

# **Overcoming Short-termism:**

*A Call for a More Responsible Approach to  
Investment and Business Management*



**September 9, 2009**

**We believe** a healthy society requires healthy and responsible companies that effectively pursue long-term goals. Yet in recent years, boards, managers, shareholders with varying agendas, and regulators, all, to one degree or another, have allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corporation. We believe that short-term objectives have eroded faith in corporations continuing to be the foundation of the American free enterprise system, which has been, in turn, the foundation of our economy. Restoring that faith critically requires restoring a long-term focus for boards, managers, and most particularly, shareholders—if not voluntarily, then by appropriate regulation.

A coalition has been working for several years on what business and investors can voluntarily do to address market short-termism, including the reform of executive compensation to focus on long-range value creation (See Appendix). A new administration in Washington and unprecedented public attention to business and financial markets, offer a unique opportunity for public policy recommendations in pursuit of long-term wealth creation to gain visibility, and to obtain real traction. Others will study and recommend actions to be taken by boards, managers and regulation to restore long-term focus. The recommendations in this document, directed at influencing the behavior of shareholders, present an important step towards an integrated approach to ensuring long-term wealth creation.

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## **Shareholder Short-Termism**

The word “shareholders” evokes images of mom-and-pop investors saving for their retirement or their children’s college tuition. Individual investors do participate directly in the market, but they are mostly passive and unorganized and their role has diminished in recent years. The largest and most influential shareholders today are institutions — including pension funds, mutual funds, private investment (or “hedge”) funds, endowments and sovereign wealth funds — many of which serve as agents for the providers of capital, their ultimate investors. For example, one-third of U.S. corporate equity today is held by mutual funds and hedge funds.

The diversity of investment vehicles contributes to healthy competition and liquidity and is a strength of our capital markets. Properly incentivized institutions of different kinds can contribute to long-term wealth creation. However, the influence of money managers, mutual funds and hedge funds (and those intermediaries who provide them capital) who focus on short-term stock price performance, and/or favor high-leverage and high-risk corporate strategies designed to produce high short-term returns, present at least three problems:

- First, high rates of portfolio turnover harm ultimate investors’ returns, since the costs associated with frequent trading can significantly erode gains.
- Second, fund 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, including appropriate proxy voting and corporate governance policies, that are beneficial and sustainable in the long-term. Risk-taking is an essential underpinning of our capitalist system, but the consequences to the corporation, and the economy, of high-risk strategies designed exclusively to produce high returns in the short-run is evident in recent market failures.
- Third, the focus of some short-term investors on quarterly earnings and other short-term metrics can harm the interests of shareholders seeking long-term growth and sustainable earnings, if managers and boards pursue strategies simply to satisfy those short-term investors. This, in turn, may put a corporation’s future at risk.

If corporate law or other public policy mechanisms grant investors additional rights, we believe it is vital that all institutional investors and related intermediaries be properly incentivized to focus on the interest of promoting sustainable, long-term growth.

Encouraging investors and intermediaries representing investors to adopt a long-term perspective will ultimately encourage and empower boards of directors to adopt long-term strategies for growth and sustainable earnings, and to rely on long-term, forward-looking metrics in the consideration of compensation and performance incentives. In the absence of real changes in the focus of institutional investors and related intermediaries, the various corporate governance reforms currently being discussed are unlikely to reduce the likelihood of boards and managers responding to short-term pressures. Accordingly, the recommendations in this report take on great importance.

## **Call to Action: Key Leverage Points**

We repeat, short-termism is not limited to the behavior of a few investors or intermediaries; it is system-wide, with contributions by and interdependency among corporate managers, boards, investment advisers, providers of capital, and government. Thus, effective change will result from a comprehensive rather than piecemeal approach. We present the following recommendations to focus attention and dialogue on the intricate problems of short-termism and what we believe are the key leverage points to return to a responsible and balanced approach to business and investment.

