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P. Alexander Quimby
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P. ALEXANDER QUIMBY

ABSTRACT

The classic concept of patient investing and long-term corporate governance has largely disappeared. Dispersed investors with long-term investment horizons have been replaced by concentrated institutional investors, which trade and control corporations solely for the short-term. This new model of investment and corporate governance (deemed “short-termism”) has a negative impact on society as a whole and has been blamed for recent financial crises and a lack of investment in research and development.

Although others have addressed short-termism, their efforts generally avoid providing actual solutions to the problem. This Note fills that void: it provides a model for promoting long-term investment and corporate governance, while not eliminating the benefits conferred by short-term trading. This goal can be accomplished by making a “loyalty shares” provision available to public corporations. By adopting a loyalty shares provision, the gains generated from the sale of that corporation’s stock would be subject to a periodically reduced capital gains tax rate over time, while the voting rights attached to that stock would be periodically enhanced over time. Adoption of the provision would entice more shareholders to invest for the long-term, while also increasing these long-term shareholders’ control over the corporation. Mindful of the experiences of European and Canadian companies that use other types of control-enhancing mechanisms, this proposal contains several features which avoid the pitfalls inherent in an uncapped system of enhanced voting rights.

I. INTRODUCTION

Although the American corporation originated as a vehicle to promote the public good, that primary purpose slowly eroded and...
gave way to a new fixation: increasing shareholder wealth. This shift in purpose is particularly important due to the significant role public corporations play in the United States: in the economic context, the increasing interconnectedness of markets has allowed Wall Street to substantially affect Main Street; politically, the Supreme Court’s controversial Citizens United decision opened the door even wider than before for large corporations to wield great influence through political spending; and the products, services, and messages of these corporations help shape American (and world) culture. Yet even as the goal of individual corporations has changed, the justification for their existence is still premised—at least in part—on the belief that they confer an overall benefit to society.

historically, states granted authority to public and private corporations to undertake specific activities, and how even private corporations “existed largely to serve a public good”).


4. See Eamonn K. Moran, Wall Street Meets Main Street: Understanding the Financial Crisis, 13 N.C. BANKING INST. 5, 10 (2009) (“Rippling effects from a worsening economy have trickled down from Wall Street into Main Street as the capital markets—the pipes through which money flows to finance student loans, car loans, home loans, family needs, and small businesses’ payroll and inventory—[sic] fell victim to the credit freeze. These drastic events have reverberated far beyond the trading floors of Wall Street and board rooms of corporate America, as almost no industry has been spared as the crisis that first emerged in the subprime mortgage market metastasized.”); John C. Bogle, Restoring Faith in Financial Markets, WALL ST. J., Jan. 18, 2010, http://online.wsj.com/article/SB10001424052748703436504574640523013840290.html (noting that in recent decades “the financial sector became the driving force in the U.S. economy”).


6. The Court struck down a federal law banning corporations from using their general treasury funds to make independent, election-related expenditures. Id. at 913; see also President Barack Obama, State of the Union Address (Jan. 27, 2010) in 156 CONG. REC. H418 (daily ed. Jan. 27, 2010) (“I believe [the Court’s decision] will open the floodgates for special interests . . . to spend without limit in our elections. I don’t think American elections should be bankrolled by America’s most powerful interests . . . .”); Ofer Raban, Constitutionalizing Corruption: Citizens United, Its Conceptions of Political Corruption, and the Implications for Judicial Elections Campaigns, 46 U.S.F. L. REV. 359, 382 (2011) (interpreting the Court’s decision as the “constitutionalization of political corruption”).

7. See Jena McGregor, The World’s Most Influential Companies, BLOOMBERG BUSINESSWEEK, (Dec. 10, 2008), http://images.businessweek.com/ss/08/12/1211_most_influential/2.htm (listing American public companies Apple, Wal-Mart, Google, Microsoft, and others as among the most influential in the world).

8. See REINIER KRAAIKAMEN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 28 (2d ed. 2009) (stating the normative “objective of corporate law—as of any branch of law—is presumably to serve the interests of society as a whole”); Leo E. Strine, Jr., One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?, 66 BUS. LAW. 1, 2 (2010) (“I believe that the generation of durable wealth for its stockholders through fundamentally sound economic activity, such as the sale of useful products and services, is the primary goal of the for-profit corporation. . . .
But over the last several decades the manner in which public corporations operate has changed drastically, in a way that threatens the nation’s long-term well-being. The familiar concept of public stock being owned by individual American citizens has largely disappeared. Instead, institutional investors—entities that pool together and then invest the money of numerous end-user investors (both companies and individuals)—are now the dominant holders of public stock and wield substantial influence over corporate boards of directors. The rise of institutional investors has coincided with the rise of short-termism: the practice of short-term investing by shareholders and short-term business decisions by directors and managers at the expense of long-term corporate sustainability. It was this type of short-termism that contributed to recent financial crises and also poses serious problems for the nation going forward, including a lack of investment in research and development (R&D) and increased market volatility.

Although Congress, scholars, and other commentators have sought to alleviate the problem of short-termism, their efforts have largely been either misguided or too passive. For example, the Dodd-Frank Act and other legislative measures endorsed increased shareholder empowerment as a way to ameliorate short-termism, yet ignored the fact that the very shareholders they were empowering had primarily short-term interests. Others have often devoted their time...
to analyzing why short-termism is a problem without providing a solution or have offered only general guidance, rather than specific proposals, for policy-makers to adopt.

In this Note, I propose a plan that would reduce short-termism to a healthy level. This proposal advocates for the availability of a “loyalty shares” provision to public corporations. If a corporation adopts a loyalty shares provision, the gains generated when an investor sells that corporation’s common stock would be subject to a periodically reduced capital gains tax rate, while the voting rights attached to that stock would be periodically enhanced. The immediate result of this proposal would be a renewed focus on long-term corporate health; the broader result would be a corporate sector that is more prosperous, stable, and beneficial to society.

