

**DOES SHAREHOLDER-SPONSORED CORPORATE GOVERNANCE
PROPOSAL MATTER? THE CASE OF
EXECUTIVE COMPENSATION**

by

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ABSTRACT

DOES SHAREHOLDER-SPONSORED CORPORATE GOVERNANCE PROPOSAL MATTER? THE CASE OF EXECUTIVE COMPENSATION

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This study investigates the role of shareholder-sponsored corporate governance proposals in monitoring top management compensation. In particular, I test whether theories of agency costs, corporate governance, and optimal contracting can explain why shareholders submit executive-pay proposals, and examine the economic consequences of these shareholder proposals for the targeted firms.

I find that firms are more likely to receive performance-oriented shareholder executive-pay proposals when the firms have higher agency costs, stronger shareholder rights, or higher unexpected executive compensation. Shareholder executive-pay proposals gain more voting support from shareholders if the proposals

are performance-oriented (than non-performance-oriented), sponsored by pension or union funds (than individual or religious groups and other institutions). In one year subsequent to the year of receiving performance-oriented shareholder executive-pay proposals, proposal firms' executive pay-performance sensitivities in stock option grants, and cash and total compensation increase more than control firms'. In addition, CEOs' compensation structures shift more toward equity-based for the proposal firms than for control firms in the year subsequent to the proposal year.

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CHAPTER 1

INTRODUCTION

Institutional and individual investors have frequently used shareholder proposals to express their concerns about top management compensation. For example, shareholder executive-pay proposals have been among the most frequently included shareholder proposals in corporate proxy statements since 2003¹. In 2007, the number of shareholder executive-pay proposals was nearly double the 2006 figure². However, the role of the shareholder proposal in the executive pay-setting process has received relatively little attention in the extant accounting and finance literature.

In this thesis, I investigate why shareholders submit executive-pay proposals and analyze how shareholders and firms react to these proposals. The remainder of this chapter includes a brief background and motivation in Section 1.1, the originality and contribution in Section 1.2, and the organization of the rest of this study in Section 1.3.

1 According to Georgeson Inc., the number of voted shareholder executive-pay proposals had the highest proportion in 2003, 2004, and 2005.

2 According to Institutional Shareholder Services and The Wall Street Journal, shareholders submitted 266 executive-pay proposals through March 9 for the 2007 proxy season, nearly doubling the number submitted in the same period in 2006.

1.1 Background and Motivation

In 1942, the Securities Exchange Commission (SEC) promulgated Rule 14a-8, usually called the Shareholder Proposal Rule, in accordance with the Securities Exchange Act of 1934. This rule, revised many times (see Figure I for a timeline for major events), is a “formal mechanism through which concerns about corporate governance and corporate performance can be raised.”³

The Shareholder Proposal Rule allows eligible shareholders to present their proposals in a company’s proxy statement for a vote at shareholder meetings. When the management receives the proposal, it can 1) include the proposal in the proxy, 2) negotiate with the shareholders for a withdrawal, or 3) request that the SEC not penalize the company if it excludes the proposal from the proxy based on The Rule’s provisions of exclusion. SEC staff can 1) ask the company to include the proposal in the proxy, 2) agree to exclude the proposal, or 3) give the shareholders a chance for a revision.

During the 1950s, the number of total shareholder proposals submitted was about 860. That number soared to more than 2,600 and 7,000 during the 1980s and the 1990s, respectively (Brownstein and Kirman, 2004)⁴, partly because the 1992 proxy rule reform significantly increased communication between shareholders and enabled

³ Gillan and Starks (2000), p. 276. (9.)

⁴ These figures are cited from different sources by Brownstein and Kirman (2004). Some are “pre-1997 figures from W Trexler Proffitt, Jr., *The Evolution of Institutional Investor Identity: Social Movement Mobilization in the Shareholder Activism Field* 128-29 (2001) (unpublished Ph.D. dissertation, Northwestern University) (on file with authors), who compiled them from IRRC data, Gilbert Annual Reports, and company proxy statements”. Figures after and including 1997 were provided directly by the IRRC or ISS.

them to coordinate “in proxy contests against management ... at a significantly reduced cost” (Thomas and Martin, 1999). According to a 2006 report by Georgeson Inc., a proxy advisory firm, currently popular issues include board-related policies, executive compensation, poison pill rescission, and declassification of the board, all of which are important corporate governance structures⁵.

The ascending role of shareholder corporate governance proposals has roots in the rise of institutional investors in the 1970s and 1980s when institutional investor holdings of total outstanding equity in the U.S. increased from a 6.1% in 1950 to close to 20% in 1970 to more than 37% in 1980. From the late 1980s through the 1990s, pension funds such as CalPERS, labor funds such as AFL-CIO affiliated funds, and other institutional shareholders were instrumental in making the shareholder proposal into a low cost corporate governance mechanism. However, the effectiveness of this mechanism remains uncertain.

There are number of studies that examine the role of shareholder proposals in corporate governance. Some investigate the short-term or long-term market or operating performance of the firm (Del Guercio and Hawkins, 1999; Gillan and Starks, 2000; Karpoff, Malatesta and Walkling, 1996; Prevost and Rao 2000; Smith,

⁵ Declassification means elimination of a classified board system, where only part of the whole board is elected in any given year, which could prevent timely changes of the composition of a board even when situation warrants such changes. Anti-takeover devices refer to provisions in corporate by-law or charter making an acquisition prohibitively expensive to an unwelcome acquirer. The colloquial term for such an often used tactic is “poison pill” (or “shareholder rights plan”). Under such a provision, the target company will issue securities to the remaining shareholders at bargain prices, making a dilution to the point that it is impractical for the bidder to control the target company through open market purchases.

1996; Strickland, Wiles and Zenner, 1996; Wahal, 1996). Others analyze the proxy voting outcomes as shareholder reactions (Bizjak and Marquette, 1998; Gillan and Starks, 2000; Thomas and Martin, 1999; Wahal 1996). Still others examine management turnover (Karpoff, Malatesta and Walkling, 1996), executive compensation (Johnson, Porter and Shackell, 1997; Thomas and Martin, 1999), anti-takeovers mechanisms (Bizjak and Marquette, 1998; Del Guercio and Hawkins, 1999), or other corporate governance related changes (Loring and Taylor, 2006; Tkac, 2006) subsequent to shareholder proposals.

The results from these studies appear inconclusive. For instance, Del Guercio and Hawkins (1999) find that shareholder proposals are followed by significant additional corporate governance changes, such as asset sales and restructurings. Karpoff, Malatesta and Walkling (1996) find that governance proposals have a negligible effect on firm value, operating performance, top management turnover, and firm policies. Bizjak and Marquette (1998) document that the announcements of poison-pill rescission proposals are associated with negative returns, and that firms are more likely to restructure or rescind poison pills when such proposals are present. Johnson, Porter and Shackell (1997) report that receiving shareholder proposal is not associated with a subsequent increase in cash compensation's sensitivity to firm performance. Thomas and Martin (1999) discovered that proposals restricting executive compensation are more likely to gain voting support than those simply

asking for more disclosure, and that higher voting support is associated with lower change in annual cash payout.

Despite the conflicting results in the extant research over time, shareholders increasingly urge corporate governance changes through shareholder proposals. According to Georgeson Inc., the number of voted corporate governance shareholder proposals increased 62% from 237 in 2002 to 385 in 2006. Among all proposals, executive-pay proposals were the highest proportion in 2003, 2004, and 2005 (Figure II). Why do shareholders file such proposals? Why in recent years have shareholders concentrated so much on the executive pay issue among all corporate governance structures? One approach to understand these questions is to examine whether or not shareholder proposals affect corporate governance through executive compensation.

One of the most controversial issues concerning executive compensation involves the CEO's pay. Advocates of CEO pay argue that at the current level CEOs are not overpaid, because the growth in CEO pay is due to greater risk bearing and increased demand for talent (Core, Guay and Thomas, 2005). They also maintain that CEOs do have increasing incentives (Hall and Liebman, 1998), and that there is little evidence for optimal contracting or for CEOs having too much freedom to unwind the incentives (Core, Guay and Thomas, 2005).

Critics contend that the CEO pay-setting process itself is flawed – the contracting between CEOs and boards has been shadowed by pervasive managerial influence (Bebchuk and Fried, 2005b). For instance, the pay-performance relation may

be at stake when executives are paid more from market upturns but receive not much less from market downturns, especially under weak corporate governance (Garvey and Milbourn, 2006). When shareholders consider the board not effective in aligning agents' interest to that of the shareholders in the executive pay-setting process, they may exert whatever influence they can on the board, be it private negotiation, corporate governance proposal, proxy contest, takeover, or litigation. This thesis focuses on shareholder executive-pay proposals, particularly those proposals that target firm pay-for-performance policies⁶.

1.2 Originality and Contribution

Despite of a growing body of research on corporate governance proposals, there have not been many studies showing significant impact of corporate governance proposals sponsored by shareholders. Some detect negligible or small changes in governance structures, accounting performance, or abnormal stock returns (Karpoff, Malatesta and Walkling 1996; Gillan and Starks 2000; Wahal, 1996). The studies that do find some influence focus either on a specific type of proposal (Bizjak and Marquette, 1998), a single sponsor – CalPERS (Smith, 1996), or the proposals sponsored by institutional investors (Del Guercio and Hawkins, 1999; Gillan and Starks 2000; Prevost and Rao, 2000).

⁶ Such issues include but not limited to tying pay and performance more closely, and executive severance and pension/retirement policies.

There has been even less empirical evidence on shareholder executive-pay proposals. Johnson, Porter, and Shackell (1997) document that the receiving of shareholder proposal is not associated with significant changes in the level of total compensation or a subsequent increase in the sensitivity of cash compensation to firm performance. Thomas and Martin (1999) discovered that proposals restricting executive compensation are more likely to gain voting support than those simply asking for more disclosure, and that higher voting support is associated with lower change in annual cash pay.

Thomas and Martin (1999) also document that firms with executive-pay proposals tend to be large, underperforming, and have high level of pay. However, they do not test other corporate governance factors that may increase the likelihood of shareholders submitting executive-pay proposals.

Moreover, there were very few performance-oriented shareholder executive-pay proposals in the sample period of these studies. Johnson, Porter, and Shackell (1997) test only those firms that have CEO compensation in excess of \$1 million. Thomas and Martin (1999) take all available executive-pay proposals with varied agendas. The mixed economic effects of those proposals may have uncertain directions and therefore are less predictable. Thus, it would be very hard to detect subsequent changes in pay-performance sensitivity or shift in incentive pay structure for both studies.

