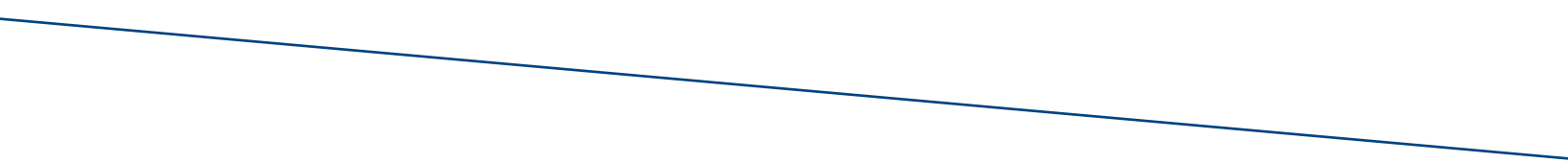


# BUILDING A LONG-TERM SHAREHOLDER BASE: ASSESSING THE POTENTIAL OF LOYALTY-DRIVEN SECURITIES



CONSULTATION FINDINGS



This report was prepared by Jane Ambachtsheer and Ryan Pollice of Mercer and Ed Waitzer and Sean Vanderpol of Stikeman Elliott LLP. The report is the product of the collaborative efforts of Mercer, Stikeman Elliott LLP, and the Generation Foundation and has drawn on the expertise and advice of numerous specialists and practitioners. We thank everyone who contributed to this process, and in particular, acknowledge those who shared extensive time and insight with us. The views expressed in this report are those of the authors and do not necessarily reflect the views of those who participated in the consultation. We accept any errors in this document as our own.

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The Generation Foundation (the “Foundation”) was part of the original vision of Generation Investment Management LLP when the firm was founded in 2004. Charged with a mission of strengthening the field of sustainable capitalism, the Foundation’s funding is based on receiving a distribution from Generation Investment Management’s annual profitability. For more information, visit [www.genfound.org](http://www.genfound.org).

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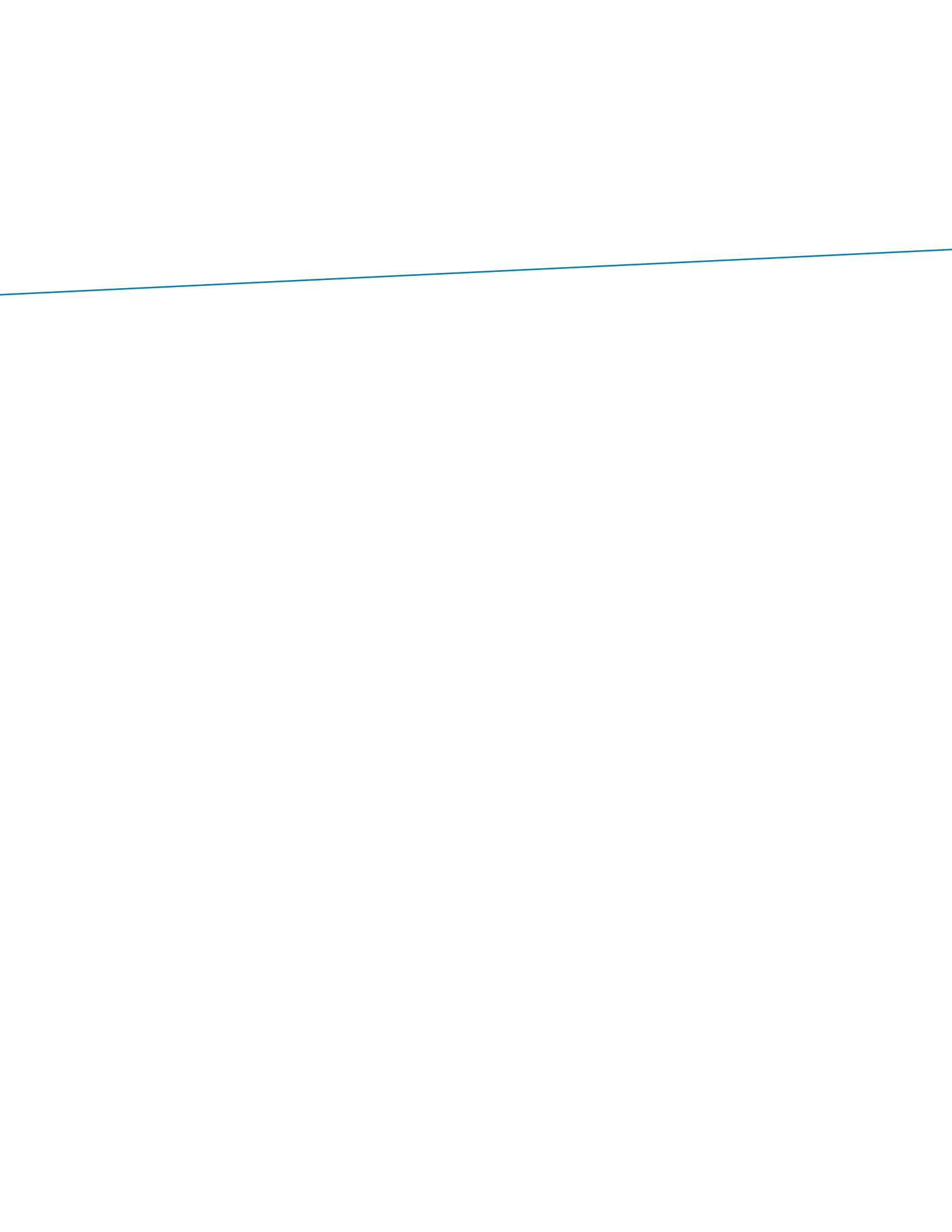
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# FOREWORD

Investors and other market participants are increasingly recognising that fostering longer-horizon thinking and behaviour in financial markets is critical. Concerns that an excessive short-term focus can undermine the creation of long-term value are central to the work of the Generation Foundation and many others committed to exploring this topic and potential solutions.

In 2012, the Generation Foundation published *Sustainable Capitalism*, which identifies five actions that financial market stakeholders could pursue to counteract many of the sources of short-termism and promote financial markets that operate with the goal of promoting long-term sustainable economic growth. The actions include:

- Identify and incorporate risks from stranded assets.
- Mandate integrated reporting.
- End the default practice of issuing quarterly earnings guidance.
- Align compensation structures with long-term sustainable performance.
- Encourage long-term investing with loyalty-driven securities.

Generation has committed to undertaking and supporting additional research in order to further develop these actions. In this spirit, we commissioned Mercer and Stikeman Elliott LLP to manage a series of consultations to explore the relationship between issuers and their shareholders by considering the potential use of loyalty-driven securities by issuers as a means of cultivating a base of long-term shareholders. Loyalty-driven securities have been the subject of increasing debate in terms of its potential to more closely align company executives and long-term shareholders towards a greater focus on long-term value creation.

We believe that a more robust relationship between companies and their long-term owners can support more sustainable capitalism. The findings from our consultation suggest this is a widely held view. Although the consultations in this study revealed why loyalty-driven securities face challenges for implementation, the study did highlight other ways in which patient capital can be incentivised.

We look forward to further exploring the alternative ideas set forth in this report in pursuit of our aim to achieve long-term oriented alignment in financial markets.

THE GENERATION FOUNDATION

Investors and other market participants are increasingly recognising that fostering longer-horizon thinking and behaviour in financial markets is critical.

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# EXECUTIVE SUMMARY

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Through building a base of more patient capital in the form of a more stable group of long-term shareholders, the intended aim would be to reduce short-term pressures on boards and senior executives and better align companies and investors with a shared focus on long-term value creation.

The concept of loyalty-driven securities is a share structure that provides differentiated rights or rewards to a group of shareholders identified on the basis of the tenure of their shareholding. Various models include the use of extra dividends, warrants, or additional voting rights granted to investors that achieve minimum holding periods (for example, shareholders that held their shares for three or more years would be eligible). Loyalty-driven securities have been presented as a potential means by which issuers could cultivate a base of long-term shareholders by incentivising longer holding periods. Through building a base of more patient capital in the form of a more stable group of long-term shareholders, the intended aim would be to reduce short-term pressures on boards and senior executives and better align companies and investors with a shared focus on long-term value creation.

Discussions about the potential use of loyalty-driven securities have occurred against the backdrop of broader debates on the differential treatment of shareholders as a means of curbing short-termism. For example, the Kay Review most recently discussed the potential for offering enhanced rights to longer-term investors and challenging the “one share, one vote” principle of Anglo-Saxon corporate governance. The European Commission is also reportedly considering a proposal to give “loyal” shareholders extra voting influence. These developments have occurred alongside other observers questioning whether giving long-term shareholders greater rights could improve corporate governance.

In *Sustainable Capitalism*, loyalty-driven securities were one of five key proposals the Generation Foundation identified as a potential tool to accelerate the transition to sustainable capitalism. While the concept was appealing, it was largely contested. Thus, the foundation commissioned Mercer and Stikeman Elliott LLP to manage a series of consultations to explore the relationship between issuers and their shareholders by considering the potential use of loyalty-driven securities by issuers as a means of cultivating a base of long-term shareholders. This report presents the findings from a series of consultations held globally to determine the extent to which actors across the investment chain view loyalty-driven securities as both attractive and likely to be effective. Over an eight-month period, Mercer and Stikeman Elliott LLP organised individual interviews and group discussions held via teleconference and in-person in New York, Toronto, London, Sydney, and Melbourne. In all, more than 120 individuals provided their valuable insights and feedback. Appendix A of this report outlines the methodology behind the consultation and the findings.

## KEY FINDINGS

Our consultations indicate that there is broad consensus around the belief that short-term behaviour on the part of investors is driving non-optimal behaviour by companies, a problem exacerbated by corporate and investment-manager norms and incentive structures. However, we found little support for the introduction of loyalty-driven securities.

A small minority of participants believed loyalty dividends and L-shares (special warrants) may alter investor behaviour and could produce ancillary benefits. However, loyalty-driven securities were, in general, not seen as a measure that would contribute significantly (and positively) to the perceived problems or address what were viewed as the root sources of short-term pressures (misaligned incentives throughout the investment chain), even if adopted on a widespread basis. With the exception of a small number of participants in the consultations (including existing issuers of loyalty-driven securities), issuers and investors consulted did not view loyalty-driven securities (and the commensurate differential rights for shareholders of a certain holding period) as an attractive proposition. The key criticisms of the concept are outlined below.

- **Discrimination between shareholders** — The endorsement of the principle of “one class, one share, one vote” as corporate governance best practice represents a significant barrier to the widespread introduction and acceptance of loyalty-driven securities by both issuers and investors. Many participants were of the view that differentiated rights and/or dual-class share structures were not supportive of strong and effective corporate governance systems. Therefore, a mechanism to address short-termism that relies on contravening this principle was not viewed favourably.
- **Risk of unintended consequences** — Investors raised concerns that eligibility criteria based solely on holding period (in proposed and existing

examples to date) would favour certain types of investors and may produce outcomes that may not be consistent with the objectives of loyalty-driven securities.