II. THE RISE OF INSTITUTIONAL INVESTORS AND SHORT-TERMISM

Both the identity of shareholders and how they invest changed drastically during the twentieth century. Historically, shareholders were dispersed individuals with modest holdings of public stock. Because shareholders elect directors and directors make business decisions that are carried out by their managers, scholars of the time were largely concerned with the inability of shareholders to exert influence over the corporations they owned. Adolf Berle and Gardiner...
Means famously characterized the weak control shareholders possessed as a “separation of ownership and control.”19 Over the years, common reform efforts aimed at narrowing that separation included increasing proxy access and disclosure.20

But the classic portrait of dispersed, weak shareholders slowly changed.21 Individual investors were gradually replaced with institutional investors.22 These new pooled investment vehicles came in many shapes, sizes, and names: including mutual, hedge, pension, insurance, and index funds.23 The rise of institutional investors over the last seventy-five years has been startling. In 1950, institutional investors held only 8% of outstanding public stock.24 That number skyrocketed to 51% by 2000, 61% by 2005,25 and reached nearly 70% of all public stock in 2010.26 Of that number, mutual funds alone control 26%, while private pension plans and government pension plans own 11% and 9%, respectively.27

The rise of institutional investors may initially seem like a positive. Because institutional investors aggregate tremendous amounts of stock and, consequently, tremendous amounts of votes, they are better positioned than their dispersed predecessors to play an activist role in corporate governance.28 This reality suggests Berle and Means’s concern with the separation of ownership from control is outdated.29 Indeed, examples of institutional investors accomplishing their goals include changing CEO compensation to be primarily tied to their corporations’ stock price, widespread adoption of majority voting statutes, and huge stock buyback programs.30

21. See id. at 1828.
22. Id.
24. Anabtawi & Stout, supra note 9, at 1275.
27. Id.
28. See Anabtawi & Stout, supra note 9, at 1276.
29. See Leo E. Strine Jr., Why Excessive Risk-Taking Is Not Unexpected, N.Y. Times (Oct. 5, 2009, 1:30 PM), http://dealbook.nytimes.com/2009/10/05/dealbook-dialogue-leo-strine/ (“[T]here is now a separation of ‘ownership from ownership’ that creates conflicts of its own that are analogous to those of the paradigmatic, but increasingly outdated, Berle-Means model for separation of ownership from control.”).
30. See Strine, supra note 8, at 14-16 (detailing some of the changes achieved by institutional investors).
But while the problem evidenced by Berle and Means’s characterization has declined, a new characterization—replete with its own problems—has emerged. Corporate governance is now faced with a “separation of ‘ownership from ownership.’ ” One difficulty is that the existing model of corporate law focuses solely on the fiduciary duties corporate managers owe to their shareholders, to the exclusion of the end-users who fund those shareholders. Moreover, institutional investors may invest in a manner inconsistent with their end-users’ long-term goals. Also, “in most institutions the persons charged with making investment decisions have relatively little or no responsibility for voting the institution’s portfolio shares.” The fact that many institutional investors rely on the voting advice of proxy advisory firms adds even more separation between end-users and boards of directors.

But while those problems are concerning, the most serious threat to American public corporations stems from their shareholders’ investment time horizons. Just as the existence of individual investors gradually gave way to institutional investors, the reality of patient, long-term investing acquiesced to short-termism. As institutional investors competed to attract new end-users every quarter by posting the most impressive returns, their portfolios began turning over at

31. See Strine, supra note 29.
32. See Anabtawi & Stout, supra note 9, at 1265 (describing how, generally, officers and directors only owe fiduciary duties to shareholders); Strine, supra note 8, at 10 (“The existing model of corporate law focuses solely on the duties managers owe to stockholders. It does not address the reality that most ‘stockholders’ are now themselves a form of agency, being institutional investors who represent end-user investors.”). In describing the disparity between directors and end-users, Vanguard founder John Bogle wrote: “[I]n this Alice-in-Wonderland world of the financial markets, the investor feeds at the bottom of the food chain.” Bogle, supra note 4.
33. See Strine, supra note 8, at 12 (“The focus of many of these institutions on quarterly earnings and other short-term metrics is fundamentally inconsistent with the objectives of most of their end-user investors, people saving primarily for two purposes, to put their kids through college and to fund their own retirements. These end-user investors do not care about quarterly earnings or short-term gimmicks. These end-user investors want corporations to produce sustainable wealth that will be there when they need it.”) (footnotes omitted).
35. Id. (detailing the range of practices used by some fund managers, “from outsourcing the mechanics for actually voting shares . . . , to making recommendations on how to vote all portfolio companies’ shares on all matters brought to shareholder meetings, to exercising discretionary proxy authority to vote the portfolio companies’ shares without reference to the investment manager”).
36. See supra text accompanying notes 24-26.
37. See supra text accompanying note 11.
an alarming rate. “In 2009, the average stock turnover appears to have exceeded 250% (changed hands two and a half times), compared to 78% a decade ago, and 21% barely 30 years ago.”39 Mutual funds—which are the primary 401(k) contribution investors for Americans40—turn over 117% of their stock portfolio a year,41 while hedge funds turn over 300% annually.42 The presence of short-termism from other vantage points is also readily apparent. The stockholder base of public companies now turns over nearly 100% every year.43 On the New York Stock Exchange, stocks were held for—on average—between five and nine years from 1945 to 1975, for three years by 1980, and for less than one year by 2005.44 Overall, the average holding period for United States equities is just six months.45

But the proliferation of institutional investors has broader consequences than just short-term trading; it also impacts corporate governance. These short-term investors are unlikely to be concerned with, much less promote, policies that are beneficial to the corporation in the long-term.46 When shareholders have short-term goals, they elect directors with similar interests and apply subsequent pressure to ensure these goals are met.47 This results in managers engag-

40. See Strine, supra note 8, at 10.
41. Brian Reid & Kimberlee Millar, Mutual Funds and Portfolio Turnover, INVESTMENT COMPANY INSTITUTE (Nov. 17, 2004), http://www.ici.org/pdf/rc_v1n2.pdf; see also Strine, supra note 8, at 10 n. 32.
42. Strine, supra note 8, at 10.
43. Id. at 17.
44. See Michael C. Thomsett, GETTING STARTED IN STOCK INVESTING AND TRADING 99-100 (2011). Furthermore, the annual turnover of stocks traded on the NYSE reached over 138% in 2008, compared to 88% in 2000 and 36% in 1980. See Strine, supra note 8, at 10 n.32, 11 n.35.
45. Sparks & DiTomo, supra note 16, at 129.
46. See BUS. & SOC’Y PROGRAM, THE ASPEN INST., OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (2009), available at http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/oVERCOME_short_state0909_0.pdf (“[F]und managers with a primary focus on short-term trading gains have little reason to care about long-term corporate performance or externalities, and so are unlikely to exercise a positive role in promoting corporate policies . . . that are beneficial and sustainable in the long-term.”). Note that the coalition who provided this report was comprised of many influential investors, including Warren Buffett and John Bogle. Id.
47. See Brian J. Bushee, Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?, 18 CONTEMP. ACCT. RES. 207, 229 (2001) (presenting empirical evidence that short-term institutions “exhibit preferences consistent with a short-term focus, supporting [the] view that this type of investor is most likely to create pressure for strong short-term earnings performance”).
ing in short-term tactics at the expense of long-term strategies. Additionally, institutional investors who tend to focus on short-term performance are associated with low information quality, as well as weak monitoring and a weak bargaining position in acquisitions.