This study contributes to the body of research in corporate governance and executive compensation by reexamining the role of shareholders' governance proposals in aligning managers' interest to that of the shareholders'⁷. In particular:

- 1) I investigate whether high agency costs and some corporate governance characteristics increase the probability of shareholders submitting executive-pay proposals. For instance, I test the roles of managerial ownership, the horizon problem, the strength of shareholder rights, and the monitoring cost in determining the likelihood of a firm receiving a shareholder executive-pay proposal.
- 2) I extend the corporate governance proxy voting literature by examining the voting outcome and the systematic variations in one particular class of proposal – shareholder executive-pay proposal – in terms of the type and sponsor of the proposal.
- 3) This study contributes to the executive compensation literature by introducing the shareholder executive-pay proposal as an additional factor determining pay-performance sensitivity. No studies to date on the determinants of pay-performance sensitivity have found the shareholder executive-pay proposal as a statistically significant determinant. In this study, I document the impact of shareholder executive-pay proposals on

⁷ For example, the roles of shareholder proposals on executive compensation were examined by Johnson, Porter, and Shackell (1997), and Thomas and Martin (1999). However, this paper conducts an reexamination from different perspectives.

subsequent pay-performance sensitivities as well as executive-pay structures.

1.3 Organization of This Study

The remainder of this study is organized as follows: Chapter Two provides the institutional background of shareholder-sponsored corporate governance proposals. I revisit the history of shareholder initiatives in corporate governance, explore the legal environment of the Shareholder Proposal Rule, and review the existing evidence on shareholder proposals. In Chapter Three I discuss the controversies and evidence in top management compensation. Chapter Four examines the history of shareholder sponsored executive-pay proposals and develops testable hypotheses as to why these proposals exist and what the consequences are. I describe the sample selection procedure and research methodologies in Chapter Five. Chapter Six presents the empirical results. Finally, Chapter Seven concludes with the implications of the findings in this study for existing research in corporate governance, shareholder voting, and executive compensation.

CHAPTER 2

BACKGROUND OF SHAREHOLDER PROPOSALS

2.1 The Shareholder Proposal Rule

Revised numerous times since its inception, the Shareholder Proposal Rule in its current form generally allows eligible shareholders to make their proposals to be presented in a company's proxy statement for a vote at shareholder meetings.

Shareholder proposals submitted under this rule become increasingly popular because they are much less expensive than other corporate governance measures such as tender offer or proxy contests (Eisenhofer and Barry 2006). The total number of shareholder proposals soared to more 7,000 in the 1990s from about 860 in the 1950s (Brownstein and Kirman, 2004)⁸. In 2005 alone, there were over 1,100 shareholder proposals (McCarthy, 2005)⁹. These numbers do not exclude those that were withdrawn for various reasons.

2.1.1 How Shareholder Proposal Works

Here is how the shareholder proposal works. Essentially, there are three parties involved:

⁸ These figures are cited from different sources by Brownstein and Kirman (2004). Some are "pre-1997 figures from W Trexler Proffitt, Jr., *The Evolution of Institutional Investor Identity: Social Movement Mobilization in the Shareholder Activism Field* 128-29 (2001) (unpublished Ph.D. dissertation, Northwestern University) (on file with authors), who compiled them from IRRC data, Gilbert Annual Reports, and company proxy statements". Figures after and including 1997 were provided directly by the IRRC or ISS.

⁹ The figure is cited from *The Corporate Library* by Michael McCarthy, "Exec, Shareholders Don't Get Mad – They Get Even," *USA Today*, May 15, 2005.

- a) an eligible proponent,
- b) the management of a company, and
- c) the staff in SEC's Division of Corporate Finance (SEC staff).

The proponents of shareholder proposals could be blockholders (Gordon and Pound, 1993), small individual shareholders (Strickland, Wiles and Zenner, 1996), pension funds (Gillan and Starks, 2000), non-profit organizations, or other institutional shareholders.

To meet the minimum eligibility requirement, a proponent has to have an ownership of at least \$2,000 in market value or 1% of voting shares with a holding period of at least one year and through the date of the annual meeting, and to attend (or authorize a qualified representative to attend) the meeting to present the proposal¹⁰. An eligible proponent may submit to a company's management a proposal with supporting statements (not exceeding 500 words) to be included in the company's proxy materials.

When a company's management receives the proposal, it can respond in three ways:

- a) to include the proposal in the proxy materials;
- b) to negotiate with the proponent for withdrawal; or
- c) to send a request to SEC staff for "no action".

¹⁰ Eisenhofer and Barry (2006) stated that an institutional investor would meet the SEC ownership requirement if it is the "beneficial owner of the securities held by a fund or other collective investment vehicle", and if it includes with its proposal "a written statement by the broker or custodian bank regarding the fund or funds' ownership of shares".

A contentious moment arises when the management chooses to send a “no action” request. A company is allowed to exclude a shareholder proposal without violating SEC rules – that is, triggering no action by the SEC – if the proposal:

- 1) is deemed improper under the laws of the jurisdiction of the company;
- 2) would cause the company to violate any state, federal, or foreign law to which it is subject;
- 3) violates SEC proxy rules including §240.14a-9, which prohibits materially false or misleading statements in proxy soliciting materials;
- 4) relates to personal grievance or special interest not shared by the other shareholders;
- 5) deals with operations valued at less than 5 percent of the company's total assets, or net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business;
- 6) would put the company in a situation where the company lacks the power or authority to implement the proposal;
- 7) deals with a matter regarding the company's ordinary business operations;
- 8) relates to an election for the company's board of directors or analogous governing body;
- 9) directly conflicts with one of the company's own proposals;

- 10) has already been substantially implemented by the company;
- 11) substantially duplicates another proposal to included in the company's proxy materials for the same meeting;
- 12) relates to substantially the same subject matter as another proposal or proposals previously included in the company's proxy materials and supported with less than 3% of the vote at first submission (6% at second submission and 10% at subsequent submissions) within the preceding 5 calendar years¹¹; or
- 13) deals with specific amounts of cash or stock dividends.

If the management seeks “no action” from SEC, it has to send a copy of the request to both the SEC and the proponent, who may decide to rebut the management stance, to withdraw the proposal, or to revise the proposal and resubmit if given the chance by the SEC staff.

SEC staff upon receiving the “no action” request can ask the company to

- a) include the proposal in the proxy statement,
- b) express no view,
- c) agree to exclude the proposal, or
- d) give the proponent a chance for a revision.

¹¹ The exclusion in this situation applies within three years since the latest submission of the proposal.

Such decisions are based on the SEC staff's interpretation of the Rule 14a-8 and other applicable laws and regulations¹².

The following scenario explains the “no action” request process of a 1998 shareholder proposal that specifically asked for Wal-Mart to report on wages:

- A 1998 proposal targeting Wal-Mart – shareholders wanted Wal-Mart to report several issues.
- Wal-Mart's request to the SEC for a no-action letter (Wal-Mart's attempt to throw the resolution out) - the company cites precedence, by naming other employment resolutions which the SEC has thrown out.
- Shareholder's rebuttal - the shareholder rebuts each of the cited cases, and demonstrates that the issue is not mundane, nor lacking in policy significance. The proponent cites news articles, consumer studies, Congressional and White House activity, etc.
- Wal-Mart's final response - the company cites past SEC rulings demonstrating that tying social issues to employment issues doesn't take employment matters out of the realm of ordinary business.
- SEC's no action letter - rules in the company's favor. Wal-Mart excluded the proposal from the company's proxy statement¹³.

2.1.2 The Types and Sponsors of Shareholder Proposals

The types of the proposals cover a wide range of topics including but not limited to:

- a) declassification of the board (Loring and Taylor, 2006)¹⁴,
 - b) social and environmental issues (Tkac, 2006)¹⁵,
 - c) elimination of anti-takeover devices (Bizjak and Marquette, 1998)¹⁶,
- and

12 Sometimes, the SEC staff expresses no view if no clear legal basis is found for either to include or to exclude the proposal from the company's proxy materials.

13 Available at <http://www.foe.org/international/shareholder/fights.html#WalMart>

14 Declassification means elimination of a classified board system, where only part of the whole board is elected in any given year, which could prevent timely changes of the composition of a board even when situation warrants such changes.

15 The social and environmental issues include but not limited to political contributions disclosure, global labor standards, board diversity, equal employment, human rights, sustainability reporting, climate changes, and environmental pollutions.

d) executive compensation (Thomas and Martin, 1999).

Excluding social and environmental issues, the number of shareholder proposals that were voted on increased from 237 in 2002 to 385 in 2006, according to Georgeson Inc., a proxy advisory and solicitation firm. The types of the proposal and the percentage of each type recorded by Georgeson are in Figure II.

According to Georgeson's report, the popular issues voted on include board-related policies¹⁷, executive compensation, poison pill rescission, and declassification of the board. Among all issues, the executive compensation took the top spot in 2003, 2004, and 2005.

Among the sponsors of corporate governance proposals reported by Georgeson (Figure III), labor funds and individuals filed about 80% of all proposals in both 2005 and 2006. The United Brotherhood of Carpenters and Joiners of America filed the most proposals among all sponsors.

2.1.3 Common Exclusions of Shareholder Proposal

When a company seeks to exclude a proposal from the proxy statement, the most commonly cited arguments are

1) that the proposal violates applicable laws because the subject would be improper under the laws of the jurisdiction of the company or because adopting the

¹⁶ Anti-takeover devices refer to provisions in corporate by-law or charter making an acquisition prohibitively expensive to an unwelcome acquirer. The colloquial term for such an often used tactic is "poison pill" (or "shareholder rights plan"). Under such a provision, the target company will issue securities to the remaining shareholders at bargain prices, making a dilution to the point that it is impractical for the bidder to control the target company through open market purchases.

¹⁷ Board-related matters include majority vote to elect directors, independent board chairman, director term limit, etc.

proposal would cause the company to violate any state, federal, or foreign law to which it is subject¹⁸; or

2) that the proposal deals with a matter regarding the company's ordinary business operations (the “ordinary business” rule).

Although the SEC has changed positions from time to time, it generally allows companies to exclude proposals that fall into the “ordinary business” category or are phrased as binding or mandatory upon the board, because the SEC believes that most state corporate laws consider the board having “exclusive discretion in corporate matters”. Thus according to the SEC, directing a company’s board to take certain actions through shareholder proposals would be against most state laws. Therefore, SEC staff recommends that shareholders use “precatory” rather than mandatory wording in their proposals. Thus, the proposals usually are nonbinding even if they are approved by a majority vote (Eisenhofer and Barry 2006).

However, shareholders increasingly file by-law proposals to circumvent this rule. Whether a mandatory by-law proposal by itself violates state laws or other applicable laws is highly controversial in the legal profession and the corporate law systems. The controversy arises from the apparently competing rules stipulated in Section 109(b) and Section 141(a) of the Delaware General Corporation Law. The first rule emphasizes the rights of the shareholders to influence “business affairs” of a corporation; the latter stresses that the management is responsible for business

¹⁸ Rule 14a-8(i)(1) and Rule 14a-8(i)(2).

operations (Eisenhofer and Barry 2006). Without lingering on the legal details of the two rules, it is suffice to say that the conflicting court judgments of late based on these two rules staged a constant battleground between shareholder activists and corporations.

