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CULTIVATING QUALITY: TEN TOOLS MANAGERS CAN USE TO GET LONG- TERM COMMITTED SHAREHOLDERS

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ABSTRACT

Considerable effort goes into forging tools a corporation can use to shape its shareholder base. Much effort is geared toward promoting long investor time horizons, presumed to be a valuable but rare appetite among many shareholders. Less attention has been focused on promoting greater commitment, though attracting shareholders willing to stake large percentages of their portfolio in a given company's stock may prove way more valuable than having numerous large index funds on the shareholder list.

In three ways, this article adds to the toolkit on shareholder cultivation. First, this article stresses that a shareholder's relative portfolio concentration in a particular company's stock is as important as average holding periods. Such an orientation is unusual in corporate life. But today's world is dominated by index fund investors whose portfolio diversification limits their ability to act as informed shareholders. A focus on relative portfolio concentration is therefore becoming critical.

Second, this discussion introduces, and is motivated by, new evidence showing a correlation between a high density of such shareholders and superior corporate performance. In fact, shareholders exhibiting both traits—patience and conviction—have long been cultivated by an elite group of companies whose long-term performance has benefited. The most famous is Warren Buffett's Berkshire Hathaway and there are scores of other less famous but equally accomplished.

Third, focusing on such quality shareholders, as Buffett long ago dubbed them, this article offers numerous tools a corporation may use to achieve a shareholder base with a high density of quality shareholders. These include communications strategies, such as stressing long-term performance metrics in corporate disclosure, and substantive practices, such as prioritizing the art of capital allocation. Managers and quality shareholders themselves are the target audience.

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TABLE OF CONTENTS

INTRODUCTION	2
I. STAKES	4
A. Past Practice	4
B. Today's Index Dominance	6
C. Advantages of Quality	8
II. CORPORATE COMMUNICATIONS	12
A. Annual Meetings	12
B. Shareholder Letters	16
C. Quarterly Retention	17
D. Accounting Information	21
E. Stock Price and Stock Splits	23
III. SUBSTANCE	25
A. Capital Allocation	26
B. Separation Transactions	30
C. Trading Activity	37
D. Director Selection	40
E. Dual Class and Quality Voting	44
CONCLUSION	44

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INTRODUCTION

So complex is today's shareholder demographic that some say it is akin to the U.S. Electoral College—an arcane but powerful maze intelligent candidates must master.¹ Just as Presidential campaigns first lock up their base and then seek the swing voter, corporate leaders must first secure a faithful shareholder cohort and then assure any further votes that might determine voting outcomes. The map varies by company, but consists of activists, indexers, transients, and long-term concentrated owners. As in politics, these groups may be as reliable as California or Texas, or as up-for-grabs as Ohio or Pennsylvania.

While the analogy is intriguing, there is one huge difference between political and corporate elections. Unlike politicians, who are stuck with the citizens they face, directors can influence the mix of the make-up of their shareholder base, in terms of such important features as time horizon, commitment level, and engagement.

Many managers use their bully pulpit to deter shareholders unaligned with their corporate philosophy. At a Starbuck's shareholders meeting, Howard Schultz told a shareholder challenging the company's hiring practices that he should sell the stock. Joe Steinberg so advised a Leucadia shareholder challenging the company's hold-or-divest policies. In a letter to shareholders of The Washington Post Co., Don Graham stressed the company's long-term outlook, adding: "If you are a shareholder and YOU care about our quarterly results, perhaps you should think about selling the stock."

Besides hectoring, a variety of tools have been shown to be useful in sculpting a shareholder base. Analysis has focused heavily on practices designed to entice long-term shareholders. They span the range of corporate affairs, from by-laws to mission statements and governance philosophy to dividend policy.

This Article contributes three transformative points. First it adds to time horizon the feature of concentration, establishing a focus on quality shareholders (hereinafter abbreviated as QS).² Second, it provides new evidence of the value of this perspective, from the perspective of both QS and the companies they invest in. Third, it explores how numerous corporate practices can be used to attract QS.

Cultivation options include communications strategies such as mounting appealing annual meetings, issuing candid annual shareholder letters, dampening quarterly forecasting, and stressing long-term performance measures. Substantively, cultivation options include developed and publicized standards governing capital allocation, from acquisitions to dividends, as well as divestitures, and governance strategies such as board selection criteria and enhanced shareholder voting rights for coveted shareholder cohorts.

¹ See James Woolery, Rob Leclerc & Richard Fields, *The Ashland-Cruiser Proxy Contest—A Case Study*, HARV. GOV. BLOG (Feb. 20, 2019).

² The abbreviation QS for quality shareholders conveys both an informal and formal meaning. The informal sense is of shareholders who are among the most patient and most concentrated among shareholders. The formal definition is based on a variety of statistical methods used to identify those possessing such features from the entire population of institutional shareholders obliged under federal securities laws to disclose such information. The research is explained in LAWRENCE A. CUNNINGHAM, *QUALITY SHAREHOLDERS: HOW MANAGERS ATTRACT THE BEST SHAREHOLDERS* (2020), App. A.

These perspectives are necessitated by changing shareholder demographics. The rise of indexing, including its seemingly effortless strategy of investing along with enormous power in voting, has crowded out the share of corporate equity held by QS. The latter is down to as little as \$4 trillion in assets, in all, compared to a total market capitalization exceeding \$30 trillion. This Article responds to the fact that the quality population has been shrinking. It stresses the untapped potential of QS and offers methods to attract and cultivate them.

I. STAKES

This Part opens with a review of the literature on corporate cultivation to shareholder tastes. It turns to the current landscape, indicating that the literature warrants updating in light of the rise of indexers and the appeal of quality.

A. Past Practice

The shareholder cultivation literature coalesces around a discrete group of practices and variations on their themes, with greatest attention focused on long-term versus short-term shareholders. Encompassing the recognized elements of corporate administration, this body of research can provide a useful framework for organizing analysis. Yet a review of this literature entices attention to the gaps it leaves, in both the available practices and the relevant shareholder types.

The literature's most general treatments cover many of the topics appearing on most syllabi for a basic course in corporations, such as place of incorporation and transfer restrictions³ as well as stock exchange listings and the content of bylaws.⁴ For example, a Delaware incorporation and New York Stock Exchange listing signal credibility that's important to certain investors and will attract them. While importantly treating hotly contested topics of corporate governance, such as board structures and director independence,⁵ the result is a selective and provisional body of work.

Among specific topics receiving significant attention in this literature are corporate communications,⁶ including particular focus on the statement of corporate mission⁷ as well as deterring short-term shareholders by avoiding emphasis on quarterly earnings and forecasts.⁸ On

³ See Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 CORNELL L. REV. 849 (2012).

⁴ See Tamara Belinfanti, *Shareholder Cultivation and New Governance*, 38 DEL. J. CORP. L. 789 (2014).

⁵ See Alicia J. Davis, *The Institutional Appetite for "Quack Corporate Governance,"* COLUM. BUS. L. REV. 1 (2015) (the title's quoted clause references its critique of influential piece it critiques).

⁶ See Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. REV. 1822 (2011).

⁷ See Henry T.C. Hu, *Corporate Governance: Buffett, Corporate Objectives, and the Nature of Sheep*, 19 CARDOZO L. REV. 379, 394 (1987).

⁸ See Michael R. Siebecker, *Bridging Troubled Waters: Linking Corporate Efficiency and Political Legitimacy Through a Discourse Theory of the Firm*, 75 OHIO ST. L.J. 103, 131 (2014) (noting that law's requirements are limited to disclosure under the reasonable investor standard); Nadelle Grossman, *Turning a Short-Term Fling into a Long-Term Commitment: Board Duties in a New Era*, 43 U. MICH. J.L. REFORM 905, 915-918 (2010) (short-term information bias inherent in the type of information required to be

the other hand, less detailed attention has examined two tools of particular use in attracting QS: the annual meeting⁹ and annual letter to shareholders.¹⁰ Perhaps of central importance to attracting QS, the literature has treated aspects of capital allocation prominently, especially dividends and buybacks,¹¹ though not acquisitions or divestitures.¹²

The literature has devoted considerable analysis of alternative capital structures, some as part of the broader debate on dual class capital structures.¹³ In a related vein, increasing thought is given to tailoring shareholder voting rules to cater to desired cohorts, especially time-weighted voting¹⁴ or granting enhanced voting rights to a separate class of long-term shares.¹⁵ I have recently contributed the specific perspective of QS by putting forth a proposal for enhanced voting power for QS, based on both long holding periods and high portfolio concentration.¹⁶

Much of this literature consciously focuses on investment time horizons,¹⁷ exploring the practices that attract or repel long-term rather than short-term shareholders,¹⁸ Some work draws

disclosed); Lynne L. Dallas, *Long-Term Shareholders and Time-Phased Voting*, 40 DEL. J. CORP. L. 541, 560 (2016); Rock, *supra* note 3, at 870; Rodrigues, *supra* note 6, at 1850.

⁹ See Iris H-Y Chiu, *Reviving Shareholder Stewardship: Critically Examining the Impact of Corporate Transparency Reforms in the UK*, 38 DEL. J. CORP. L. 983, 1012-15 (2014) (noting potential for richer periodic narrative messages to shareholders, along with related structural changes); Rock, *supra* note xx (noting Buffett's influential letters).

¹⁰ See Michael R. Siebecker, *Bridging Troubled Waters: Linking Corporate Efficiency and Political Legitimacy Through a Discourse Theory of the Firm*, 75 OHIO ST. L.J. 103, 144-145 (2014) (robust discussions at regular corporate meetings can shape the shareholder base); see also Rock, *supra* note 3, at 904-05; compare Belinfanti, *supra* note 4, at 842 (relative appeal of annual meetings depends on topics discussed).

¹¹ See William W. Bratton, *The New Dividend Puzzle*, 93 GEO. L. J. 845 (2005); Belinfanti, *supra* note 4.

¹² See Edward S. Adams & Arijit Mukherji, *Spin-Offs, Fiduciary Duty, and the Law*, 68 FORDHAM L. REV. 15, 41-50 (1999) (noting that spin-offs can be value enhancing for shareholders); York Schnorbus, *Tracking Stock in Germany: Is German Corporate Law Flexible Enough To Adopt American Financial Innovations?*, 22 U. PA. J. INT'L ECON. L. 541 (2001) (tracking stocks enhance shareholder value).

¹³ See Ron W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697 (2009); Young Ran (Christine) Kim & Geeyoung Min, *Insulation by Separation: When Dual-Class Stock Met Corporate Spin-Offs*, 10 U.C. IRVINE. L. REV. 1, 22-29 (2019); Rock, *supra* note 3.

¹⁴ See Dallas, *supra* note 8.

¹⁵ See Patrick Bolton & Frederic Samama, *L-Shares: Rewarding Long-term Investors*, 25 J. APPLIED CORP. FIN. 86 (2013); Belinfanti, *supra* note 4.

¹⁶ See Lawrence A. Cunningham, *The Case for Empowering Quality Shareholders*, 63 BYUL. REV. --- (forthcoming 2020).

¹⁷ E.g., Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554 (2015).

¹⁸ See Emeka Duruigbo, *Stimulating Long-Term Shareholding*, 33 CARDOZO L. REV. 1733, 1733 (2012); Emeka Duruigbo, *Tackling Shareholder Short-Termism and Managerial Myopia*, 100 KY. L.J. 531 (2011/2012).

explicit attention to relative percentage ownership share ownership of the corporation.¹⁹ But none addresses relative portfolio concentration at all, whether alone or in combination with time horizon.²⁰ The topics addressed in this Article have been chosen generally because of their under-treatment in this literature and specifically because of their unique appeal to QS, both long-term and concentrated.

B. *Today's Index Dominance*

In decades past, shareholders seemed to be monolithic. In 1965, for example, institutional investors held \$436 billion of \$1.4 trillion in total market capitalization, with nearly \$1 trillion owned by individual households. Managers could view individual stockholders as sharing similar interests, principally long-term corporate value, and giving managers broad discretion to pursue it. Less than 15% of the market, or \$100 billion, was held by the day's mutual funds, pension funds, and insurance companies (respectively holding \$36, \$43, and \$21 billion 5%, 6%, and 3%).²¹ The appetites of such firms did not differ greatly from one another or from the individual investor.

Over the past several decades, shareholders have become increasingly diverse and more demanding of managers. These range from indexers who buy everything to high-frequency traders who flip every minute. Some shareholder activists prescribe strategies for maximum short-term shareholder gain through divestitures while socially oriented activists make shareholder proposals in the name of environmental, social and governance (ESG) objectives.

Several seismic forces contributed to the changed demographics. The broadest was the eclipse of individual shareholders by institutional investors. Since 2016, institutions have held the vast majority of the \$30+ trillion in total market capitalization, with mutual funds, pension funds, and insurance companies together commanding a decisive majority (respectively, \$9.1 trillion, \$2.3 trillion, and \$811 billion).²²

Among institutions, three critical changes have occurred in recent decades. In the context of the shareholder cultivation literature, the most important has been the substantial shortening of average holding periods, indicative of increased trading for arbitrage, momentum strategies, and other short-term drivers. Average holding periods they shortened significantly from the mid-1960s through the early 2000;²³ while the average has held steady since, this appears to be due to how the shorter horizons of many are offset by the more permanent holdings of the indexers.²⁴ Best-

¹⁹ E.g., Belinfanti, *supra* note 4, at 829 (referencing twenty percent ownership level without triggering shareholder vote under state corporate law or registration under federal securities law).

²⁰ One exception is Cunningham, *The Case for Empowering Quality Shareholders*, *supra* note 16.

²¹ Board of Governors of the Federal Reserve System, Financial Accounts of the United States: Historical Annual Tables (1965-1974).

²² Board of Governors of the Federal Reserve System, Financial Accounts of the United States: Historical Annual Tables (2005-2015), at 123 <https://www.federalreserve.gov/releases/z1/current/annuals/a2005-2015.pdf>; Board of Governors of the Federal Reserve System, Financial Accounts of the United States, Second Quarter 2018 at 130, <https://www.federalreserve.gov/releases/z1/20180920/z1.pdf>.

²³ Anne M. Tucker, *The Long and The Short: Portfolio Turnover Ratios & Mutual Fund Investment Time Horizons*, 43 J. CORP. L. 581 (2018).