Of course, just because there has been a fundamental shift in how shareholders invest and control corporate governance does not, in and of itself, tell us that the overall effect is negative. After all, high frequency trading increases liquidity and market efficiency, while reducing trading costs through increased competition. And at least two authors have concluded that short-term trading by institutional investors is positively related to future stock returns and earnings. But while short-term trading and corporate governance can confer some benefits on the market, widespread short-termism delivers overwhelmingly negative effects.

III. WHY SHORT-TERMISM MUST BE CONFRONTED

“[I]n the short run the market is a voting machine, but in the long run it is a weighing machine.”

-Benjamin Graham

48. See Mercer & The IRRC Institute, Investment Horizons: Do Managers Do What They Say? 15, available at http://www.ifat.com/articles/Mercer_IRRC_Study.pdf (reporting, in a case study analysis of fund managers, that “[w]hen the discussion turned from the implications for them as fund managers to the wider market impacts, almost all the managers observed that short-termism can encourage short-term thinking among corporations, which can distract corporate directors from their strategy and potentially undermine long-term shareholder value”); Strine, supra note 8, at 16 (“As a whole, institutional investors have pushed for corporate managers to be highly responsive to the immediate pressures and incentives of the capital markets[,]” which can result in “an agenda that [does not] appropriately focus[] on the long term . . . .”).

49. See Natasha Burns et al., Institutional Ownership and Monitoring: Evidence from Financial Misreporting, 16 J. CORP. FIN. 443, 443 (2010) (“[T]he likelihood and severity of financial misreporting is positively related to aggregate institutional ownership and this effect can be largely attributed to ownership by institutions with short investment horizons—those with little incentive to engage in costly monitoring of firm activities and precisely those that sell at the announcement of a [financial] restatement.”).


52. See Xuemin (Sterling) Yan & Zhe Zhang, Institutional Investors and Equity Returns: Are Short-Term Institutions Better Informed?, 22 REV. FIN. STUD. 893, 893 (2009) (“[T]he positive relation between institutional ownership and future stock returns . . . . is driven by short-term institutions. Furthermore, short-term institutions’ trading forecasts future stock returns. . . . Short-term institutions’ trading is also positively related to future earnings surprises.”).

The pervasiveness of short-termism among institutional investors challenges one of the basic rationales for how the corporate structure is designed: Shareholder voting rights are premised on the theory that shareholders have an interest in increasing the firm's long-term profitability.\textsuperscript{54} Shareholders' incentives are supposed to be aligned with the maximization of firm profitability because they are residual claimants.\textsuperscript{55} “But in corporate polities, unlike nation-states, the citizenry can easily depart and not ‘eat their own cooking.’ As a result, there is a danger that activist stockholders will make proposals motivated by interests other than maximizing the long-term, sustainable profitability of the corporation.”\textsuperscript{56}

The question that must be asked is, “What long-term policies will corporations give up to appease short-term shareholders?” One of the most concerning answers is investment in research and development.\textsuperscript{57} When a corporation's stock is owned “by institutions that have high portfolio turnover and engage in momentum trading . . . the probability that managers [will] reduce R&D [investment] to reverse an earnings decline” significantly increases.\textsuperscript{58} In contrast, high proportions of ownership by institutions with low portfolio turnover and longer-term holdings have “no incremental impact” on the likelihood of cuts in R&D.\textsuperscript{59}

The inverse relationship between short-termism and R&D investment is especially concerning when viewed alongside other R&D trends. Over the years, the scientific and technological advances made by United States companies have created new industries, new jobs, and an improved standard of living for Americans.\textsuperscript{60} But in the

\textsuperscript{54} See Strine, supra note 8, at 8 (“The rights given to stockholders to make proposals and vote on corporate business are premised on the theory that stockholders have an interest in increasing the sustainable profitability of the firm.”).

\textsuperscript{55} See STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 470 (2002) ("[S]hareholders have the strongest economic incentive to care about the size of the residual claim, which means they have the greatest incentive to elect directors committed to maximizing firm profitability.").

\textsuperscript{56} Strine, supra note 8, at 8.

\textsuperscript{57} Brian J. Bushee, The Influence of Institutional Investors on Myopic R&D Investment Behavior, 73 ACCT. REV. 305, 305 (1998); see also Strine, supra note 8, at 3 (“To build wealth in a durable manner, corporations need to commit capital to long-term endeavors, often involving a lag time between the investment of capital and the achievement of profit, a long time during which activities like research and development occur.”).

\textsuperscript{58} See Bushee, supra note 57, at 305.

\textsuperscript{59} See id. at 310-11, 328-30.

\textsuperscript{60} See Nat’l Sci. Bd., Research and Development: Essential Foundation for U.S. Competitiveness in a Global Economy, NAT’L SCI. FOUND. (Jan. 2008), http://www.nsf.gov/statistics/nsb0803/start.htm (“The scientific and technological advances that have led to our Nation’s remarkable ability to create new industries and jobs, improve the standard of living for people, and provide sophisticated technology that ensures our national security can be traced back to the outcomes of basic research.”).
past decade industry support for its own basic research has stagnated. \(^61\) Meanwhile, the federal government has decreased its support of academic R&D and basic research. \(^62\) These reductions could have serious implications on the ability of the United States to compete for highly skilled and manufacturing jobs at home and in international markets. \(^63\) Overall, the continued rise of short-termist institutional investors and the decline in R&D investment which accompanies it is likely to exacerbate this problem in the future.

Short-term corporate governance can also result in corporations foregoing other important long-term strategies. For example, corporations may be too impatient to wait for appropriate regulatory approval before bringing new products into the market. \(^64\) Corporations may also choose to generate short-term earnings at the expense of building crucial new factories \(^65\) or making other necessary capital investments. \(^66\) Additionally, managers may terminate workers if it will result in an increase in short-term earnings. \(^67\)

Besides short-termism’s negative influence on corporate governance, excessive short-term trading can also directly cause problems in the market. The intense focus on short-term speculation has caused stock prices, rather than more reliable fundamentals, to take center stage in the eyes of many investors. \(^68\) One result has been an increase in volatility, in that “stocks that are mostly held by short-term investors experience . . . more severe price drops and larger price reversals than those mostly held by long-term investors.” \(^69\) Moreover, the prevalence of investors with short investment horizons causes, in the aggregate, “market-wide negative shocks.” \(^70\)

\(^61\) Id. (stating “U.S. industry and the Federal Government are the primary pillars of financial support for the U.S. [R&D] enterprise” but “industry support for [its] own basic research has stagnated over the last several years”).