- **Administrative complexities** — From a practical perspective, the introduction and administration of loyalty-driven securities was viewed as creating significant complexities around tracking tenure of ownership, share transfer, registration, and custody. While these barriers could be addressed — for example, Bolton and Samama propose the use of SEDOL codes for tracking of L-shares — participants in the consultation did not believe the demand necessary to drive these changes was likely to develop.<sup>1</sup>
- **Weak incentives** — The nature of the reward (extra voting rights or nominal increased dividend) was not viewed as significant enough to incentivise a desired change in behaviour. Further, a number of participants expressed the view that the amount of the reward was unlikely to be significant enough to forgo securities lending revenues.
- **No consensus that loyalty-driven securities address root causes of short-termism** — A large majority of those consulted did not agree that an incentive or reward for holding shares for a specified period of time was directly related to addressing sources of short-term pressures on companies. There was significant debate as to whether holding periods of institutional investors had declined significantly and if so, how declining holding periods would function to generate short-term pressures that, in turn, influence corporate decision-makers. In general, those that participated in the consultation (including most issuers consulted) did not equate the problem to an issue of declining holding periods and therefore viewed loyalty-driven securities as unlikely to incentivise significant constructive change in behaviour by investors or reduce short-term pressures on companies.

## BUILDING ON THE CONSULTATION'S FINDINGS: IF NOT L-SHARES, THEN WHAT?

Discussions led to three distinct but interconnected priority themes for continued focus. Each of these three areas plays a critical role in establishing a relationship whereby long-horizon investors and companies make sound decisions, and have the time and infrastructure to stick by them.

1. **Longer time horizons for investment analysis** — Applied to investment opportunities and company projects, a longer-term outlook allows for increased focus on long-term value drivers, including innovation and management of different forms of capital (physical, financial, human). This speaks to the core of “short-termism”, as it relates to the mindset that individuals (in investment firms or companies) use to make decisions on a day-to-day basis.
2. **Aligned frameworks for performance measurement and reward** — A longer-term perspective for value creation and delivery is only possible if supported by appropriately aligned performance measurement and reward frameworks. Otherwise, individuals (in investment firms or companies) will be penalised for decisions that may not be rewarded by short-term share price movements but will pay off over the long term.
3. **Stronger relationships between companies and investors** — A more constructive relationship between companies and their long-horizon investors is required to deliver longer-term value creation. If investors are going to support long-term decisions, which may take some time to pay off, they need to have faith in the strategy and also the executive team that will execute it. This may require more information — on paper, and sometimes in person.

We believe a number of opportunities exist across these themes for near term action. These include:

- a. **Supporting better-informed fiduciary oversight.** A proactive intervention in the trustee world with the goal of informing and equipping fiduciaries to understand and act on their responsibilities could be an important step forward (an idea also highlighted in Generation's 2012 *Sustainable Capitalism* paper). The goal is not just to inform, but to put concepts into practice. For example:

- Board/investment committee education programs present an opportunity to either include content on these themes, or develop curriculum specific to them. Some examples exist (for example, the Rotman School of Management's Board Effectiveness Program) but room for more exists.
- A database of “sustainable financial market-certified” candidates for board/trustee/investment committees could be developed, similar to the US Diverse Director Datasource (for corporate board candidates). This could be developed as a global model, with local partnerships.
- Policy and regulatory frameworks play a critical role in shaping behaviour, and further focus on how they help or hinder behaviour that is conducive to long-horizon value creation is warranted (by investors and companies).
- b. **Move from talk to action.** The past five years have seen significant focus within the investment community on pioneering “new ways to do things” to better align beneficiaries, fiduciaries, investors, and companies. Now is the time to move beyond “blue sky” discussions and put these revised systems and frameworks into practice. For example:
  - Numerous investment strategies exist that have long-horizon investment as their core proposition. Investors can actively preference long-horizon strategies as they replace and select new fund managers. The key point is that low-turnover (or long-horizon) strategies are out there — but they need to be used. Further, asset owners should speak to their managers about how they value longer-term ESG risks and exercise their rights as shareholders. We should not underestimate the ability for client demand to change behaviour at the fund manager level.
  - A live “shadow monitoring” pilot could establish a wider set of metrics against which to monitor and report fund manager performance to clients. This process could facilitate active client feedback to then refine the process and subsequently embed it as “the new norm”. The refined metrics would look beyond relative benchmark performance (such as return on invested capital) as well as performance on voting and monitoring.



- Alignment of incentives in the executive compensation context is also an area that has seen considerable focus by industry commentators. What is needed is for more implementation of the “best ideas” into practice. This requires more demand from shareholders, but an active project to facilitate match-making between long-horizon investors and long-horizon companies to proactively tackle this issue could help to set important industry precedents.
- c. Change the dialogue between owners and companies. A key takeaway from the consultation is that we need to find a new and better way for investors and companies to have a relationship. On the active side, this could be a natural evolution of lower-turnover portfolios with heightened focus on engagement. For passive managers, one-to-one engagements with issuers are of course much more challenging. Thus, a key opportunity is to establish a mechanism for passive managers and large issuers to come together to address major systemic issues and develop relevant standards.
- Establish an investor-issuer council for systemic risk focused on establishing a formal relationship between institutional shareholders and companies. It would be important for this to include commercial passive managers, given the large and growing assets under management.
- Launch a campaign to encourage analysts and investors to ask companies during quarterly earnings calls and other meetings what their plans are to build wealth over a five- to seven-year time horizon. Then, ensure voting decisions are executed consistent with this time frame.

Mercer, Stikeman Elliot LLP, and the Generation Foundation will continue to work independently and collaboratively to action these concepts and support a more proactive approach to addressing issues or short-termism and systemic risk across the investment chain. We encourage others to share this proactive approach and look forward to collaborating for a better financial future for all.

# AN OVERVIEW OF LOYALTY-DRIVEN SECURITIES

## THE NATURE OF THE PROBLEM

Several definitions and descriptions have been offered to provide context for the nature of the problems related to short-termism.<sup>2</sup> The Business Roundtable Institute for Corporate Ethics and CFA Centre for Financial Market Integrity defined short-termism as “the excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation.”<sup>3</sup> The common theme of the various definitions is that an excessive focus on the short-term results in decision-making or behaviour that comes at the expense of, or results in, suboptimal long-term effects.

Heightened interest in “short-termism” also reflects the belief that the causes of short-termism — as observed today — are products of poorly designed organisational incentives and failures of corporate governance systems rather than simply a result of information asymmetry, technological innovation, or the cognitive limits of decision-makers.<sup>4</sup>

Relating to the perceived need to insulate boards and senior executives from short-term pressures, a set of proposals is receiving increasing attention that suggest distinguishing between long- and short-term shareholders by allocating differentiated shareholder rights. Proposals have included limiting proxy access to shareholders of a specified minimum duration, inferior voting rights for short-term shareholders as well as increasing voting rights for long-term shareholders.<sup>5</sup> Other proposals have highlighted various means to more directly penalise short-term investing<sup>6</sup> or reward longer-term shareholding using tax and subsidy measures or financial rewards in the form of an extra dividend, for example.

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... an excessive focus on the short-term results in decision-making or behaviour that comes at the expense of, or results in, suboptimal long-term effects.

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For the purpose of this consultation, we were chiefly concerned with measures that could be adopted and implemented by individual companies as a means of cultivating a base of long-term shareholders rather than tax or other regulatory-based measures.

## LOYALTY-DRIVEN SECURITIES

Loyalty-driven securities allocate differential rights to shareholders who hold their shares continuously for a minimum specified period of time. In this way, loyalty-driven securities have been presented as a potential means by which companies could build a base of more patient capital that is intended to reduce short-term pressures on the company and better align companies and investors with a focus on long-term value creation.

Conceptually, such proposals have been supported by those that argue that the existence of a group of long-term shareholders can mitigate pressures for short-term behaviour, either through monitoring and a disciplinary role or by mitigating pressures coming from other, more short-term shareholders of the company.<sup>7</sup> While in many cases, this is done informally through investor relations activities, various proposals have called for companies to extend this principle by incentivising long-term shareholders through the issuance of what have been termed “loyalty-driven securities”. Emerging models outlined below, such as the loyalty dividend or the loyalty shares (L-shares) concept<sup>8</sup> as well as the use of double or extra voting rights provides suggestions for how this could be achieved.

## MODELS FOR IMPLEMENTATION

- **Voting rights:** Multiple or double voting rights that vest if shares are held continuously for the minimum “loyalty period”.<sup>9</sup>
- **Dividends:** The awarding of an extra or “preferential” dividend or share bonus on a one-time or recurring basis for those shares that are held continuously for the minimum loyalty period.<sup>10</sup>
- **Warrants (L-shares):** A call warrant would be granted to shares that are held continuously for the minimum loyalty period that vest at the expiration of the loyalty period and confer the right to purchase a pre-determined number of shares at a pre-determined price.<sup>11</sup> Bolton and Samama have been integral to the development of this concept and what they refer to as L-shares.<sup>12</sup>

Common characteristics of loyalty-driven securities include:

- The loyalty rights would be available to the shareholder and/or exercisable if the share is held for the specified loyalty period of, for example, three years.
- There would be a need for registrars to establish and track which shareholders qualify according to the eligibility criteria. In France, for example, shareholders are required to convert or transfer their shares to registered shares to be eligible (in either directly or managed form).
- The share must be held continuously. If the share is sold before the loyalty period ends, the rights are lost.
- Under the various proposals reviewed, the transfer of shares pursuant to a stock-lending arrangement would terminate the share lender’s period of ownership and therefore result in the loss of the rights attached to the loyalty-driven security.
- All shareholders would be eligible to participate provided they meet the qualifying conditions, whether defined by holding period or other criteria. Issuers or policy makers may, in turn, seek to cap the benefit qualifying shareholders may receive.

## WHY CONSIDER LOYALTY-DRIVEN SECURITIES?

As detailed below, loyalty-driven securities or “loyalty rewards” have been presented by some as a potential means by which issuers could cultivate a base of long-term shareholders by incentivising longer holding periods. Indeed, discussions about the potential use of loyalty-driven securities have occurred against the backdrop of broader debates on the differential treatment of shareholders as a means of curbing short-termism. For example, the Kay Review most recently discussed the potential for offering enhanced rights to longer-term investors and challenging the one-share, one-vote principle of Anglo-Saxon corporate governance. The European Commission is also reportedly considering a proposal to give “loyal” shareholders extra voting influence. These developments have occurred alongside other observers questioning whether giving long-term shareholders greater rights could improve corporate governance.<sup>13</sup>

## EXAMPLES OF LOYALTY-DRIVEN SECURITIES ISSUED TO DATE

### Loyalty Extra Voting Rights

In France, corporate law permits the awarding of double voting rights to reward long-term shareholders who have held their shares continuously in registered form for a minimum of two years (although the articles of association may provide for a required holding period of greater than two years). To date, more than 70 issuers in the Société des Bourses Françaises 120 Index have articles of association that provide such rights.