2.1.4 The 1992 Proxy Reform and Shareholder Communication

One cannot discuss corporate governance proposals without analyzing the drastic changes in shareholder communications brought by the 1992 proxy reform. According to Choi (2000), “proxy solicitations serve to inform shareholders on corporate voting issues and garner shareholder votes on these issues.” As mentioned earlier, the Shareholder Proposal Rule contains numerous restrictions on shareholder proposals included in company proxy statements, including the one limiting the length of a proposal to only 500 words. Consequently, communications between shareholders other than the proposal in the proxy statement become critical to generate voting support. Unfortunately, such communication was severely constrained by the proxy rules prior to the 1992 reform. Before 1992, the SEC Rule 14a-1(1) treats any communication “reasonably calculated to affect voting decisions” as a “solicitation” of a proxy (Choi, 2000). Choi (2000) explicitly describes how onerous and costly it was for shareholders to communicate with each other on voting issues prior to the 1992 proxy reform:

“Solicitations are not allowed until a formal proxy statement containing information specified by the SEC is delivered to the solicited shareholder. Proxy solicitations are also subject to coverage of Rule 14a-9’s antifraud provisions... Investors communicating with one another on how to respond to an issue proposal, therefore,

potentially must file a preliminary proxy statement with the SEC, wait for SEC approval, and then mail a formal proxy statement to all those privy to the communications. Aside from imposing direct mailing and filing costs as well as delays, this regime discourages communications by those investors desiring anonymity. Because proxy statements are required to be filed publicly with the SEC, the proxy company and other shareholders are able to determine not only the identity of communicating parties but also the substance of such communications. Moreover, because Rule 14a-9's antifraud prohibitions apply to all proxy solicitations, investors also face the specter of potential antifraud liability. Pound (1991:271-274) provides anecdotal evidence that the possibility of nuisance suits brought by incumbent management for violation of the proxy rules raises the costs of proxy communications and hampers the private supply of information."

The 1992 proxy reform made several exemptions and narrowed the definition of "proxy solicitation" to communications that seek "the right to vote on behalf of another shareholder" (Choi, 2000; Heard, 1995). Proxy solicitation exemptions allow shareholders to publish their views through various media on how they intend to vote and their voting guidelines, and shield the communicators from antifraud prohibitions (Choi, 2000; Heard, 1995; Thomas and Martin, 1999). As Choi (2000) points out, "the reforms increased in theory the flow of privately supplied information", enhanced the "ability of shareholders to communicate anonymously and at lower costs, especially where shareholders fear alienating management", and alleviated the "collective action problem facing individual shareholders."

The implications of the 1992 proxy reform on shareholder corporate governance proposal are two-fold. First, the management became more willing to talk to shareholders because it recognized an increased likelihood of a proposal being successfully included in the proxy statement due to the enhanced shareholder interactions. Shareholders would prefer private pressures on the management to a

more expensive proposal if such pressure can induce intended managerial actions (Gillian and Starks, 2000). On the other side, the reform “enabled shareholders to engage in proxy contests against management ... at a significantly reduce cost” (Thomas and Martin, 1999), therefore allowing more proposals to be filed at lower cost by certain shareholders if the management refused to talk to them.

2.1.5 Shareholder Proposals and Executive-Pay

The 1992 proxy reform was ostensibly accompanied by another reform – the reform on executive pay disclosure. As discussed later, the revised disclosure rule requires drastic changes in the way companies present their top executive compensation. This reform made available more detail information on components of executive pay, which had not been accessible to the public. Also in 1992, the SEC reversed a previous position so that shareholder proposals on executive-pay can no longer be excluded based on the “ordinary business” rule (Thomas and Martin, 1999).

The new disclosures and the SEC’s new position on executive-pay issues provided ample ammunition to shareholder activists to monitor executive pay through shareholder proposals. According to the data tracked by Investor Responsibility Research Center (IRRC), a corporate governance research organization, the number of shareholder executive-pay proposals increased from a paltry 14 in 1990 to 201 in 2004, a jump of more than thirteen times¹⁹. I will describe in detail these shareholder proposals in Chapters Three and Four.

¹⁹ According to IRRC data identified in Gillian and Starks (2000) and in Eisenhofer and Barry (2006).

In December 2006, yet another pay disclosure rule promulgated by the SEC went into effect. In addition to previous requirements, this most recent rule commands public companies to disclose in detail the deferred compensation, the value of the vested stock options, the severance packages, the aggregate increase in actuarial pension value, and the perquisites valued at least \$10,000 for top executives²⁰. As discussed later, the perquisites, the severance packages, and the pension value are among the most opaque portion of the top management compensation to date. In a recent study of 100 firms that disclosed, Paul Hodgson of the Corporate Library finds that the amount of perks given to CEOs under the “other annual compensation” in 2006 were 131% higher than in the same category in 2005²¹. Such new revelation puts “the rewards of America's company bosses face yet more scrutiny and attack²².” In fact, The Wall Street Journal reported that shareholders submitted 266 executive-pay proposals through March 9 for the 2007 proxy season, nearly doubling the number submitted in the same period in 2006 (Lublin and Dvorak, 2007).

2.1.6 Recent Development on Shareholder Proposals

The distaste for “sky-high pay [of top executives] despite poor corporate performance” has united various groups of stakeholders, including corporate lawyers, university professors, legislators, state officials, fund trustees, and union leaders

Institutional Shareholder Services (ISS) recently acquired IRRC's commercial business in 2005. RiskMetrics Group, a former division of JP Morgan and a leading financial risk management firm, acquired ISS in January 2007.

20 SEC Votes to Propose Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters. <http://sec.gov/news/press/2006-10.htm>

21 The Economist, The politics of pay - Executive salaries, 24 March 2007.

22 The Economist, The politics of pay - Executive salaries, 24 March 2007.

(Lublin and Dvorak, 2007). This new movement started when large corporate scandals early this decade “outraged investors and fueled reform-minded groups to press companies as never before to clean up their acts²³.” The number of shareholder executive-pay proposals nearly quadrupled from 40 in 2002 proxy season to 144 in 2003 proxy season for S&P 500 firms²⁴. Recent revelations about CEOs large exit packages and “rigged stock options” helped stoke the fire once again. Rep. Barney Frank introduced legislation to give shareholders a vote on executive-pay²⁵. In addition, “a number of large institutional investors have announced their intention to focus heavily on compensation matters” (Finseth and Carlson, 2007). Indeed, The Wall Street Journal proclaimed that the “unusual new movement” “has turned executive-pay activism into a potent mainstream force” (Lublin and Dvorak, 2007).

The post-Enron regulatory changes (i.e. Sarbanes-Oxley Act of 2002 and NYSE compensation committee independence) and pending regulations increase the personal liabilities of the directors. According to Jesse Brill, a corporate lawyer, directors had rarely paid off their legal liabilities personally until 2005, when Enron’s directors paid \$13 million out of their own pockets. As a result, corporate management became more responsive to shareholder corporate governance proposals (Eisenhofer and Barry, 2006). The New York Times reported that the number of

23 Trigaux, R., Corporations start to listen as shareholders find their voices, St. Petersburg Times, 17 Feb. 2003. The scandals swept through some of the largest business organizations such as Enron, Worldcom, Global Crossing, Adelphia, and Tyco.

24 Data collected by this author.

25 His bill was approved by the House Financial Services Committee in March 2007 and will likely be considered by the House of Representatives in April 2007.

companies responded to these shareholder proposals by changing part of their corporate behaviors increased from 17% in 2002 to 28% in 2003²⁶.

In 2003, the SEC proposed a new proxy rule revision, which is still pending approval. The new rule, dubbed the “shareholder access” rule, would allow shareholders to nominate their own slate of candidates to the board of directors. Corporations fiercely oppose this proposed revision because such shareholder access could dramatically change the current balance of power in corporate boardrooms.

Given the uncertain prospect of the proposed shareholder access rule, shareholders adopted other means to participate in corporate governance. Some began to file the controversial binding by-law proposals²⁷. Others managed to get “say on pay” proposals onto proxy statements²⁸. Still others push for “majority voting” of directors, which means a director can be elected only if she gets a majority of votes, instead of the “plural voting”, which means the directors with the most favorable votes (the “for” votes) are elected, regardless of the number of unfavorable votes (the “abstain” or “withhold” votes)²⁹. Shareholder proposals to adopt the majority-voting standard have gained traction among the institutional investors, because the influential

26 Morgensen, G., An emboldened investor class is not likely to go away soon, *The New York Times*, 3 March 2004.

27 Mentioned earlier in Section 1.2.3.

28 For example, *The Wall Street Journal* reported that shareholders at about 60 companies (including Citigroup Inc., Wells Fargo & Co., WellPoint Inc. and Northrop Grumman Corp.) sought an “advisory vote on executive pay” in the 2007 proxy season. The shareholders “hope that public censure, or the threat of it, would prompt directors to curb outsized awards and better link pay with performance”. (Source: Erin White and Aaron O. Patrick, *Shareholders Push for Vote on Executive Pay*, 2/26/2007, *The Wall Street Journal*.)

29 Under the plurality standard, a director with only one “for” vote still can win even if all the other votes are “withheld”. This standard makes it very difficult to remove incompetent directors.

Institutional Shareholder Services (ISS), a proxy advisory company, supports majority voting.

ISS also supports another increasingly popular form of shareholder activism – the “vote no” campaign. When a board refuses to implement a majority-passed corporate governance proposal, ISS may advise shareholders to withhold votes for the directors at the next board election. Even though such a tactic by itself does not make an elected director “unelected”, it could stir a loss of confidence in the investment community as well as in the public and therefore cause the exit of the director targeted. For instance, Michael Eisner was replaced as the company’s chairman by Disney’s board in 2004 just “hours after shareholders withheld 42% of the vote from him”, and “announced his resignation as CEO several months later” (Eisenhofer and Barry, 2006).

As new tactics evolve, the shareholder’s role in corporate governance also evolves. The question is whether the shareholder corporate governance proposals have their intended impact. In other words, does the shareholder proposal matter in corporate governance?

2.2 Corporate Governance and the Role of Shareholders

According to Gillan and Starks (1998), corporate governance is a “term that is often used, but rarely defined”. They perceive governance as “a nexus of contracts” related to the organization, including forms of entities, operational structures, relations

among participants, and incentive alignment mechanisms. Shleifer and Vishny (1997) view corporate governance as relating to “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” Hamilton (2000) defines the term as “the relationships among the professional managers of a publicly held corporation, its board of directors, and its shareholders.”

A common theme among these views is that shareholders, as participants in the “nexus of contracts” and “suppliers of finance to corporations” (directly or indirectly), are instrumental forces in corporate governance. Shareholders’ role in corporate governance, however, has evolved during the past century in the form of institutional ownership, shareholder activism, and the market for corporate control (Gillan and Starks, 2000; Hartzell and Starks, 2003; Hamilton, 2000). Shareholder activism, particularly corporate governance related shareholder proposals, will be the primary focus of the discussion that follows.