1. **Market Incentives:** encourage more patient capital
2. **Fiduciary Duty:** better align interests of financial intermediaries and their investors
3. **Transparency:** strengthen investor disclosures

### ***Key Leverage Point 1—Market Incentives: Encourage Patient Capital***

The first key leverage point, market incentives to encourage patient capital, is likely to be the most effective mechanism to encourage long-term focus by investors. Capitalism is a powerful economic and societal force which, if properly directed, can have a hugely beneficial impact on society at all levels. By enlisting natural market forces and establishing incentives for market actors to modify their respective behaviors, the following recommendations encourage patient capital, discourage investor ‘churning’, and generally reinforce society’s long-term goals.

- Revise 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. Capital gains tax rates might be set on a descending scale based on the number of years a security is held.<sup>1</sup> An excise tax could be imposed that would also allow for the inclusion of tax-exempt and other investment entities.
- Remove limitations on capital loss deductibility for very long-term holdings, now capped at \$3,000 per year for losses related to holdings of any duration.<sup>2</sup>
- In exchange for enhancing shareholder participation rights, consider adopting minimum holding periods or time-based vesting, along the lines of the one-year holding period required under the SEC proxy access proposal currently under review.<sup>3</sup>

## ***Key Leverage Point 2—Fiduciary Duty: Better Align Interests of Financial Intermediaries and Investors***

The second key leverage point is focused on ensuring that the fiduciary duties of financial intermediaries are clarified, enhanced and rigorously enforced to better align the interests of the intermediaries and the long-term interests of investors.

Federal subsidies help American investors save for purposes vital to our nation's and people's well-being: retirement and college savings. These policies in turn create demand for the mutual fund industry—a demand that is growing due to the decline in defined benefit pension plans. Naturally, these policies are effective only to the extent fund managers invest prudently for the long-term, and avoid short-term behavior that generates costs and incurs excessive risk. Presently, however, many college savings, 401(k), and related retirement funds engage in behavior that is inconsistent with their investors' goals, as they trade securities, pay their managers, and engage in (or support) activism in pursuit of short-term financial objectives at the expense of long-term performance and careful analysis of fundamental risk. Another tension exists when pension funds are caused to pursue high returns in order to reduce pressure on their sponsors for greater contributions. These long-term funds may require structural changes, but should, in any event, be subject to clearer and more rigorously enforced enhanced fiduciary duties to address the disconnect between the interests of intermediaries and ultimate investor/beneficiaries.

For example, the Investment Advisers Act of 1940 applies to “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.”<sup>4</sup> While the Advisers Act does not expressly address the fiduciary duties of investment advisers, the U.S. Supreme Court has long recognized that such duties underlie the Advisers Act.<sup>5</sup> The Obama Administration has issued a proposal to establish a clear fiduciary duty for investment advisers as well as for brokers/dealers.<sup>6</sup>

In addition, ERISA, the 1974 federal law that governs some private pension plans and provides tax-advantaged status to such plans, and other acts (UPIA, UPMIFA, MPERS) that govern funds to be invested for beneficiaries with long-term horizons delineate the fiduciary duties of those responsible. ERISA, for example, explicitly imposes on fiduciaries a duty of loyalty and prudence, as well as a duty to diversify investments.

The challenge of addressing the misalignment between the interests of the ultimate investors/beneficiaries and society in the long run and the incentives and perceived duties of the institutional investor community and other financial intermediaries is considerable.<sup>7</sup> Improved alignment might be accomplished through the clarification of existing or creation of new federal laws or regulations, including the following:

- Apply a higher degree of accountability and enhanced fiduciary duties to financial intermediaries, by requiring increased disclosures on compensation, incentives, trading, policies on proxy voting and other matters that indicate compatibility (or lack thereof) with the fund's stated objectives, and the goals of the ultimate beneficiaries.

- Modify ERISA allowable investment practices through rule changes to promote long-term investing by those investors holding equity in tax-advantaged accounts.<sup>8</sup>
- Ensure, through clearer and more rigorously enforced fiduciary duties, that investment advisers of all types take into account, and clearly inform investors of, tax and other implications of changes made to encourage long-term holding as recommended herein.
- Pursue regulation or policy to base the compensation of long-term oriented fund managers on the fund's long-term performance and extend to such funds the compensation disclosure requirements that are currently applicable to operating companies.