### Loyalty Dividends

In France, several issuers have proposed — and won shareholder approval for — the issuance of loyalty dividends to shareholders who hold their shares in registered form for at least two years (the minimum period may be longer and is set by the issuer). By law, corporations are limited to issuing an extra dividend that is no greater than 10% of the regular dividend. Further, the number of shares eligible for this extra dividend is restricted. A sample of French issuers of loyalty dividends includes Air Liquide, Credit Agricole, Lafarge, L’Oreal, and Group SEB. Outside of France, loyalty dividends have been considered but not implemented by Netherlands-based Royal DSM NV.

In addition to loyalty dividends, some companies have occasionally granted one-time bonus shares. For example, shareholders of Australia-based Telstra that participated under the company’s 2006 initial public offering were entitled to receive one bonus Telstra common share for every 25 common shares acquired under the offering, provided the shareholder held his or her shares until 15 May 2008. Additional examples can be found in the United Kingdom (British Telecommunications PLC, Standard Life), Singapore (Singapore Telecom), and Germany (Deutsche Telecom).

### Loyalty Warrants (L-shares)

The use of loyalty warrants is still at the conceptual stage. As an example of the proposal, Bolton and Samama cite the decision by the French company Michelin in 1991 to grant one-call warrant for every 10 shares held following a dividend cut, exercisable at a four-year horizon at an out-of-the-money strike price of FRF 200 (compared with FRF 115 at the time of the announcement).

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... “loyalty rewards” have been presented by some as a potential means by which issuers could cultivate a base of long-term shareholders by incentivising longer holding periods.

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## ARGUMENTS MADE IN SUPPORT OF THE USE OF LOYALTY-DRIVEN SECURITIES

- Proponents argue that to the extent that loyalty-driven securities serve to attract and retain long-term investors, they may assist a company seeking to develop a base of longer-term shareholders on the premise that this will reduce short-term pressure on company management.
- Loyalty-driven securities may serve as a means of transferring wealth and/or rights, empowering long-term shareholders with greater influence over corporate governance matters.
- To the extent there is a correlation between longer-term holding periods and monitoring costs, loyalty rewards serve as a reward for the latter. For example, some have argued that loyalty dividends can be seen as a means of compensating long-term investors for the cost of monitoring/engagement activities.<sup>14</sup> In turn, investor stewardship — done well — is increasingly viewed as beneficial to company performance and general market functioning.<sup>15</sup>
- The administration of a loyalty reward scheme may also support conditions for improved shareholder identification and communication as the requirement to register shares to be eligible to receive the reward may increase transparency, enabling the company to have better knowledge of its shareholder base, which may facilitate better dialogue.
- Some have argued that loyalty rewards — for example, loyalty dividends — serve as a mechanism for reducing the available stock for lending purposes and increase borrowing costs. This is seen as beneficial to those that feel stock lending is a destabilising activity.<sup>16</sup>
- Another perceived attraction is that issuers may adopt the use of loyalty-driven securities on their own initiative and structure it to fit their particular circumstances provided it is consistent with applicable corporate law. As outlined in the Appendix, the use of differentiated rights as contemplated under certain models for loyalty-driven securities are permitted by corporate law in many jurisdictions provided it is authorised by its articles of incorporation.

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## FINDINGS FROM THE CONSULTATION

### OBJECTIVES

In setting out to test this concept with key actors across the issuer and investment communities our objectives were to:

1. Determine market sentiment with regards to whether loyalty-driven securities are viewed as attractive proposals for companies looking to incentivise and cultivate a base of long-term shareholders.
2. Determine the extent to which actors across the investment chain view loyalty-driven securities as a measure that, if adopted more broadly, would be effective in promoting longer horizons among investors and a greater alignment of company executives and long-term shareholder interests.

The following section presents the key findings from the consultation and details the range of opinions we received, areas where consensus emerged, and where there was disagreement among those consulted.

### FINDINGS

Loyalty-driven securities were generally not seen as a measure that would contribute significantly (and positively) to the perceived problems or address the root sources of short-term pressures, even if adopted on a widespread basis. With the exception of a small number of participants in the consultations (including

existing issuers of loyalty-driven securities), issuers and investors consulted did not view loyalty-driven securities (and the commensurate differential rights for shareholders of a certain holding period) as an attractive proposition. The concept was not generally viewed as a strong incentive to drive changes in investment behaviour viewed as the source of short-term pressures in markets. Participants expressed strong beliefs that loyalty-driven securities result in discrimination between shareholders, risk entrenchment problems, and present administrative complexities in their implementation. Where support for loyalty-driven securities was voiced, warrants were seen as having the greatest potential to lengthen the time horizon in which an investor forms his or her opinion of the company's prospects, in turn encouraging a greater focus on a company's fundamentals, governance, and long-term strategy.

**The endorsement of the principle of “one share, one vote (and one dividend)” as corporate governance best practice represents a significant barrier to the endorsement of loyalty-driven securities.**

An overwhelming majority of participants shared the view that the use of loyalty-driven securities by publicly traded companies would amount to permitted discrimination among shareholders, treating one class of shareholders that is eligible to — and opts to — receive the reward in a different way to the rest. This was particularly the case for loyalty-driven

securities that grant double or multiple voting rights. Nearly all participants were of the view that differentiated rights and/or dual-class share structures were not supportive of “strong and effective corporate governance systems” and could lead to a negative performance drag. The potential contribution of loyalty-driven securities to the concentration of voting rights (most apparent in the case of shares that provide extra voting rights, but also in the case of loyalty warrants over time) was seen to risk leading to agency and entrenchment problems.

*“As a long-term investor, we see a number of issues with implementing loyalty shares and would not support an issuer moving to a loyalty-share structure. Our main concern is that in providing enhanced benefits of extra voting and/or dividend rights to a select group of shareholders, loyalty shares create dual class structures that are not conducive to creating strong and effective corporate governance. The most effective governance results from ownership structures that provide voting rights in direct proportion to ownership as no one shareholder or group of shareholders can exert influence that is not in direct relationship to the size of their investment.”*

Ontario Teachers’ Pension Plan

**Widespread concerns were raised that eligibility criteria based solely on holding period would preference certain types of investors and may lead to perverse or unintended outcomes.**

Concerns were raised that eligibility criteria based solely on holding period could reward insiders or founders or long-term, disengaged investors — an outcome that would be counter-intuitive to the objectives. On this latter issue, a common criticism of the proposals was that passive (index) managers will, by their very nature, be a long-term holder of the shares of index constituents. Views were put forth that while some passive managers will exhibit active ownership-type behaviour, others put much less focus on their processes around share voting and company dialogue and do not represent an engaged shareholder.

There was also considerable debate as to whether holding period was a sufficient defining characteristic of “shareholder loyalty” or long-term investing. In general, two descriptions of long-term shareholders were articulated: 1) a long-term shareholder is a shareholder who makes his or her investment decisions based on the long-term performance prospects of the company (for example, this long-term view is the basis for your decision to invest); or 2) an engaged shareholder sees themselves as the long-term owner of a company and encourages long-term thinking. Importantly,

participants were not comfortable with the notion of identifying “long-term shareholders” on the basis of holding period. There was also less agreement in terms of what “long-term owners of a company” means and what is desirable. For example, many investors said there is a need for more engaged ownership, but neither the meaning of this nor that “more engaged ownership” should always be equated with positive outcomes (in terms of long-term shareholder returns) were clear. Others said companies do not want engaged investors — so either side may not see each other’s roles in the same way. Doubts were raised as to whether the use of loyalty-driven securities would be likely to improve the quality of the communication between long-term shareholders and company executives.

*“Providing a reward to those who continuously hold shares for a specified period of time favours passive investors who are less-incentivised to engage and who are restricted from holding shares at weights outside of the benchmark. They would have to sell the shares granted by the loyalty warrant to stay in balance with the index anyway. Why would receiving an economic reward now incentivise them to change their behaviour?”*

Fund manager

*“A key point is that solutions to short-termism should not be “product driven” [the interviewers took this to mean there should not be undue weight placed on any one part of the investment chain] — the “product” is the share or the loyalty share and in this context took this to mean two important points. First, the weight of money in the great majority of companies is already long-term capital — essentially, these shareholders will receive an incentive in the form of loyalty rewards, but really they wouldn’t have behaved differently in the absence of a loyalty reward. Second, there is a group of investors in most companies that may be termed speculators, driven by arbitrage strategies — and adding extra bits and pieces in the form of L-shares will not alter their behaviour — they will not wait the two years.”*

Company director

**The introduction and administration of loyalty-driven securities by issuers was viewed as creating significant complexities around the matter of tracking tenure of share ownership, share transfers, registration, and custody.**

A recurring perspective from those interviewed who were familiar with the usage of loyalty-driven securities in France was that the process to register for the reward was overly cumbersome and complex for institutional investors. One issuer termed the administrative issuers around tracking tenure of ownership as “an administrative nightmare”. Where eligible, none of the institutional investors we consulted with had registered to receive the loyalty dividends available from a number of French issuers.

Investors that were interviewed cited difficulties in registering and the potential time lag associated with de-registering as limiting the attractiveness of loyalty shares and imposing liquidity constraints. This was also confirmed by a French issuer (that provides a loyalty bonus dividend to registered shareholders of longer than two years) that suggested the existing process was “unfriendly” to large, institutional investors and particularly those outside of France. It was recognised that in other markets, the system could be more straightforward. For example, Bolton and Samama propose the use of SEDOL codes for tracking of loyalty share eligibility. However, participants in the consultation did not believe the demand necessary to drive these changes was likely to develop. The perception was that there remains limited incentive for those responsible for driving changes to implement and absorb the costs of such changes (for example, registrars, custodians).