2.2.1 The Rise of Institutional Investors

The increasing role of shareholder activism in corporate governance has roots in the rise of institutional investors in the 1970s to 1980s when the institutional investor holdings of total outstanding equity in the U.S. increased from a mere 6.1% in 1950 to close to 20% in 1970 and more than 37% in 1980 (see Figure IV).

As the institutional holdings continued to rise to over 60% in 2005, the once diffusive stock ownership by individual investors has been gradually transformed into more concentrated stock ownership by institutional investors. Those institutions that

held large block of shares of a company started to pay attention to the corporate policies of the company. When SEC began to allow shareholder proposals on important public policy matters in 1972, institutional shareholders, particularly public pension funds, increased significantly their proposals on corporate behavior during the rest of 1970s (Eisenhofer and Barry, 2006).

2.2.2 Pension Fund and Institutional Activism

Initially, many institutional shareholders focused primarily on social and environmental policies, including but not limited to political contributions disclosure, global labor standards, board diversity, equal employment, human rights, sustainability reporting, climate changes, and environmental pollutions. However, when pension funds such as CalPERS (California Public Employee Retirement System) and TIAA-CREF (Teachers Insurance and Annuity Association – College Retirement Equities Fund) emerged as leading institutions in shareholder activism in mid-1980s, shareholder’s focus began to shift to corporate governance policies. According to Gillan and Starks (2000), pension funds activism started to submit proxy proposals in 1986 and 1987, mostly on corporate governance issues.

CalPERS was instrumental in 1985 of creating the Council of Institutional Investors, which is a nonprofit association of many public, labor, and corporate pension funds³⁰. Like many pension funds and other institutional investors, the Council “has encouraged member funds to use their proxy votes, shareowner

30 The Council of Institutional Investors is an association of 130 public, labor, and corporate pension funds with assets exceeding \$3 trillion. (Feb. 2007, <http://www.cii.org/about/>).

resolutions, pressure on regulators, discussions with companies, and, when necessary, litigation to protect plan assets”³¹. The Council increased interactions and communications between public pension funds and labor funds which began to coordinated effort in corporate governance proxy voting.

2.2.3 Robert Monks, Nell Minow, Labor Funds, and Institutional Shareholder Services

Two influential people have to be mentioned in the history of labor funds and the shareholder activism – Robert Monks and Nell Minow. Monks served as the Administrator (office is now Assistant Secretary) of the Office of Pension and Welfare Benefits Administration (Department of Labor) in charge of the private pension system in the United States in early 1980s³². Under Monks’ leadership, the Labor Department encouraged labor funds to influence corporate governance so as to protect their plan assets in the companies. Public pension funds, albeit not under the administration of Labor Department, heeded its advice and stepped up their efforts in corporate governance related activism.

Leaving the Labor Department, Monks subsequently founded Institutional Shareholder Services (ISS) in 1985. ISS provides proxy advisory services to institutional investors by rendering recommendations that are “often the single deciding factor in contested proxy situations, like for example the merger of Compaq and Hewlett Packard in 2002”³³. Nell Minow served as the president of ISS in its

31 Feb. 2007, <http://www.cii.org/about/>.

32 <http://www.lensadvisors.com/who.html>

33 <http://www.lensadvisors.com/who.html>

early years and before that worked as an attorney in Environmental Protection Agency and the Department of Justice. In 1999 the two founded The Corporate Library, providing corporate governance ratings and informational services. Together they have published several books on corporate governance and shareholder activism since 1991³⁴ and organized the Lens Investment Management, an investment firm utilizing activism to increase shareholder value. According to its website, Lens outperformed S&P 500 index between its inception in 1992 and its closing in 2000 (see Figure V).

As ISS established a completely new industry of proxy advisory, labor funds together with pension funds became the driving force in institutional shareholder activism. Indeed, the primary source of institutional shareholder activism today come from public pension funds and labor funds, whose success is from time to time influenced by ISS' position and voting guidelines on a particular corporate governance issue.

2.2.4 Different Shareholder Initiatives in Corporate Governance

Since shareholder activism's influence on corporations became a "permanent feature of corporate governance in the United States" during the nineteen seventies, there have been several alternatives where a shareholder can participate in corporate governance of a public company³⁵.

34 The books include *Power & Accountability* (Harper Collins, 1991), *Watching the Watchers* (Blackwell, 1996), and three editions of the standard case book, *Corporate Governance*, (Blackwell, 3rd ed. 2004)

35 Vogel, D., 1983, Trends in Shareholder Activism: 1970-1982, *California management review* 25, 3, 68.

The first one is through private negotiations (Carleton, Nelson and Weisbach, 1998), talking with the CEO (and/or the board of directors) of the company to lodge complains, to express concerns, or to provide suggestions. This is the friendliest way.

If the CEO (or the board) does not listen or take appropriate steps to address the issues, the shareholder may exert pressure on the board by withholding votes for the directors (Del Guercio, Wallis and Woidtke, 2005) in director elections.

If the previous two methods do not work, a more costly and forceful tactic for the shareholder is to acquire substantial stake of the company and propose additional slate of directors (or threaten to take such measures), forcing the management either to oblige the shareholder requests or to fight during a proxy contest. However, proxy contests for a shareholder are very costly and have many barriers (Pound, 1988).

The fourth alternative is to take over the control of the company through friendly tender offer (Dasgupta and Nanda, 1997), hostile takeover bid, or leveraged buyout (Hamilton, 2000). Such a measure is most efficient with respect to taking control of a company. Nonetheless, the cost is prohibitively high for most shareholders.

If shareholders lost all hope in a company, they can walk the “Wall Street Walk”, selling the company shares previously held and staying away from the company for good.

An increasingly popular alternative is to file shareholder corporate governance proposals (Gillan & Starks, 2000) according to the Shareholder Proposal Rule based on principles in the Securities Exchange Act of 1934.

Recent encounters between New York Times Co. and one of its large institutional shareholders – Morgan Stanley, reported by The Wall Street Journal, dated March 21, 2007, vividly illustrate how a shareholder takes different levels of initiatives in order to influence corporate governance. Managing 5% of NYT shares, the Morgan Stanley portfolio manager Hassan Elmasry began to contact New York Times Co. (NYT) in 2005, and asked to meet NYT’s chairman Arthur O. Sulzberger Jr. in order to privately negotiate NYT’s strategic direction. When his meeting request was rejected, Mr. Elmasry wrote a cordial letter to Mr. Sulzberger. When Mr. Sulzberger and his board repeatedly defended his strategies in private negotiations without actions to change, Mr. Elmasry went public his position and withheld votes for NYT directors in 2006. Although Mr. Elmasry did not initiate a proxy contest or tender offer, Morgan Stanley CEO John Mack did discuss with other investors about taking over NYT. Additionally, Mr. Elmasry had considered but not acted on the “Wall Street Walk” option – selling the NYT stake. Finally, he submitted shareholder proposals to NYT for the 2007 proxy season recommending the company to declassify the board’s dual-class structure and to separate the roles of chairman and publisher (Ellison, 2007). ISS and Glass Lewis, another influential proxy advisor firm,

recommended NYT shareholders to withhold their votes for directors at the company's 2007 annual meeting (Thomas, 2007; Ovide, 2007)

Although shareholder proposal is a relatively recent mechanism compared to other devices of shareholder governance, there has been some empirical research in this area. I review this line of research in the following section.

2.3 Review of Research on Shareholder Proposals

This section reviews the empirical evidence of the firm and corporate governance characteristics and the consequences of shareholder proposals.

2.3.1 The Puzzle Surrounding the Shareholder Proposal

If a shareholder proposal is nonbinding, why do shareholders submit it? If submitted, what factors drive the voting outcome of the proposal? Does the proposal influence the decisions of the management and the board? Extant research has tried to answer the three questions.

Why do shareholders submit proposals? Research shows that firms with a certain set of characteristics may attract shareholder proposals. For example, shareholder proposals are more common in firms that have poor prior performance, larger size, or higher institutional ownership (Bizjak and Marquette, 1998; Karpoff, Malatesta and Walkling, 1996). Nevertheless, few studies to date have shown empirical evidence on whether agency costs or the strength of shareholder rights can explain why shareholders submit proposals. Agency cost is important because if

agency cost is high the principal may increase monitoring to reduce agency cost. Shareholders may use proposals as a monitoring mechanism. The strength of shareholder rights is important because managers in firms with stronger shareholder rights may feel more pressure by shareholder proposals.

When a proposal appears on a company's proxy statement, what factors would influence shareholders' voting? Gordon and Pound (1993) examine how ownership structure and other firm characteristics affect voting outcomes on corporate governance proposals sponsored by shareholders. They find that the voting outcomes are associated with the governance and performance of target firms, the sponsor identity, proposal type, and ownership by insiders, institutions, and outside blockholders. Later studies largely confirm their findings (Bizjak and Marquette, 1998; Gillan and Starks, 2000).

Compared to the first two questions, the third one is rather controversial – does a shareholder proposal really matter in the decisions of the management and the board? For instance, a firm amends its by-laws for director election from once in three years to once a year after receiving a shareholder proposal with a request of such a by-law change. This amendment could occur because of either a) the shareholder proposal, b) private negotiations between an institutional investor and the management of the targeted company started before the shareholder proposal, or c) some other economic and political changes (Gillan and Starks, 1998).

In spite of the difficulties, there are quite a few studies examining the socioeconomic consequences of shareholder proposals. Some investigate the short-term or long-term market or operating performance (Del Guercio and Hawkins, 1999; Gillan and Starks, 2000; Karpoff, Malatesta and Walkling, 1996; Prevost and Rao 2000; Smith, 1996; Strickland, Wiles and Zenner, 1996; Wahal, 1996). Others analyze the voting outcomes (Bizjak and Marquette, 1998; Gillan and Starks, 2000; Thomas and Martin, 1999; Wahal 1996). Still others examine management turnover (Karpoff, Malatesta and Walkling, 1996), executive compensation (Johnson, Porter and Shackell, 1997; Thomas and Martin, 1999), anti-takeovers mechanisms (Bizjak and Marquette, 1998; Del Guercio and Hawkins, 1999), or other corporate governance related changes (Loring and Taylor, 2006; Tkac, 2006).

Some empirical evidence shows positive effect of shareholder proposals. Strickland, Wiles and Zenner (1996) look into the economic consequences of shareholder proposals sponsored by small investors. They find that small shareholders coordinated by United Shareholder Association (USA) can enhance shareholder value by targeting and sponsoring proposals to firms with poor performance and high institutional ownership, and that there are positive abnormal returns for targeted firms when negotiated settlements are announced between USA and those firms. Studying proposals filed by five of the largest pension funds (SWIB, CREF, CalPERS, CalSTRS, and NYC) during 1987-1993, Del Guercio and Hawkins (1999) find that

shareholder proposals are followed by significant additional corporate governance changes, such as asset sales and restructurings³⁶.