²⁴ K.J. Martijn Cremers & Simone M. Sepe, *Institutional Investors, Corporate Governance, and Firm Value*, 41 SEATTLE U. L. REV. 387, at n. 42 (2018).

selling author, Michael Lewis, dramatized the stakes in his 2014 book, *Flash Boys*, and the pace of acceleration continues with sustained technological advances in computing algorithms, artificial intelligence and machine learning.²⁵

Related to the issue of short-termism has been the rise of activism. Shareholder gadflies have roamed corporate America since the Gilbert brothers popularized the practice in the 1950s.²⁶ And from the 1970s through the 1990s, incumbent managers always faced constant threats to corporate control from rival firms, takeover artists, and colorful raiders such as Carl Icahn and Nelson Peltz.²⁷ But it is only in the past two decades that a vast pool of capital developed among specialty firms, dubbed shareholder activists, dedicated to the practice featuring a well-developed playbook, a cadre of professional advisers, and repeat players such as Bill Ackman, Dan Loeb and Paul Singer.²⁸

Yet while the shareholder cultivation literature has considered time horizon—including among activism—the foremost demographic change has been neglected: the large and growing percentage of shares are held by indexers. Indexing, popularized by the late Jack Bogle, was a marginal practice through the 1990s, but today is a familiar approach. His company, Vanguard, is a household name. Large indexers command trillions of assets, representing one-quarter to one-third or more of total U.S. public company equity. In 1997, less than 8% of mutual funds were indexed, whereas today more than 40% are.

A substantial literature is emerging to address the rise of indexers, but mainly to debate whether their influence is too great or how they perform their oversight functions.²⁹ There has been no discussion of this cohort in the shareholder cultivation literature. In one way, that's unsurprising: indexers need no cultivation or enticing since they buy every stock in the index. Indeed, to the extent concern rivets on short-termism, indexers may receive a critical pass, as they are generally long-term holders (subject to forced sales due to rebalancing). On the other hand, the omission is glaring, since the more indexers own the less room there is for quality. Quality shareholders are congenial to private corporations and public policy alike.

C. Advantages of Quality

Each shareholder segment adds unique value: activists promote management accountability; index funds enable millions to enjoy market returns at low cost; and traders offer liquidity. With such advantages, however, come disadvantages: activists becoming overzealous;

²⁵ See Tom C. W. Lin, *Artificial Intelligence, Finance, and the Law*, 88 *FORDHAM L. REV.* 531 (2019).

²⁶ See Lawrence A. Cunningham & Stephanie Cuba, *Annual Shareholder Meetings: From Populist to Virtual*, *FIN. HIS.* (Fall 2018).

²⁷ See *KNIGHTS, RAIDERS AND TARGETS* (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988).

²⁸ See WILLIAM W. BRATTON & JOSEPH A. MCCAHERY, *INTRODUCTION TO INSTITUTIONAL INVESTOR ACTIVISM: HEDGE FUNDS AND PRIVATE EQUITY*, *ECONOMICS AND REGULATION* 1-38 (2015).

²⁹ See Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 *COLUM. L. REV.* 2029 (2019) (agency cost indictment of indexer capability) with Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 *U. PA. L. REV.* 17 (2019) [hereinafter Fisch, *The New Titans*] (ringing theoretical defense of indexer capability).

indexers lacking resources to understand specific company details; and traders inducing a short-term focus. Quality shareholders balance the base, and counteract these downsides.

As to curbing overzealous activism, QS can be white squires—a term dating to the 1980s referring to block shareholders tending to support management.³⁰ When a board perceives activist excess, it helps to have a few large long-term owners to consult. As a united front, the company's hand is strengthened, resisting excess while addressing legitimate concerns activist may have.³¹

Quality shareholders study company specifics which indexers, being stretched thin, cannot.³² Indexers may be good at analyzing dynamic issues as they arise, but rarely develop deep knowledge that QS command. Indexers invest most of their limited resources to develop views about what is best generally in corporate governance, not what is best for particular companies.

Quality shareholders differ from both activists and indexers regarding director elections. Activists nominate directors, fellow board members often resist, and indexers almost never nominate directors at all. QS offer a supply of outstanding directors for their investees, often themselves.³³

Being long-term, QS offset the short-term preferences of transients. A high density of QS, with their characteristic patience, helps managers operate strategically, with a long-term outlook.³⁴ Such effects can percolate throughout a company. If less pressure comes from shareholders to produce short-term results, then directors, officers, employees, suppliers, strategic partners and others can operate in the same manner.³⁵

Shareholder cohorts have different preferences about the price levels of stocks they own. Transients generally prefer the highest price possible for maximum profit on immediate sale; indexers favor the highest reasonable price because they assume, consistent with efficient market theory, that price and value are substantially the same; and QS, generally uninterested in an immediate sale and attune to stock market volatility, prefer a stock price that bears the most rational relationship possible to the company's intrinsic business value.³⁶ (At purchase, of course, QS seek prices below value.)³⁷

Many managers tend to likewise prefer the highest possible stock price, perceiving it as a

³⁰ See *supra* text accompanying note 27.

³¹ See James Woolery, Rob Leclerc & Richard Fields, *The Ashland-Cruiser Proxy Contest—A Case Study*, HARV. GOV. BLOG (Feb. 20, 2019).

³² See *infra* Part III for aspects of the related debate.

³³ See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 2 (Chapter 3).

³⁴ See Brian L. Connelly, Laszlo Tihanyi, S. Trevis Certo & Michael A. Hitt, *Marching to the Beat of Different Drummers: The Influence of Institutional Owners on Competitive Actions*, 53 ACAD. MGMT. REV. (2010) (finding positive association between high density of quality shareholders and strategic management decision making).

³⁵ CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 2 (chapter 3).

³⁶ See WARREN E. BUFFETT & LAWRENCE A. CUNNINGHAM, *THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA* (5th ed. 2019) 38.

³⁷ BENJAMIN GRAHAM, *THE INTELLIGENT INVESTOR*.

measure of their own performance, the higher the better.³⁸ But while they often complain that their company's stock price is too low, under- and over-pricing are equally likely and neither is desirable.³⁹

A share price that is rationally related to business value can be a huge asset for several purposes, including making acquisitions, compensating employees, and facilitating fairly priced gains (or losses) when shareholders must sell.⁴⁰ While there is a lively debate over the degree of such market efficiency—of how well price approximates value—companies with the closest nexus enjoy clear advantages over those with the widest gaps. Evidence suggests that companies with ownership dominated by QS tend to enjoy stock prices that are less volatile and more rationally related to business value.⁴¹

Above all, a company's shareholder mix can influence corporate behavior and performance. Patient shareholders invite managers to invest in long-term projects promising high returns on invested capital; short-term traders stimulate activities that translate into increases in quarterly earnings per share. Shareholders with large stakes relative to the rest of a company's shares determine the level of managerial accountability through majoritarian voting traditions. Those with large stakes relative to their other investments tend to be more engaged, epitomized by hedge fund activists.

There is a correlation between stock price performance and QS density. For instance, in related research, I first identified the leading QS measured by patience and concentration during the five-year period from 2014-2018 and used that to identify the companies that attract this cohort in the highest density over that period.⁴² Then I compared a portfolio comprised of the 25 companies at the top of the QS density and 25 companies at the bottom of the QS density. The high QS density portfolio outperformed the low QS density portfolio in each of the five years.

There is also evidence that the patient-concentrated strategy associated with QS can enable this cohort to outperform investment markets systematically. Conventional wisdom—and considerable research—challenged claims that individual stock picking strategies can systematically outperform index benchmarks, at least after fees.⁴³ However, changes in

³⁸ See BARUCH LEV, WINNING INVESTORS OVER: SURPRISING TRUTHS ABOUT HONESTY, EARNINGS GUIDANCE, AND OTHER WAYS TO BOOST YOUR STOCK PRICE 103-105 (2014).

³⁹ *Id.*

⁴⁰ See BUFFETT & CUNNINGHAM, THE ESSAYS, *supra* note 36, at 38 (Berkshire's owner-related business principles, number 14).

⁴¹ See Paul Borochin & Jie Yang, *The Effects of Institutional Investor Objectives on Firm Valuation and Governance*, 126 J. FIN. ECON. 171 (2017) (including a robust propensity score model for identify quality shareholders). Other recent research affirms other advantages that long-term investors contribute to companies they invest in. See Cunningham, *The Case for Empowering Quality Shareholders* (footnote citing Jarrad Hartford etc.)

⁴² Lawrence A. Cunningham, *Quality Outperforms: Evidence on Portfolios of Companies with Relative Densities of Quality Shareholders* (draft in circulation summer/fall 2020).

⁴³ See Eugene Fama & Kenneth French, *Luck Versus Skill in the Cross-Section of Mutual Fund Performance*, 65 J. FIN. 915 (2010) (while some managers are skilled, few deliver on that value for customers after fees); Mark Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57 (1997)

shareholder demographics during the past two decades, including increased competition and lower fees, produced a new strand of research challenging these conventional views.⁴⁴

For instance, there is evidence that the average active fund does outperform an equivalent index;⁴⁵ some top-performance records do persist;⁴⁶ and a sizable cohort of managers with particular traits demonstrate skill that covers their fees.⁴⁷ Among those traits are conviction and

II. CORPORATE COMMUNICATIONS

The shareholder cultivation literature extensively discusses communications strategies as ways to sculpt a shareholder base. The tendency is to orient disclosure toward attracting long-term shareholders. There is substantial criticism of short-term reporting, especially against quarterly earnings reports, forecasts and calls.⁴⁸ After all, disclosure focused on short-term goals in disclosure may attract short-term biased investors.⁴⁹ The literature notes the potential for securities regulations to backfire in this regard, when prescribing increased disclosure that overemphasizes short-term horizons.⁵⁰

More generally, the shareholder cultivation literature on disclosure portrays proxy statements and other formal communications as an opportunity to educate shareholders.⁵¹ Related messaging can be tailored as much as possible to attract or repel shareholders defined in various ways, whether time horizon, relative concentration, or otherwise. That includes the relative appetite for socially oriented investors who would find ESG-based integrated reporting appealing.⁵²

Financial disclosure can serve in the same way. Managers who provide the numbers that really matter, rather than just generic earnings metrics, are likely to attract shareholders with an analytical appetite.⁵³

(finding that the empirical evidence did “not support the existence of skilled or informed mutual fund portfolio managers”).

⁴⁴ See Martijn Cremers, Jon Fulkerson & Timothy B. Riley, *Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds*, 75 FIN. ANALYSTS J. 8 (2019).

⁴⁵ Jonathan Berk & Jules van Binsbergen, *Measuring Skill in the Mutual Fund Industry*, 118 J. FIN. ECON. (2015); Jonathan B. Berk & Jules H. van Binsbergen, *Mutual Funds in Equilibrium*, 9 ANN. REV. FIN. ECON. 147 (2017); Hyunglae Jeon, Jangkoo Kang & Changjun Lee, *Precision About Manager Skill, Mutual Fund Flows, and Performance Persistence*, 40 N. AM. J. ECON. FIN. 222 (2017).

⁴⁶ Nicolas Bollen & Jeffrey Busse, *Short-term Persistence in Mutual Fund Performance*, 18 REV. FIN. STUD. 569 (2005); Robert Kowoski, Allan Timmermann, Russ Wermers & Hal White, *Can Mutual Fund “Stars” Really Pick Stocks? New Evidence from a Bootstrap Analysis*, 61 J. FIN. 2551 (2006).

⁴⁷ Yakov Amihud & Ruslan Goyenko, *Mutual Fund’s R2 as Predictor of Performance*, 26 REV. FIN. STUD. 667 (2013); Martijn Cremers & Antti Petajisto, *How Active is Your Fund Manager? A New Measure that Predicts Performance*, 22 REV. FIN. STUD. 3329 (2009).

⁴⁸ Dallas, *supra* note 8, at 560; Rock, *supra* note 3, at 870.

⁴⁹ Rodrigues, *supra* note 6, at 1850.

⁵⁰ *Id.*

⁵¹ Rock, *supra* note 3, at 870.

⁵² Belinfanti, *supra* note 4, at 856.

⁵³ Hu, *supra* note 7, at 403.

While the shareholder cultivation literature's treatment of communications strategies is accordingly rich, this Part fortifies it in numerous ways. First, it treats two topics the literature has almost entirely overlooked: annual meetings and shareholder letters, of particular interest not merely to the long-term shareholder but to the concentrated one. Second, it reorients two topics—the quarterly communications and reporting accounting information—as corollaries and presents a third topic—stock splits—as a corporate communications strategy, being a signal about managerial expectations rather than, as conventionally presented, part of dividend policy. In each case, the discussion includes historical context along with contemporary utility.

A. Annual Meetings

At most companies, the annual meeting is a perfunctory affair, with a two-hour meeting considered lengthy.⁵⁴ While time is usually allotted for shareholder questions, the “questions” often seem more like pet peeves than probes of company strategy and prospects. Those responding tend to focus narrowly or literally on the particular questions, rather than listening for clues about wider shareholder concerns that create opportunities to educate shareholders about the company's strategy and prospects.

But it doesn't have to be that way, and scores of companies buck the boring approach, in part to entice QS. They offer videos, product samples, lengthy Q&As, educational programs, and more. In a few cases, additional events surround the meeting, such as separate meetings of major subsidiaries or breakout sessions with key managers. As *New Yorker* columnist John Brooks reported, annual meetings “bring companies to life.”⁵⁵ QSs relish this.

1. History. Before the 1930s, annual shareholder meetings were perfunctory legal affairs that achieved little and attracted few. Amid rising individual share ownership, a vocal group of gadflies, led by the brothers John and Lewis Gilbert, spent the next four decades making meetings matter.

By the early 1960s across corporate America, up to ten annual meetings drew more than 1,000; two dozen between 300 and 900; and AT&T, boasting millions of shareholders, set the era's record at 12,000 attendees. A 1964 *New York Times* story proclaimed: “the vociferous minority shareholders helped popularize meetings by their persistent attendance and their keen questioning on controversial matters.”

In the early 1970s, a movement to abandon the annual meeting flickered fleetingly. In 1972, Delaware, leading state of incorporation for public companies, updated its law to let shareholders act by written consent rather than at meetings. In a *New York Times* op-ed, J.B. Fuqua, of Fuqua Industries, advocated for abolition, in favor of voting by mail.

But shareholders overwhelmingly pushed back and stock exchanges ruled that the consent method did not meet their requirement to have an annual meeting. By 1975, the abolition movement was dead, wryly judged by *The New York Times* as “notably unsuccessful.”