*“There are some regulatory developments that are more promising and loyalty rewards will effectively add complexity. Rather, we need intelligent regulation that enables simplicity and enhances the ability of key actors in the process (especially companies) to think more long term — especially: (1) the integrated reporting initiative, and (2) Australian Securities and Investments Commission’s Consultation Paper 187 ‘Effective disclosure in an operating and financial review. The approach represented by these two initiatives is likely to be more effective than loyalty shares. Emphasis should be on regulation to make companies better not convoluted mechanisms to improve markets.”*

*Investor relations professional*

**The nature of the reward and eligibility criteria tied to holding period was viewed as not significant enough to incentivise a change in behaviour.**

Concern was also expressed that loyalty reward schemes could be gamed. For example, shareholders could employ the use of derivatives to receive the reward while hedging exposure to the issuer’s stock. Efforts are also likely to be required to limit the parameters of the reward to reduce abuses by controlling shareholders (for example, the French Code de Commerce limited the parameters of the reward, placing an upper cap on the amount of the extra dividend (no more than 10% premium to company’s ordinary dividend) and a limit on the number of eligible shares (0.5% of total shares outstanding). These limits can function to negate the benefit when weighted against the process of registering for rewards, limited liquidity, and forgoing share lending (which would make an investor ineligible to receive the reward).

Beyond concerns about control, there was general consensus that loyalty rewards seem unlikely to improve shareholder involvement. There were strong reservations regarding their potential effectiveness in stimulating and rewarding an active attitude of shareholders. Two themes of particular relevance emerged. First, while issuers generally speak favourably about having a stable group of long-term shareholders, they are not always necessarily keen on involving shareowners in the governance of companies. In many cases, shareholders also do not have the formal levers or rights to effectively influence companies. Second, some “active” shareholders will by nature not be long-horizon in their view of that particular company, and may legitimately “exit” when they believe an adequate return on invested capital has been achieved. Many institutional investors consulted identified with this latter point and expressed doubt that differential rights would alter this decision.

*“The issue with solutions such as loyalty rewards is that the real issue is company value and whether to buy and hold. A mechanism such as loyalty rewards will not be sufficient to outweigh that consideration — an incentive in the region proposed by loyalty shares (for instance 10% of dividends) will be marginal in relation to that fundamental value decision to be made by the investor. And it should be marginal. If loyalty shares were of a magnitude to be influential, they would probably be massively distortionary and/or dilutionary.”*

*Fund manager*

*“We need to consider what will actually change behaviour. Loyalty shares are unlikely to be of sufficient scope or weight to make a difference, and if it was that big it would likely be very disenfranchising. Over time, most of the options would be priced in and therefore would have limited long-term impact — markets will quickly absorb and nothing much may change.”*

*Company director*

*“This will be gamed. As an illustration, if the incentive is sufficient to alter behaviour and the investor doesn’t like the stock, then the investor will hold to ‘loyalty’ maturity but will use derivatives/synthetics to get rid of the exposure. Whatever it is, there’ll be people trying to arbitrage the deal ...”*

*Fund manager*

**A small minority of participants believed loyalty dividends and L-shares (special warrants) may alter investor behaviour and could produce ancillary benefits.**

A stable base of long-term shareholders was viewed by some as being favourable insofar as this “stickier capital” can function to insulate the company from short-term demands. Where support did exist, it was mainly

in regards to financial rewards (in the form of extra dividends or warrants) rather than extra voting rights. Some were of the view that issuing warrants to long-term shareholders may result in better alignment between shareholders and corporate executive time horizons, functioning almost as a stock option of sorts for shareholders. As outlined by Bolton and Samama, warrants were seen as having the potential to lengthen the time horizon in which an investor forms his or her opinion of the company's prospects, in turn encouraging a greater focus on a company's fundamentals, governance, and long-term strategy.

Finally, some viewed the introduction of loyalty-driven securities favourably from the perspective of the ancillary benefits that could result. For example, the potential for loyalty rewards to serve as a mechanism for reducing the available stock for lending purposes as outlined by Butler (2006, 2011) and Bolton and Samama was viewed as a positive attribute among a minority of participants who raised concerns that share lending could be a destabilising activity for equity markets and issuers.

*"While misalignment of interests may be the ultimate issue, finding the solution that realigns incentives among the thousands of agents in the investment supply chain is a long way off. In the meantime, loyalty warrants should be supported as an incremental 'step in the right direction' with little downside risk (entrenchment will always be a concern in any case). Providing an economic incentive in the form of a loyalty warrant responds to the simple fact that for most it is simply not in their interest to think long-term at the moment and we continue to have a cycle of funding the short term."*

*Renowned governance expert*

**A large majority of those consulted do not agree that an incentive or reward for holding shares for a specified period of time is directly related to addressing sources of short-term pressures on companies.**

Reservations about practical matters relating to the administration of loyalty-driven securities aside, a large majority of those consulted (both issuers and investors) do not agree that an incentive for holding shares for a specified period of time is directly related to addressing the sources of short-term pressures on companies.

In discussing differentiated rights for long-term shareholders, participants often framed the advantages and disadvantages of loyalty-driven securities in terms of their potential to address what they viewed as the underlying issues, relationships, or incentives that result in short-term pressures. There was significant debate as to whether holding periods of institutional investors had declined significantly and if so, how declining holding periods would function to generate short-term pressures that, in turn, influence corporate decision-makers. In general, those that participated in the consultation (including most issuers consulted) did not agree with this premise and viewed loyalty-driven securities as unlikely to incentivise changes in investor behaviour that would have a direct impact on reducing short-term pressures in financial markets. We further elaborate on this issue in the next section of this report.

*"It is hard to escape from the thought that the loyalty rewards are really directed at the symptoms — as opposed to the cause — of this problem. We need to direct our efforts at the causes of short-termism."*

*Fund manager*

*"In the most general terms I have some sympathy for the view that markets are too short term in nature — however, this characterisation is too broad-ranging and is simplistic. Time frames will depend a lot on the sector involved. In resources for example, time horizons for projects will be in the region of 15 years plus, and if directors and management are not thinking in those terms then they will not be optimising investment opportunities. However, other sectors will have shorter time frames."*

*Company director*

*"Turnover is not in and of itself bad. Fund managers will trade in and out — that is the nature and function of capital markets — [they] need that flexibility and [it is] also important for companies to receive signals. My position as an investor is that if something has changed in the business, then loyalty shares will not change my view ... Being able to exit is important — send a signal to companies about value and company strategy."*

*Fund manager*

*"Turnover is not itself inherently 'bad' or undesirable. Fund managers will have exit strategies (and that will form part of the basis for their appointment). In any case this market activity — turnover, price signalling, and discovery — while it may have the appearance of short-termism, is in fact an essential part of how markets operate."*

*Asset owner*

*"You've got to be really clear about the behaviours that you want to dampen or eliminate and those you retain — and then as a separate step, construct the means to achieve that. We need to be careful about 'loyalty' and the implied 'disloyalty' — a pejorative meaning that is misleading and just wrong — it's not 'disloyal' to have a rational exit strategy and to get out of a position."*

*Investor relations professional*



# 3

## BUILDING ON THE CONSULTATION'S FINDINGS: IF NOT LOYALTY-DRIVEN SECURITIES, THEN WHAT?

### THREE AREAS FOR CONTINUED FOCUS

Discussions led to three distinct but interconnected priority themes for continued focus. We set forth these themes not as relevant to investors or companies, but to look at how they relate to both groups. This framing is deliberate — discussions around addressing short-term behaviour in capital markets typically focus on one group or the other, which reinforces the separation between companies and their investors and ignores the fact that they are really two sides of the same coin. It also leads to a disconnect between how company objectives and incentives are established and reported against, and how investors identify and monitor value creation. Too often, this “exchange” is distilled into one metric: share price.

Each of these three areas plays a critical role in establishing a relationship whereby long horizon investors and companies make sound decisions, and have the time and infrastructure to stick by them.

1. **Longer time horizons for investment analysis** — Applied to investment opportunities and company projects, a longer-term outlook allows for increased focus on long-term value drivers, including innovation and management of different forms of capital (physical, financial, and human). This speaks to the core of short-termism, as it relates to the mindset that individuals (in investment firms or companies) use to make decisions on a day-to-day basis.
2. **Aligned frameworks for performance measurement and reward** — A longer-term perspective for value creation and delivery is only possible if supported by appropriately aligned performance measurement and reward frameworks. Otherwise, individuals (in investment firms or companies) will be penalised for decisions that may not be rewarded by short-term share price movements but will pay off over the long term.

3. **Stronger relationships between companies and investors** — A more constructive relationship between companies and their long-horizon investors is required to deliver longer-term value creation. If investors are going to support long-term decisions, which may take some time to pay off, they need to have faith in the strategy and also the executive team that will execute it. This may require more information — on paper, and sometimes in person.

We now take a look at each of these focus areas: what they would mean in practice, how they may be achieved, and the barriers they face. We are certainly not the first to focus on these themes, and a range of papers explore these concepts in fuller detail. What we aim to do here is outline the key changes that will be required to address the problems associated with undue short-term behaviour by investors and companies.

**FOCUS 1:**  
**Longer Time Horizons for Investment Analysis**

Within the investment community, there already exist a number of asset owners and asset managers who take a truly long-term approach — both in understanding their liabilities and in exercising investment decisions, at least in the way that some of their assets are managed.

It is not realistic or desirable to envision an outcome where all market participants are investing for the long term, as shorter-term drivers will always play a role. We face a similar situation with regards to companies — there are a growing number of examples of corporate leaders that focus on the long term and openly “recruit” long-horizon shareholders. But some sectors will be more

short term than others as will be the motivation between some types of decisions. A recent study found that firms with investor communications that focus on the short term tend to have short-term investor bases, increased stock-price volatility, higher betas, and a higher cost of capital.

Shifting the overall balance further towards a focus on value/growth of the business rather than the share price, among both investors and companies, would be ideal. The following tables set out the key changes involved in facilitating such a change and address existing barriers.