\(^62\) Id. (stating “Federal Government support for academic R&D began falling in 2005 for the first time in a quarter century” and federal support for basic research has stagnated in recent years).

\(^63\) Id.

\(^64\) See Sparks & DiTomo, supra note 16, at 128.

\(^65\) Id.

\(^66\) See John R. Graham et al., The Economic Implications of Corporate Financial Reporting, 40 J. ACCT. & ECON. 3, 32-35 (2005) (surveying the CFOs of 400 major corporations and revealing they would have been willing to lay off workers, delay necessary capital investment, and cut R&D budgets in order to meet quarterly stock price projections).

\(^67\) See id.

\(^68\) See Bogle, supra note 4 (“The momentary illusion of the price of a stock took center stage, replacing the enduring reality of the company’s intrinsic value—the discounted value of its future cash flow.”).


\(^70\) See id. at 1.
Even more troubling, short-termism can incentivize the type of excessive risk-taking and financial gimmickry that was prevalent in recent financial crises. For example, when investors, executives, and directors obsessively traded mortgage-backed securities and collateralized debt obligations to generate short-term profits, they failed to adequately assess the long-term risks and complexity of their investments. And when investors’ continued demand for ever-higher returns could not be met legitimately, they were sometimes met by fraud. The pressure applied to executives by investors hungry for quarterly profits has also been cited as one cause of the disaster at Enron.

As discussed previously, institutional investors are better positioned to influence corporate governance than their dispersed predecessors. But so long as the investors who determine the fate of their directors are unconcerned with the long-term, we should not expect corporations to be concerned with the long-term. And while many have criticized managers for being unresponsive to shareholders, it is disingenuous to then disparage those managers for failing to resist shareholders’ demands for risky short-term strategies.

Although there are some benefits to short-term trading and short-term corporate governance which should not be disregarded, our current system can be improved by reducing the overall level of short-termism. One reason such a reduction would be beneficial is because institutional investors with long-term investment horizons are associated with more efficient monitoring than their short-term counterparts. Additionally, corporations managed for the long-term

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71. See The Conference Bd., supra note 12, at 17; Sparks & DiTomo, supra note 16, at 128 (“[A]s evidenced by the recent financial crisis, short-termism may incentivize excessive risk-taking.”); Strine, supra note 8, at 17 (stating the agenda of short-termists “has been on increasing stock prices as fast and as much as possible, even if that requires financial gimmickry and risk”).
73. Id.
74. Katharine V. Jackson, Towards a Stakeholder-Shareholder Theory of Corporate Governance: A Comparative Analysis, 7 Hastings Bus. L.J. 309, 324 n.110 (“Also familiar are the accounting shenanigans leading to the doom of Enron and other notorious corporations. Many blame such bad behavior on the pressure brought on executives by investors hungry for quarterly profits.”).
75. See supra text accompanying note 28.
76. See Strine, supra note 8, at 1-2 (“[W]hy should we expect corporations to chart a sound long-term course of economic growth, if the so-called investors who determine the fate of their managers do not themselves act or think with the long term in mind?”).
77. Id. at 17 (“It is contradictory to demand managerial responsiveness to stockholder sentiment, and then criticize managers for failing to resist stockholder demands for riskier business strategies and more highly levered balance sheets.”).
78. See supra text accompanying notes 51-52.
are more apt than those managed for the short-term at creating stable employment, wealth, and goodwill. Moreover, because most well-developed business plans are projected beyond a one- to two-year horizon, a corporation governed with a disproportionate focus on short-term earnings is ill-equipped to grow in a sustainable way.

The desire to see a renewed corporate focus on long-term strategies is not new. Numerous investors and scholars already support a greater level of long-term focus by shareholders and corporations. The remainder of this Note outlines how this goal can actually be accomplished.

IV. PROMOTING LONG-TERM INVESTMENT AND CORPORATE GOVERNANCE

A. Loyalty Shares

To contend with short-termism, a proposal is needed that incentivizes long-term stock ownership and allows long-term owners to have increased influence. This can be accomplished by allowing public corporations to adopt a “loyalty shares” provision in their charter or bylaws. If a corporation chooses to adopt a loyalty shares provision, two results would follow.
First, the voting rights attached to each share of common stock would gradually increase over time to ensure corporate boards receive a healthy amount of influence from long-term shareholders. Accompanying provisions related to voting rights ceilings, transparency, and conflicts of interest would be included as default rules to prevent the potentially negative results of enhanced voting rights.

Second, when a corporation adopts the loyalty shares provision, the capital gains generated when an investor sells that corporation’s stock would be taxed in a gradually decreasing manner—based on how long the investor held the stock. The effect would be that shareholders have adequate incentives to hold stock for the long term. As discussed supra, long-term ownership has reached an anemic level. 84 Without properly incentivizing investors to hold stock for the long-term, step one of this proposal might be meaningless; there would likely be an insignificant number of investors capable of taking advantage of the enhanced voting rights. Apart from the benefits that enhanced control and reduced tax liability separately confer to the shareholder, they also maintain a symbiotic relationship: A shareholder with increasing control of corporate governance benefits by influencing the implementation of sound, long-term corporate policies because its investment receives increasingly favorable tax treatment over time.

B. Enhanced Voting Rights

1. The Method of Enhancing Voting Rights

Generally speaking, a single share of common public stock is entitled to one vote on any matters brought before the shareholders at a shareholder meeting. 85 In other words, a shareholder who has maintained his ownership for five years wields identical influence—all else being equal—to the shareholder who has maintained his ownership for five days. The problem with this model is evident when it comes time for shareholders to elect directors to the board. 86 If directors implement a corporate policy that sacrifices some short-term earnings in favor of long-term investment, they may be on the hot seat at the next annual election. If, as is often the case, much of the

84. See supra notes 39-45 and accompanying text.
86. Divergent interests between short-term and long-term shareholders could also arise in the context of mergers and acquisitions. See Jennifer E. Bethel et al., The Market for Shareholder Voting Rights Around Mergers and Acquisitions: Evidence from Institutional Daily Trading and Voting, 15 J. CORP. FIN. 129, 129 (2009) (“A fundamental tenant of shareholder governance is the right of shareholders to vote on key managerial decisions such as mergers and acquisitions.”).
voting stock resides in the hands of investors who have held—and only intend to hold—stock for the short term, the directors will likely find themselves out of a job.87 Practically, directors may not put forth long-term corporate policies in the first place if the threat of removal by short-sighted investors looms ahead.