That same year, Warren Buffett began building what would become the most popular annual shareholder meeting, at Berkshire Hathaway. In 1975, a dozen attended in an Omaha office

⁵⁴ See Robert E. Denham, *The Shareholders You Deserve*, in LAWRENCE A. CUNNINGHAM & STEPHANIE CUBA, *THE WARREN BUFFETT SHAREHOLDER: STORIES FROM INSIDE THE BERKSHIRE HATHAWAY ANNUAL MEETING* (2018), p. 171.

⁵⁵ John Brooks, *Stockholder Season*, *THE NEW YORKER* (October 8, 1966).

cafeteria, but then for the next three decades added a digit—hundreds by 1985, thousands by 1995, and tens of thousands by 2005. In 2018, more than 40,000 attended, the record for a U.S. public company.

While the Berkshire meeting’s main feature has long been a six-hour Q&A with Buffett and vice chairman Charlie Munger, it has evolved into a long-weekend extravaganza. The company for decades has hosted events on the days surrounding the meeting—a Friday night ball game, Saturday evening cookout, Sunday champagne brunch—and shareholders have added their own conferences, panels, and parties that alone draw hundreds or thousands. It is a series of energetic scenes of engaged Q&As.⁵⁶

Markel Corporation hosts an impressive annual meeting in its hometown of Richmond, Virginia—but also hosts a separate gathering, drawing some 1,300 shareholders in Omaha during the weekend of the Berkshire meeting. Detecting overlap in both shareholders and values, CEO Tom Gayner began the tradition in 1985, when he was a junior insurance manager. A half dozen joined him. Gayner has continued to lead the event since.

2. Evolution. From 1980 through 2010, ownership of public company equity shifted from individuals to institutions. With that shift, companies increasingly communicated to shareholders throughout the year, always at regular quarterly intervals and often more frequently, approaching a model of continuous disclosure.

While ownership and communication changed, the annual meeting remained a staple of corporate life, an important opportunity for shareholders—both individuals and representatives of institutions—to meet management, pose questions, press issues and resolve debate.

But if the prior era’s annual meetings stressed individual shareholders and associated “democratic” rights, this one increasingly brought out corporate identity and culture. For example, Ben & Jerry’s Homemade, from 1984 until its sale to Unilever in 2000, attracted a crew of socially responsible owners to a meeting that looked more like Woodstock than Wall Street.

Held among cattle farms near Burlington, Vermont, the founders ran the meeting informally, weaving in the vocabulary of hippies: Jerry Greenfield, one of the founders, might intone, “Hey, man, time for a little Q&A.” If Ben Cohen made a motion, in unison a chorus could be heard paraphrasing Smokey Robinson, singing “I second that motion.”⁵⁷

The company’s commitment to sustainable profitability, and social responsibility through charitable giving, resonated with this group. Pressed by critics on board authority to allocate corporate profits to charitable causes, Ben Cohen, Greenfield’s partner, explained:

We’ve never taken a formal vote of all the shareholders, but at our annual meetings, I usually ask them—just a show of hands, it’s nonbinding—if they support the company’s supporting the community and giving away what are really their profits. And they’re all in favor of it.

⁵⁶ See LAWRENCE A. CUNNINGHAM & STEPHANIE CUBA, *THE WARREN BUFFETT SHAREHOLDER: STORIES FROM THE BERKSHIRE HATHAWAY ANNUAL MEETING* (2018) (illuminating essays by forty denizens of the Berkshire shareholder meeting).

⁵⁷ See RANDY CEPUCH, *A WEEKEND WITH WARREN BUFFETT AND OTHER SHAREHOLDER MEETING ADVENTURES* (2007).

The Ben & Jerry's annual meeting helped to communicate the company's brand, attracting both consumers and like-minded shareholders, forging enduring loyalties. Moreover, it was achieved at low cost and produced high returns.

Another mighty American town, Fayetteville, Arkansas, has been the scene of the Walmart stockholders' meeting, most distinctive because of its conscious focus on employees, many of whom are also shareholders. Founder Sam Walton hosted the first Walmart Stores annual meeting in 1970 at a coffee shop with five other people. Since the 1980s, the meetings have added special events and celebrity guests drawing large crowds. The venue has moved from the headquarters auditorium to University of Arkansas arenas now seating 20,000.

Walmart executives bound onto stage under flashes of light, met with roars of crowd approval. Managers get the crowd to spell out Walmart, declare that the store is "number one" and proclaim their love of the brand. Though Walmart remains an economic powerhouse serving its shareholders well, its identity is in its employees, whom it affectionately calls "associates." The annual meeting is their centerpiece.

The annual meeting can be a place where shareholders see the human face of a company and its culture. They meet the chairman, operating and executive teams, and even the board. During his tenure at DuPont, CEO and chairman, Chad Holliday, would wander up and down the aisles, shaking hands with shareholders in a show of savvy but human leadership.⁵⁸ Directors usually attend shareholders meeting and are introduced to the crowd. In some cases, they are asked to play additional roles, from serving as emcee to introducing themselves and given their backgrounds.

At some annual meetings, companies offer freebies to shareholders, as at Tootsie Roll. Product samples from Ben & Jerry's ice cream are given out at Unilever meetings, box lunches are served at Marks & Spencer and British Petroleum.⁵⁹ These gestures keep those attending happy and entices their return. Successful shareholder meetings tend to draw more people every year—as a company prospers and word spreads.

3. **Future.** Executives who have perfected the practice of the live annual meeting may have a competitive advantage as companies migrate to the virtual approach, both voluntarily and thanks to the coronavirus that drove almost annual meetings to virtual format from the second quarter of 2020.

Authorization to host virtual-only shareholder meetings was first enacted in 2000 by Delaware corporate law. Today, most state corporate laws permit the practice as well.⁶⁰ In the first decade, a smattering of smaller companies opted in. During this period, a few big names publicly evaluated the virtual-only option. Among these, a half dozen opted against doing so after hearing negative feedback from shareholders, while another half dozen went forward, despite negative feedback.

Notably, the companies who went forward tend to enjoy a relatively higher QS density than those pulling back. Among those adhering to live meetings are several in the top quarter in

⁵⁸ *Id.*, p. 120.

⁵⁹ See CEPUCH, *supra* note 57, at 190-191.

⁶⁰ Both federal and stock exchange rules defer to state law on the manner of holding annual meetings.

attracting Qs: Conoco Phillips, Symantec and Union Pacific. Among those who went virtual yet remain adept at attracting Qs: Comcast, Duke Energy, Intel, and PayPal.⁶¹

Proponents cite several advantages for virtual-only shareholder meetings, which opponents counter. Advantages are lower costs, potentially increasing the number of shareholders tuning in, and a cost-benefit framework that stresses that few attend and little occurs. Opponents counter that such features are not inevitable, as many managers have harnessed the shareholder meeting as a productive forum for all. Poor turnout and banality are managers' fault and more a sign of a problem to be fixed than a rationale for further dilution, critics say.

Another general argument holds that institutional owners cannot attend all the meetings where they own stock because their portfolios are so diversified, and having the ability to tune-in increases coverage. This argument may be especially compelling for indexers owning stock in hundreds or thousands of companies without the staff to attend most of them. But this seems more a critique of indexing than of live meetings. In any event, at current staffing levels of indexers, they would not be able to attend a great many meetings even if all were virtual.

But whatever relative appeal exists in the merits of live versus virtual meetings, the pandemic reality warrants increased investment in the quality of virtual meetings. For the sake of attracting QS, the virtual event remains the sole opportunity for managers and directors to connect with shareholders and shareholders to get acquainted managers and directors. Such a special opportunity should not be overlooked.

B. *Shareholder Letters*

An artfully-drafted shareholder letter provides insights into a company's values, culture, and outlook. It is the forum of greatest freedom for CEO expression, as the letter is both optional and unregulated. It is therefore the ideal place for the CEO to convey both individual and corporate personality. They reassure current shareholders by reiterating corporate values, reintroducing management personalities, and reflecting the corporate trajectory. These communications are an excellent tool in attracting Qs.

One reason the shareholder letter provides an excellent way to cultivate quality is that so many CEOs simply don't bother with them—those who try have an automatic competitive advantage. Even across companies offering such letters, only a minority of companies archive them on their web sites. Among those that are readily accessible, analysts who have read large samplings attest that only a handful are worth reading—fewer than three percent by one estimate.⁶²

Scan surveys of the best shareholder letters—either a search of published materials or a poll at an investor gathering—and the same names keep coming up. Observers, however, give high marks to shareholder letters for different reasons.

⁶¹ The assertions in this paragraph rank companies involved in public discussions of the format of their annual meeting in relation to CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 2, at App. A (QS Density Ranking).

⁶² Elizabeth J. Howell-Hanano, *Pearls of Wisdom: The Best Shareholder Letters Nobody Is Reading*, TOPTAL (November 7, 2017) (study of all companies in the S&P 600 small cap index).

For example, many rankings of the “best” shareholder letters score general clarity; some run algorithms searching for linguistic cues across the continuum from candid to obfuscating.⁶³ Some investors view shareholder letters as a screen for prospective investments to supplement more typical analytical filters.⁶⁴

Single letters taken in isolation are less meaningful than the arc over many years. Quite a few CEOs have written one great letter but the best keep it up year after year. Studying the letters of a large number of companies over a long period of time yields valuable guidance for shareholders and managers alike.

A common theme: growing into the letters. The best letters are those of the experienced leader—outstanding executives tend to develop in the job, and get better with engagement. CEOs should not get discouraged: writing shareholder letters can be difficult at first, but it tends to get easier with passing years.

Many CEOs find support in the letter-writing from other members of their team. Some CEOs share the burdens and joys of letter writing with colleagues. Yet others have gained inspiration by making their letters into a company pitch. They target not only Qs but outline acquisition criteria and even advertise the company’s products. As an additional opportunity, there is no better place than the shareholder letter to include a pitch to prospective business partners and sellers.

Another feature of outstanding letters is originality, reflecting the personality of the writer and culture of the company. Qs know the difference between legitimate emulation and mindless copycatting. The best letters—as with any kind of writing—are those written with sincerity and passion. Above all, the Golden Rule of shareholder letters: Buffett says he writes to provide shareholders information he would want to have if their “positions were reversed.”

A degree of repetition is valuable—especially on enduring core values and practices. One endearing feature of many letters for Qs are core principles that do not change. Such a firm belief system is valuable to Qs—whatever happens in the world, they know the company stays true to its values. Such statements are therefore worthy of repetition.

Consistency is a virtue, especially in presenting figures and charts. As data lovers, Qs appreciate substantial historical figures. Many shareholder letters feature such information, at least a decade, some going back multiple decades and one nearly a century (Genuine Parts Company, from 1928).

When authors introduce new metrics and charts, they explain their utility. If omitting data in one year that appeared previously, the writer must explain why. Readers who need to hunt to see if goalposts have changed may instead change their views on the company’s appeal.

⁶³ See LAURA RITTENHOUSE, *INVESTING BETWEEN THE LINES: HOW TO MAKE SMARTER DECISIONS BY DECODING CEO COMMUNICATIONS* (2013).

⁶⁴ See Eric R. Heyman, *What You Can Learn From Shareholder Letters*, AMERICAN ASSOCIATION OF INDIVIDUAL INVESTORS (October 2010) (recommending studying a company’s shareholder letter with as much care as its financials, looking for general adequacy of explanations spanning from financial strength to addressing economic challenges).

One expert on the shareholder letter, Laura Rittenhouse, stresses that reading the best letters can “boost your strategic IQ and your investment returns.” relative candor and clarity. In a recent annual ranking, Rittenhouse designated the top 25 by her measures, the vast majority of which rank among the highest in terms of attracting QS. Table 5-B lists these 20 companies.⁶⁵

C. *Quarterly Reticence*

While quarterly conference calls have been a staple of corporate life for decades, as structured today they are not congenial forums to draw many Qs or communicate useful information. When held for the purpose of providing quarterly forecasts, they can pose serious side-effects. They can make CFOs resemble gold rush prospectors in Mark Twain’s definition of a mine: “a mine is a hole in the ground with a liar standing over it.” Therefore, many companies are considering alternatives. Let’s review the debate.

1. Forecasts. Begin with the quarterly forecast. For one, there is no legal requirement that companies publicly predict upcoming performance. The practice of providing “quarterly guidance” began to spread in the 1980s and 1990s after decades when such forecasting was illegal.⁶⁶ Securities laws forbade prognostications for several reasons, primarily that such predictions are given undue credence and create perverse incentives to reach them.

Once permitted, forecasting proliferated, largely in response to appetites of financial analysts. They are genuinely hungry for analytical grist such guidance provides, as it helps them make their own forecasts.

While proponents of quarterly forecasting continue to assert that more management reporting is an inexorable good, that group is becoming the minority. Most observers now recognize that the drawbacks of quarterly management forecasts far outweigh the benefits.

First, even if more information might generally be better (contestable, given today’s information overload), forecasts are not information. They are predictions and guesses. Given the vicissitudes of business, no one can be highly confident in them, no matter how carefully developed.

No business operates in a predictable environment and most face considerable volatility risk. Take examples from two very different industries showing the many risk factors that come into play. A shipping company must worry about docking and repairing vessels, moving deep-water drilling rigs, responding to hurricanes, and cleaning up oil spills; a media company must work through news cycles, election waves, sporting events, and financial gyrations.⁶⁷

Second, it takes enormous time and effort to develop quarterly estimates, diverting managerial resources from other important business. Three-month forecasts draw attention and focus to current quarterly outcomes, away from ensuing quarters, years, or decades. As the

⁶⁵ See Rittenhouse Rankings Press Release, Companies Excelling in Rittenhouse Candor Analytics™ Substantially Outperform the Market in 2016 (December 13, 2016); CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 2, at App. A (QS Density Ranking).

⁶⁶ See Lawrence A. Cunningham, *Finance Theory and Accounting Fraud: Fantastic Futures versus Conservative Histories*, 53 BUFFALO L. REV. 789 (2005).

⁶⁷ These points are inspired by the shareholder letters by Charles Fabrikant of SEACOR and Don Graham of The Washington Post Co.

managers at Loews quipped “we attach a much greater priority to generating superior stock price performance over the next twelve years than over any single twelve-month period.”⁶⁸

Third, quarterly estimates become both goals and a test. Internal goal-setting is necessary to measure and motivate managers. But by publicizing forecasts, managers strive for those targets instead, creating perverse incentives.