**Adopting Longer Time Horizons for Investment Analysis — What it Means for Investors**

Key changes	How this could be facilitated	Key barriers to consider
<ul style="list-style-type: none"> <li>• Increase the prevalence of long-term thinking.</li> <li>• Increase the utilisation of fundamental analysis with appropriate discount rates for future cash flows.</li> <li>• Consider environmental, social, and governance (ESG) issues more robustly to account for externalities and broader market impacts.</li> </ul>	<ul style="list-style-type: none"> <li>• Reflect these expectations in conceptualisation of fiduciary duty and trustee training and investor education programmes, including CFA curriculum and the CFA Future of Finance programme.<sup>17</sup></li> <li>• Adopt more broadly the investment beliefs that reflect a focus on long-term valuation creation.<sup>18</sup></li> <li>• Make a concerted effort to push this approach through the investment chain, including sell-side research.<sup>19</sup></li> <li>• Produce increased data on “stranded asset” risks.<sup>20</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Growth of momentum style investing.</li> <li>• Need for investors to react to short-term market fluctuations.</li> <li>• Underutilisation of ESG data due to perceived lack of financial materiality; lack of standardised/complete datasets; and lack of regulatory action to price externalities.</li> </ul>

Key changes	How this could be facilitated	Key barriers to consider
<ul style="list-style-type: none"> <li>• Increase focus on innovation and long-term value creation.</li> <li>• Reduce focus on “doing whatever it takes” to deliver short-term results.<sup>21</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Develop organisational structures that clearly articulate the type of work that executive directors are expected to do.</li> <li>• Include a clear description of long-term strategy, progress towards previously declared long-term goals, and actions taken and investments made in pursuit of long-term goals in company reporting.</li> <li>• Abandon quarterly reporting, as some believe it has an adverse effect on both companies and investors. Others said the issue is not the act of quarterly reporting, but the emphasis put on it.</li> <li>• Evolve internal (corporate) and external (MBA) training programmes to reflect this approach.</li> </ul>	<ul style="list-style-type: none"> <li>• Decreasing tenure of CEOs can reduce time horizon over which value creation is envisioned.</li> <li>• Motivations of various agents across capital markets drive short-term “activity” of various types.</li> <li>• “Maximising shareholder value” as short-term imperative has become a behavioural norm reinforced by legal and corporate infrastructure.</li> </ul>

## FOCUS 2:

### Aligned Frameworks for Performance Measurement and Reward

The second focus area is on building longer time horizons into performance measurement and reward. Incentives are at the heart of personal motivation, and if performance measurement and reward frameworks are not aligned with achieving long-term outcomes, it will be impossible to move the dial in this direction. Observers have highlighted the economic incentives for investors that tend to focus on short-term performance. A central cause of increasing pressure from equity markets on quarterly earnings and short-term performance is argued to be the result of the considerable pressure under which institutional fund managers are expected to perform. Performance monitoring and incentives may be driven by efforts to control or monitor parties that have been delegated investment decision-making responsibilities. The result can, in some cases, be that incentives are given to fund managers, for example, that shorten time horizons or fail to reward a longer time horizon. Several studies suggest that shareholders, placing significant value on short-term firm performance measures and stock price volatility, can put significant pressure on corporate boards and executives to deliver short-term gains in stock price that may come at the expense of balanced, long-term investment and prudent risk management aimed at generating long-term sustainable growth.

Investors we consulted suggested that those entrusted to invest on behalf of those with a long-term orientation may be constrained from taking a longer-term view on the basis of how their performance is evaluated and rewarded. While significant work and debate had produced model investment terms to more fully address time horizon and engagement expectations through the International Corporate Governance Network’s Model Mandate Initiative, it was felt by consultation participants that there was still a disconnect in terms of implementing variations of the model clauses in investment contracts.<sup>22</sup> Similarly, much work has been done to consider the problem around current models of performance measurement and executive compensation and the outcomes they drive, but we have not yet seen a “solution” that can drive meaningful change.

Recent research by Mercer focuses on the expected turnover stated by global, EAFE and US large-cap equity managers. If we define “long-term” as less than 40% turnover per annum, approximately 35% of managers in these universes fall into this category. In these cases, we do tend to see compensation arrangements with a component of five-year rolling performance targets. This would suggest that this type of investing (with aligned compensation arrangements) is available, but it would require investors to actively seek it out, as two-thirds of managers in these universes have annual turnover in excess of 40% per annum.

## Aligned Frameworks for Performance Measurement and Reward — What it Means for Investors

Key changes	How this could be facilitated	Key barriers to consider
<ul style="list-style-type: none"> <li>• Shift from client/agent to partnership model.</li> <li>• Change the focus of manager meetings from short-term relative performance to longer-term objectives/strategy.</li> <li>• Ensure compensation is commensurate to the risk-adjusted value-add of the manager’s activities.</li> </ul>	<ul style="list-style-type: none"> <li>• Evolve mandate design to reflect longer time period, including a refocus of monitoring away from relative (benchmark or peer) performance<sup>23</sup> towards longer-term absolute performance and a review of how managers are executing the process/strategy they were hired to follow.</li> <li>• Explore allocating assets to long-horizon strategies (where suitable).</li> <li>• Structure compensation appropriately to reflect this different approach to monitoring. Alignment can be supported through: <ul style="list-style-type: none"> <li>• Institute reasonable base management fees that reflect the nature of the strategy and position of the business.</li> <li>• Use performance fees, where the calculation period is sufficiently long (e.g. 5-year periods).</li> <li>• Measure performance on voting and engagement.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Regulatory requirements that drive regular performance reviews.</li> <li>• Mark-to-market accounting means that short-term share price movements can have a meaningful impact on funding status.</li> <li>• Industry daily/monthly “league tables”.</li> <li>• Manager career risk in periods of short-term underperformance.</li> <li>• Investment products are “sold” not “bought”.</li> <li>• Justification of paying a manager to “watch the farm” in low turnover strategies.</li> </ul>

## Aligned Frameworks for Performance Measurement and Reward — What it Means for Companies

Key changes	How this could be facilitated	Key barriers to consider
<ul style="list-style-type: none"> <li>• Establish performance measurement and executive compensation structures to put more focus and weight on long-term value-drivers such as strategy and innovation.</li> </ul>	<ul style="list-style-type: none"> <li>• Encourage industry associations and compensation consultants to adopt/create new approaches.</li> <li>• Encourage investor behaviour that can support this change, e.g. through “say on pay” discussions.</li> </ul>	<ul style="list-style-type: none"> <li>• Average CEO tenure of 6 years makes concept of 5-year rolling pay period more challenging.<sup>24</sup></li> <li>• Difficult to change industry norms and practices.</li> <li>• Investors initially (and successfully) advocated for equity compensation as a means to align executive compensation with investor interests, which had severe and unintended consequences.</li> </ul>

### FOCUS 3:

#### Stronger Relationships Between Companies and Investors

In many cases, a more constructive relationship between companies and their long-horizon investors could support investors in maintaining a long-term outlook. That is, if investors are going to support long-term decisions that may take some time to pay off, they need to have faith in the strategy and also the executive team that will execute it. This may require more information — on paper, and sometimes, in person.

From the company perspective, the pertinent questions are whether companies take a clear approach to communicating with their investors and what type of investors do management and directors spend time with. Views differed about the extent to which companies currently cultivate a particular shareholder base, but there seems to be an underutilised opportunity to preference dialogue and communication with investors that take a longer-horizon view towards value creation. Growing attention is being given to the role of the board and company culture<sup>25</sup> and leadership in supporting the long-term strategy and performance

of the company, often focusing on the impact of how firms communicate their corporate strategy and attract shareholders aligned with this time-horizon.<sup>26</sup>

A number of participants argued that shareholder intervention and engagement can provide long-term benefits to companies. Some argued for the need to further strengthen the power of shareholders and increase the accountability of boards to shareholders (and reducing the board's dependence on the CEO and other managers). Bebchuk<sup>27</sup> finds that empirical research on the effects of shareholder engagement suggests a positive impact on company performance in both the short and long term. Further thought is required about which rights could or should be strengthened, and whether more rights entail more responsibilities. Industry developments around "say on pay" are trending towards enhanced shareholder influence, although we have seen relatively limited utilisation of this tool by investors to express dissatisfaction with company performance.

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A number of participants argued that shareholder intervention and engagement can provide long-term benefits to companies. Some argued for the need to further strengthen the power of shareholders over managers, increasing the accountability of boards to shareholders (and reducing the board's dependence on the CEO and other managers).

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## Stronger Relationships Between Companies and Investors — What it Means for Investors

Key changes	How this could be facilitated	Key barriers to consider
<ul style="list-style-type: none"> <li>• Move beyond the (important and legitimate) ex-post-oriented practice of voting at AGMs (approving reports, remuneration) towards appropriate ex-ante engagement (not engagement for the sake of engagement, but engagement that ensures a constructive shareholder voice).<sup>28</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Investors make better use of their influence regarding director nominations, management succession planning, executive compensation, and other key areas.               <ul style="list-style-type: none"> <li>– For active managers, a more active prioritisation process regarding company engagement.</li> <li>– For passive managers, an industry-wide approach is required to make this efficient.</li> </ul> </li> <li>• Asset owners and consultants put greater focus on how well their internal/external management teams undertake engagement.</li> <li>• Introduce stewardship codes in additional regions; move existing codes from voluntary to mandatory.</li> <li>• Third-party collaborative engagement approaches (for profit and non-profit) can supplement the engagement undertaken by investors, and there is room for these services to grow.</li> </ul>	<ul style="list-style-type: none"> <li>• Investors allocate limited resources to managing governance issues (which may also lead to heavy reliance on proxy advisors). This lack of resource relates to:               <ul style="list-style-type: none"> <li>– Lack of evidence that engagement adds value (although there was a view this evidence is building).</li> <li>– The difficulty in measuring engagement success (and, as a consequence, justifying research and designing compensation arrangements for engagement staff).</li> <li>– The “free rider” issue.</li> </ul> </li> <li>• High-quality engagement is time consuming and requires senior staff.</li> <li>• Collaboration on engagement is challenging; there have been a number of false starts.</li> <li>• Consultants do not evaluate managers on or credit them for strong stewardship capabilities.</li> <li>• A contentious issue regarding whether asset owners or fund managers should lead engagements when fund management is delegated.</li> </ul>

## Stronger Relationships Between Companies and Investors — What it Means for Companies

Key changes	How this could be facilitated	Key barriers to consider
<ul style="list-style-type: none"> <li>• Issuers actively seek to attract and recruit the type of investors they desire by communicating about the long-term to attract long-term investors.</li> </ul>	<ul style="list-style-type: none"> <li>• Board diversity and use of board evaluation tools could raise awareness of and opportunity to communicate more effectively with long-horizon shareholders.<sup>29</sup></li> <li>• Create more formal structures for board to seek shareholder input, such as through shareholder committees and formal shareholder input process to nominating committees.</li> <li>• Long-horizon investors could jointly articulate that brokers should not set up CEO road shows as a point of best practice.<sup>30</sup></li> <li>• More focus on long-horizon investors by investor relations professional societies and training programmes.</li> </ul>	<ul style="list-style-type: none"> <li>• Risk that enhanced communication will take place between short-term investors and short-term executives, reinforcing negative cycle.</li> <li>• Practical difficulties in setting up formal shareholder committees: process could be undemocratic; may place undue burden on large investors; insider-trading provisions may dissuade investors from participating. There was a preference for advisory versus supervisory status voiced during consultation.</li> </ul>

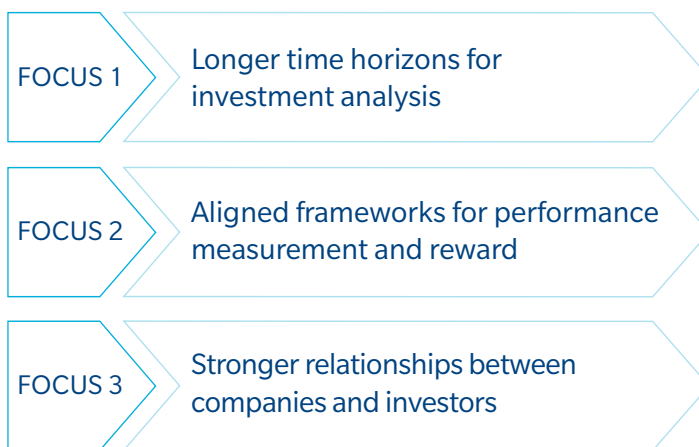
# 4

## CONCLUSION AND NEXT STEPS

Going in to the consultation, we had an open mind about what we would find and we hoped to uncover a range of views. We were struck by the widespread discomfort with and sometimes very strong negative reaction to the loyalty rewards concept. At the same time, we were encouraged by the general consensus that there is a need to create more constructive relationships between investors and companies as a central means of strengthening the focus on long-term value creation. We propose that if a greater proportion of investors on quarterly investor calls posed the question, “What is your plan to build wealth over a five- to seven-year time horizon?” then a fundamental shift in narrative would result.