To be clear, we cannot know for sure that the investor who held stock for five years still intends to hold it in the future, just as we cannot know that a new investor is only concerned with short-term performance at the expense of long-term growth. But an ex post view of the duration of ownership seems like the best proxy for predicting the duration of future ownership.88 Moreover, because the tax scheme discussed infra would incentivize long-term investing more so than the current model does, investors would be more likely to own stock for the long-term. One alternative would be to actually penalize short-term stock ownership, either by tax penalties or, in the very extreme, disgorgement of some short-term profits. But the loyalty shares proposal is better because it recognizes that short-term strategies are not void of any benefits. Rather than try to stamp out short-termism altogether, this proposal uses gradual incentives to entice shareholders, while not drastically disincentivizing short-term trading for those who still desire to do so. The ultimate goal is to reach a healthier balance between long- and short-term investment and governance than our present system does.

A system in which the voting power of a share increases in correlation with the length of time an investor holds the share allows investors with long-term horizons to have increased influence on corporate policies. Although the “one share, one vote” method is dominant in United States corporations,89 approaches that alter the proportionality between ownership and control have been used before, primarily in European and Canadian companies.90 Sometimes referred to as “control enhancing mechanisms” (CEMs), these approaches include multiple voting rights shares, non-voting shares, pyramid structures, and voting rights ceilings, among others.91 Consequently, the task of designing the appropriate structure for loyalty shares has some guidance. A study of CEMs showed multiple voting rights shares are available in 53% of European Union member states, and have actually been implemented in 50% of those countries.92 The percentage of

87. See supra notes 46-48 and accompanying text (describing the ability of short-term investors to influence directors and corporate policy).
88. See supra note 14 and accompanying text (discussing how using an ex post view of duration to empower long-term shareholders in the hopes of alleviating short-termism was endorsed in the SEC’s proposed Rule 14a-11).
89. See EASTERBROOK & FISCHER, supra note 85, at 72.
90. See, e.g., infra text accompanying notes 92-93, 112.
91. See INST. S’HOLDER SERVS. ET AL., supra note 83, at 23.
92. Id. at 18.
companies within a given country who have implemented multiple voting rights shares varies drastically, with the United Kingdom (U.K.) at the low end (5%), and Sweden at the high end (80%).

Importantly, many of the companies that adopt multiple voting rights shares do so by creating distinct classes of shares, which are bought and sold with the enhanced voting rights already attached. On the other hand, the common practice in France—for example—is for voting rights to double only when the particular shareholder has held the same share for a specific duration of time set out in the company’s bylaws (the duration must be at least two years). In the French model, only the specific long-term investor who has owned the stock for a set duration maintains the enhanced voting rights; they dissolve upon sale.

Although primarily a feature of corporate governance in France, shares with voting rights that increase after a certain period of ownership are (rarely) found in the United States. A study by the European Commission revealed that nine out of 4399 United States companies sampled (0.2%) granted shareholders some form of loyalty votes. In those companies, common stock generally received five or ten votes per share after being held for four years.

This Note’s proposal envisions a more gradual enhancement of voting rights. Instead of having a drastic doubling of voting rights after two (or more) years, the voting rights attached to a particular share would increase by one-twelfth every six months, for up to three years. As shown infra, increasing voting rights in this manner would correlate with the decreasing tax burden on capital gains derived from selling these shares. This approach would not suffer from the all-or-nothing pitfalls inherent in a model that doubles voting rights one time after a certain period. Other shareholders and potential investors would be able to see how the shareholders with enhanced voting rights behave as their corporate control increases and can then react as they see fit. Potential investors who see the prospect of future value in the way a loyal shareholder’s track record of corporate governance emerges would have notice and could invest early. On the other hand, a current shareholder who believes the loy-
al shareholder’s track record reflects an irresponsible approach to corporate governance can exit the company before its stock price takes a downturn.

2. Concerns with Enhanced Voting Rights

Of course, with the presence of any CEM comes an increased ability for shareholders to gain control of the corporation. As indicated in a study by Institutional Shareholder Services et al., some potential investors fear that the presence of CEMs in European companies could indicate a board might ignore minority shareholders’ interests, prevent or restrict takeover bids and their potential share-price upside, and create conflicts of interest for significant shareholders and their boards.101 The fact that some European crises were made possible by the existence of dominant shareholders is also concerning, as some of them were able to extract benefits from the corporation at the expense of other shareholders.102

But these issues present less of a threat in United States public corporations, where the level of shareholder concentration is generally much lower than in European companies. In 2001, only 2% and 1.7% of United States companies listed on the Nasdaq and NYSE, respectively, were under majority control.103 The next closest country or region was the U.K. (2.4%), followed distantly by Sweden (26.3%), and with Austria at the high end (68%).104 The percentage of widely held companies in several European countries adds further perspective, revealing Italy at 20%, Germany at 50%, and France at 60%.105 On the other hand, 80% of United States companies are widely held.106 These numbers suggest that, when compared with European companies, United States public corporations are far less likely to have their corporate policies dominated by any one shareholder. Moreover, the higher concentration of ownership in European companies is presumably enhanced by the existence of multiple types of CEMs, not just multiple voting rights shares (which are more similar to loyalty shares).107 And to be sure, there are at least some benefits

101. See INST. S’HOLDER SERVS. ET AL., supra note 83, at 87.


104. Id.


106. Id.

107. See INST. S’HOLDER SERVS. ET AL., supra note 83, at 6 (stating “Control Enhancing Mechanisms are rather common” in the 464 European companies considered and “[l]arge companies in the European Union under analysis feature a variety of CEMs”).
to a corporation that is not widely held, including an increased ability for shareholders to monitor management.108