Finally, a quarterly focus tempts imprudent spending cuts.⁶⁹ At Unilever, for instance, such a focus led to reducing research, technology and investments. This form of earnings management can have disastrous effects, from distorting internal decision making to snowballing into accounting irregularities or even financial fraud.

Recent trends point to a decline in quarterly forecasting. As few as one in five public companies maintains the practice, many out of sheer habit, though there has been a modest uptick in the percentage in recent years.⁷⁰

Yet even if convinced by proponents, one thing is clear: Qs oppose quarterly guidance. They prefer managers to focus on the long-term economics of a business, not short-run accounting results.

None of this is to say that quarterly results do not matter. Often, they matter a great deal, which is why law requires public companies to publish quarterly results. It’s also why some companies, while skipping guidance, nevertheless still host quarterly conference calls. The key point, however, is to avoid letting quarterly events—reports, calls, or guidance—replace long-term thinking.

A recent study found that companies who quit forecasting came to attract a larger proportion of long-term institutional investors.⁷¹ Quitting may be difficult over the short-term, and those trying to stop face resistance and sometimes even a decline in average ensuing share price. But the long-term advantages are strong.

3. Calls. Quarterly conference calls pose similar challenges to quarterly guidance. For one, again, neither logic nor law requires such calls. They became staples of corporate life as the forum to provide and update quarterly forecasts. Quarterly gatherings pose most of the problems that guidance does, though perhaps of smaller magnitude.

⁶⁸ Loews letter, 2007.

⁶⁹ See John R. Graham, Campbell R. Harvey & Shivaram Rajgopal, *The Economic Implications of Corporate Financial Reporting*, J. ACC. & ECON. (2005).

⁷⁰ A 2006 article by McKinsey & Co. researchers reported a plateau around 2001 in the number of companies maintaining the practice (about 1,200 or 4,000 companies surveyed) accompanied by a steadily increasing number of companies ending their former practice of providing quarterly guidance., a figure exceeding 200 by 2004. Peggy Hsieh et al, *The Misguided Practice of Earnings Guidance*, MCKINSEY & CO. STRATEGY & CORP. FIN. (March 2006). On the other hand, data reported in 2017 by S&P Global Market Intelligence reported that 146 companies of the S&P 500 provided earnings guidance that year, the highest number in a decade. See Stephen Grocer, *Quarterly Guidance*, N.Y. TIMES (September 26, 2018).

⁷¹ Yongtae Kim, et al., *Does the Cessation of Quarterly Earnings Guidance Reduce Investors’ Short-Termism?* (2017); see also Shuping Chen, et al, *Is Silence Golden? An Empirical Analysis of Firms that Stop Giving Quarterly Earnings Guidance in the Post Regulation-FD Period*, J. ACC. & ECON. (2011).

But there are potential benefits of hosting a quarterly huddle. Shareholders may have valid questions throughout the year worth addressing between annual meetings. Managers may benefit from hearing those and thinking them through using a shareholder perspective. In principle, it should be possible to arrange such gatherings while keeping short-term pressures in check. One step would schedule them as far away from publication of quarterly results as possible, rather than as close, which seems to be the common pattern.

Prudence would limit discussion to past performance and strategic outlooks, rather than forecasting results. It would be a forum where executives educate shareholders to understand the business. Managers would reference recent results as briskly as possible, then focus on big-picture, long-term goals, like successful product launches, opening new markets, and gaining market share.

There are other issues with the current quarterly conference call. Despite regulatory efforts dating back two decades to assure access to all shareholders on these calls (“Regulation FD”), they remain dominated by financial analysts whose firms specialize in selling securities, with Qs in the quiet minority. While some analyst questions add value, many follow-ups do not, and while answers sometimes seem useful, many seem guarded or superficial or simply reference published materials.

Technology is also being used to erode the value of the quarterly conference call. High-frequency traders use artificial intelligence to conduct sentiment analysis while calls are in progress. The procedure interprets the call’s tone and messaging in real-time and directs instant trading decisions throughout the session. The goal is to profit from a few seconds worth of “advance knowledge.”

4. Better Ways. For managers and shareholders who hope to stay connected and engaged year-round there are a number of alternatives. The two most common alternatives are direct meetings and written questions; less common are formal shareholder liaisons.

Companies are increasingly turning away from quarterly calls in favor of the periodic written Q&A. Companies invite shareholders to email written questions, managers prepare responses, and all are posted at times calculated to minimize any market effects. Posts are indexed and searchable on company websites.

An online Q&A can address questions from any source, not only shareholders, so long as the source is disclosed. For instance, executives might scour reliable internet sites, such as Reddit, to address the most frequently posed questions. To be more proactive, a company could crowd source questions from shareholders.

Some companies are willing to host direct meetings between shareholders and managers or even directors. Securities laws limit the scope of company disclosure to public information (under Regulation FD, if nonpublic information is disclosed to one shareholder it must be disclosed to all). But that still leaves ample room for productive talk.

Shareholders may be interested in engaging with independent directors, which can be conveniently done around the time of the annual meeting over lunch or dinner. Take care that directors interacting with shareholders are trained to know the scope of information that is allowable for discussion under securities laws. If there is any doubt, they should err on the side of silence. The boundaries should be delineated to the attending shareholders ahead of time.

Veterans of the process suggest a few guidelines, with varying degrees of flexibility designed to promote productive exchange rather than straitjacket the initiative: (1) a stated policy

concerning timing, topics, and shareholder participants; (2) a set of criteria to determine which directors participate; (3) an outline of goals or objectives for the gatherings; (4) coordination between directors and executives; and (5) legal compliance standards to avoid impermissible disclosures.⁷²

Such discussions highlight shareholder concerns as well as reiterate what attracted them to the company in the first place. Shareholders size up directors and vice versa. Conversation helps identify areas of contentment as well as room for improvement.

Whether to engage should be in the discretion of directors. Many energetically oppose the idea, while others are game. Opponents see the outreach as investor relations, not the board's job; supporters see it as part of corporate governance, where the director-shareholder relationship is central. Likewise, some CEOs will support the outreach while others recoil at the prospect.

For those interested in a more formal and routinized approach, a shareholder liaison committee can appeal. Common among large listed French companies, these representatives regularly meet with the board of directors. On their websites, companies such as BNP Paribas and Air Liquide publish the names of the liaison committees and topics of discussion. They state that any shareholder can become a candidate for the committee, whose members typically serve three-year terms.

Board meeting agendas occasionally include time for the shareholder liaison committee. Ground rules vary: the one-way approach permits the board to ask the shareholders questions but not vice versa whereas the two-way invites dialogue. The exchange of ideas can be productive, and certainly to research and act on questions concerning shareholders. While QS regard quarterly guidance and forecasts as unnecessary, a dialogue is always valuable.

D. Accounting Information

Financial reporting offers numerous alternative snapshot figures to portray business performance and condition. Among alternative performance metrics are economic profit, book value, and return on equity or invested capital. Qs appreciate explanations for which is preferred—and also insist on consistency in sticking with the same measure over the years, not picking and choosing depending on which looks best in any given year.

Consistency is important because, at almost any company in any given year, there is almost always a metric out there which can portray positive results. metrics portray something positive. Choosing the assertions that provide silver linings is tempting—better accounts receivable turnover despite sluggish sales, faster inventory turns despite production problems, reduced debt despite greater reduction in equity.

Companies attract and keep Qs by having the courage to report the same items about the same core sources of value creation year in and year out, whether positive, negative or neutral. Qs want the entire picture. Whatever metric is chosen, the methodology and rationale must be explained.

Economic profit is an example, of great appeal to QS. It is an honest picture of performance, taking into account multiple factors, including the cost of equity capital. One of the

⁷² See Lex Suvanto, *Should Boards of Directors Communicate With Shareholders?*, IR MAGAZINE (January 2015).

pioneers of using economic profit was Roberto Goizueta, CEO of The Coca-Cola Company. He began using this measure in 1993, as reported in his ensuing 1994 letter to shareholders, presenting this as a central performance metric:

We now evaluate our business units and opportunities based primarily on their ability to generate attractive economic profit, not just growth in revenues or earnings. We define economic profit as net operating profit after taxes, less a charge for the average cost of the capital employed to produce that profit. That shift in evaluation methodology prompted us to begin divesting ourselves of businesses with financial characteristics inferior to the remarkable fundamentals of our core soft drink business.

Companies who take economic profit seriously tend to attract QS. While only a dozen such companies, and all but one is in the top third of companies measured by relative density of QSs. Besides Coca-Cola and Credit Acceptance, these companies include Clorox, Crown Holdings, International Flavors, and Lear Corporation.⁷³

1. Perspectives and Adjusted Metrics. It is the rare corporate executive who believes that thoroughgoing compliance with GAAP (or IFRS) produces a faithful economic statement of performance and results. That's why virtually all managers supplement their reports with adjusted and alternative metrics that, they believe, more faithfully reflect economic reality, whether economic profit or any of dozens of other refinements.

While managers must explain the accounting results, most QSs also appreciate accounting's inherent limitations. They welcome a CEO's analysis of supplemental metrics and particularly the CEO's views of how the economics differ from the accounting.

The need for adjusted metrics and analysis may be isolated to a one-time event or may recur, spanning from a single acquisition to debate over annual amortization of intangibles. The shareholder letter is an excellent place to explain the company's and CEO's view, ideally in plain enough language for general understanding.

Perhaps the most recurring challenge in accounting, and its relation to economics, is the difference between accounting earnings and various formulations of economic earnings, such as EBITDA (earnings before interest, taxes, depreciation and amortization). While volumes are devoted to this topic, CEOs must explain the specific thinking of how these measures fit the company's particular circumstances.

Berkshire supplements its reports with a concept Buffett calls "owner earnings" for its acquired businesses, rather than rely solely on GAAP operating earnings or cash flow. Cash flows are commonly calculated as (a) GAAP operating earnings plus (b) depreciation expense and other non-cash charges.

⁷³ The assertions in this paragraph are based on a search of all 10K reports from 1996 through 2018. The term "economic profit" appeared 641 times, in filings of some 200 different companies. Limiting the search to those companies with at least seven instances, twenty companies appeared—half continuing to use the term through the present and the other half using it having ceased using it at some point in the recent past. See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 2.

But Buffett's owner earnings calculation subtracts one element: (c) required reinvestment in the business, or "the average amount of capitalized expenditures for plant and equipment, etc., that the business requires to fully maintain its long-term competitive position and its unit volume."

Given how common it is for (c) to exceed (b), Buffett's metric is a more useful approximation of economic reality than typical cash flow or GAAP earnings figures. Most importantly, Buffett has consistently provided this information and explained the reasoning behind it.

2. Warning. Despite the utility of non-GAAP measures, some managers and accountants abuse the opportunity in order to paint false impressions. An age-old problem, deception through non-GAAP reporting became widespread during the 1990s. Lynn Turner, then SEC chief accountant, famously quipped that using non-GAAP measures turned many financial reports into BS—Turner dubbed it "everything but the bad stuff." The pervasive problem was a factor in the accounting scandals that prompted the Sarbanes-Oxley Act of 2002, which told the SEC to regulate the practice.

In response, the SEC's Regulation G has since required companies using non-GAAP measures to reconcile them to the nearest GAAP measure. Also banned were a variety of misleading practices that had become all too common, such as excluding various categories of expenses. Even so, non-GAAP reporting remained a fraud risk factor, prompting the SEC since 2013 to police the practice more pro-actively. Over ensuing years, non-GAAP reporting has drawn a substantial volume of SEC comment letters to issuers.⁷⁴

One clue is the invention of novel definitions of profit that myopically ignore "bad stuff." While sometimes these are specific to a particular company, the most pernicious practices become widespread across an industry or sector. For example, consider contribution margin. This purports to show selling price per unit less variable costs per unit—ignoring fixed costs. While potentially useful internally to manage a business, fixed costs cannot be ignored.

Critics pounced on such tools embraced by companies such as Peleton Interactive, Shake Shack, Uber, and WeWork's parent to exempt expenses such as rent, marketing and stock option pay.⁷⁵ At ride-sharing companies they called it "core platform contribution profit." It reversed out expenses that, while necessary to operate the business and therefore real, did not connect to the "core platform."⁷⁶

At WeWork's office leasing business, for example, GAAP net income was negative. Under a notion called "community-adjusted" earnings, however, a profit was shown by ignoring a variety of necessary outlays. For one, GAAP accounting for leases requires recognizing an expense on a straight-line basis over a lease term; but some of WeWork's leases gave it rent discounts in the earlier years of the lease. Wishing to present the economics only of those early years, it opted to exclude future rent expense. That's myopic, not illuminating.

⁷⁴ See Seanna Asper, Chris McCoy & Gary K. Taylor, *The Expanding Use of Non-GAAP Financial Measures Understanding their Utility and Regulatory Limitations*, CPA JOURNAL (July 2019).

⁷⁵ See Amanda Iacone, *SEC Flags Cash-Flow Measure That Made WeWork Look Profitable*, BLOOMBERG (Dec. 3, 2019).

⁷⁶ See Howard Schilit, *Do Ride-Sharing Customers Sit in Front?*, WALL ST. J. (April 28, 2019).

Managers interested in attracting QS present reliable and useful financial information. They do not play games with the numbers or their investors. QS are alert to the difference between analytical tools and legerdemain, between genuine and fakes, and between the trustworthy and the charlatan.

E. Stock Price and Stock Splits

Stock price levels are largely outside the control of corporate issuers, though historically boards often influenced the level through devices such as splitting the stock (dividing each share into multiple shares with corresponding price reductions per share) or combining it (called a reverse stock split, combining multiple shares with corresponding price increases per share).

The shareholder cultivation literature explored how such decisions could sculpt the shareholder base. According to Professor Rock, stock splits can be used to attract individual shareholders if offered when there are high investor valuations on the firms.⁷⁷ Low stock prices may attract investors who buy for non-value reasons—perhaps short-term investors seek to profit from erratic price swings. He noted that such effects may be countered by corporate communications stressing long-term prospects.⁷⁸

The shareholder cultivation literature concerning stock price and stock splits warrants updating to account not only for focusing on QS but also in light of contemporary developments affecting the practice of stock splits.

Splitting the stock means turning a single share into two or three shares. This increases the number of shares outstanding, proportionally cuts the value allocable to each, and drives per share price down accordingly. Splits do not change the company's total value or per share value but only carve the corporate pie into more slices.