The goal is to shift the amount of time corporate executives spend managing the balance sheet (although this is still important) towards more time focused on business strategy and innovation. The answer to the question of how we get there is not obvious. The financial sector is a highly complex, multifaceted world where informational asymmetry and misaligned interest often result. The end beneficiary should be the most motivated to drive change, yet they are often the ones most in the dark, with little capacity to influence.

We identified three focus areas where we believe change is critical:



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## In addressing the prevalence of short-term thinking as well as the range of systemic risks facing capital markets, the need for informed fiduciary oversight is ever more apparent.

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A number of industry groups and initiatives are working on different parts of these areas, with some important results. However, we highlight here a small number of proposals that could be most helpful in the near term.

### 1. Supporting better-informed fiduciary oversight —

In addressing the prevalence of short-term thinking as well as the range of systemic risks facing capital markets, the need for informed fiduciary oversight is ever more apparent. Yet trustees and investment committee members are often stretched in terms of governance. A proactive intervention in the trustee world with the goal of informing and equipping fiduciaries to understand and act on their responsibilities could be an important step forward (an idea also highlighted in Generation's 2012 *Sustainable Capitalism* paper). The goal is not just to inform, but to put concepts into practice.

For example:

- a. Board/investment committee education programmes present an opportunity to either include content on these themes or develop a curriculum specific to them. Some examples exist (for example, the Rotman School of Management's Board Effectiveness Program<sup>31</sup>) but room for more exists. A compendium of supporting resources could be developed and widely promoted (relevant literature, case studies, tools, guides, etc.).
- b. A database of "sustainable financial market-certified" candidates for board/trustee/investment committees could be developed, similar to the US Diverse Director Datasource<sup>32</sup> (for corporate board candidates). This could be developed as a global model, with local partnerships.

- c. Policy and regulatory frameworks play a critical role in shaping behaviour, and further focus on how they help or hinder behaviour that is conducive to long-horizon value creation is warranted (by investors and companies).
2. Move from talk to action — The past five years have seen significant focus within the investment industry on pioneering "new ways to do things" to better align beneficiaries, fiduciaries, investors, and companies. Now is the time to move beyond "blue skies" discussions and put these revised systems and frameworks into practice. For example:
- a. Numerous investment strategies exist that have long-horizon investment as their core proposition.<sup>33</sup> Investors can actively preference long-horizon strategies as they replace and select new fund managers. The key point is that low-turnover (or long-horizon) strategies are out there — but they need to be used. Further, asset owners should speak to their managers about how they value longer-term ESG risks and exercise their rights as shareholders. We should not underestimate the ability for client demand to change behaviour at the fund manager level.
  - b. A live "shadow monitoring" pilot could establish a wider set of metrics against which to monitor and report fund manager performance to clients. This process could facilitate active client feedback to then refine the process and subsequently embed it as "the new norm". The refined metrics would look beyond relative benchmark performance (such as return on invested capital) as well as performance on voting and monitoring.
  - c. Alignment of incentives in the executive compensation context is also an area that has seen considerable focus by industry commentators. What's needed is for more

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A key takeaway from the consultation is that we need to find a new and better way for investors and companies to have a relationship.

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implementation of the best ideas into practice. This requires more demand from shareholders, but an active project to facilitate matchmaking between long-horizon investors and long-horizon companies to proactively tackle this issue could help to set important industry precedents.

3. **Change the dialogue between owners and companies** — A key takeaway from the consultation is that we need to find a new and better way for investors and companies to have a relationship. On the active side, this could be a natural evolution of lower turnover portfolios with heightened focus on engagement. For passive managers, one-to-one engagements with issuers are of course much more challenging. Thus, a key opportunity is to establish a mechanism for passive managers and large issuers to come together to address major systemic issues and develop relevant standards.
- a. Establish an investor-issuer council for systemic risk focused on establishing a formal relationship between institutional shareholders and companies. An important element is for this to include commercial passive managers, given the large and growing assets under management.
  - b. Launch a campaign to encourage analysts and investors to ask companies, “What is your plan to build wealth over a five- to seven-year time horizon?” during quarterly earnings calls and other meetings. Then, ensure voting decisions are executed in a way that is consistent with this time frame.

Mercer, Stikeman Elliot LLP, and the Generation Foundation will continue to work independently and collaboratively to action these concepts and support a more proactive approach to addressing issues or short-termism and systemic risk across the investment chain. We encourage others to share this proactive approach and look forward to collaborating for a better financial future for all.

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The following participants have given their permission to be referenced in the list below:

Christopher J. Ailman, CalSTRS	Stuart Dodd, Renaissance Asset Management
Keith Ambachtsheer	Stephen Erlichman, Canadian Coalition for Good Governance
James Anderson, Baillie Gifford	Colin Galbraith, Gresham Partners
Jenny Anderson, The Pensions Trust	Michael Garland, Office of NYC Comptroller
Rick Bennett, GMI Ratings	David Gonski
Christine Berry, ShareAction	Tim Goodman, Hermes Equity Ownership Services Ltd.
Bruno Bertocci, UBS Global Asset Management	Anita Green, Wespath Investment Management
BlackRock	Martin Grosskopf, AGF
Patrick Bolton, Columbia Business School	Danyelle Guyatt, Catholic Super Fund
Jocelyn Brown, Financial Reporting Council	James Hall, Brambles
David Carey, ARC Resources	Gordon Hagart, Future Fund
Klaus Chavanne, MEAG New York Corporation	Dr Don Hamson, Plato Investment Management Ltd.
Joseph Chi, Dimensional Fund Advisors	Craig Hurt
Sarah Cleveland	Johnson & Johnson
Chaya Cooperberg, Progressive Waste Solutions Ltd.	Erica Karp, Cornerstone Capital Inc.
Jennifer Coulson, bclMC	George Kesteven, Sterling Resources
Jill Craig, ANZ Banking Group Limited	Tom Kiely, McKinsey
Steve Crane, Nib Holdings Limited	Ben Kottler, MFS Investment Management
David Crawford	Orin Kramer, Boston Provident LP
Louise Davidson, Construction and Building Industry Super (Cbus)	Denis Kwok, Ontario Teachers' Pension Plan
Glenn Davis	Cédric Laverie, Amundi Asset Management
Chris Davis, Ceres	Paul Lee, Hermes Equity Ownership Services Ltd.
Donna Dabney, The Conference Board	Richard Lewis, Fidelity
Michael Deakin	Yvette Lokker, Canadian Investor Relations Institute
David Denison	Jon Lukomnik, Sinclair Capital L.L.C.
Philippe Desfossés, L'établissement de Retraite Additionnelle de La Fonction Publique (ERAFP)	Peter Lunt, VicSuper

Catherine McCall, Canadian Coalition for Good Governance  
Mike McCauley, Florida State Board of Administration  
Duncan Mathieson, Addenda Capital  
Niall Mills, First State Investment Management (UK) Ltd.  
Ira Millstein  
Brian Minns, Addenda Capital  
Robert A.G. Monks, GMI Ratings  
Peter Montagnon, Institute of Business Ethics, UK  
Margaret Moore  
National Employment Savings Trust (NEST)  
Matt Orsagh, CFA Institute  
David Paradice, Paradice Investments Ltd.  
Gerry Paul, Alliance Bernstein  
Howard Pearce, Environment Agency Pension Fund  
Anna Pinedo, Morrison & Foerster LLP  
Peter Polson  
Will Pomroy, The National Association of Pension Funds Limited  
Nancy Ross, Ontario Municipal Employees Retirement System  
William Royan, Ontario Teachers' Pension Plan  
David Russell, USS Investment Management Ltd.  
Jo Saleeba, HESTA Super Fund  
Antonio Salerno, RWC Partners Ltd.  
Frederic Samama, Amundi & SWF Research Initiative  
Paul Schneider, Ontario Teachers' Pension Plan  
Anne Sheehan, CalSTRS  
Anita Skipper, Aviva Investors  
Rogier Snijdewind, PGGM Vermogensbeheer B.V. (PGGM)  
Alex van der Velden, Ownership Capital  
Mariela Vargova, Rockefeller & Co., Inc.  
Talieh Williams, UniSuper  
Stuart Wilson, Sunsuper  
Simon Wong, Northwestern University School of Law  
& London School of Economics  
Michele Wucker, World Policy Institute  
Lindsay Yelland, Global Red Pty Ltd.  
Ann Yerger

# APPENDIX A: METHODOLOGY

This project was based on research, as well as interviews and group discussions with key participants in capital markets. The project consisted of three phases:

1. **Concept framing:** the initial phase of the project consisted of a review of the literature and expert interviews on short-termism from both the perspective of corporate and investor behaviour. The review considered the incentives and structural elements of the capital markets that drive short-termism, the desirability and/or concerns of such behaviour and reviewed the broad categories of proposed solutions (primarily loyalty-driven securities, but also other market-based or regulatory measures that have been proposed). At this stage, we conducted a review of the legal permissibility of loyalty-driven securities across a number of jurisdictions, identifying existing legislation or legal precedent that could impact the implementation or effectiveness of loyalty-driven securities. The output of this phase included a compendium of the literature reviewed and a concise briefing note on the key issues, challenges, and opportunities surrounding the introduction and utilisation of loyalty-driven securities. This document formed the background reading and discussion material for participants in the structured interviews and group discussions that occurred in the next phase of the project. This document is available at [www.mercer.com/loyaltyrewards](http://www.mercer.com/loyaltyrewards).
2. **Semi-structured discussions:** over an eight-month period, Mercer and Stikeman Elliott LLP organised seven group meetings in New York, Toronto, London, Sydney, and Melbourne, as well as 18 individual interviews conducted by telephone and in person. In all, we spoke to more than 120 individuals representing a variety of perspectives from a range of backgrounds and expertise. The purpose of the interviews and group discussions was to identify sentiment towards the use of loyalty-driven securities by issuers. Participants included:
  - Chief investment officers, trustees, and investment officers from 41 asset-owner organisations representing a mix of public and corporate pension plans as well as sovereign wealth funds and large endowments and foundations.
  - Portfolio managers, heads of equity, and corporate governance analysts from 43 investment-management organisations representing a mix of active and passive managers and global and regional firms.
  - Company directors, corporate secretaries, chief governance officers and investor-relations persons representing 22 publicly listed companies headquartered in the US, Canada, Australia, UK, France, and Singapore.
  - Representatives from proxy-voting advisory firms, corporate-governance advisory firms, securities regulators, and securities law firms.
3. **Review of interview results and report on findings:** detailed notes of the interviews and group discussions were reviewed to identify participant views and determine whether a dominant view came from one type of participant versus another. Participants from the small group discussions and interviews as well as those consulted in the concept framing and literature review phases provided input to the structure and content of the final report. Given that the discussions naturally gravitated to potential alternatives to loyalty-driven securities, the project team's process was to develop a long list of ideas discussed during the group discussions, interviews, and desk research. The alternative recommendations were then developed and grouped into key themes. From this, a more targeted list of potential high-impact actions for investors, company boards, and executives was developed, with input from a number of external reviewers.