Other empirical evidence indicates negligible effect of shareholder proposals. Karpoff, Malatesta and Walkling (1996) find that shareholder proposals have negligible effect on firm value, operating performance, top management turnover, and firm policies. Black (1998) apparently agrees. He finds that institutions achieve not much effect on firm performance because their efforts are constrained by legal rules, agency costs within the institutions, information costs, collective action problems, and limited institutional competence. Del Guercio and Hawkins (1999) find that the anti-takeover proposals are followed by tenuous short-term and insignificant long-term stock returns or accounting performance.

Still other evidence depicts both negative and positive effect for shareholder proposals. Bizjak and Marquette (1998) document that the announcements of poison-pill rescission proposals are associated with negative returns, that such proposals receive more votes when firm performance is poor, and that firms are more likely to restructure or rescind poison pills when such proposals are present. Prevost and Rao (2000) test voted proposals sponsored by public pension funds in 1988-1994. Their results suggest that a proposal may signal the management's unwillingness or inability to settle with the proposal sponsors, and that short-term negative market reaction

36 SWIB: State of Wisconsin Investment Board; CREF: College Retirement Equities Fund; CalPERS: California Public Employees' Retirement System; CalSTRS: California State Teachers' Retirement System; NYC: New York City Employees' Retirement System.

provides “an incentive for management to accommodate the funds' concerns and avert future proposal submissions”.

2.3.2 The Attempts to Disentangle the Puzzle

Some factors may explain the uncertain and conflicting effects of shareholder proposals. Testing a sample of 100 proxy contests from the period 1981-1985, Pound (1988) finds many difficulties for shareholders to challenge the incumbent management. Among them are management's vote-getting advantage in proxy solicitation process, and institutional investors' reluctance to vote against management due to conflict-of-interest pressures.

Romano (2001) suggests that those “no effect” findings are consistent with the fact that many proposals target corporate governance changes known to have few short-term effects on firm performance. She argues that were investors to refocus more carefully their activities on substantive reforms known to affect performance in the near term, their actions would have a higher likelihood of having a significant impact on firms.

Karpoff (1998) also tries to disentangle the puzzle of the varied performance of shareholder activism. He surveys previous empirical research and concludes that most evidence indicates that shareholder activism can prompt small changes in target firms' governance structures, but has negligible impacts on share values and earnings. He conjectures that discrepancies may arise because of differences in the definition of success.

For instance, using operating performance as the definition for success, shareholder proposals have negligible effects on firm performance (Del Guercia and Hawkins, 1998; Smith, 1996). If success is defined as the abnormal return, shareholder proposals sometimes do enhance firm values conditioning upon settlements between proposal sponsors and targeted firms (Smith, 1996; Strickland, Wiles and Zenner, 1996), and other times destroy firm values conditioning on proposal types (Bizjak and Marquette, 1998; Del Guercio and Hawkins, 1999). Indeed, if success is defined as a withdrawn proposal (which may signal some sort of corporate action through dialogue or settlement), proposals on corporate social responsibilities achieved at least 30 percent success rate in 1992-2002 (Tkac, 2006).

Discrepancies may also arise because of differences in the timing of events (Karpoff, 1998), the sponsor identity, or the types of the proposal analyzed. Karpoff, Malatesta and Walkling (1996) analyze events mainly in the 1980s while Strickland, Wiles and Zenner (1996) focus on events in the 1990s. Moreover, Gillan and Starks (2000) find that the voting outcomes vary across time, and that both voting outcomes and investor short-term reactions vary systematically with sponsor identity and proposal type.

2.3.3 The Puzzle Lives On

Several observations emerge from previous studies on shareholder proposals. Firstly, shareholder proposals do have small effects on corporate governance and firm performance in certain situations (Gillan and Starks, 2000; Karpoff, 1998; Karpoff,

Malatesta and Walkling, 1996). Secondly, whether the small effect is positive or negative, the result is sensitive to how the success is operationalized (Karpoff, 1998). Thirdly, some governance changes are the results of private negotiations and settlements besides shareholder proposals (Karpoff, 1998; Strickland, Wiles and Zenner, 1996). Finally, the effect of shareholder proposals may vary across time. In fact, not only favorable votes for shareholder proposals increased over time (Gillan and Starks, 2000), but the implementation percentage increased across time for majority-approved shareholder proposals (Loring and Taylor, 2006).

Most research either tests all types of shareholder proposals (Gillan and Starks, 2000; Karpoff, Malatesta and Walkling, 1996; Loring and Taylor, 2006; Strickland, Wiles and Zenner, 1996; Tkac, 2006), or focuses on shareholder proposals targeting anti-takeover mechanisms (Bizjak and Marquette, 1998; Del Guercio and Hawkins, 1999).

In this thesis, I investigate only shareholder proposals that target the issue of top management compensation. I examine whether the findings in prior studies on other types of shareholder proposals apply to executive-pay proposals; explore whether the likelihood of submitting a shareholder executive-pay proposal increases with the level of agency costs and shareholder rights; detect whether the presence of a shareholder executive-pay proposal is associated with subsequent shift in executive pay structure and in pay-performance sensitivity.

Before examining the roles played by shareholder proposals in executive compensation in Chapter Four, I first explain the controversies surrounding the top executive pay-setting process in Chapter Three.

CHAPTER 3

THE MONITORING OF EXECUTIVE PAY

3.1 What is with Executive Pay?

When CEO Robert Nardelli left Home Depot in January 2007 with an exit package valued at about \$210 million, The Wall Street Journal cited reasons for his departure including his failed attempt to “reignite Home Depot's slowing sales and sagging stock price”, his autocratic management style, and his mishandling of the company's most recent annual meeting.

Nevertheless, the most damaging reason may be the decline in Home Depot’s shareholder wealth accompanied by Mr. Nardelli’s outsized compensation awards. During his tenure, the company’s stock price fell 8% while Mr. Nardelli received total compensation valued at more than \$240 million³⁷. That outraged shareholders like the American Federation of State, County and Municipal Employees (AFSCME), a large labor union, and Relational Investors LLC, an investment firm. AFSCME organized a protest during the most recent annual meeting, whereas Relational Investors threatened a proxy contest to put new directors on the board³⁸. After Mr. Nardelli’s exit, the

³⁷ Joann S. Lublin, Ann Zimmerman and Chad Terhune, Moving Out: Behind Nardelli's Abrupt Exit -- - Amid a Pay Dispute, Home Depot's Chief Faced Board Tensions, The Wall Street Journal, 4 January 2007.

³⁸ Alan Murray, BUSINESS: Behind Nardelli's Abrupt Exit --- Executive's Fatal Flaw: Failing to

board vowed to tie future CEO's pay closely to the performance of the company.

In terms of mega CEO pay package, Mr. Nardelli's pay is not alone. From Computer Associates' Charles Wang and Disney's Michael Eisner in the 1990s to Yahoo's Terry Semel and Exxon Mobil's Lee Raymond of late, CEO pay went from the level of million-dollar closer and closer to the level of half a billion-dollar. The real question, however, hinges on whether and how such pay package is justified.

Advocates argue that at the current level CEOs are not overpaid because the growth in CEO pay in the US is due to CEOs bearing greater equity risk and increased demand for talented CEOs to manage larger and more complex companies (Core, Guay and Thomas, 2005). They also maintain that CEOs do have increasing incentives (Hall and Liebman, 1998), and that while there is little evidence for optimal contracting, nor is there much evidence on CEOs having too much freedom to unwind the incentives (Core, Guay and Thomas, 2005).

Critics contend that the CEO pay-setting process itself is flawed – rather than the arm's length contracting presumed by most economists, the contracting between CEOs and boards has been shadowed by pervasive managerial influence (Bebchuk and Fried, 2005b; Crystal, 1992). The pay-performance relation may be weakened when the average executive loses 25-45% less pay from bad luck than is gained from good luck, that is, managers “enjoy stronger pay” when the market goes up but do not suffer as much when the market goes down (Garvey and Milbourn, 2006). Similarly, when

Understand New Demands on CEOs, The Wall Street Journal, 4 January 2007.

stock option awards (Yermack, 1997) and their repricing (Callaghan, Saly and Subramaniam, 2004) have very good timing, backdating is the major source of such good timing (Heron and Lie, 2007) and reduces the intended incentive effect in the stock options. Alternatively, when there are no clawback provisions in bonus, pension, and deferred compensation plans (Jensen, Murphy and Wruck, 2004), shareholders may award top executives large pay packages for “outstanding” performance only to find out later that performance was previous manipulated or falsified at the expense of the shareholders. In addition, CEOs may use golden parachutes as entrenchment devices (Shleifer and Vishny, 1989; Subramaniam, 2001), essentially enriching themselves while destroying shareholder wealth.

Jensen and Murphy (2004) discuss many problems in the process of setting managerial compensation that may be the barriers to optimal contracting and better pay-performance relations. A few of them are listed below to illustrate how CEOs can influence their own pay and how the board may not effectively control the process of setting executive compensation:

1. The compensation committee may consciously or unconsciously allow “management to *de facto* seize the remuneration initiation rights”, such as allowing compensation consultants to be hired by and report to management rather than the compensation committee.

2. There are “structural, social and psychological environment” of the board that make even the independent directors see themselves as “effectively the employees of the CEO”.
3. Some firms even pay the contracting agents negotiating for the CEOs, a practice that could be considered “a violation of the board’s fiduciary responsibility” to the firm.

3.2 The Monitoring of Executive Pay

In spite of diverging views on executive pay, both the advocates and the critics agree that the link between executive compensation and firm performance should be strong, and that there is little empirical evidence of optimal or value-maximizing contracting of top executive pay (Bebchuk and Fried, 2005b; Core, Guay and Thomas, 2005). Thus, there is still something to be done with the current managerial pay system, particularly when it is difficult for the board to award managers effectively in the best interest of the shareholders.

Some suggest that a more independent board and compensation committee might help alleviate the problem. In fact, the current SEC regulations preclude inside directors from serving on a firm’s compensation committee. Nonetheless, there is “little evidence that greater (compensation) committee independence affects executive pay” (Anderson and Bizjak, 2003). Part of the reason is that a board (or compensation committee) may not be effective despite its apparent independence (Bebchuk and

Fried, 2005b). An independent board may not be effective in monitoring CEOs if the outside directors are actually appointed by the CEO (Bebchuk and Fried, 2005b) and the appointed directors are not free from conflicts of interest (Shivdasani and Yermack, 1999); if the outsider directors serve on too many boards (Fich and Shivdasani, 2006); or if the board is too large (Yermack, 1996).

Others show that institutions can play a monitoring role in mitigating the problem. For example, Hartzell and Starks (2003) find a positive (negative) association between institutional ownership concentration and pay-performance sensitivity (the level of executive compensation). Although CEO pay is positively correlated with the presence of institutions if they are “pressure sensitive” (i.e. having business ties with the firm) and subject to managerial pressure (David, Kochhar and Levitas, 1998). Shareholders could even be hurt when institutions “have conflicts of interest with other shareholders” (Woidtke, 2002).