Historically, stock splits were common and per share prices rarely exceeded \$100. The traditional rationales for splitting the stock, and thereby cutting the per share price, were to expand the pool of potential buyers and increase market liquidity. At the time, however, stocks had to be traded in even lots of 100 or additional fees applied. So pricey stocks translated into large dollar order sizes—out of reach for many.

But there have always been downsides to stock splits. Side-effects often include *increasing* the market capitalization, despite no change in fundamentals. Yes, the aggregate post-split price (the lower price times the greater number of shares) may rise and end up greater than the total pre-split price, an irrational response attributed to market perceptions that splits signal managerial belief in prosperity ahead. While appealing to those preferring a high price no matter what, it's unappealing to QSs, who prefer a price rationally related to value.

Today, with the advent of on-line trading, single shares trade without fee premiums, making low per share prices less important to individual investors. If the old-fashioned rationale for splits was to entice investors with stronger appetites for more affordable price ranges, that reasoning diminished greatly in a world dominated by indexers, which buy stocks without regard to price. Moreover, institutional investors, especially index funds who trade in significant volumes without regard to price, oppose the increased costs associated with lower-priced shares.

The financial crisis of 2008 also fostered changing attitudes on the optics of relative share prices. Whereas a low price was previously portrayed as signaling pending prosperity, post-crisis,

⁷⁷ Rock, *supra* note 3, at 881.

⁷⁸ *Id.* at 880.

a high price became a sign of success. That was particularly true at the depths of the crisis, when pervasive low-pricing was a stigma to be overcome, not a sign of good times ahead.

For all these reasons, while stock splits were frequent in the late 1990s and early 2000s, popularity has ebbed. From 2014 to 2019, fewer than 60 splits occurred among S&P 500 companies, for instance.⁷⁹

That said, there are valid substantive reasons for splitting a stock. A common one is to make it easier for shareholders to give gifts of their shares to family or charitable organizations. A stockholder owning shares trading at multiples of an intended gift size is handcuffed. Splitting the stock to low prices facilitates splicing the gift as the shareholder may desire.

Another valid reason is when a company uses its stock to pay for an acquisition. A high-dollar stock may exceed the value of shares held by some selling shareholders, especially employees owning small stakes, who would otherwise be cashed out. Their interest in remaining stockholders can be accommodated by splitting the stock to a lower price.

For example, if Company A, with a \$1000 stock price, pays shares to buy Company B, with a \$50 stock price, any Company B stockholders owning fewer than 20 shares would be paid cash in lieu of fractional shares. This situation arose when Berkshire Hathaway acquired BNSF Railway in 2010. It was one reason Berkshire split its class B shares (50-for-1) to enable more BNSF employees to continue to own more of their employer's stock.⁸⁰

An elite group of companies have avoided splitting the stock as price has run to four digits and more. Alphabet, having gone public (as Google) in 2004 at around \$100 per share, has never split its stock, even as it rose above \$600 in 2011 and twice that as of this writing. This club of four-figure stocks has few members: Amazon, Booking, Markel, NVR, Seaboard and White Mountains Insurance. Berkshire's class A shares take the cake with a six-figure share price.

All these companies, not incidentally, rank very high in QS density.⁸¹ While causation cannot be shown, the philosophy reflected by not splitting pervades the companies, so this cannot be dismissed as mere coincidence.

A small number of companies boast three-digit share prices—in 2019, there were 37 S&P 500 stocks priced at \$250 per share or more. Again, there is a positive association between high-priced stocks and a high-density of QS. Among the highest price three-digit stocks are the following, all of which rank in the top third in terms of attracting QS: AutoZone, Equinix, Intuitive Surgical, Mettler-Toledo, and TransDigm.⁸²

There is an association between companies with the highest price stocks and high QS density. For instance, among the 100 highest priced shares in the S&P 500, more than 1/3 are in the highest decile for QS density and well more than 1/2 are in the top quarter. Among the names

⁷⁹ Matt Krantz, *Stock Splits: Out Of Fashion*, INVESTOR'S BUSINESS DAILY (May 16, 2019).

⁸⁰ On the flip side are reverse stock splits. Instead of dividing shares, they are combined and, instead of driving a price reduction, price rises. Again, rationales vary, some more shareholder oriented than others.

⁸¹ See CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 2, App. A

⁸² This is a complete list of three-digit priced stocks appearing in a list compiled in Matt Krantz, *Stock Splits: Out Of Fashion*, Investor's Business Daily (May 16, 2019). All rank among the top third in Cunningham, QS Density Ranking (described in Appendix A).

appearing at the top of both lists: American Tower, Avalon Bay, McCormick, Roper, Stryker, and Thermo Fisher Scientific.⁸³

While stock splits may once have been useful cultivation tools, as suggested in the literature, those days are largely gone. In the case of cultivating quality, a rising stock price appeals, rather than one cut through the optical procedure of the stock split. It remains the case, however, that stock splits are best seen as part of a communications strategy, and the signals they send are unlikely to resonate with QS.

III. SUBSTANCE

The shareholder cultivation literature has considered shareholder appetite for dividends, and how corporate dividend policy may therefore shape the shareholder base. Common conceptions hold that that older and poorer retail investors prefer high dividend yield stocks and greet a dividend increase more favorably, but such assertions have a weak empirical confirmation.⁸⁴

The literature has investigated the tax-related aspects of dividend policy. For instance, dividends may attract institutional investors whose dividend tax rate is lower than capital gains tax.⁸⁵ Individual investors in high tax brackets have been found to hold dividend-paying stocks.⁸⁶ Accordingly, dividend policy can influence the shareholder base in terms of the mix of institutions and individuals.⁸⁷

The literature offers innovative uses of dividends. One proposal targeted to lengthening investor time horizons would create time-weighted dividends.⁸⁸ From the funds a board declares as a dividend, payments would be proportioned to shares based on their duration of ownership by the same shareholder.⁸⁹

The literature also treats share buybacks, often to accompany discussion of dividends. Buybacks can attract or repel a variety of shareholders depending on how they are made. They may serve long-term shareholder interests by increasing their allocable share of the corporate pie and related claim to earnings.⁹⁰ That is at least true when the price paid is less than the company's inherent business value, whereas the opposite is too often true. In the case of overpayment, shorter-term shareholders gain at the expense of longer-term shareholders.⁹¹

⁸³ Source: Author compilation, using S&P data combined with Cunningham, QS Density Ranking (described in Appendix A).

⁸⁴ Bratton, *supra* note 11, at 858.

⁸⁵ Rock, *supra* note 3, at 876.

⁸⁶ *Id.*

⁸⁷ Rock, *supra* note 3, at 876.

⁸⁸ Belinfanti, *supra* note 11, at 850.

⁸⁹ *Id.* A more ambitious proposal would increase dividends to shareholders who satisfy mission standards the corporation would set. Belinfanti, *supra* note 4, at 851.

⁹⁰ Bratton, *supra* note 11, at 879.

⁹¹ *Id.*; see also Fried, *supra* note 17 (for adverse effects of share repurchases on long-term holders).

The otherwise robust shareholder cultivation literature, however, has tended to isolate discussion of dividends and buybacks without connecting them to equally important issues of capital allocation and stock market trading. Concerning capital allocation, the literature has overlooked topics such as acquisitions and divestitures—both of great importance to QS and warranting treatment along with dividends and buybacks.

Finally, the shareholder cultivation literature has devoted considerable attention to the topic of stock market listing and related effects—such as liquidity, stock price and stock splits. In this case, however, new evidence suggests that this emphasis is not warranted, at least insofar as QS are concerned, which exhibit no preference between today’s two dominant—and highly competitive—stock exchanges. In fairness, the earlier treatment may prove prescient, and warrants updating, in the face of the recent creation of a new U.S. stock exchange, the Long Term Stock Exchange.

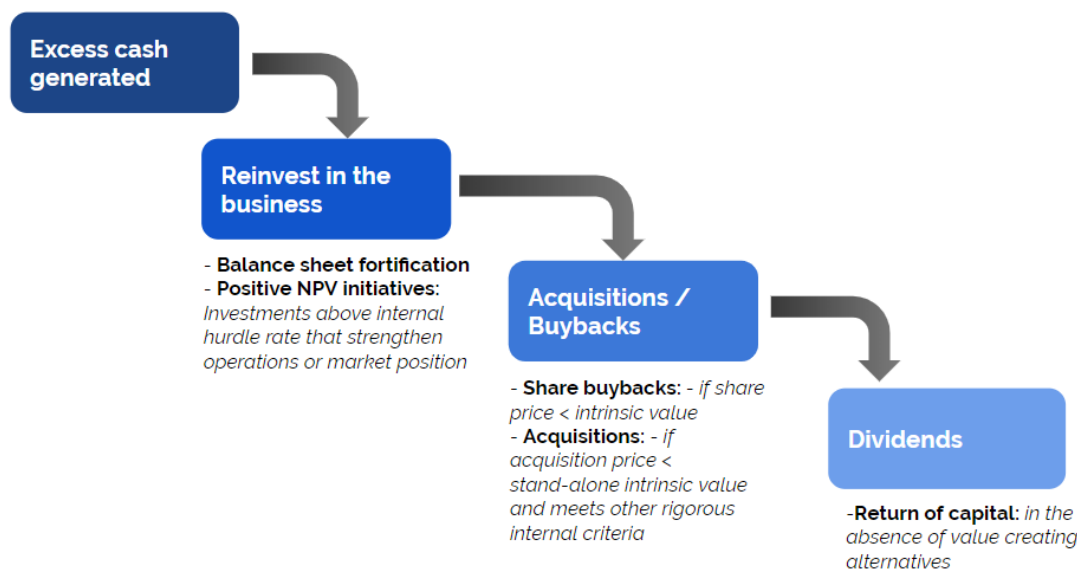
A. Capital Allocation

Capital allocation is a technical term that denotes simply how corporate dollars are invested. Capital can be allocated to many different ends concurrently: fortifying the balance sheet by repaying debt or building cash reserves, funding initiatives to maintain or grow existing businesses, making acquisitions, buying back shares, or paying dividends. QSs value strong track records in capital allocation, measured by return on invested capital.

Table 1 presents a framework for thinking about capital allocation and to organize discussion. It is not a directive or road map, as optimal priorities among the depicted choices will differ among companies and managers at different times. In fact, the various uses of excess cash are neither mutually exclusive nor sequential—funds can be optimally allocated to all uses and priorities given to those anywhere on the chart.

Table 1 Capital Allocation Framework

Capital Allocation - How to think about excess cash?



Start with a general approach to measuring capital allocation effectiveness. First, for any given year, calculate the corporation's average invested capital available. Begin with an estimate of the amount of money shareholders have invested. Then, each year, update by adding net income and the proceeds of any share issuances, subtracting any dividends, and adjusting for any compensation paid in shares.

Thereafter, measure overall performance as a return on the average invested capital. For example, take net income as a percentage of invested capital (ROIC), as an ultimate measure of capital allocation effectiveness.

To maximize ROIC on an ongoing basis, measure every corporate project accordingly. Track every allocation, including reinvestments and acquisitions, on a project-by-project basis using conventional after-tax internal rates of return (IRRs—the rate where the net present value of project cash flows are zero). Be sure all company personnel are trained to be familiar with this tool. For oversight, have the board periodically set the required hurdle rate for all project types (the minimum required IRR to green light the proposed capital allocation).

As rigorous as this sounds, beware that IRRs are complex, future oriented, and require judgement. Managers charged with related measurement may naturally tend to overestimate. To compensate for this, compute an additional measure of overall annual capital allocation effectiveness. Consider one that is simpler, historical and less-judgment laden: add annual ROIC to annual growth in organic revenue (not acquired) and compare the sum to the hurdle rate. The tools can be adapted to all of the capital allocation opportunities presented in Table 1. Such an approach is an excellent way to attract Qs.

1. Reinvestment. While there is fluidity to capital allocation, the first priority ought to belong to reinvestment in current businesses to increase competitive advantage. The chief concerns for corporate leadership and Qs are managerial rationalizations about the prospects of such a use of capital. Managers are often optimistic, usually a desirable trait in an entrepreneur, but not if excessive. Standard measurements, such as IRR and hurdle rates, along with related oversight, help keep them in check.

Another aspect of reinvestment is fortifying the balance sheet. Companies need sufficient liquidity to be prepared for economic distress as well as to take advantage of fruitful opportunities.

2. Acquisitions. For acquisitions, the capital allocation test is simple: whether the acquisition makes current shareholders wealthier on a per-share basis. That means paying a price less than the target company's stand-alone value, ideally delivering an expected return (IRR) that exceeds a preset hurdle rate.

Despite the simple test, acquisitions are a common source of capital destruction. What's essential in this step is skepticism of optimistic scenarios, such as forecasts of value arising from synergies or other opportunities expected to materialize post-acquisition.

Improving an acquired company's operations post-acquisition is a source of value creation. But managers do not always provide investors with sufficient information to evaluate proposed acquisitions completely or objectively. They provide projections that look compelling and business rationales that seem logical.

Yet acquisitions can be emotional, exciting managers and stoking optimism. Managers cultivate Qs by playing down expectations from acquisitions, skipping talk of synergies and other often-elusive veins of value. An even better one: conducting ongoing post-acquisition analysis,

constantly updated, to compare expected IRR with actual ROIC and determining reasons for the difference.

Another source of discipline is using cash in preference to stock to pay for acquisitions. Using stock can inflate the price, often felt as play-money, more like poker chips than cash.

3. Share Buybacks. At least one capital allocation decision can directly improve the quality of the shareholder base: share buybacks. When companies buy their own shares, the most likely cohort interested in meeting the demand are transients, who by definition are prepared to sell at all times. That automatically increases the proportion of shares held by longer term shareholders, such as QS.

But share buybacks are only rational for shareholders if the company pays a price less than a conservative estimate of the company's per share intrinsic value. If so, that is prudent capital allocation; if not, it is capital squandering.

Buybacks were uncommon through the 1970s and 1980s, as dividends were the popular route for corporate distributions to shareholders.⁹² The pioneers stood out, including under Roberto Goizueta at Coca-Cola; Larry Tisch at Loews Corporation; Henry Singleton at Teledyne; and Kay Graham at The Washington Post Co. In that era, companies like those followed the textbook, repurchasing shares as a capital allocation exercise, when no better alternatives existed and price was below value.⁹³

By the late 1990s, buybacks had become a common practice across corporate America. Such proliferation raised a new concern: whether managers possessing superior valuation information exploit selling shareholders when buying at a discount. To address this, managers must provide shareholders with all relevant valuation information. Otherwise, insiders take advantage of uninformed shareholders, confiscating their interests at pennies on the dollar—anathema to QSs.