# APPENDIX B: LEGAL PERSPECTIVES ON THE USE OF LOYALTY-DRIVEN SECURITIES

Is the use of differentiated rights as contemplated in the concept of loyalty-driven securities possible?

Australia	Yes	Provided that the company's constitution or a special resolution by the company provides for the issuance of shares with different rights.
Canada	Yes	Provided a dual-class share structure.
France	Yes	Corporate law permits the awarding of double voting rights and/or a "loyalty dividend" to reward long-term shareholders who have held shares continuously in registered form. Shares must be held for a minimum of two years. The articles of association must provide for such rights.
Germany	No	Not currently permitted.
Italy	Yes	Corporate law states that companies may pay a loyalty dividend if permitted by their articles of association.
Netherlands	Yes	In the case of Royal DSM N.V. proposal to issue a loyalty dividend, the Supreme Court upheld a company's right to offer loyalty rewards. However, the company subsequently withdrew its proposal and no subsequent proposals have since been made by issuers for the different treatment of shareholders in equal circumstances under the loyalty-share concept.
New Zealand	Yes	Subject to the terms of the company's constitution and terms of issue of the share.
Singapore	Yes	Provided it is authorised by its articles of incorporation.
US	Yes	Provided it is authorised in the corporation's certificate of incorporation.
UK	Yes	Loyalty dividend possible provided it is authorised by its articles of incorporation.

For a more detailed review, please visit <http://www.mercer.com/articles/loyalty-rewards>.

# APPENDIX C: SELECT QUOTES FROM THE CONSULTATION

*“Short-termism can be a problem — for example, in the case of a company [that] derives short-term profit based on a substandard quality of customer service, leading to a loss of market share and the company consequently being forced into catch-up mode. Companies often make decisions that have a negative impact on long-term value by prioritising short-term profit because of perceived market pressures. Companies in general are not set up to operate and think in five-year plus time frame — maybe 5%–10% of companies would — this is because the short-term pressures are so significant.”*

Investor relations professional

*“We have to be very careful to define the problem: markets generally work well. Volatility is not in itself a problem (in fact it’s essential for the functioning of markets). However, short-termism has become a problem — the quarterly cycle has become damaging.”*

Portfolio manager

*“The problem is about short-term thinking and giving someone a loyalty share will reward those that are doing it anyway. I’m not sure it’s going to incentivise anyone to change strategy or think more long-term. From our perspective, not many issuers are looking to implement this concept because of 1) vocal opposition from investors to dual-class and differential treatment among shareholders, and 2) we aren’t certain that much benefit is to be gained by the company. Our primary challenge is to clearly articulate and communicate our business strategy because we want to attract investors that believe in our strategy.”*

Corporate secretary

*“Companies can shape their share registries but not many do this; they’re either beaten by time pressures or focused on building the business. As a consequence of this, the short-termism of key actors such as brokers and fund managers prevails, and companies take a dim view of capital markets. Really, they should be taking a strategic approach to capital markets and work to understand the incentives and characteristics of particular actors.”*

Fund manager

*“The smarter companies know they have to allocate time for this purpose [talking to investors].”*

Fund manager

*“In a business environment of impatient capital, the board of directors has a key role to play in defining the long-term interests of the company and ensuring that management is not excessively distracted by the short-term pressures emanating from the equity market ... As long as the board remains convinced of the viability of the company’s chosen strategy, it should support management in the face of external market pressures. Furthermore, the board (particularly the chairman) should play an active role in justifying the company’s long-term orientation to markets and seek to attract investors to the company that share a similar investment time horizon.”*

Dr Roger Barker, Institute of Directors <sup>34</sup>

*“Brokers play a very significant role in IPOs and placements in allocating shares to investors. Brokers will reward their high-turnover clients — because a key part of their remuneration is driven by turnover. This leads to a dynamic that is an important part of short-termism in markets (and is also something individual companies should be much more aware of). Trading is core to brokerage. The effect is to reward short termism — to allocate shares to those least likely to be characterised as patient long-term capital. Companies tend to be naïve about this and think of it as process, rather than how this can be employed strategically. Brokers and companies do not necessarily have the same agenda — their interests are not necessarily aligned. Companies should take a much more critical and strategic approach to brokers.”*

Portfolio manager

*“The use of loyalty rewards is a blunt instrument to treat symptoms — not the root cause. Rather than incentivise long-term investing through an economic reward (L-share), we should be focusing on addressing the misalignment of institutional investors (and agents throughout the investment chain) with the long-term interests of end beneficiaries in mind.”*

Asset owner

*“It is not clear how an incentive for investors based on holding periods — even if it has the intended effect of encouraging long-term investing — will change the behaviour of corporate managers, boards, analysts, and the 24-hour financial news cycle that are sources or conduits of short-term pressure.”*

Fund manager

*“Fund manager mentality and behaviour is a real problem — two components: (1) the mentality of the safety of the herd and (2) the mentality of a trader and an owner.”*

Company director

*“The key drivers of behaviour within companies are most often directly tied to remuneration structures and bonus arrangements.”*

Investor relations professional

*“Companies with good long-term strategies don’t need to do anything special to attract long-term investors. Research by Serafeim et al. (2012) shows that companies with a short-term orientation attract investors interested in short-term time frames and vice versa. Managers are often responding to incentives — relative versus absolute performance — that are not well-aligned with their end beneficiaries. This is the real problem.”*

Fund manager

*“At present, superannuation funds are long-term investors in the sense of their future liabilities — however, they interact with fund managers on a short-term basis. A key issue is how fund managers are remunerated and currently there is a fundamental mismatch between asset owners and fund managers. Of critical importance therefore are questions about how funds are measured, the benchmarks they operate in relation to, and the frequency of measurement.”*

Investor relations professional

*“One key driver of short-termism is the performance benchmarks that are used to determine remuneration of executives in fund managers and (to a lesser extent, perhaps) asset owners. The suspicion is that churn/activity is generated in the lead-up to key ‘end’ dates [that] will determine the end of the measurement period for remuneration purposes — the effort is to meet the benchmark. As a starting point, disclosure of remuneration arrangements for executives in fund managers and asset owners would be helpful in making this dynamic visible.”*

Company director

*“We need to look at performance fees for fund managers — current three-, six-, and 12-month focus [is] very damaging. With these kinds of fee structures (common in this industry) you are bound to get short-term outcomes. There is a profound disconnect between the time frame that applies to pension funds (40 years plus) and the actions of their agents — fund managers — that will act in accordance with how they are paid.”*

Company director

*“Fund managers themselves are often inhibited from taking a longer-term view as they so often manage to benchmark.”*

Fund manager

*“An important issue is how asset owners monitor and assess performance. If there is to be a long-term investment approach, then there is a challenge for asset owners in how they respond to poor performance over short-term periods. If there is, for example, a period of underperformance of 18 months, there must come a point where the decision becomes whether to sack or retain. If it is the latter, then the trustees need a defensible basis for that decision (a different kind of monitoring/evaluation methodology) in order to mitigate peer risk. This issue highlights the need to review many aspects of the relationship between asset owners and fund managers. For example, questions related to how fund managers are compensated, aligning IMAs, the suitability of common policies of ‘one in, one out’ on manager turnover, and the internal resources required by asset owners to assess fund managers.”*

Asset owner

*“The relationship between asset owners and companies is of the most fundamental importance. The key thing is that asset owners have to ‘recapture’ the relationship with companies. This critical relationship has too much been left to fund managers to manage — fund managers as agents for the asset owners. This is not in the interests of asset owners, and in part because of how they are paid. We should also acknowledge that this is evolving and that significant change — in how asset owners think and structure their relationships with other key actors in the investment chain — has occurred over the last decade and especially over the last five years. There are in fact considerable grounds for optimism that some deep and beneficial change can take place.”*

Governance specialist

## IMPORTANT NOTICES

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# NOTES

<sup>1</sup> Bolton P and Samama F. "Loyalty-Shares: Rewarding Long-term Investors," *Journal of Applied Corporate Finance*, Volume 25 (5) (Summer 2013).

<sup>2</sup> Different actors have been the focus of different authors. Broadly speaking, the relevant literature for our purposes identifies a broad set of corporate stakeholders, including investors, managers, board members, employees, auditors, etc. For a variety of definitions see:

- Laverty KJ. "Economic 'Short-Termism': The Debate, the Unresolved Issues, and the Implications for Management Practice and Research," *The Academy of Management Review*, Volume 21 (3) (1996), pp. 825–860.
- Brunzell T, Liljeblom E, and Vaihekoski M. "Short-term Expectations in Listed Firms: The Effects of Different Owner Types," available at <http://www.ssrn.com/>, accessed 2 October 2013.
- CFA Centre for Financial Market Integrity and Business Roundtable, "Breaking the Short-term Cycle," Institute for Corporate Ethics, 2006.
- See also: CFA Institute. "Visionary Board Leadership — Stewardship for the Long Term," 2012; Jackson G. and Petraki A. "Understanding Short-termism: the Role of Corporate Governance," *Glasshouse Forum*, 2011.
- Rappaport A. "Saving Capitalism From Short-termism: How to Build Long-term Value and Take Back Our Financial Future," McGraw-Hill, 2011; Kay J. "The Kay Review of UK Equity Markets and Long-Term Decision Making," UK Business, Innovation, and Skills Committee, 2012.

<sup>3</sup> CFA Centre for Financial Market Integrity and Business Roundtable, 2006, p. 3.