### ***Key Leverage Point 3—Transparency: Strengthen Investor Disclosures***

The final leverage point, greater transparency in investor disclosures, can also play an important role in helping corporations maintain a long-term orientation. The advent of increasingly complex non-traditional structured and derivative arrangements has enabled some investors to influence corporate decision-making without being subject to duties to disclose the existence or nature of their positions or their plans. This lack of transparency undermines the efficacy of the disclosure regime and creates opportunities for investors to use their influence to achieve short-term gains at the expense of long-term value creation. These opportunities may take many forms. To cite some extremes, they range from an activist who becomes a formal shareholder with voting power while simultaneously “shorting” a corporation’s shares or entering into a derivatives contract to hedge away its economic interest, to an investor who owns shares of one company and uses that position to increase the value of its holdings in another company instead. There are other more sophisticated techniques. Updated disclosure rules that take into account these complex but increasingly common arrangements can play a significant role in helping corporations maintain a long-term orientation by encouraging investment behavior consistent with longer term value creation and providing corporate decision-makers with a better understanding of the corporation’s shareholders and their motivations.

### **Concluding Thoughts**

The trend toward greater shareholder power as encapsulated in legislative proposals under consideration in the 2009 legislative session should be accompanied by greater investor and intermediary responsibility. Institutional investors now wield substantial power — power that affects American citizens as well as global capital markets. The maturation of the institutional investor community creates both opportunity and responsibility to promote the long-term health of capital markets and, in particular, to pursue investment policies and public policies that empower and encourage business managers and boards of directors to focus on sustainable value creation rather than evanescent short-term objectives.

For the purpose of stimulating dialogue, we have offered here key leverage points for addressing one part of market short-termism. The undersigned, who have a wide range of affiliations, backgrounds and experience as participants in and students of the capital markets, are united in urging prompt and serious consideration of these policy initiatives which will, we believe, promote the sustainable growth and investment returns that are essential to healthy capital markets.

## Appendix: Inputs to this Process

Since 2004, the Aspen Institute Business and Society Program, and specifically its Corporate Values Strategy Group (CVSG) has been facilitating dialogue among corporations, organized labor, public pensions and other institutional investors, and government, academic and judicial leaders. Organized around the pervasive and destructive problem of market short-termism, CVSG aims to promote business, government and market practices that curb short-termism and refocus the relevant players on creating long-term value for all stakeholders, with special focus on augmenting the voice of long-term oriented investors.

The Aspen Principles on Long-Term Value Creation, released to the public in June 2007, served as a starting place for its work on public policy. Drafted under the leadership of CVSG members including senior-level representatives from business, corporate governance, public pensions and organized labor, the Principles represent a consensus of “strange bedfellows” on actions aimed at counteracting short-term focus at the company level, and that may have broader ripple effects throughout the wider market. The Principles urge companies to define firm-specific metrics of long-term value, and then use these metrics both to communicate with investors around long-term measures and activities, and to better align compensation of executives and investors with the creation of long-term value.<sup>i</sup>

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### Endnotes:

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<sup>1</sup> The Obama Administration has called for an increase in the longer-term capital gains rate to 20 percent. Instead, if a choice is made to implement this idea through capital gains, the Administration may consider a capital gains rate that is positively and dramatically skewed toward longer-term holdings.

<sup>2</sup> The tax treatment of a capital loss for non-corporate taxpayers that provides a \$3,000 annual limitation on the deduction against ordinary income has been in place since the 1976 Tax Act. In recent years a number of proposals have been put forward to increase the \$3,000 yearly limit on a capital loss deduction against ordinary income. While a higher deduction limit makes sense to account for inflation, we suggest that a capital loss tax policy should be implemented that favors very long-term losses, for example when one sells an asset that has been held for 10+ years or longer at a loss, a 100% deduction against ordinary income in the year in which the asset sale occurs is allowed.