Despite the prevalence of widely held companies in the United States, the enhanced voting rights attached to loyalty shares should nonetheless be tempered. If not constructed properly, the method of providing enhanced voting rights—as described thus far—could eventually lead to excessive proportionality differences between voting rights and ownership. Such excesses have manifested themselves within some European and Canadian companies. For example, a shareholder in a large Italian company (i.e., a market capitalization of $40 billion) controlled 18% of the votes—making it the largest shareholder by far—yet held only 0.7% of the cash flow rights;109 a German family controls 25.1% of Volkswagen AG despite owning only 9.44% of the cash flow rights;110 and even more startling, a single family shareholder controlled 50% of the Stockholm stock exchange through recourse to CEMs.111 In Canada, drastic proportionality differences are readily apparent at companies listed on the Toronto Stock Exchange, including Magna International (where a shareholder owns 1% of equity and 56% of the voting power); Canadian Tire (3%, 61%); and Shaw Communications (9%, 78%).112

Such drastic proportionality differences manifest problems in many ways: namely, decreased liquidity;113 prevention of possible takeover bids that could ultimately be favorable to non-controlling shareholders;114 (as mentioned previously) providing an incentive to shareholders whose control greatly exceeds their ownership rights to extract value from the company at the expense of non-controlling shareholders;115 and a misalignment of incentives between the controlling shareholder and non-controlling shareholders when the controlling shareholder’s voting power greatly exceeds her financial risk.116

108. See BECHT, supra note 103, at 5.
110. Id. at 120-22.
111. See COMM’N OF THE EUROPEAN CMTYS., supra note 102, at 11.
114. See INST. S’HOLDER SERVS. ET AL., supra note 83, at 11.
116. See Parizeau, supra note 112, at 6-7 (“In my view, the structure of capital with multiple voting shares can only be justified when the controlling shareholder owns a significant part of the company and, therefore, when that shareholder is much more at risk than any other shareholder.”).
3. Preventing Drastic Ownership-Control Proportionality Differences

These potential proportionality differences would be constrained by including the following default rules in the loyalty shares provision. First, after three years the voting rights would no longer expand. For example, an investor who bought 12 shares of common stock would see his voting rights enhanced by 50% (to 18 votes) if he continued his ownership of those particular shares for three years. Because the increments used to enhance voting rights would never allow for more than a 50% increase in voting power, the excessive proportionality differences cited above would be unobtainable.

Second, a voting rights ceiling attached only to loyalty shares would ensure dominance does not result from long-term holdings alone. United States companies that currently use voting rights ceilings generally set them at 10% of total outstanding shares.117 For the sake of simplicity, assume a corporation has 200 shares of outstanding stock and the voting rights ceiling on loyalty shares is set at 9%. An investor who held 12 shares for three years would have 18 votes.118 Therefore, the investor would own 6% of the corporation’s stock and have 9% of the voting rights. Note that the investor has reached the cap on allowable votes derived from loyalty shares. If the investor purchases three more shares of stock, she will have 15 shares and 21 votes, meaning she will own 7.5% of the outstanding stock and 10.5% of the votes. Because the investor previously hit the votes ceiling on loyalty shares, the new shares she purchases will not receive enhanced voting rights no matter how long she holds them.

By applying the voting rights ceiling only to loyalty shares, ambitious shareholders would still be able to increase their control through normal market mechanisms (i.e., buying more shares). The benefits of allowing shareholders to compete for control of corporations in which they see value will not be significantly deterred. The three-year limit on enhanced voting rights—combined with the voting rights ceiling on loyalty shares—would allow a healthy, increased influence from long-term shareholders, while preventing the dangers seen with enhanced voting rights in Europe and Canada. Moreover, because these accompanying provisions would be default rules, directors and shareholders would have the flexibility to adopt different limits through private ordering if they are deemed more beneficial.

117. INST. ST.HOLDER SERVS. ET AL., supra note 83, at 81. By comparison, common voting rights ceilings in France include 6%, 10%, and 15%. Id. at 46.
118. To recap, the proportion of votes per loyalty share increases by 1/12 after six months, 2/12 after one year, 3/12 after one-and-a-half years, 4/12 after two years, 5/12 after two-and-a-half years, and 6/12 after three years.
4. Additional Safeguards to Ensure the Success of Loyalty Shares

While the foregoing should largely suppress fears that shareholders with relatively small equity would dominate corporate policymaking, corporations could mitigate any remaining risks by adopting additional measures (via default rules) already used by European companies.119 These include standard corporate governance rules designed to prevent conflicts of interest (e.g., rules on related party transactions, minority protection in the context of take-over bids, and the prevention of market abuse).120 Certain rules could also require transparency, such as disclosure obligations for enhanced voting rights holders.121 Furthermore, there is an additional safeguard already present in United States corporate governance: Controlling shareholders owe a fiduciary duty to non-controlling shareholders.122

Although the study by Institutional Shareholder Services et al. indicated that many institutional investors had negative opinions of multiple voting rights shares in European companies, some investors instead indicated they were enticed to invest in companies with CEMs, noting the potential for more responsible and committed management.123 Importantly, the study did not distinguish investors’ sentiments based on the specific kinds of multiple voting rights shares available;124 thus, it is impossible to infer from the study how investors might feel about loyalty shares specifically. Even assuming for the moment there would be some negative sentiment toward loyalty shares, the use of France’s relatively similar approach125 is as prevalent in large French companies as in recently listed French companies, “showing no decline in this practice.”126 Presumably, these companies see the increased prospect of long-term sustainability that is derived from rewarding long-term shareholders with more control. Moreover, it is notable that 52% of the large-cap companies analyzed in the study had CEMs while only 26% of recently listed companies had them.127 When these numbers are compared with the prevalent

120. See id.
121. See id. at 21-22.
122. See Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) (“[A] shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.”); Anabtawi & Stout, supra note 9, at 1265 (noting “courts have held that majority shareholders, like corporate officers and directors, owe a fiduciary duty of loyalty to minority shareholders that precludes them from using their positions as controlling shareholders to extract material economic benefits from the firm at the minority’s expense”).
123. See INST. S’HOLDER SERVS. ET AL., supra note 83, at 91-92.
124. Id. at 27 (detailing some of the different types of multiple voting rights shares in particular countries, but summarizing respondents’ answers as “multiple voting rights shares” generally).
125. See supra text accompanying notes 95-96.
126. INST. S’HOLDER SERVS. ET AL., supra note 83, at 44.
127. Id. at 6.
use of France’s relatively similar approach to loyalty shares in both large and recently listed companies, it indicates shares with loyalty enhanced voting rights are the most preferred type of multiple voting rights shares. Furthermore, the fact that roughly 40% of French public companies are owned by foreign investors suggests that—as a general matter—investors are not hesitant to buy equity in companies with loyalty shares.128