If all the other monitoring devices fail, many argue, that there is still the market for corporate control. However, top executives may use anti-takeover measures to thwart the control attempts. For instance, CEOs of firms adopting poison pills have higher compensation before the adoption and even higher compensation after the adoption (Borokhovich, Brunarski and Parrino, 1997). Furthermore, CEOs may negotiate special payout in the event of a change of control, therefore shielding them from effective monitoring by the market for corporate control. Certain target CEOs can “negotiate large cash payments in the form of special bonuses or increased golden

parachutes”, which in turn are positively associated with prior excess compensation (Hartzell, Ofek and Yermack, 2004).

As discussed above, suppose the board is not effective, institutional owners are subject to conflicts of interest, and the market for corporate control does not work, what other mechanisms are available to monitor executive pay and align the manager’s interest? Agency theory leads us to the natural selection – the shareholders. Yes. The board is supposed to represent shareholders. However, the board’s “actual power in fact derives from the CEO”, which “tends to dilute [the board’s] legitimacy not only generally, but quite specifically in determining the CEO’s pay” (Monks, 2001 – p.182). Thus, the monitoring of managers’ compensation “relies on the vigilance of the nonmanaging shareholders” (Ang, Cole and Lin, 2000 – p.82). If the CEO (or the board) does not listen or take appropriate steps to address the issues, the shareholder may exert pressure on the board by withholding votes for the directors (Del Guercio, Wallis and Woidtke, 2005) in director elections.

Since other types of shareholder actions may be either indirect (i.e. withholding votes from directors) or too costly (i.e. proxy contest), as mentioned earlier in Chapter Two, shareholder proposal may be a cost effective mechanism to monitor top management compensation. Next, I develop testable hypotheses to examine what role a shareholder proposal plays in the executive pay-setting process.

CHAPTER 4

SHAREHOLDER PROPOSALS AND EXECUTIVE PAY

This chapter develops hypotheses in order to answer the questions raised in previous chapters: 1) Are shareholders more likely to submit executive-pay proposals when agency costs are high or when shareholder rights are strong? Do firm size and performance affect the shareholder executive-pay proposal as they affect other types of shareholder proposals? 2) Do the factors that drive the voting outcome in other shareholder proposals also contribute to the voting outcome of the shareholder executive-pay proposals? 3) Does a shareholder executive-pay proposal serve as an useful monitoring device? Is receiving a shareholder executive-pay proposal associated with subsequent shift in executive pay structure and in pay-performance sensitivity?

4.1 The Role of Shareholder Proposal in Executive Pay-Setting

When other monitoring mechanisms (i.e., the board, institutional ownership and the market for corporate controls) are compromised, the agency costs of the firms would be high without additional monitoring. Do shareholders submit proposals in order to monitor potential managerial shirking and thus reduce the agency costs? Can

a shareholder proposal, as an alternative, effectively monitor executive pay and align the manager's interest to that of the shareholders?

Empirical results thus far are inconclusive. To the best of my knowledge, two papers to date investigate executive-pay proposals sponsored by shareholders³⁹. Without testing the determinants of a shareholder proposal, Johnson, Porter and Shackell (1997) investigate four different stakeholder pressures on executive compensation from 1992 to 1994⁴⁰. They find no evidence of associations between receiving a shareholder proposal and significant changes in compensation levels or in the cash pay sensitivity to firm performance.

Thomas and Martin (1999) focus on the impact of shareholder proposal on the level and composition of CEO's compensation at target companies between 1993 and 1997. They discovered that proposals restricting executive compensation are more likely to gain voting support than those simply asking for more disclosure, and that higher voting support is associated with lower change in annual cash payout but not with the change in total compensation⁴¹. They also find that firms receiving executive-

39 There have been several studies on management-sponsored executive-pay proposals (Martin and Thomas, 2005; Morgan, Poulsen and Wolf, 2006), which are very different from shareholder proposals and therefore are not in the scope of this study. Other shareholder-proposal studies either focus on poison pill proposals or include all types of proposals without differentiating each type. In an unpublished manuscript, Johnson and Shackell (1997) obtain similar result as indicated in Johnson, Porter and Shackell (1997), which appear to revise and expand the scope of Johnson and Shackell (1997).

40 The four stakeholder pressures are shareholder proposals, tax law of \$1 million cap, financial press coverage, and institutional investor targeting.

41 The "restrictive" proposals include those that limit total pay to a specified level or multiple, that seek to stop stock based pay, that request pay linked to firm stock price, and that ask executive pay to be approved by the shareholders (Thomas and Martin, 1999). The cash payout includes annual salary and bonus, and "other annual" compensation defined by ExecuComp as "the dollar value of other annual

pay proposals are large firms, underperforming firms, or firms with high level of top management pay. Nevertheless, they do not test how those firm characteristics influence the probability of a firm receiving an executive pay proposal, or whether other corporate governance factors affect the probability of a firm receiving an executive pay proposal.

In addition, there were very few performance-oriented shareholder executive-pay proposals in the sample period of these studies, which may have inadvertently influenced their research design and statistical inferences. Johnson, Porter, and Shackell (1997) focus on political pressure and tax issue. Thus, their sample is restricted to those firms that have CEO compensation in excess of \$1 million. Such sample of firms may have different characteristics than the population of firms.

Thomas and Martin (1999) study shareholder executive-pay proposals of all types, the economic consequences of which may diverge. For example, a proposal to reduce top management compensation and a proposal to link pay to stock prices may have opposite economic consequences when stock prices go up. Thomas and Martin (1999) do consider the type of a proposal as a potential source of variation of the proposal's impact. Nonetheless, they do not classify proposals primarily based on the economic impact upon implementation of the proposals. One explanation may be that

compensation not properly categorized as salary or bonus.” (Thomas and Martin, 1999) See data definitions by Standard and Poor's ExecuComp for more details.

there was not enough number of performance-oriented proposals in their sample for robust econometric tests⁴².

Interestingly, most of the prior studies in corporate governance proposals draw data in periods before 1997⁴³. However, the regulatory and economic changes and the institutional adaptation to the changes during the past fifteen years have resulted in structural differences between the proposals filed a decade ago and the proposals filed since the late 1990s. These structural differences indicate the evolving role of the corporate governance shareholder proposal in the executive pay-setting process.

4.2 The Evolution of Executive-Pay Proposals

4.2.1 The Change in Regulatory and Economic Environment

The regulatory and economic environment for shareholder executive-pay proposals in this decade is very different from the environment in the 1990s. For instance, as mentioned earlier in Chapter Two, a far-reaching proxy reform occurred in 1992. In principle, this reform allows shareholders to “communicate with each other outside the management-dominated proxy system (Thompson and Davis, 1997),” which drastically reduces one of the barriers (Pound, 1988) and thus the cost for shareholders to challenge incumbent management.

42 In fact, of all shareholder proposals in their sample, fewer than 10% are performance-oriented.

43 There has been research on events occurred after 1997 examining shareholder proposals targeting social (Tkac, 2006) and environmental issues, or looking into the board implementation of majority-approved shareholder proposals. None of them investigates the shareholder proposal’s monitoring role in executive pay setting process.

Another reform in executive pay disclosure requirements also happened in 1992. This disclosure reform refers to amendments to Regulations S-K and S-B that require extensive disclosures about corporate executive compensation (Thomas and Martin, 1999). This new requirement enabled the public to access and analyze compensation data that previously had been available only to compensation consultants and a limited number of organizations (i.e. Forbes magazine, Business Week, The Conference Board, and The Wall Street Journal, etc.).

Furthermore, the structure and level of top executive compensation have experienced fundamental changes during the dot com boom-bust cycle and its aftermath since 1992. For example, in 1992, stock based pay was only about 30 percent of the median CEO total compensation whereas salary was 41 percent. The stock based pay ballooned to around 54 percent in 1998 (Hall and Murphy, 2002), and stayed above 50% percent ever since⁴⁴.

4.2.2 Shareholder's Adaptation to the New Environment

Given the fundamental changes in the regulatory and economic environment, investors need time to adapt. "It takes at least three to five years for a new kind of proposal to seep into the consciousness of the institutional investor community deeply enough to become a part of their standard proxy voting guidelines⁴⁵," says Nell Minow, former president of Institutional Shareholder Services and cofounder of The

⁴⁴ Data compiled by this author using ExecuComp database shows that the percentages are 57, 62, 56, 52, and 52 from 2000 through 2004.

⁴⁵ Romanek, B. and B. M. Young, 2004, www.shareholderproposals.com.

Corporate Library. Suppose it took four years for the 1992 reforms to take substantial effect as Minow indicates, most prior research may not have captured such effect fully, if at all⁴⁶. Thus, an examination of shareholder proposals submitted after 1997 may provide additional evidence on why shareholders propose and how that affects investor and corporate behaviors.

As an example to illustrate the fundamental changes in shareholder executive-pay proposals over time, Figure VI shows that the number of proposals increased from 31 to 143 for S&P 500 companies during 1995-2005. Two hundred and five firms received at least one proposal in this period. Figure VII demonstrates that the number of firms targeted increased from about 20 in 1995 to about 90 in 2005⁴⁷. According to the data tracked by IRRC, the number of executive-pay proposals increased from a paltry 14 in 1990 to 201 in 2004, a jump of more than thirteen times⁴⁸.

Shareholder proposals have gained traction especially since large corporate scandals broke out one after another in the late 1990s and the early 2000s. The outraged investors successfully submitted an average of 128 executive-pay proposals from 2003 to 2004, tripling the average number of proposals from 1999 to 2002 for S&P 500 firms. As a result of increased director liabilities by the Sarbanes-Oxley Act of 2002 and other regulations, companies began to respond to shareholder proposals by changing their practices (Eisenhofer and Barry, 2006).

46 For example, Johnson, Porter and Shackell (1997)'s sample period stops at 1994; Thomas and Martin (1999)'s latest year of the sample is 1997, only five years after the 1992 proxy and disclosure reforms.

47 Author collected data.

48 According to IRRC data identified in Gillian and Starks (2000) and in Eisenhofer and Barry (2006).

Besides the increasing momentum in shareholder proposals, the shareholders' primary motivation on executive-pay proposals has shifted from social and environmental concerns to economic concerns in the last decade. For example, the number of proposals motivated by economic rationality particularly accounting and market performance⁴⁹ (rather than non-financial-performance related social and environmental issues⁵⁰) among all executive-pay proposals voted in S&P 500 firms increased from an average of less than 20 percent in 1995-2000 to an average of more than 60 percent in 2001-2006. Appendix I illustrates the examples of non-performance-oriented vs. performance-oriented executive-pay proposals.

