With Call Option Model (vesting + maturity, spot, strike, dividend yield, interest rates, implied volatility)

VI] IMPLEMENTING LOYALTY-SHARES

There are a number of important institutional and contracting issues with the implementation of L-Shares, such as the tracking of shareholder loyalty, the accounting treatment of L-warrants, tax implications, corporate governance, etc., which we address in this section.

VI.1 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, and as such should therefore not affect the income statement. Thus, consistent with both US GAAP and with IFRS, the attribution of an L-share should therefore have no impact on reported earnings per share.

VI.2 Tracking Loyalty

How can an issuer of L-shares verify that a shareholder is entitled to an L-warrant—when she held her shares throughout the loyalty period—and at the same time preserve the shareholder's anonymity? This is a key question, which fortunately has a simple technological answer.

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 an 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.

Of course, companies such as Air Liquide for example, who ask their shareholders to become "registered shareholders" (either in a direct registry held by the company or in a *street-name* administered registry) can, of course, simply check the register to verify loyalty. But these companies take a risk of dissuading ownership by a significant shareholder clientele that wishes to preserve their anonymity.

VI.3 Treatment of L-Shares in an M&A Transaction

A company may be affected by many major events during the loyalty period, some of which may require adjustments to the basic terms of L-Shares outlined above. In particular, we single out for discussion events that trigger major changes in ownership of the corporation: an acquisition, a takeover, or a bankruptcy. Consider first how L-Shares ought to be adapted

to an acquisition during the loyalty period. The key difficulty with an acquisition is that if the company is acquired through a friendly acquisition then the exchange of shares of the target company (for cash and/or for shares in the merged entity) is dictated by a shareholder vote. In other words, the exchange 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. One advantage of this change in terms is that it puts all shareholders on an equal footing when deciding on the merits of the acquisition. Otherwise, long-term shareholders would have an incentive to vote against their company's acquisition in an effort to hold on to their promised warrants. Also, it eliminates any incentives by management to bring forward a merger deal in an effort to void the firm's obligations on its L-Shares. One objection might be that the acceleration may have similar diluting effects to a poison pill. But, note that the warrants would likely represent only a small fraction of outstanding shares. Moreover, if share dilution is sterilized through a share repurchase program then the only effect of the acceleration of the maturity of the loyalty period would be to bring forward a cash payment to shareholders. On net, it is therefore not obvious that the acceleration of the loyalty period will be a worse obstacle to an acquisition than the non-acceleration, which would result in long-term shareholder entrenchment.

VI.4 Treatment of L-Shares in Bankruptcy

What about the effects of a bankruptcy filing before the expiration of the loyalty period? To the extent that L-Shares only commit the firm to issue more shares to loyal shareholders (at pre-specified terms through a warrant) it makes sense to simply merge long-term shareholders in the same pool as other common equity holders. Loyalty-shares do not put long-term shareholders ahead of other common shareholders in any way, so that there is no reason to classify them separately. Also, should equity holders be so lucky to emerge with some equity claims from bankruptcy then the bankruptcy filing would have neutral effects with respect to any change in ownership, so that there would be no need to change the terms of the loyalty share. The only issue concerning acceleration is whether it makes sense to grant more voting rights in bankruptcy to long-term shareholders. However, in this state of the world giving long-term shareholders more say is likely to have only a marginal impact.

VI.5 Voting Rights of L-Shareholders

This brings us to the issue of other rewards to long-term shareholders in terms of greater voting rights. 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. Note, however, 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 they should get even more control rights. If the company deems it desirable to increase the share of votes in the hands of loyal shareholders there should be nothing stopping it from attaching an L-warrant only to a class-A share that has more voting rights than B-shares (assuming that the company already has a dual-class ownership structure). If the company does not have a dual-class structure and wishes to quickly put in place a loyal shareholder base with more voting control it would have to set up a dual-class structure, which admittedly may be difficult under US corporate law. Inevitably, it would also come at the cost of reduced liquidity.

VI.6 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. Moreover, if the L-shares are granted through an unrestricted rights offer then there would be no further disclosure requirements. 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.

VI.7 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. For an individual investor this would currently mean that a tax rate of 18% plus a rate of 12.1% towards social contributions would be applied to the realized capital gain. For corporations, realized capital gains on the sale of L-shares would simply be consolidated into corporate earnings and as such be taxable at the standard corporate tax rate of 33.3% currently. But corporations could also benefit from a favorable tax treatment for *long-term capital gains* if: (i) the shares represent at least 5% of the firm's equity and 5% of the voting rights; (ii) the shares are held for at least 2 years; and (iii) the shares are registered in a so-called "participation" account. If all these conditions are met then the relevant tax rate that is applied to the capital gain on L-shares is only about 1.65%.

VI.8 Corporate Law Issues

Under French Law, specifically under article L. 232-14 of the *Code de Commerce* a company can grant something like an L-warrant or loyalty dividend (*dividende majoré*) or additional voting rights subject to shareholders holding their shares for a two-year holding period.

However, in most countries the legal status of L-Shares has not been defined explicitly.