5. Concerns About Principles of Shareholder Democracy

Critics may argue the enhanced voting rights attached to loyalty shares violate the democratic principle of one-share-one-vote.129 But this idealistic rationale overlooks the multitude of schemes already used by corporations to alter the proportionality between ownership and control. For example, many United States corporations already issue dual-class shares—where one of the classes has either fewer votes than the other or no votes at all—representing in the latter case an infinite separation of ownership and control.130 Additionally, corporate boards routinely adopt methods to entrench themselves and stifle shareholders’ democratic power.131 Finally, shareholders sometimes enter into agreements that control, in one way or another, how they must vote in director elections and on other matters,132 and in the case of voting trusts, legal title to shares is actually

128. See, The French Investment Climate, AM. CHAMBER OF COM. IN FR. (Mar. 2010), http://www.amchamfrance.org/theme1.php?idcontenu=107&idpage= (“Foreigners [held] approximately 39 percent [sic] of the capital of large publicly traded French companies (CAC 40) in December 2008.”); Paris Stock Exchange (PAR) .PA, INVESTOPEDIA, http://www.investopedia.com/terms/p/paris-stock-exchange-par-.p.asp#axzz1s8NHLkQv (last visited Feb. 18, 2013) (“Now known as the NYSE Euronext (NYX), the Paris Stock Exchange trades both equities and derivatives and posts the CAC 40 Index. This index is made up of French companies, although nearly half of these are owned by foreign entities.”).

129. See EASTERBROOK & FISCHER, supra note 85, at 72-73.

130. See INST. S’HOLDER SERVS. ET AL., supra note 83, at 81.

131. See Jay B Kesten, Managerial Entrenchment and Shareholder Wealth Revisited: Theory and Evidence from a Recessionary Financial Market, 2010 BYU L. REV. 1609, 1611 (2010) (“Between 1990 and 2005, managerial entrenchment levels had remained more or less stable. In 2006, however, average entrenchment spiked nearly 50% as measured by an index of the six most impactful entrenchment devices: poison pills, staggered boards, executive golden parachutes, supermajority voting requirements for the approval of mergers, and limitations on shareholders’ ability to amend corporate bylaws and charters . . . .”) (footnote omitted).

132. See Annotation, Validity and Effect of Agreement Controlling the Vote of Corporate Stock, 45 A.L.R.2d 799, 801-02 (describing various types of voting agreements and stating “[a]lthough, in a relatively small number of cases, stockholders’ contracts by which the manner in which they may vote their holdings is controlled have been held to be, by their nature, fatally defective . . . , the modern view on the question whether a stockholder’s contract, by which the manner in which he may vote his holdings is controlled, is valid, appears to be that such contracts contain no inherent defect requiring that they be struck down”) (footnotes omitted).
transferred to trustees who vote them in accordance with the terms of the trust instrument.\textsuperscript{133}

The difference between those methods and the one proposed in this Note is, with the latter, the altered proportionality is premised on enhancing a long-term view of corporate governance, a path both scholars and prominent investors have strongly endorsed.\textsuperscript{134} As detailed above, default safeguards—as well as the fiduciary duty a controlling shareholder owes to non-controlling shareholders—would prevent abuses.\textsuperscript{135}

C. Incentivizing Long-Term Ownership Through the Tax Code

While enhanced voting rights alone may entice some otherwise short-term shareholders to invest over a longer time horizon, the competition between institutional investors for clientele would likely prevent a major shift.\textsuperscript{136} Until long-term shareholding becomes more enticing from a financial perspective, the hands of institutional investors will be forced by the marketplace for end-users.\textsuperscript{137} This hurdle could be cleared if institutional investors were able to advertise their ability to distribute more favorable after-tax profits to end-users. Several authors have supported the use of tax incentives to promote long-term holdings.\textsuperscript{138} However, the manner in which this should be done has often gone unexplained.\textsuperscript{139}

These tax benefits should be aimed at the funds’ clients (i.e., their end-users) because, first, the sustainability of institutional investors depends on attracting clients, and second, institutional investors themselves are generally pass-through entities for tax purposes.\textsuperscript{140}

\begin{itemize}
\item \textsuperscript{134} See supra note 82.
\item \textsuperscript{135} See discussion supra Part IV.B.3-4.
\item \textsuperscript{136} See supra note 38 (describing the intense competition among institutional investors for end-users).
\item \textsuperscript{137} See id.
\item \textsuperscript{138} See, e.g., Strine, supra note 8, at 18 (“Areas that would be productive for examination include . . . pricing and tax strategies to encourage investing and discourage churning by institutional investors and ‘fund hopping’ by end-user investors . . . .”); Sparks & DiTomo, supra note 16, at 136 (supporting incentives for “long-term investments through revised regulation (e.g., preferential tax treatment)” as a way to address short-termism).
\item \textsuperscript{139} See Strine, supra note 8, at 18; Sparks & DiTomo, supra note 16, at 136.
\end{itemize}
Under the current tax model, an end-user who buys shares in an institutional investment fund will be taxed on the capital gains generated from the fund’s sale of stock, whether those gains are distributed to the end-user or reinvested in the fund.\(^1\) If the fund holds the stock for over a year before selling it, the gains or losses will be taxed at a preferential long-term capital gains rate.\(^2\) Generally, long-term capital gains are subject to a 15% rate.\(^3\) On the other hand, short-term capital gains are subject to ordinary federal income tax rates, which can be as high as 35%.\(^4\)

Because the preferential capital gains rate for stock plateaus after one year, there is no direct financial incentive for investors to hold stock for longer durations.\(^5\) Moreover, by not providing any incentives prior to the one-year mark, many investors who hold stock for short durations (e.g., six months or less) may be indifferent to the prospect of long-term capital gains because realization of them is so far into the future.


\(^2\) See 26 U.S.C. § 1222(3) (2006) (defining “long-term capital gain” as “gain from the sale or exchange of a capital asset held for more than 1 year”).


\(^4\) Mutual Fund Taxes, supra note 141.