Most importantly, more and more shareholder proposals began to aim to align the interest of the agent to that of the principal. For instance, Rappaport and Nodine (1999) propose a "new thinking on how to link executive pay with performance" in light of the sensational rise of stock-based CEO compensation. Specifically, they argue that because "even below-average performers reap huge gains from stock options when the market is rising rapidly" stock options need to be tied to a market or peer index. They predict that "shareholders will applaud changes in pay schemes that

49 E.g. proposals that related to large severance/pension packages, stock options, or relative performance. Such proposals may recommend to link top executive pay closer to financial performance, to use peer or market index to evaluate the market performance in stock option awards, to restrict stock options vesting to performance-based instead of time-period-based, and to see seek shareholder approval for future severance pay, golden parachutes, and executive pensions and supplementary executive retirement plans, etc.

50 E.g. proposals that link executive pay to labor standards, environmental issues, inequality of pay, political contribution, diversity, or other social and political issues. Such proposals may recommend a ratio between CEO pay and the average pay of the lowest-paid workers, to cap the executive pay at an arbitrary dollar amount, to freeze top executive pay during downsizing, to require more disclosure regarding top executive pay, to consider executive pay along with corporate labor standards, environmental pollutions, diversity, etc.

motivate companies to deliver more value.” Indeed, in 1999, shareholders started to send the first proposals urging companies to adopt indexed stock options.

4.3 The Classification of Shareholder Executive-Pay Proposals

Although the business press and many shareholder activists have relentlessly focused on how much CEOs are paid, they may be missing the larger issue in the agency theory (Jensen and Meckling, 1976) that agent compensation needs to be aligned with principal (shareholder) interest especially in firm performance⁵¹(Jensen and Murphy, 1990). Pay-for-performance is the paramount issue in the executive pay-setting process. Unfortunately, most of the shareholder proposals simply ignored this issue virtually throughout the 1990s. For example, about 94.5 percent of all executive-pay proposals in Thomas and Martin (1999)’s study do not focus on pay-for-performance issue. Those few proposals that do suggest pay-for-performance in this period received lukewarm support (16.4% on average).

The trend started to turn in the late 1990s when at least 50 percent of the median pay to CEOs were stock-based awards for three consecutive years in 1997, 1998, and 1999 (Hall and Murphy, 2002). Since 1999, the year Rappaport and Nodine (1999) proposed a “new thinking on how to link executive pay with performance,” the number of proposals has increased from twelve in 1999 to seventy-eight in 2005 for

⁵¹ Although social and environmental responsibilities are of the shareholder interest (Tkac, 2006; Rehbein, Waddock and Graves, 2004), this study does not focus on these issues.

shareholder proposals linking pay and performance directly or indirectly in S&P 500 companies⁵².

In this thesis, two types of proposals are considered as linking pay and performance, which I label “performance-oriented”. A proposal is classified as “**directly**” performance-oriented if it is written in the proposal as such or something to that effect. This type includes proposals to recommend indexing options, vesting options based on performance criteria instead of time, and linking pay closer to market performance and accounting performance, etc. For instance, in the 2005 proxy season, shareholders at UnitedHealth Group Inc. recommend performance-based stock option grants:

"Resolved: That the shareholders of UnitedHealth Group Inc. (the "Company") request that the Compensation Committee of the Board of Directors adopt a policy that a significant portion of future stock option grants to senior executives shall be performance-based. Performance-based options are defined as follows: (1) indexed options, in which the exercise price is linked to an industry or well-defined peer group index; (2) premium-priced stock options, in which the exercise price is set above the market price on the grant date; or (3) performance-vesting options, which vest when a performance target is met."

A proposal is classified as “**indirectly**” performance-oriented if the proposal recommends shareholder approval for large severance payments, golden parachutes, executive pension and retirement plans, supplementary executive retirement plans (SERP), or deferred compensation etc⁵³. I will discuss the reason for this classification in detail next.

⁵² Data is hand-collected by the author.

⁵³ There are other types of compensation as well. Since the proposals related to severance and pension take the majority portion, I discuss severance and pension issues in this dissertation proposal.

As an example, a shareholder proposal in Raytheon's 2002 proxy statement illustrates that shareholders are concerned about large severance packages and their potential negative impact on shareholder wealth:

Severance agreements may be appropriate in some circumstances. Nonetheless, we believe that the potential cost of such agreements entitles shareholders to be heard when a company contemplates paying out at least three times the amount of an executive's last salary and bonus.

The existence of such a shareholder approval requirement may induce restraint when parties negotiate such agreements. In addition, if a change in control situation occurs, the reason may be that executives have not managed the company in ways that maximize shareholder value, a factor that argues against overly generous severance pay--or at least a shareholder say on the matter.

A branch of "rent extraction" theory suggests that executives "camouflage" their compensation to "minimize outrage" among shareholders while concealing the true amount of pay and pay-performance sensitivity (Bebchuk and Fried, 2005b). Executive pension plans, deferred compensation and severance agreements (arising from the change of control or the change of CEOs) are among the most opaque compensation schemes that could be subject to "camouflage". For example, deferred compensation, executive pensions, and change in control severance agreements are among the six "hidden pay" described by Forbes magazine⁵⁴. Sundaram and Yermack (2006) report that disclosure is extremely limited for deferred compensation, and that estimating the annual pension value that each CEO is entitled to receive upon retirement often requires time-consuming research for each company. Bebchuk and

54 The six hidden pays are perks, deferred compensation, valuing stock options, pensions, change in control (pay) agreements, dividends on restricted stock. Available at http://www.forbes.com/2006/04/20/CEO-pay-hiding_cx_hc_06ceo_0420hidepay.html

Fried (2005a) vividly describe what it takes to find the information related to the pension value of Fannie Mae's CEO Franklin Raines (more details in Appendix II).

“... estimating the dollar value of each of the components of Raines's retirement package requires some time and effort as well as certain information that is not readily available to investors. Even for those accustomed to reading SEC filings, coming up with these estimates requires a bit of work. The Black-Scholes value of the options must be calculated. The ages of Raines and his spouse must be determined. The annuity value must be estimated. The medical coverage for Raines and his family, as well as the life insurance, must be valued. It certainly would have made more sense for Fannie Mae to provide values for the components of the retirement packages rather than forcing investors to estimate the value of the packages based on incomplete information. But, Fannie Mae, like other companies, chose not to make the value of the retirement package transparent.”

Bebchuk and Jackson (2005) find that about two-thirds of S&P 500 CEOs have executive pension plans. In their sample of 51 current and retired CEOs, the median actuarial pension value is about one-third of the total compensation awarded during their entire service period as CEOs, making the compensation “much less linked to performance than commonly perceived” when their pension value is added back to calculate executive pay.

In another report, Alvarez and Marsal, a tax advisory firm, finds that more than 60 percent of CEOs at 200 top public companies would receive severance payments at least three times their annual (total) compensation in a change of control⁵⁵. Moreover, Yermack (2006) documents a strong negative association “between the transparency of a CEO's separation package and the extent to which a package is larger than

55 Business Wire, New Report by Alvarez & Marsal Tax Advisory Services reveals Details of Executive change in Control Agreements at 200 Top Publicly Traded U.S. Companies, 7 December, 2006

expected, particularly in the cases of voluntary turnover. In addition, shareholders react negatively to severance agreement disclosures in these cases.

To the extent that executive severance and pension packages are widely adopted and often are large in big corporations yet prone to obscure the linkage between pay and performance, shareholder proposals targeting such compensation are classified as performance-oriented proposals.

4.4 Hypotheses Development

This section develops testable hypotheses on the factors that may affect the probability of a firm attracting a shareholder executive-pay proposal in Section 4.4.1, on shareholder reactions through voting in Section 4.4.2, and on firm reactions reflected in the change in pay-performance relations and the change in executive pay structures in Section 4.4.3.

4.4.1 Why Do Shareholders Submit Executive-Pay Proposals?

Many factors may influence the probability of shareholders submitting executive-pay proposals. I explore the explanatory variables based on theories of agency cost reduction, corporate governance, and optimal contracting.

If firms hand out or “camouflage” large pay packages to under-performing CEOs, the pay-performance relations can be obscured (Bebchuk and Fried, 2005b; Bebchuk and Jackson, 2005). This misalignment of the interests between the

shareholders and the managers indicates that the agency costs of the firms may be high. If shareholders identify this problem, they will submit performance-oriented executive-pay proposals in order to monitor managers, realign the interests between managers and shareholders, and reduce the agency costs. Therefore, I expect that firms with high agency costs are more likely to receive performance-oriented shareholder proposals. To proxy for agency cost, I use three alternative variables – low managerial stock ownership, horizon problem, and high stock return volatility.

Agency theory suggests that managers with lowest level of fractional managerial stock ownership may be prone to shirk at the expense of the shareholders (Jensen and Meckling, 1976). I expect that shareholders are more likely to target firms with lower managerial ownership. This leads to the hypothesis:

H1a: Firms with lower managerial ownership are more likely to receive performance-oriented shareholder executive-pay proposals than control firms would.

CEOs closer to retirement age may have less incentive to invest in projects good for long-term growth because the current CEO has to bear the expenses upfront yet may have to let successors to reap the benefits (Dechow and Sloan, 1991; Mehran, 1995). When shareholders find out that firms led by CEOs nearing retirement appear to show the horizon problem, they would increase their monitoring activities. This conjecture leads to hypothesis:

H1b: Firms with CEOs closer to retirement are more likely to receive performance-oriented shareholder executive-pay proposals than control firms would.

To proxy for monitoring cost, I use the stock return volatility, which measures the noise that increases monitoring cost (Demsetz and Lehn, 1985; Core and Larcker, 2002). Since shareholder proposal is a cost effective monitoring mechanism, shareholders would be more likely to use this device than other tools for monitoring for firms with high monitoring cost. This leads to hypothesis.

H1c: Firms with higher stock return volatility are more likely to receive performance-oriented shareholder executive-pay proposals than control firms would.

Shareholders do not target firms randomly. For instance, they target firms with large size and poor prior performance (Bizjak and Marquette, 1998; Karpoff, Malatesta and Walkling, 1996). They also would like to attract as much voting support as possible. For example, they coordinate with each other for higher voting support and stronger negotiation status (Strickland, Wiles and Zenner, 1996). Another way to gain higher level of support is to select target companies that have strong corporate governance characteristics (i.e. strong shareholder rights). Gompers et al. (2003) derive a governance index to proxy for shareholder rights. Using twenty-four corporate governance provisions for about 1,500 firms, this index indicates the balance of power between managers and shareholders. Strong corporate governance, in this

case, higher level of shareholder power means more support for shareholders. Thus, shareholders would be more likely to submit proposals to firms with stronger shareholder rights. This leads to hypothesis:

H2: Firms with higher shareholder rights are more likely to receive performance-oriented shareholder executive-pay proposals than control firms would.