The advice Warren Buffett gives to investors applies equally to managers making capital allocation decisions: be fearful when others are greedy, and greedy when others are fearful. The most obvious application of this investment principle in the context of capital allocation concerns share buybacks. Companies make errors of both commission—buying too no matter how high the price—as well as omission—failing to buy when prices plummet.

Buybacks automatically increase earnings per share (EPS) and tend to boost stock prices. QSs are alert to these effects and oppose managers whose buybacks are motivated by such results rather than rational capital allocation. They are therefore skeptical of buyback formulas or quotas. Moreover, since buybacks automatically boost EPS, if that metric is an important part of managerial performance reviews or compensation, boards must be especially vigilant to deter share buybacks designed to boost executive pay.

Finally, when choosing between paying a cash dividend or buying back shares, the effects on shareholders and option holders differ greatly. Dividends increase returns to shareholders but

⁹² See Michael J. Barclay & Clifford W. Smith, *Corporate Payout Policy: Cash Dividends versus Open Market Share Repurchases*, 22 J. FIN. ECON. 61-82 (1988) (while 81% of NYSE firms paid dividends from 1983 to 1986, less than 12% conducted share buybacks).

⁹³ The legendary Teledyne executive, Henry Singleton (1916-1999), is an all-star for shareholder buybacks. See WILL THORNDIKE, *THE OUTSIDERS*.

decrease the value of options, while buybacks boost earnings per share and therefore increase option value. A conflict of interest looms between what is best for managers holding options and all other shareholders. That's why Qs are skeptical of companies with significant executive stock option compensation coupled with significant share buybacks. In many such cases, a better capital allocation for shareholders would be dividends.

4. Dividends. Dividends are another capital allocation decision that can directly shape the shareholder base. Regular dividends give shareholders a reason to stick around during troubled patches—they can be a useful magnet that lengthens holding periods and sometimes induces taking larger positions. This point was stressed by one of the more frenetic and diversified stock pickers, Peter Lynch, who gained fame as both a stock picker and author.⁹⁴

A small group of companies boast paying an increasing dividend over the past five decades. A few examples, all of which are high on the list of attracting Qs: Coca-Cola, Dover, Genuine Parts, Hormel Foods, Johnson & Johnson, and Procter & Gamble. Even sustaining regular dividend increases for one decade is difficult, with fewer than 300 companies having managed to do so of late.

At the other end of the spectrum are companies that have not paid dividends, either ever or in recent memory. The reasons are mixed, running the gamut from dazzling growth opportunities to trouble meeting bills. Whatever the direction taken, it is best for CEOs always to explain capital allocation policy and choices in their annual shareholder letters.

5. Board Oversight. Corporate law requires that boards approve major acquisitions and dividends, and as a practical matter to approve share buyback programs.⁹⁵ Along with such approvals, good practice dictates that the board's principal role is setting applicable hurdle rates, for reinvestment and acquisitions.

Companies wishing to make capital allocation a priority could revisit whether to create a board committee with this oversight. At S&P 500 companies, boards maintain an average of four committees, and about 1/3 include a committee on capital allocation, finance or investment.⁹⁶ Charters might call for post-investment reviews on all important allocations, especially organic growth initiatives, acquisitions, and share buybacks.

If one advantage of cultivating Qs is developing relationships and potential directors, capital allocation is an area where they can add particularly rich value. So long as a board boasts some such expertise, and the rest of the board learns from them, there's no need for a capital allocation committee.

B. *Separation Transactions*

Conventional wisdom says that “the whole is greater than the sum of its parts.” But often the opposite is true, and the parts are more valuable on their own. For companies, a simple way to capture that greater value would be to sell the higher-valued parts. While commonplace, doing so poses adverse tax consequences that destroy rather than enhance shareholder value. Many better

⁹⁴ PETER LYNCH, ONE UP ON WALL STREET (1989).

⁹⁵ *E.g.*, Del. C. §§ 154 (dividends), 160 (repurchases technically do not explicitly require board approval but statutory rules violations expose directors to personal liability); 251 (mergers).

⁹⁶ *See* Phil Ordway Research.

alternative approaches have been devised to solve this problem, to channel value to shareholders, while offering the added advantage of segmenting the shareholder base and attracting QS.

Collectively called “separation” transactions, these are well-known, if exotic, structures such as tracking stocks, public offerings of minority interests in subsidiaries, and spin-offs. Separation transactions produce potential benefits for both the parent as well as the newly-separated business. The parent may gain from a sharper focus on its core retained businesses—along with improved pricing rationality of its stock—and the separated business may gain from its new status as an autonomous entity freshly nurtured by that parent.

From the viewpoint of shaping the shareholder base, these transactions offer additional benefits: tracking stocks can create internal business delineations to separate QSs from transients, with QSs tied to a core business and transients to the non-core business. Spin offs of non-core businesses can be designed to appease, deter or thwart activists. Both of these and similar other transactions sometimes trigger screens that result in companies being excluded from major indexes such as the S&P 500—a benefit to any companies wishing to reduce the density of indexers in their shareholder base.

1. Trackers.⁹⁷ The simplest and most obvious way to segment the shareholder base is to create multiple tracking stocks for a single company. The technique is designed to match different shareholder bases to different businesses, without legally separating them. For example, a business requiring long-term R&D investment with long product cycles should attract longer-term shareholders while one selling quotidian commodities at spot prices might attract shorter-term shareholders.

Tracking stocks, corporate equity of a parent tied to the economic performance of a subsidiary, were the 1984 brainchild of Georgetown University tax professor Martin D. Ginsburg, late husband of Justice Ruth Bader Ginsburg. Prof. Ginsburg’s design, still used to this day, solved a problem for H. Ross Perot, the colorful Texas billionaire.

In 1984, when General Motors Co. acquired Mr. Perot’s company, Electronic Data Systems, he and his many employee-shareholders were concerned that EDS’s performance would be lost within the GM behemoth. They wanted to ensure that superior performance of EDS would be rewarded regardless of how the rest of GM performed, including due to the relative time horizons of each company. The solution: the EDS group accepted shares in GM, but performance was tied to the economics and related time horizons of EDS, aptly dubbed “Class E stock.”

Prof. Ginsburg’s invention was so effective that GM copied it the next year when acquiring Hughes Aircraft Company—using currency dubbed GM “Class H stock.” Both trackers remained in place for more than a decade until GM spun the companies off, distributing all GM’s stock in them to GM shareholders to form freestanding companies. GM’s tracking stock worked well for all concerned, especially Mr. Perot, who showed his gratitude by endowing a professorship at Georgetown: The Martin D. Ginsburg Chair in Taxation.

The Ginsburg Model. When corporations issue stock, stockholders enjoy many rights against that issuer; boards control the whole and owe associated duties to all stockholders; and governments levy associated taxes. Trackers splice rights to different shareholder groups, without

⁹⁷ See Lawrence A. Cunningham & Patrick T. Brennan, *Tracking Stocks: Rise, Fall, Revival*, FIN. HIS. (Fall 2017).

relinquishing board prerogatives or repudiating duties, while simultaneously deferring tax consequences.

The terms of tracking stock put parental control in its board, provide mechanisms to track the economic performance of the targeted business, and set policies for dealings between parental units to be at arm's-length. Boards often adopt dividend policies based on cash flows of targeted businesses, retain power to convert tracking stock into the parent's common (an "unwind" feature), and pledge to redeem the stock upon the sale of the tracked business's assets. Otherwise, tracking stock terms are the same as the parent's ordinary common, on matters such as voting rights and rights upon parent liquidation, although some variation is possible.

Exact advantages of tracking stock structures vary depending on the specific features of the various businesses and how they interact. Benefits may include offsetting tax benefits when one business generates substantial taxable profits while another incurs substantial losses; combined balance sheet strength equating to lower borrowing costs; immunization from antitrust laws that might prohibit two independent businesses from coordination that is perfectly legal among business units of the same family; and adding incentives for managers to enhance the performance of businesses they run by compensating them in their own tracking stock.

Rise. The original tracker model, tailor-made for GM's acquisitions, was soon adapted to other settings. In 1991-92, U.S. Steel Corporation enjoyed synergies through common control of such diverse subsidiaries as Delhi Group and Marathon Oil, which shared gas-processing plants and enjoyed lower borrowing costs together than if independent. But the businesses had distinct economics so that a tracking stock would both keep the advantages of common control while increasing visibility into the tracked business with gains for stockholders and managers alike. The solution worked for a decade until USX spun Marathon Oil off.

In 1995, after the government's antitrust break-up of AT&T, US West was a regional telephone company which also owned cable and cellular assets. Long-term investors attracted to the stability of the telephone utility might recoil at the volatility of media assets; shorter-term investors seeking rapid growth would have opposite tastes. Trackers satisfied the demand of each while housing all operations under common control, harvesting related synergies. To further meet investor tastes, the utility side would pay regular dividends as the media side would reinvest earnings. And the arrangement could be unwound as circumstances changed: in fact, in 1998, after synergies proved elusive, US West spun off the media business.

In the mid-1990s, the iconic investor and telecom mogul, John Malone, used trackers to segment the economics of diverse media assets he had been acquiring for decades through TeleCommunications Inc. (TCI). In addition to other advantages ranging from antitrust to tax, Malone realized that cable assets along with programming, for example, were better combined than separate from an operations perspective. Yet they featured different economic attributes. Using tracking stocks for such businesses could translate into higher price-earnings multiples, which can be valuable when using stock to acquire other companies.

The TCI transactions were distinct in both complexity and boldness, which drew critics. They referenced conflicts of interest between siblings that all parent boards using trackers face. TCI's prospectus said as much, then simply avowed confidence in its directors' ability to discharge their duties. This amounted to an "implicit message of 'trust us'," critics said, urging such boards to establish structural cures, such as independent committees. But no governance devices can

resolve such problems, and one truth about trackers is that, to make them beneficial for all parties, the parent's board must be trustworthy.

Stumble and Fall. As QS Bill Ruane once lamented: on Wall Street, the process goes from innovation to imitation to irrationality. The same held for trackers, as they proliferated in the late 1990s technology sector amid irrational exuberance fueling the bubble. A common theme featured a traditional company offering trackers in an internet subsidiary: bookseller Barnes & Noble for its e-tailing operations; The Walt Disney Company with Go.com; brokerage firm Donaldson, Lufkin & Jenrette for its online trading businesses, DLJdirect; and publisher Ziff-Davis for its online operations, ZD.net.

Nearing a peak, in mid-2000 about 30 listed trackers traded—half issued during the bubble—and several then pending were soon aborted, including for DuPont Co.'s life sciences business, The New York Times online, and Staples.com. Others soon wound down, including at Disney and DLJ (then owned by CSFB). While the market for tech recovered, appetite for trackers remained dim. Although a few trackers launched in 2001 and 2002, none debuted during 2003 or 2004.

Skeptics included luminaires from the value investing world such as Columbia Business School professor Bruce Greenwald and *Wall Street Journal* veteran Roger Lowenstein. They challenged many companies' trackers as "putting lipstick on a pig" or "rearranging deck chairs on the Titanic." Proponents of efficient market theory could not imagine how ownership structures could affect the market's valuation of businesses.

During the bubble, many companies used trackers less to solve a knotty business problem—which could as easily be resolved by separate audited financials—than to follow frothy markets. Many issuers lacked the compelling rationale that makes trackers suitable—operational synergies, interdependence, tax efficiency, or acquisition opportunities. It was not enough to repeat versions of the US West story—which had in any event faltered.

But despite the broad retreat from trackers, Malone saw them as an ideal solution for numerous challenges he faced managing Liberty Media. By 2005, Liberty was a complex group of diverse media assets needing simplification. Malone began by spinning off two businesses—a collection of international media assets and a 50% stake in Discovery Communications. Still, Liberty Media perceived continued stock market undervaluation—by as much as 70 percent.

To address these challenges, Liberty Media created trackers, Liberty Interactive (LINTA) and Liberty Capital (LCAPA). LINTA was anchored by Liberty's 98% interest in QVC, the television shopping channel and strong cash generator, and included the company's 22% interest in Expedia, the online travel agency, and 22% stake in IAC, owner of such companies as Ask Jeeves and Ticketmaster.

LCAPA would house all other assets, including, as the prospectus explained, "video programming and communications technology and services involving cable, satellite, the Internet and other distribution media as they evolve"—in other words, anything telecom related. These assets included a variety of businesses and securities, such as the wholly-owned Starz and On Command; the partly owned FUN; and public equity in Motorola, News Corp., Sprint, and Time Warner—the latter accompanied by a variety of complex hedging instruments.

Liberty thus created two sets of assets of appeal to different types of investors. Those who favored predictable cashflows from QVC and other straightforward stalwarts would be more

attracted to LINTA; those wanting to bet on Malone's record of buying and selling a variety of diverse media assets and financial hedging transactions could gravitate towards LCAPA.

When trackers increase a company's aggregate valuation, that strengthens a company's hand in acquisitions it pays for using stock. For Liberty Media, this proved valuable by 2008 in the depths of the financial crisis, when LCAPA acquired satellite radio operator SiriusXM. With a total return exceeding 38 times its initial investment (to date), this is among the most successful investments of the century, outdoing even those famously executed during the crisis by Warren Buffett.

Critics would say that if parent stock is undervalued, a board can intensify buyback programs until corrected, and if a company is too complex, it should be simplified. On the other hand, Liberty had tried both buybacks and spin-offs but undervaluation persisted. Costs of the tracking structure include internal managerial resources to design and implement it, along with external costs of educating analysts and investors on the rationales. But these costs are not great and, if the program fails, it can readily be unwound, also at modest incremental cost.

The issue came down to a venerable debate, whether trackers are mere financial engineering—in the purely negative sense of doing nothing to increase underlying fundamental value—or a financial achievement that increases value by deftly combining assets to cater to differing investor appetites while maintaining economic efficiency. Given the dot.com experience, the verdict for almost all companies was in, but for Malone and Liberty Media, the jury was out.

After all, the same critical logic would denounce spinoffs yet history proves their value—and, for that matter, the dot.com era aside, history had proven the value of trackers, as the McKinsey study showed. Today, history appears to be on the side of trackers: in 2008, the Wall Street Journal declared them “relics” on the “verge of extinction.” In 2016, tax lawyers from Fried Frank—where Prof. Ginsburg once worked—proclaimed, with apologies to Mark Twain, that reports of the death of trackers are “greatly exaggerated.” A new wave of trackers had emerged, offering compelling rationales.