\(^5\) See Sparks & DiTomo, supra note 16, at 129 (“Lastly, because preferential capital gains rates are available to investors after they hold their investment for only 1 year, investors are not encourage[d] to hold an investment for longer periods.”). Congress has altered the holding period that triggers the preferential capital gains rate on several occasions. In 1921, the alternative maximum rate for capital gains applied to capital assets held for more than two years. See STAFF OF THE JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAXATION OF CAPITAL GAINS JCX-4-98 (1998), available at http://www.jct.gov/jct_html/x-4-98.htm. In 1934, the exclusion of varying percentages of capital gains and losses depended on holding periods of one to two years, two to five years, five to ten years, and over ten years. Id. In 1938, Congress implemented relevant holding periods of 18 months to two years, and over two years. Id. In 1942, Congress provided preferential treatment for capital assets held for more than six months. Id. The holding period was increased to nine months in 1977 and one year in 1978—with the latter holding period remaining largely in effect up to the present time. Id. The current 15% rate on capital assets held for over one year is a matter of public debate, and could increase to 20% for those assets in the near future, with an 18% rate on gains from assets acquired after December 31, 2000 and held for over five years. See Bill Bischoff, Preparing for the End of the Bush Tax Cuts, WALL ST. J., (May 18, 2012, 5:32 PM), http://online.wsj.com/article/SB10001424052702303879604577410143118102490.html.
A simple method to ensure investors have reasonable financial incentives to hold stock for the long-term is to align the capital gains rate on loyalty shares with the incremental periods for enhanced voting rights previously discussed. This can be accomplished by applying a 17.5% rate to gains on stocks held for over six months; 15% for over one year; 12.5% for over one and a half years, 10% for over two years, 7.5% for over two and a half years, and 5% for over three years. This method would provide short-term traders with a realistic incentive to hold stock for a longer period of time, even when the current one-year mark seems too distant from their usual investment horizon to be worth consideration. This method would also provide incentives for investors to hold stock for longer than the current one-year mark.

In fashioning a new capital gains structure, one must be cognizant of potential market inefficiencies. A capital gains rate of any kind can disrupt efficient market allocation through the lock-in effect, discouraging the sale of an asset that would otherwise occur in the ab-

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146. See supra note 99 and accompanying text.
147. The U.K. has experimented with a tax scheme based on similar principles. In 1998, it introduced “taper relief,” whereby “the amount of gain charged to tax [capital assets] would be reduced the longer an asset had been held at the time of its disposal.” See ANTONY SEELY, CAPITAL GAINS TAX: BACKGROUND HISTORY 12 (2010), available at www.parliament.uk/briefing-papers/SN00860.pdf. The goal was to “increase the quantity and quality of long-term investment.” Id. The scheme provided that, for non-business assets, 100% of the gain would be taxed for an asset held for less than three years; 95% of the gain would be taxed for an asset held for three years; and, every additional year held thereafter would decrease the percentage of the gain that would be taxed by 5%, down to a minimum of 60% of the gain taxed for ten years or more. See LUCY CHENNELL ET AL., A SURVEY OF THE UK TAX SYSTEM 11 (2000), available at http://www.ifs.org.uk/bns/taxsurvey2000.pdf. For business assets, the rate was 87.5% for one year, 75% for two years, 50% for three years, and 25% for four years or more. Id. Taper relief was withdrawn in 2007 and replaced with a different scheme of taxation for capital gains. See SEELY, supra, at 1. Although some supported the withdrawal of taper relief, asserting its implementation had little effect on increasing long-term investment and entrepreneurship, see id. at 22-23, a group of business group leaders argued “[t]he impact of the decision will be felt throughout the economy. The net effect will be to set back the growth of the economy over coming years, by discouraging longer-term investment and risk-taking.” David Frost et al., Open Letter to Chancellor Alistair Darling, BUSINESSZONE (Oct. 15, 2007, 4:16 PM), http://www.businesszone.co.uk/item/174278 (stating concerns in a letter signed by the Director General of the British Chambers of Commerce, the Director General of the CBI lobbying organization, the National Chairman of the Federation of Small Businesses, and the Director General of the Institute of Directors). Note that the tax scheme outlined in this paper contains far fewer holding period distinctions—and is thus less complex—than the U.K.’s taper relief scheme.
148. See generally George R. Zodrow, Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity. 48 TAX L. REV. 419, 424-29 (1993) (reviewing some of the existing literature on the effect of capital gains rates on the market). “Economists long have noted the efficiency cost imposed by the lock-in effect. Specifically, under a capital gains tax based on the realization principle, the imposition of tax only upon sale or exchange of an asset implies that investors are reluctant to sell assets with accrued gains; that is, the opportunity to defer tax by holding the asset discourages sales that would occur in the absence of taxation.” Id. at 467.
sence of taxation. By adding more increments to the current one-year model, overall market efficiency could theoretically be disrupted even more than may already be the case. Additionally, an argument can be made that the market loses efficiency whenever more complexity is added to the tax code.

But drawing such conclusions is risky because much of the traditional literature on the subject is inconclusive. Regardless, certain features of the model presented in this Note should alleviate many of those concerns. First, the 15% tax rate on stocks held for over one year, which Congress has already deemed appropriate, is preserved. Second, any potential inefficiencies can be justified by the goal of gradually increasing long-term corporate governance. As argued throughout this Note, decreasing short-termism to a healthier level would have widespread benefits. Consequently, policy-makers should be willing to sacrifice some level of potential market efficiency if it would result in a more beneficial financial sector overall. Third, the proposed tax scheme does not significantly increase complexity. Instead, the investor is provided with a consistent and simple capital gains scheme. Well-respected and highly-influential investors have already endorsed the use of modified capital gains rates that encourage long-term share ownership. By aligning the capital gains rates for loyalty shares with the accompanying enhanced voting rights, investors and corporations could easily weigh the pros and cons associated with loyalty shares before deciding whether to adopt them.

V. CONCLUSION

Because public corporations play a vital role in the American economy, the focus by institutional investors on short-term earnings at the expense of long-term growth presents serious problems. These include decreased investment in R&D and capital infrastructure, as well as the termination of employees. Unless major changes are made to the corporate landscape, there is no reason to think these problems will subside in the future. Although the issue of short-termism has

149. Id.


152. See generally Zodrow, supra note 148 (detailing empirical evidence on the subject and noting the difficulty in finding conclusive answers).

153. See BUS. & SOC'Y PROGRAM, supra note 46, at 3 (suggesting policy-makers “[r]evise capital gains tax provisions or implement an excise tax in ways that are designed to discourage excessive share trading and encourage longer-term share ownership”).
not gone unnoticed, many legislative efforts and scholarly papers have failed to provide adequate solutions.

This Note proposes using the tax code to entice more shareholders to invest long-term and then granting them increased control via enhanced voting rights. By learning from the experiences of European and Canadian companies with other types of control enhancing mechanisms and incorporating many of their procedural safeguards as default rules, the potential pitfalls of this proposal are avoided. Adoption of this proposal would ultimately cause a renewed focus on long-term corporate governance, without eliminating many of the benefits that accompany short-term trading.