Several of the key corporate law issues raised by L-Shares have recently been considered in a Dutch case involving *Royal DSM NV* and some of its shareholders, who objected to the company's plan to issue a *loyalty dividend*. These issues include: possible violations of the principle of equal treatment of shareholders, and whether to require a shareholder vote on the decision to grant L-shares.

Equal treatment of shareholders

Consider first the issue of equal treatment of shareholders. As the plaintiffs in the *Royal DSM NV* case have argued, one concern could be that L-shares or any similar mechanisms might violate the principle of equal treatment of shareholders. We believe that this is debatable for two main reasons. First, as we have outlined, L-shares could be offered to all shareholders on an equal basis. Every shareholder then has the same opportunity to acquire L-warrants on the same terms. Second, L-warrants are obtained by holding shares for a pre-specified period of time, starting at the moment a share is sold to a shareholder. There is then no discrimination among shareholders, and access to L-warrants only depends on the shareholders' behavior during the loyalty period, which, again, is the same for all shareholders. In other words, all shareholders can be given equal chance to get an L-warrant.

Interestingly, the Supreme Court of the Netherlands reversed the Amsterdam Court of Appeals' decision to ban *Royal DSM*'s proposed loyalty dividend, by referring to the French

statutes and arguing that the principle of *equal treatment of shareholders is only a means to an end*: the maximization of enterprise value. To the extent that maximization of enterprise value may be achieved by deviating from the strict adherence to shareholder equality, such a deviation is permissible.

Shareholder vote

A shareholder vote to grant L-shares would be necessary if the granting of L-shares requires a modification of the company's by-laws. Otherwise, the distribution of L-warrants should be treated the same way as a dividend payment or a classic equity issue.

VI.9 Other Issues: Decoupling and Arbitrage

A natural question concerning 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 stick 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. Would these schemes undo L-shares altogether?

Note first that forward trades in L-shares are unlikely as the counterparty of the forward trade would probably have to borrow the shares for hedging purposes (and the shares are likely to be borrowed from some long term investors asking for the value of the warrant to lend them). Second, these trades would also involve a counterparty risk, which would inevitably be reflected in the forward or derivative price and would consequently discourage such trades. As for setting up an intermediary fund (to take uniquely advantage of the L-Warrant), note that this would result in reduced liquidity for a limited gain.

VII] COMPARISON OF DIFFERENT TYPES OF REWARDS FOR LOYALTY

How do loyalty-rewards in the form of L-warrants compare with other observed types of rewards, such as *loyalty dividends*? At some level the nature of the reward is of secondary importance relative to the existence of a reward. Still we believe that L-warrants are likely to be better instruments as they are more flexible.

Relative to simply granting additional shares at the expiration of the loyalty period, L-warrants have a first added benefit of allowing the firm to take advantage of a leverage/insurance effect (disproportionately rewarding long-term investors in the most profitable states of the world).

Second, 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. Third, 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.

Relative to rewarding long-term investors with additional voting rights, we also believe that L-warrants may be preferable as 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.

Relative to rewarding long-term investors with a special dividend, as in the case of L'Oreal, the benefit of L-warrants is that they do not tend to depress the stock price to the same extent as the special dividend, thus better helping align the long-term objectives of the CEO with the long-term objectives of L-shareholders. We summarize these points in the table below.

Comparison between the Different Solutions

	Extra Shares	Extra Voting Rights	Loyalty Shares	Tax Treatment	No Quarterly Results
Impact on Liquidity	**Limited and only if increase**	**Limited**	**Limited and only if increase**	**Limited and only if increase**	**Limited**
Impact on Volatility	**No**	**No**	**Potentially *reduces* it**	**No**	**No**
Impact on Share Borrowing Cost	**No**	**No**	**Potentially *increases* it**	**No**	**No**
Sensitivity of the Incentive to the Market Conditions	**Yes**	**No**	**Yes**	**Yes**	**No**
Takes into Account the Volatility	**No**	**No**	**Yes**	**No**	**No**
Increases the Alignment with the Management	**No**	**No**	**Yes**	**No**	**No**

VIII] CONCLUSION

As more and more commentators are arguing, there is a greater need than ever of counteracting the short-termist outlook of modern financial markets. Continuous electronic trading platforms, computer trading algorithms, the growth of day-trading, have all contributed to accelerating the response of speculative investors to news and to increasing the returns to short-term speculative activities. What has suffered as a consequence is long-term investing focused on an evaluation of the long-term fundamental value of a firm.

Loyalty-shares provide in our view a simple contractual innovation that helps restore the balance between long-term investors and short-term speculators. They allow issuers to

discriminate between long-term and short-term investors and to reward those shareholders that are most loyal to the company. At the same time loyalty-shares do not require firms to make radical financing and corporate governance changes. They offer a simple correction towards a more long-term fundamental value outlook, which can be scaled up at will by the corporation. But, their introduction will not disrupt the functioning of secondary markets or undermine stock market liquidity.

There is also a growing long-term oriented investor constituency comprising pension funds, employee stock-ownership plans, and sovereign wealth funds, which would be a natural investor clientele for L-shares. We therefore believe that these are propitious times for this simple innovation, as both the need for a more long-term management reorientation, and the demand for long-term investment products has never been greater.

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