Revival. In 2013, Fantex, whose business consists of separate branding contracts with professional athletes, offered trackers tied to the economic value of those contracts; in 2014, Fidelity National Financial Inc., a title insurance company with an investment strategy focused on individual businesses, offered trackers tied to its core business as well as those investees; in 2016, Dell used tracking stock as part of its purchase of EMC Corp., tracking EMC's 80%-owned subsidiary, VMWare, Inc., a publicly-traded software company.

Researchers at Merrill Lynch in 2016 published a paper identifying all the familiar benefits as well as costs and stressed that trackers are only advisable when a company can offer a compelling rationale. It devoted a full page depicting nearly a dozen Liberty Media trackers, and said: “The tracking stocks and spin-offs issued by Liberty from 2004-2015 have resulted in an out-performance vs. the S&P 500 Index of >200% for the Liberty investor.”

Aside from segmenting the shareholder base between transients and Qs, trackers may also dramatically reduce the indexing cohort. This is because many index providers, such as the S&P 500, exclude companies with tracking stocks from their index—as some likewise do to companies with dual class capital structures. The same result follows for companies with subsidiaries that are publicly traded.

2. Public Subsidiaries. While indexing offers some advantages to companies and shareholders alike, too much indexing can be a negative. For managers and directors concerned about excessive concentration of indexers in their stock, a few observations are warranted. For one, despite the pervasiveness and scale of indexers, many wonderful publicly-traded companies, large and small, avoid inclusion on indexes altogether and even more are outside the index-heavy populations such as the S&P 500. This is because the index managers apply various filters in assembling indexes.

While index managers such as the S&P may appear to sweep up all companies possessing specific criteria of size or sector, most apply additional screening rules. Companies in the screens are excluded from certain indexes, reducing the proportion of their shareholder base drawn from the indexing cohort.

Some screens offer most companies no flexibility to reduce index exposure. For instance, U.S. index managers usually exclude non-U.S. issuers and few companies would opt for an overseas incorporation solely to reduce the percentage of indexers in the shareholder base. In fact, the opposite may be more common—non-U.S. companies, such as Alibaba, say, reincorporating in the U.S. to expand the index cohort.

Another screen excludes companies with a majority shareholder.⁹⁸ One way a company could take advantage of this screen is through subsidiary IPOs—the company lists a minority interests in a subsidiary. As the parent, the company parent enjoys ownership along with fellow shareholders who are not indexers. That translates into a more rational stock price and a more engaged shareholder base focused on business performance. Additional advantages include the following:⁹⁹

- **Market Valuation**—By giving third-party investors a basis to value subsidiaries directly in public equity markets, the listing offers parent shareholders an objective measure of the value of its publicly traded subsidiaries.
- **Transparency**—As public companies and SEC registrants, these subsidiaries provide financial disclosures that enhances transparency for parent shareholders.
- **Self-financing**—The subsidiaries can, with greater ease, directly access capital markets to finance operations and expansion, if needed.
- **Recruiting top talent**—The opportunity to hold a senior executive position in a publicly-traded company is appealing to most candidates.

Subsidiary IPOs also pose downsides, of course. Disagreements or conflicts can arise between the boards and managers of the parent and sub. Such downsides were delineated by Sony in 2013 when it rejected activist pressure to publicly offer minority shares in its entertainment unit. Sony pointed to parental reversals of subsidiary IPOs after several years at News Corporation (of Fox Entertainment) and Time Warner (of American Television and Cable).

⁹⁸ *E.g.*, S&P U.S. Indices Methodology (July 2019) (excluding tracking stocks, multiple class share structures).

⁹⁹ *See* Loews Corporation Annual Report (2016) (stating these as advantages to this company's structure with several listed controlled subsidiaries).

In some cases, trackers would be better for shareholders, for the advantages described earlier. Both alternatives warrant consideration, as does yet another: spin-offs, a device also of great value in deterring activists.

3. Spins. In recent years, amid calls for focusing rather than diversifying, managers find it increasingly difficult to justify conglomerates. A few companies have justified sprawling diversity on organizational grounds—Berkshire is a prominent example, but widely seen as one-of-a-kind, too exceptional to use as a model for public companies, at least outside the insurance industry. For most, attempts at justification fall flat and invite activists who push for prompt divestitures. To avoid that fate, and win over Qs, a regular program of growth and trimming may make more sense.

Activists have long favored spin-offs, the most common form of separation transaction. A parent corporation declares a tax-free dividend, to all its shareholders, of stock in a subsidiary business to be separated. Upon payment of the dividend, the spun business becomes a freestanding independent entity.

Spin-offs were a familiar type of corporate transaction in the 1990s, with some 325 closed that decade.¹⁰⁰ Thereafter, interest slowed to a fraction of that through 2015, but from there interest renewed and they have become more frequent. Prominent spins—all instigated by activist investors—include eBay spinning PayPal (at the urging of Carl Icahn); EMC spinning VMware (Elliott Management); and Timken spinning its steel business (Relational Investors).

Across decades, spins have had multiple uses. They have been used to separate businesses lacking a continuing strategic fit, such as when AT&T spun off Lucent and NCR in 1996. They have been used to break up conglomerates, such as when ITT split into three in 1995. In 1998, Alleghany Corporation, under the leadership of renowned investor-manager John Burns, spun-off its Chicago Title Corporation business, creating a major new independent insurance company with an initial market capitalization exceeding \$1 billion.

Some managers have used spins to clean up a business plagued by problems, as occurred with numerous spins out of Tyco International in the years following its financial scandals. A wave of spinoffs involved separating an operating company's real estate interests—often into tax-advantaged real estate investment trusts—at such companies as Macy's and MGM Resorts.

Others have used spins as part of a recurring process that involves both regular business expansion—whether acquired or organic—and later divestitures of some of them. An example is Sears Holdings, which from 1993 to 2014 spun off such powerhouses it had nurtured as Allstate, Dean Witter, Diehard, Discover, and Land's End.

The results can be mixed, however. A notable serial spinner is IDT Corporation, founded and long run by Howard Jonas, succeeded in 2014 by his son. The company and its founder are highly regarded and have achieved substantial shareholders returns, though unevenly. Effecting spins has been a part of the standard practice—some have performed exceptionally well, others the opposite.

To illustrate, Straight Path Communications, a 2013 spin that began trading around \$5 per share rose by 2019 to \$180, but Zedge, a 2016 spin that began trading at just above \$7 was in 2019

¹⁰⁰ See STEPHEN I. GLOVER, BUSINESS SEPARATION TRANSACTIONS: SPIN-OFFS, SUBSIDIARY IPOs AND TRACKING STOCK (2018).

trading below \$2. In between, the stock of IDW Media, a 2009 spin, began around \$2 and rose to as high as around \$40, before retreating in 2019 to \$17. Spins are not for the faint of heart; but Qs will be attracted to learn more from managers willing to engage with the idea.

John Malone is also an avid proponent of spin-offs, matching his enthusiasm for tracking stocks. Liberty Media is constantly making acquisitions, but also constantly divesting, whether directly in selling interests or, more often, in slicing them through spin offs (or trackers). Prominent spin-offs include: Liberty Global/Discovery, DirecTV, Liberty Global, Starz, and QVC.

The spin-off pushes interests back and outside the entity, negating conglomerate; rather than creating an empire under consolidated rule, it is as if the king hives off earldoms, dukedoms, and other fiefdoms and locates them where their value will be best appreciated.

Underlying the trackers and spins, as well as the rest of Malone's approach are optimizing leverage, efficient taxation, opportunistic deal making. In addition, such structures lead to internal growth of talented managers and better incentive programs. The output from these efforts are extraordinary shareholder returns, a compound annual growth rate since 2006 of roughly 18%. Such results attract Qs.

Spins have become increasingly common in recent years as a way to increase focus and related capital allocation, whether at conglomerates or otherwise. As such, a strategy that includes spin-offs as a regular element can be a strong general deterrent to activists, as well as a source of shareholder value.

C. Trading Activity

Professor Rock notes that listing on major exchanges signals credibility.¹⁰¹ Listing decisions could well be important to nascent corporations or a factor in some, especially foreign corporations, seeking a dual listing.¹⁰² Some companies cross-list to attract investors in specific additional locales. While cross listing may add shareholders in a new geography, this may include every type of shareholder. Managers do well to signal their particular appeal to Qs.

The New York Stock Exchange (NYSE) and Nasdaq (once known as NASDAQ) are arch rivals engaged an intense competitive battle for listings, so corporate managers would certainly have an opportunity to consider which listing, if either, delivers a more sought-after shareholder base. For purposes of this Article, it is worth considering whether one or the other is more or less appealing to Qs. As the following discussion will conclude, it does not, although the recently-formed Long Term Stock Exchange promises to disrupt the prevailing model.

¹⁰¹ Rock, *supra* note 3, at 878.

¹⁰² An instructive case concerns Fairfax Financial. The company, long listed on the Toronto Stock Exchange (TSE), in late 2002 added a NYSE listing. Fairfax had publicly discussed the listing for several years before completing it. The rationale was to attract U.S. investors and assist U.S. employees in owning the stock. But it also attracted substantial short-sellers which, Fairfax believes, manufactured negative press. The company sued, alleging illegal market manipulation. Some defendants settled the lawsuit, while others defended it vigorously. Parts of the case were dismissed for technical legal reasons, but the substantive claims remain alive, as the case continues 15 years after it began. In any event, Fairfax's need for the dual listing proved short lived. By 2009, it had become so easy for U.S. investors to use the TSE that Fairfax, by then a well-known global firm, delisted from the NYSE, saving associated administrative costs.

The different stock exchanges have established branded reputations for certain kinds of companies, with at least some small effect on attracting different investors. The NYSE, for example, has the blue-chip reputation, a ring of the establishment and permanence. On the other hand, the Nasdaq built its brand as home to vanguard tech companies.¹⁰³

Stock exchanges facilitate trading between buyers and sellers through firms which intermediate the demand and supply sides for pay. The compensation—which covers their own services and costs of system administration—is the bid-ask spread, the difference between the price intermediaries charge buyers for a stock and the price intermediaries pay sellers for it.

There is always a spread, but size varies with supply and demand and drivers such as volume and liquidity. For instance, the spread in trading currencies is almost always tiny, as those are the deepest and most liquid type of markets in the world. For stock markets, on the NYSE, the average spread (expressed as a percentage of the bid) is about ½ of one percent (50 basis points) while on the Nasdaq spreads average about 2.5% (250 basis points).¹⁰⁴

Lower bid-ask spreads have inspired some companies to move from the Nasdaq to the NYSE, including Berkshire and Markel. But that was in the period through the early 2000s, when the general pattern saw companies first list on Nasdaq and later migrate to the NYSE;¹⁰⁵ since 2005, a more common pattern has involved NYSE-listed companies moving to Nasdaq. Oracle's 2013 move from Nasdaq to NYSE was among the last of the traditional moves; Pepsi's 2017 was among the largest relisting in the new direction. Charles Schwab made a round-trip: switching from NYSE to Nasdaq in 2005 and later back.

The NYSE used to brag about its dominant position, declaring in its 2007 annual report:

From 2001 to 2006, 121 companies transferred their listing from Nasdaq to the NYSE. During that same period, only five companies voluntarily transferred from the NYSE to Nasdaq.¹⁰⁶

But that was when NYSE listing rules made it difficult for companies to leave. Departure required board and audit committee votes, notices to all shareholders, and outreach to the largest shareholders. After the NYSE repealed those requirements under pressure, Nasdaq has been on a competitive tear.

Nasdaq's 2007 annual report boasted of poaching 32 companies from the NYSE and 30 from the (soon-defunct) American Stock Exchange. Every Nasdaq annual report since describes

¹⁰³ The name change was effected in 2017. See Securities and Exchange Commission, Release No. 34-81917; File No. SR-NASDAQ-2017-111 (October 23, 2017), <https://www.sec.gov/rules/sro/nasdaq/2017/34-81917.pdf>.

¹⁰⁴ On its website, the NYSE boasts of its narrow spread—on average 46 basis points compared to all other exchanges, with NASDAQ at 253 basis points. See also Christine X. Jiang, Jang-Chul Kim & Robert A. Wood, A Comparison of Volatility and Bid-ask Spread for NASDAQ and NYSE After Decimalization, *Journal of Applied Economics* (2011) (“Transaction costs measured by quoted and effective spreads remain significantly higher on NASDAQ than on NYSE. . . .”)

¹⁰⁵ See Simi Kedia & Venkatesh Panchapagesan, *Why Do Only Some Nasdaq Firms Switch to the NYSE? Evidence from Corporate Transactions*, *J. FIN MARKETS*, 14, 109-126 (2011).

¹⁰⁶ NYSE Annual Report on 10-K, 2007 WL 8639287.

the competition for market share between Nasdaq and NYSE and tallies companies relisting from the NYSE. As of 2018, Nasdaq said it had poached a total of some 300 listings, boasting a total market capitalization of \$1.5 trillion.

Table 2 tabulates switches from NYSE to Nasdaq for the past decade. It includes quite a few companies scoring high in QS density, including Automatic Data Processing, CME Group, News Corp., PepsiCo, Workday, and Xcel Energy. However, overall, the distribution of these companies does not support concluding that the switch is associated with higher QS densities.¹⁰⁷

Table 2 Relisting from NYSE to Nasdaq

Year	No.	\$B Cap	Examples
2008	9	130	News Corp., Automatic Data Processing, CME Group, Jack in the Box, Celera, Mylan, Seagate Technology
2009	10	154	BMC Software, Cypress Semiconductor, Dreamworks Animation, Mattel, Micron Technology, Network Equipment Technologies, R.R. Donnelley & Sons, TriMas Corp., Vodafone Group, Windstream Corp.
2010	3	10	Hasbro, Avis Budget Group, Potlatch Corp.
2011	7	42	Fifth Street Finance Corp., Frontier Communications Corp., Icahn Enterprises, Magnetek, SLM Corp., Viacom Inc., Wendy's
2012	16	135	Kraft Foods, Texas Instruments, Goodyear Tire & Rubber, Analog Devices
2013	31	47	VimpelCom, Marriott International, Amdocs Limited
2014	17	5	Office Depot
2015	27	84	T-Mobile US, CSX Corp., Pinnacle Entertainment, TD Ameritrade Holding Corp.
2016	20	61	IHS Markit, Imperva, OPKO Health, Scripps Networks Interactive, tronc, Trupanion, Willis Towers Watson
2017	11	218	PepsiCo, Principal Financial Group, Workday
2018	18	111	Xcel Energy, United Continental Holdings, Regency Centers Corp., Avent, Newell Brands, Weight Watchers International

Source: Table compiled from annual reports on 10K of Nasdaq Inc.