<sup>4</sup> On these causes, see: Laverty KJ (1996), "Information asymmetry" refers to the situation where decision-makers do not have complete information about long-term prospects, and are likely to therefore use short-term performance as an indicator of performance and value maximisation. See Sappideen R. "Focusing on Corporate Short-Termism," *Singapore Journal of Legal Studies*, 2011, pp. 412–431.

<sup>5</sup> Fox J and Lorsch JW. "What Good Are Shareholders?" *Harvard Business Review*, Volume 90 (7–8) (July/August 2012), pp. 49–57.

<sup>6</sup> Regulatory measures include transaction taxes to raise trading costs and penalise short-term speculative trading as well as other forms of taxation that create a disincentive to trade (such as reforms to capital gains tax rules).

<sup>7</sup> Brunzell T, Liljeblom E, and Vaihekoski M (2012).

<sup>8</sup> Bolton P and Samama F (2013).

<sup>9</sup> Wong SCY. "Rethinking 'One Share, One Vote,'" *Harvard Business Review*, 2013.

<sup>10</sup> Butler P. Address to the ICGN Annual Conference, 2006, available at [www.governanceforowners.com](http://www.governanceforowners.com).

<sup>11</sup> Bolton P and Samama F (2013).

<sup>12</sup> Bolton P and Samama F (2013).

<sup>13</sup> See:

- "A Different Class: Would Giving Long-term Shareholders More Clout Improve Corporate Governance?" (February 2010), available at <http://www.economist.com>, accessed 2 October 2013.
- Barton D. "Capitalism for the Long Term," (2011), available at <http://hbr.org/>, accessed 2 October 2013.
- Barker A. "Brussels Aims to Reward Investor Loyalty" (2013), available at [www.ft.com](http://www.ft.com), accessed 2 October 2013.
- In addition, in 2013, a Netherlands advisory committee discussed loyalty bonuses for long-term shareholders via either increased dividends or extra voting rights; The Aspen Institute and individuals including Warren Buffett and John Bogel have advocated for similar measures to encourage longer-term shareholding (see: The Aspen Institute. "Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management," (September 9, 2009), available at <http://www.aspeninstitute.org/>, accessed 2 October 2013.

<sup>14</sup> Bolton P and Samama F (2013).

<sup>15</sup> See:

- Junkin A and Toth T. "The 'CalPERS Effect' on Targeted Company Share Prices," (July 2009), available at <http://www.calpers-governance.org/>, accessed 2 October 2013.

- Dimson E, Karakas O, and Li X. "Active Ownership," UCD & CalPERS Sustainability & Finance Symposium 2013, available at <http://ssrn.com/abstract=2154724>, accessed 2 October 2013.

<sup>16</sup> Butler P. Response to "The Kay Review of UK Equity Markets and Long-Term Decision Making," Governance for Owners, 2011.

<sup>17</sup> The interpretations of fiduciary duty that predominate were often argued to encourage an undue focus on maximising short-term returns to the detriment of focusing on longer-term returns. More explicit recognition of long-term objectives, it is argued, would reinforce broader efforts to better align incentives throughout the investment chain. (For example, see Waitzer E and Sarro D. "The Public Fiduciary: Emerging Themes in Canadian Fiduciary Law for Pension Trustees," *The Canadian Bar Review*, Volume 91 (2013).) Several proposals have argued there is a need to develop a clearer understanding of the specific fiduciary duties of agents acting for long-term investors. For example, the Milstein Centre for Corporate Governance has argued that in the US, fiduciary duties must be redefined in scope to include responsibility for a longer horizon. (Millstein I. Speech to the Washington State Investment Board, July 16, 2013, available at <http://web.law.columbia.edu/millstein-center/press/ira-millsteins-speech-washington-state-investment-board>, accessed 2 October 2013.) The UK Law Commission has also undertaken a review of whether the concept has been interpreted in an overly rigid manner as being a requirement to obtain the highest possible return over the shortest possible time. (Law Commission. "Fiduciary Duties of Investment Intermediaries," available at [http://lawcommission.justice.gov.uk/areas/fiduciary\\_duties.htm](http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm), accessed 2 October 2013.) This follows previous and ongoing initiatives led by organisations such as ShareAction (formerly FairPensions) and Tomorrow's Company (see: "FairPensions. The Enlightened Shareholder: Clarifying Investors' Fiduciary Duties," 2012; Institute of Directors, Barker Dr R. "Getting to Grips with Short-termism", 2012.)

<sup>18</sup> An example of this approach was apparent in the CalPERS' July 2013 Board Offsite review of investment beliefs, where two related beliefs were put forth:

- A long-term investment horizon is a responsibility and an advantage. This was presented with a number of associated opportunities and implications.

- Long-term value creation requires effective management of three forms of capital: financial, physical, and human. This was followed by a number of sub-beliefs, including:

- Governance is the primary tool to align interests between CalPERS and managers of its capital, including investee companies and external managers.
- Strong governance, along with effective management of environmental and human capital factors, increases the likelihood that companies will perform over the long term and manage risk effectively.
- CalPERS may engage investee companies and external managers on governance and sustainability issues (including governance practices; risk-management practices; human capital practices, including fair labor practices, health and safety, responsible contracting, and diversity; and environmental practices).

<sup>19</sup> See, for example, the ESG Research Award (<http://esgra.org.au/>), an Australian association of superannuation funds, fund managers, and asset consultants that has the single objective of increasing the amount and quality of stock broker research.

<sup>20</sup> Stranded assets broadly refer to environmentally unsustainable assets that suffer from or risk unanticipated or premature write-offs, downward revaluations, or are converted to liabilities. The range of current and emerging risk factors are, to date, poorly understood. See, for example, the work of initiatives including the University of Oxford's Smith School of Enterprise and the Environment Stranded Assets Programme (<http://www.smithschool.ox.ac.uk/research/stranded-assets/index.html?content=overview>) and the Carbon Tracker Initiative (<http://www.carbontracker.org/stranded-assets>).

<sup>21</sup> Zhang Y and Gimeno J. "Earnings Pressure and Long-term Corporate Governance: Can Long-term-Oriented Investors and Managers Fend off Short-term Analyst Earnings Pressures?" submission to Blackrock/NACD Call for Papers in Corporate Governance & Responsible Investment, (September 2012), available at <http://www.nacdonline.org/files/FileDownloads/PDF/BlackrockWinner.pdf>, accessed 2 October 2013.

<sup>22</sup> See:

- Ambachtsheer K and Bauer R. "Ten Strategies for Pension Funds to Better Serve Their Beneficiaries," Rotman International Centre for Pension

Management, available at [http://www.rijpm.com/key\\_insight\\_files/Ten\\_Strategies\\_for\\_Pension\\_Funds\\_to\\_Better\\_Serve\\_Their\\_Beneficiaries\\_June\\_20\\_2013.pdf](http://www.rijpm.com/key_insight_files/Ten_Strategies_for_Pension_Funds_to_Better_Serve_Their_Beneficiaries_June_20_2013.pdf), accessed 2 October 2013.

- In addition, the UK Financial Reporting Council (FRC) has also written in response to the European Commission's Green Paper, supporting the introduction of a principle that all those issuing fund management mandates on behalf of beneficiaries in the EU should "demonstrate that they have made a considered decision that took into account the needs and objectives of those beneficiaries. This would involve stating publicly that they had taken account of an agreed range of issues reflecting the requirements of beneficiaries. These might include fund objectives, time horizon, choice of benchmarks, willingness to pay dealing costs, expectations that the asset manager will engage with investee companies on their behalf and that remuneration structures are in line with the interests of the client." Rather than requiring that mandates have long-term horizons, the FRC favours this approach, arguing that it would push asset owners (and their advisors) to show that they have given the relevant issues due consideration.

<sup>23</sup> TUC proposed in their Kay Review response that fund managers "be required to report to clients on returns over the past twenty, ten and given years on an annual basis." See: Trade Union Congress. "Kay Review of Equity Markets — TUC Response," (2012), available at: <http://www.tuc.org.uk/tucfiles/332.pdf>, accessed 2 October 2013.

<sup>24</sup> In a study by Favaro et al. (2010), the authors found that the average tenure of CEOs in the largest 2,500 public companies in the world has dropped from 8.1 years to 6.3 years from 2000 to 2010. As noted by Palley (1997), shortening tenure may incentivise managers to focus on short-term performance and payoffs as they are unlikely to directly benefit from the success of longer-term projects.

<sup>25</sup> Eccles RG, Ioannou I, and Serafeim G. "The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance," Harvard Business School Working Paper 12-035, May 2012.

<sup>26</sup> CFA Institute. "Visionary Board Leadership: Stewardship for the Long-term," 2012.

<sup>27</sup> See:

- Bebchuk LA. "The Case for Increasing Shareholder Power," Harvard Law Review, January 2005.

- Bebchuk LA. "The Myth that Insulating Boards Services Long-Term Value," Columbia Law Review, Volume 113 (Fall 2013).

- Studies highlighted suggest arrangements to insulate boards from shareholder pressure are associated with lower firm value and poor operating performance.

<sup>28</sup> The Conference Board Taskforce on Corporate/ Investor Engagement was established in 2012 to explore this relationship in more depth: <http://www.conference-board.org/governance/index.cfm?id=14728>.

<sup>29</sup> Research is underway via a joint initiative of the Millstein Center, Columbia University, and the IRRC Institute to explore how boards of directors digest signals from the market and whether these dynamics are different at companies that have aggressive engagement policies and so hear directly from their shareholders.

<sup>30</sup> This could be coordinated through the ICGN, PRI, CFA Institute, and others.

<sup>31</sup> Rotman School of Management. Board Effectiveness Program for Pension and Other Long-horizon Investment Institutions, available at <http://www.rotman.utoronto.ca/ProfessionalDevelopment/Executive-Programs/CoursesWorkshops/Programs/Pension-Management.aspx>, accessed 2 October 2013.

<sup>32</sup> Diverse Director Datasource: <http://www.gmi3d.com/home>.

<sup>33</sup> Mercer has recently reviewed the style and performance characteristics of low-turnover managers across our global, EMEA, and US Large Cap equity universes. Within the global equity universe, there are around 70 managers with an annual turnover below 40% with a 10-year track record. This group has outperformed the medium- (40%–100%) and high-turnover (>100%) managers over this period (with some intra-period differences). A number of long-horizon, engaged-ownership investment strategies have also been launched recently. Contact Mercer for further information.

<sup>34</sup> Institute of Directors. "Response Submitted to the Initial Call for Evidence: The Kay Review of UK Equity Markets and Long-Term Decision Making," available at [http://www.iod.com/Influencing/Policy-papers/Corporate-Governance/~/\\_media/135ACB539AA14DE18C871FDC01368BCB.pdf](http://www.iod.com/Influencing/Policy-papers/Corporate-Governance/~/_media/135ACB539AA14DE18C871FDC01368BCB.pdf), accessed 2 October 2013.

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