<sup>3</sup> The SEC’s proposed proxy access rules, issued June 10 and open for comment until August 17, 2009, require a holding period of 1 year. See <http://www.sec.gov/news/press/2009/2009-116.htm>. In addition, on April 10, 2009, amendments to the Delaware General Corporation Law were signed into law that facilitate proxy access and reimbursement of proxy solicitation expenses.

<sup>4</sup> Investment Advisers Act of 1940, §202(11).

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<sup>i</sup> Aspen Institute Business & Society Program, “Guiding Principles for Long-Term Value Creation,” June 2007. At: [http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/Aspen\\_Principles\\_with\\_signers\\_April\\_09.pdf](http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/Aspen_Principles_with_signers_April_09.pdf)

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<sup>5</sup> In *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963), the U.S. Supreme Court held that the Advisers Act, “reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser, consciously or unconsciously, to render advice which was not disinterested.” The Court further held that the Advisers Act imposes an affirmative duty on the part of investment advisers to conduct their business with “utmost good faith and full and fair disclosure of all material facts” as well as an obligation to employ “reasonable care to avoid misleading clients.” Section 206 of the Advisers Act has been interpreted to impose a fiduciary obligation on investment advisers, thereby requiring that investment advisers act, at all times, “in the best interest of the fund and its investors” and provide “full and fair disclosure of all materials facts” to both investors and independent trustees. *SEC v. Tambone*, 550 F.3d 106, 147 (2009).

<sup>6</sup> The Administration’s proposal in the “Investor Protection Act of 2009” would enable the SEC to define “the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice.” The SEC would also be required to “examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors.” Accessed 26 July 2009 at: <http://ustreas.gov/press/releases/docs/tg205071009.pdf>.

<sup>7</sup> “More than eighty percent of the nation’s liquid, investable wealth is managed by trustees and investment committees.” See “Prudent Practices for Investment Advisers: Defining a Global Fiduciary Standard of Excellence,” *Fiduciary* 360, 2006, p. 8.

<sup>8</sup> The investment horizon for pension plans is by its very nature long-term. While short-term adjustments to rebalance the investment portfolio may be necessary to reflect changing market conditions, the goal of any retirement plan is to produce income for the participant sufficient to fund, in whole or in part, retirement. That requires planning for the long-term. The switch from defined benefit to defined contribution retirement plans further complicates matters, as individuals are now being asked to create a portfolio.

ERISA recognizes the basic principle of long-term horizons, a view that is further supported by U.S. Department of Labor regulations and various court interpretations. While a legal standard exists, nevertheless, there is no mechanism to impose or incent the fiduciary obligation on a plan’s investment decisions from the perspective of the plan’s beneficiary interests. Furthermore, the Pension Benefit Guaranty Corporation (PBGC) does not have a mechanism or the mission to do so, despite being the agency that partially bears the failure of private pensions.

“The U.S. Department of Labor, which administers and enforces ERISA, has promulgated regulations providing a safe harbor for fiduciaries of participant-direct plans who select investments ‘designed to provide long-term appreciation and capital preservation’ in circumstances where the participant has failed to select investment options. 29 C.F.R. 2250.404c-5(e)(4). Courts interpreting ERISA have similarly endorsed long-term investment strategies by retirement plan fiduciaries. As one court explained, an ‘investment strategy to pick solid funds and stay with them long-term is fully consistent with the duties of prudence imposed on ERISA fiduciaries.’ *Jenkins v. Yager*, 444 F.3d 916, 915 (7th Cir. 2006). As another court put it, a ‘buy and hold strategy’ is ‘particularly appropriate for pension investments,’ as it is ‘unaffected by the volatility that accompanies the announcement of particular pieces of good and bad news.’ *Rogers, v. Baxter Int’l. Inc.*, 521 F.3d 702, 705 (7th Cir. 2002).” (Source: Personal email from Paul Blankenstein, Gibson, Dunn & Crutcher LLP, 6 July 2009.)

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