There may be good reasons for a company to switch between the Nasdaq and the NYSE. But the frequency and stated rationales for such shifting suggest the causes are due more to the competition between those rivals stirring up the moves than obvious shareholder benefits.

¹⁰⁷ This is based on comparing the companies listed in Table 2 with LAWRENCE A. CUNNINGHAM, QUALITY SHAREHOLDERS: HOW MANAGERS ATTRACT THE BEST SHAREHOLDERS (2020), App. A.

Companies cite cheaper listing fees for corporations. These may diverge significantly. They run as low as \$155,000 on Nasdaq compared with up to \$500,000 for the NYSE. But while that may be attractive to the company, it ignores the relative trading costs shareholders incur, including due to Nasdaq's higher bid-ask spreads.

Two other arguments favoring Nasdaq over the NYSE contradict the goal of attracting more Qs relative to transients and indexers. First, the empirical evidence indicates that the switch tends to increase trading costs and attract transients.¹⁰⁸

Second, one consequence of a Nasdaq listing is potential inclusion in its famous indexes, such as the QQQ or the Nasdaq 100.¹⁰⁹ While some may see that as appealing, it is a disadvantage to any company wishing to attract a relatively greater density of Qs compared to indexers.

Inclusion in an index automatically means being purchased—or sold—by a large number of investors whose decisions are not based on the company's performance or prospects but merely its inclusion. The automatic trading by indexers adds liquidity, *supra* note xxx, attracting more transients. Worse, index membership tends to drive price up, sometimes above value, because purchases and sales are made based not on value but on price.

Exchanges rarely compete for branding around long-term companies and associated shareholders—after all, their lifeblood is trading. Yet an upstart, called the Long-Term Stock Exchange (LTSE), is poised to shake that up. Proposed listing standards aim to attract Qs.

In terms of the corporate menu, LTSE-listed companies would be expected to publicize their long-term strategy, update it annually, and provide relevant metrics to judge its success. In addition, companies would be prohibited from offering quarterly guidance. Among topics discussed elsewhere in this Article, LTSE supports time-weighted voting and disclosure of how share buybacks affect earnings per share. To quote LTSE's pitch:

By aiming to reduce companies' sensitivity to quarterly pressure and introduce greater accountability for the behaviors that create long-term value, the LTSE is working to forge a new relationship between long-term focused companies and their investors.

To date, shareholders have not generally expressed great preference over a company's exchange listing. LTSE's arrival promises to change that.

D. Director Selection

Today's shareholder cohorts take different approaches to the director selection process. Through the 1970s, corporate directors were chosen by chief executives, who valued shared outlooks and offered unwavering support. From the 1980s through the early 2000s, institutional shareholders gained a greater voice in the selection process as they applied pressure to appoint directors with greater independence. Today, that voice is as fragmented as the shareholder base it is supposed to serve.

¹⁰⁸ See Viet Anh et al., *The curious case of changes in trading dynamics: When firms switch from NYSE to NASDAQ*, J. FIN. MARKETS vol. 41, pp. 17-35 (2018).

¹⁰⁹ Rock, *supra* note 3, at 882.

While it is difficult to determine, empirically, which methods or structures are superior, it is illuminating to highlight some of the important differences among the approach to director selection by today's dominant shareholder cohorts.

1. Stewards. Qs seek directors with a shareholder orientation, business savvy, and interest in the particular company and its stewardship. They are more interested in those particular director traits, and the specific context of a given company, than following general formulas or perceived best practices.¹¹⁰

The number-one question Qs want to know about any director candidates, however, is whether they are shareholder oriented. That is, all directors should act as if there is a single absentee owner and do everything reasonably possible to advance that owner's long-term interest.

This is not a mandate for the immediate maximization of shareholder value, but rather a mentality to evaluate every decision from the shareholder perspective. To that end, it is desirable for directors to buy and hold sizable personal stakes in companies they serve, so that they truly walk in the shoes of owners.

The board's most important job is selecting an outstanding CEO. If the board secures an outstanding CEO, it will likely face few other major problems. All CEOs must be measured according to a set of performance standards. A board's outside directors must formulate these standards and regularly evaluate the CEO in light of them—without the CEO being present.

Standards should be tailored to the particular business culture but should stress fundamental baselines, such as returns on shareholder capital and progress in market value per share over multiple years. Above all, directors should evaluate the CEOs record on capital allocation measured against a hurdle rate it sets.

Directors need to think independently to tighten the wiggle room that “long-term” gives to CEOs: although corporate leaders should think in terms of years, not quarters, they must not rationalize sustained subpar performance by perpetual pleas to shareholder patience. After all, long-term can be excessive, passing into a euphemism for endless mediocrity. The solution: directors who insist on achieving measurable intermediate goals as well.

If the CEO's performance persistently falls short of the standards set by the directors, then the board must replace the CEO. The same goes for all other senior managers boards oversee, just as an intelligent owner would if present. In addition, the directors must be the stewards of owner capital to contain any managerial overreach that dips into shareholders' pockets. Such pickpocketing can range from imperious acquisition sprees to managerial enrichment through interested transactions or even myopia amid internal scandal and related crisis.

In addressing these problems, the director's actions must be fair, swift, and decisive. Directors who perceive a managerial problem should immediately alert other directors to the issue. If enough are persuaded, concerted action can be readily coordinated to resolve the problem.

Here, too, shareholders can play a role. As discussed in chapter 7, companies can make their directors available to their largest long-term Qs. These representatives can discuss issues put to shareholder votes that affect enduring value. A few influential Qs, acting together, can

¹¹⁰ See Lawrence A. Cunningham, *Warren Buffett's Ten Commandments for Directors*, NACD DIRECTORSHIP (July-August 2017).

effectively reform a given company's corporate governance simply by withholding their votes for directors who were tolerating odious behavior.

2. Formulaic Selection. Indexers seldom nominate directors. In fact, during the past five years, none of the largest three indexers—which own enormous swaths of corporations worldwide—have formally nominated a single director to any public company board.¹¹¹

Large indexers adopt their own guidelines stating general criteria for selection and voting while others consult the similar guidelines produced by proxy advisers. Index proponents repeatedly express their view that popular governance reform features are good for most companies across a portfolio, not necessarily for all.¹¹²

Consider the approach of the leading proxy adviser, Institutional Shareholder Service (ISS). ISS opens its discussion of the board of directors not with statements of competence or corporate stewardship, but with “four fundamental principles [that] apply when determining votes on director nominees.”

These are enumerated as independence, composition, responsiveness and accountability. Only the assessment of “responsiveness,” tends to be contextual—a statement of voting “case-by-base.”

On independence, ISS makes three prescriptions: (1) a majority of directors must be independent; (2) the board must have three standing committees operating under formal charters and staffed only with independent directors—audit, compensation, and nominating; and (3) there must either be a lead independent director or an independent chairman (not also serving as an executive officer).

Many such rules have become commonly accepted in recent decades, but the empirical evidence on their economic value remains inconclusive.¹¹³ While the prescribed committees and their functions are required by federal law or stock exchange rules, director expertise is often of even greater value than independence. Unmentioned by the indexers are valuable alternatives such as committees on capital allocation or investment—as described above.

While indexers support a rule splitting the chair and CEO roles, it is not always desirable. The theory is that boards elect and oversee the CEO so having one person wear both hats creates a conflict. Yet that is only one vote among boards with many independent directors, so any conflict can easily be neutralized.

Many corporations thrive when led by an outstanding person serving as both chairman and chief executive just as others have failed when the roles are split. Companies are about evenly divided on the practice: about half the S&P 500 split the functions while the other half combine

¹¹¹ Bebchuk & Hirst, *supra* note ____.

¹¹² Fisch et al., *supra* note ____.

¹¹³ E.g., Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002); Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, FED. RES. BANK NY ECON. POL'Y REV. 7 (2003); Lawrence A. Cunningham, *Rediscovering Board Expertise: Legal Implications of the Empirical Literature*, 77 U. CINN. L. REV. 465 (2008); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447 (2008).

them. Qs appear to think about this case-by-case and, if anything, slightly favor companies that combine rather than split the functions.¹¹⁴

On composition, ISS again states three rules: (1) directors should have diverse skills that add value to the board, rather than duplicating backgrounds from particular viewpoints, ideally presented in a graphical skills matrix to illustrate; (2) regular meeting attendance is expected, defined as at least 75% of meetings of the full board and committees; and (3) attention is expected, determined by caps on the number of public company boards individual directors may serve—five in general or two for CEOs.

Critics challenge these composition directives as intrusive and formulaic. Taking (2) and (3) first, attendance and attention are clearly necessary, but not sufficient, to determine a valuable board member. Rules of thumb are useful, but that's not how these rules operate. That is why the board of directors' section of so many corporate websites portray check marks ticking off all the governance formulas that major indexers and proxy advisors champion.

While it is prudent to be concerned about anyone stretching themselves too thin, an artificial definition, such as a maximum of two or five boards, is arbitrary and bound to miss the mark often. After all, outstanding directors with no other occupation can almost certainly handle more than six, while the least conscientious busy professional might find one too much.

On accountability, ISS calls for regular director elections, opposes staggered terms, and believes in shareholder removal power, with or without cause. But state corporate law permits all these and many other approaches to director election and removal, and leaves it to companies to choose those best suited for their circumstances.

On staggered boards, proponents stress advantages such as continuity and institutional knowledge while critics cite insulation from accountability. But answers to such issues require context. Some evidence indicates that staggered boards add value.¹¹⁵ Companies continue to be divided on the right approach.¹¹⁶ What's clear is that ISS favors regimentation over context on this issue and many others where QS prefer a contextual approach.¹¹⁷

¹¹⁴ The assertions in this paragraph are based on comparing data on companies with and without split chair-CEO functions to CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 2, at App. A (QS Density Ranking). For instance, within the S&P 500, 229 split and 245 combine the roles; of these, 216 and 234, respectively, appear in the QSDR. Of those splitting, 16% are in the top 10%, 40% in the top quarter, and 89% in the top half; of those combining, 28% are in the top 10%, 57% in the top quarter, and 84% in the top half.

¹¹⁵ See K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67 (2016).

¹¹⁶ See Bebachuk & Hirst Bebachuk & Hirst, *supra* note **Error! Bookmark not defined.** (indicating that about half the Russell 3000 companies have staggered boards). According to Wharton Research Data Services WRDS, within the S&P 500, 61 companies have staggered boards. Comparing these 61 and a random sample of 61 with unitary boards to CUNNINGHAM, QUALITY SHAREHOLDERS, *supra* note 2, at App. A (QS Density Ranking), 14% of the staggered board companies are in the top 10% of quality shareholder density versus 37% of the unitary board company sample in the top 10%.

¹¹⁷ A final prong of ISS's accountability plank prescribes that each board undertake regular performance reviews of itself. This is another fashion in corporate governance that is reinforced by consulting firms offering the service CHRISTOPHER D. MCKENNA, THE WORLD'S NEWEST PROFESSION:

Just as major indexers do not nominate directors, they rarely initiate shareholder proposals. For instance, their guidelines express a preference for annual director elections rather than for staggered board terms. While indexers often support related proposals by other shareholders, the largest among them have never put forth their own proposals to make such a change.¹¹⁸

Defenders of indexers urge deference to their relative intervention, saying their vast economies of scale warrant presuming that their decisions are in the best interests of their investors.¹¹⁹ Critics of indexers say these practices show they are beholden to management.¹²⁰ Still others chalk this up to “rational reticence:” proponents incur all costs of proposals but gain a fraction of the payoff, so it is rational to free ride by supporting others without taking the lead.¹²¹

The notion of rational reticence may be reinforced by a further possibility: the guidelines reflect “best practices” that are *probably desirable for most* while indexer inaction reflects that such practices are *certainly undesirable for some*. If indexers lack resources to determine what is best in given cases, the rational strategy may be to avoid taking the initiative but to support others who do so.

E. Dual Class and Voting

The shareholder cultivation literature has devoted considerable attention to alternative capital structures and voting regimes, especially dual class shares and weighted-voting. Professor Rock opines that dual class shares are costly and infrequent but seems to work in maintaining controlling-shareholder structure.¹²² Professor Masulis observes that dual class shares may have an adverse effect where insiders extract self-benefit and reduce company value to outside shareholders.¹²³

One alternative is tenured voting (time-phased voting). These plans give long-term shareholders more votes.¹²⁴ The logical upshot of the foregoing updating of the shareholder cultivation literature, of course, would be to refine tenured voting further to give quality shareholders more votes.¹²⁵ While administrative challenges appear, the appeal to QS as a cultivation tool may be the most compelling of all. Certainly, it deserves a prominent place on both the corporate menu and the scholarly debating room.

MANAGEMENT CONSULTING IN THE TWENTIETH CENTURY (2006). The task of self-evaluation, while important, is challenging, and observers are justified in skepticism about the results.

¹¹⁸ Bebchuk & Hirst, *supra* note ____.

¹¹⁹ Fisch et al., *supra* note ____.

¹²⁰ *Id.*

¹²¹ Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Activism*, 113 COLUM L. REV. 863 (2013).

¹²² Rock, *supra* note 3, at 899.

¹²³ Masulis, *supra* note 13.

¹²⁴ Dallas, *supra* note 8.

¹²⁵ I have extensively discussed quality voting, as well as dual class and tenured voting, *see* Cunningham, *supra* note 16, so refer readers to that analysis rather than repeat it.

CONCLUSION

This Article significantly expands the literature on corporate cultivation to shareholders to sculpt a shareholder base. The premise for doing so is intuition and evidence about the value to corporations, and society, of a substantial cohort that is both patient and concentrated. A high density of such shareholders is associated with superior corporate performance. In a world increasingly dominated by index investors, a vibrant QS cohort is especially vital. Managers wishing to attract QS in greater density can use both communications channels and substantive decisions to attract QS and repel others. In reviewing these tools, the Articles adds to the case for empowering quality and outlines numerous tools available to corporate managers to do so. While all shareholders contribute something to corporate life, cultivating quality promises outsized rewards to managers and investors alike. This Article can be seen as an updated playbook