Following Core and Larcker (2002) in spirit, I take a middle ground between the theory that firms continuously re-contract for optimality because of zero transaction costs (Demsetz and Lehn, 1985), and the theory that firms cannot re-contract continuously because of prohibitively high transaction costs (Morck et al., 1988). I assume that firms determine an optimal level of incentive compensation when they contract. However, they cannot continuously re-optimize due to high transaction costs. They can only periodically re-contract for optimality, which leads to deviations from the optimal level.

Such deviations imply that executive pay is either too high for underperformance or too low for over-performance. In the former situation, firms award unnecessary incentives to managers for destroying shareholder wealth; in the latter case, firms do not provide adequate incentives to managers. When shareholders recognize that incentive contracts deviate from the optimal level, they would increase

the monitoring in order to speed up the realignment process and help re-optimize the incentives. I test this conjecture in hypothesis:

H3: Firms with unexpected level of total compensation conditioning on poor prior performance are more likely to receive performance-oriented shareholder executive-pay proposals than control firms would.

As discussed in previous chapters, before the late 1990s, most shareholder activists focused on the absolute level instead of the optimality of executive compensation⁵⁶. So have the prior literature and the current business press. Critics of shareholder proposals dub traditional activists as “gadflies” who have “little business background” (Lublin and Dvorak, 2007). In Hypothesis 3, however, the idea that shareholders may target firms with unexpected level of executive pay provides important insights into why shareholders since the late 1990s submit executive pay proposals and how their purposes may have changed from the early 1990s.

4.4.2 Voting Outcome as Shareholder Reaction

Romano (2001) suggests that if investors refocus their activities on substantive reforms known to affect performance in the near term, their actions would have a higher likelihood of having a significant impact on firms. Thomas and Martin (1999) confirm her intuition with evidence that shareholder proposals restricting executive compensation are more likely to gain voting support than those simply asking for more

⁵⁶ Optimal level of executive compensation is difficult to observe and measure. I use the expected level of executive compensation to proxy for optimality based on the predicted values in Equation (1).

disclosure. Asking for more disclosure naturally would need other follow-up measures and thus longer time periods to take effect, if at all, than asking to restrict executive pay. In this case, the type of proposal matters to the impact of shareholder effort. The result is in line with other findings that voting outcomes vary systematically with proposal type (Gillan and Starks, 2000; Gordon and Pound, 1993). Nevertheless, asking to restrict executive pay may or may not have sound economic rationale. If the higher pay is simply a function of higher firm performance, then restricting pay will reduce the incentives to managers.

In Section 4.3, I resolve this issue by grouping shareholder executive-pay proposals into two types – performance-oriented and non-performance-oriented, following Thomas and Martin (1999) in spirit. Figure IX shows voting support by differentiating proposal types. This dichotomy helps test more directly to which extent shareholders respond to executive-pay proposals drafted in accordance with economic principles. Thus, I examine whether performance-oriented shareholder executive-pay proposals attract more favorable shareholder reactions in hypothesis:

H4a: Shareholders more favorably react to performance-oriented than non-performance-oriented shareholder executive-pay proposals.

Since pension funds started to submit proxy proposals in 1986 and 1987 mostly on corporate governance issues, pension and union funds have become increasingly influential (Gillan and Starks, 2000). According to Georgeson Inc.,

pension funds and union funds sponsored about half of all shareholder proposals in both 2005 and 2006 proxy seasons (Figure III). Since institutional investors such as pension/labor funds have been instrumental in shareholder activism (Del Guercio and Hawkins, 1999; Gillan and Starks, 2000; Monks, 2001), I expect that shareholder executive-pay proposals sponsored by pension funds and labor funds would garner more favorable shareholder reaction.

H4b: Shareholders more favorably react to shareholder executive-pay proposals sponsored by pension funds and labor funds than by other parties.

Shareholder reactions can also be measured as stock returns. However, two conflicting effects – “real effect” and “information effect” – make it difficult to have ex ante prediction on the direction of the stock returns (Gillan and Starks, 2000; Jensen and Warner, 1988). The real effect supports the notion that the market would react positively if shareholder proposals are beneficial to the target companies. The information effect indicates that the market would react negatively because the filing of a shareholder proposal reveals failed negotiations between the shareholders and the management (Gillan and Starks, 2000; Prevost and Rao, 2000).

4.4.3 Firm Reactions to Shareholder Executive-Pay Proposals

Partly because its cost is low compared to other monitoring devices such as proxy contests and tender offer, shareholder proposal becomes increasingly popular to

show dissatisfaction to management among investors “otherwise left out of the corporate governance process (Bizjak and Marquette, 1998).”

Although the low-cost nature increases the chance of investors submitting proposals of no consequence (Bizjak and Marquette, 1998), those economically valid shareholder proposals are still likely to influence corporate behavior. For instance, poison pills are economic devices that may not serve the best interests of the shareholders if not properly designed and used. Bizjak and Marquette (1998) report that poison pills are more likely to be restructured if prompted by shareholder proposals. Similarly, Del Guercio and Hawkins (1999) find that shareholder proposals are followed by “significant additional corporate governance activity and broad corporate change, such as asset sales and restructurings”.

For the same reason, performance-oriented shareholder proposals aiming to align the interests of managers are economically sound. The primary goals of these proposals are for target companies to improve pay-performance relations between managers pay and firm performance. Therefore, if the boards of directors adopt those performance-oriented shareholder proposals that serve as complementary monitoring and corporate governance device (Del Guercio and Hawkins, 1999), the change in pay-performance relations would be greater for firms receiving performance-oriented shareholder executive-pay proposals than for control firms. Hence, the hypothesis:

H5: The change in pay-performance relations would be greater for firms receiving performance-oriented shareholder executive-pay proposals than

for control firms with the same pay-performance relations in the pre-proposal period.

However, whether the boards of directors would actually listen to the shareholders and adopt their proposals is an open question. If the answer is no, then Hypothesis 5 would fall apart – “receiving” a proposal does not mean the board will adopt it. One challenge is that shareholder proposals may lack the legal power to mandate changes in corporate behavior. For example, most shareholder proposals garner fewer than 50% of the votes cast. As discussed earlier, even majority passed shareholder proposals are not necessarily binding on the management because of conflicting court rulings on shareholder proposals.

Despite such seemingly insurmountable legal obstacles, a proposal gaining more than 10% of the vote would be allowed to file repeatedly year after year. If that happens, boards of directors may be wary the fact that ignoring repeated and economically sound proposals could be used as a basis for proxy contest or litigation by some shareholders. For instance, Charles Elson, a Professor of Corporate Governance in the University of Delaware, advises the boards, “A sufficiently large number of votes in favor of the resolution ... may provide the base for a potentially successful proxy fight⁵⁷”. Jesse M. Brill, the publisher of *The Corporate Counsel* and a former attorney with the SEC, warned directors in compensation committees about the potential liabilities:

⁵⁷ Romanek, B. and B. M. Young, 2004, www.shareholderproposals.com.

“Picture proof of potential adverse consequences is reflected by the recent settlement of a lawsuit brought in Delaware against Cendant and each of its directors (who were individually named as defendants). After facing a complaint (posted on CompensationStandards.com) replete with quite detailed allegations—drawn from compensation committee minutes and more—that the committee had not met its fiduciary duty in blessing the CEO’s pay package, the company settled the case in late April, with the CEO giving up a considerable portion of his pay package. It is not hard to imagine that this seemingly novel complaint could serve as a template for bringing actions against many other compensation committees.⁵⁸”

In fact, evidence also shows that shareholder vote would be able to influence firm behavior even if the favorable vote for the a *shareholder* proposal is just around 30% (Del Guercio and Hawkins, 1999) or the unfavorable vote against a *management* proposal is greater than about 29% (Martin and Thomas, 2005). In addition, directors give more weight to shareholder proposals receiving over 10% of the vote, a magnitude viewed as a significant level of shareholder dissatisfaction (Thomas and Martin, 1999).

Because stock option has been the major pay component in the increase in pay-performance sensitivity (Hall and Liebman, 1998), and cash (including salary and bonus) compensation has been the most basic component in executive pay, it would be informative to differentiate specific pay-performance relations with respect to stock option grants, cash compensation, and total compensation. In light of this, Hypothesis 5 is divided into three separate sub-hypotheses:

58 Jesse M. Brill, The New Compensation Committee Responsibilities, A Roadmap for Meeting the New Standards and Avoiding Personal Liability, The Corporate Counsel, Vol. XXIX, No. 3, May-June 2004.

H5a: The change in stock option grant sensitivity would be greater for firms receiving performance-oriented shareholder executive-pay proposals than for control firms with the same stock option grant sensitivity in the pre-proposal period.

H5b: The change in cash pay-performance sensitivity would be greater for firms receiving performance-oriented shareholder executive-pay proposals than for control firms with the same cash pay-performance sensitivity in the pre-proposal period.

H5c: The change in total compensation sensitivity would be greater for firms receiving performance-oriented shareholder executive-pay proposals than for control firms with the same total pay-performance sensitivity in the pre-proposal period.

When companies try to increase managers' pay-performance sensitivities, stock-based pay (stocks and stock options) has been the major pay component used (Hall and Liebman, 1998). This was partly a result of financial economists' advocates for the increase in stock-based pay to align the interests between the managers and the shareholders (Jensen and Murphy, 1990; Murphy, 1999)⁵⁹. Therefore, if boards are to adopt shareholder proposals to improve pay-performance relations, stock-based pay

⁵⁹ I do not differentiate between stocks and stock options in H6. The current practice of increasing incentives is through stock options or restricted stock. However, an emerging theory predicts that CEO should receive additional stocks and hold no stock options (Dittmann and Maug, 2007).

would receive the most attention. This indicates that the proportion of stock-based pay would likely increase after firms receive performance-oriented shareholder executive proposals.

Moreover, boards of directors face increased pressure from shareholder proposals seeking for an advisory vote on severance agreements and pension plans, the executive pay components that were not required to be disclosed in the compensation table until December 2006. The boards may be tempted to shift a portion of such “camouflaged” components into stock-based pay both to appease angry investors and to keep CEOs happy at the same time. According to a U.S. News & World Report interview, when asked whether he got a large stock option grant in return for him forgoing a lucrative golden-parachute contract, Mercantile Bank CEO Edward J. Kelly answered, “There was no quid pro quo. The board was kind enough to give me a restricted stock grant in 2003, and then this year [2006] they gave me a restricted stock grant as well.”⁶⁰

This is consistent with the notion that directors, when facing shareholder pressure to improve pay-performance relations, may try to reach a certain level of managerial incentives by changing pay structures, shifting other pay components into stock-based pay, and at the same time addressing the concerns expressed in performance-oriented shareholder proposals. Such structural shifts would increase

⁶⁰ Available at <http://www.usnews.com/usnews/biztech/articles/060517/17kelly.htm>

proportion of stock-based pay in the total managerial compensation. This leads to hypothesis:

H6: The change of the proportion of stock-based pay in total compensation would be greater for firms receiving performance-oriented shareholder executive-pay proposals than for control firms with the same proportion of stock-based pay in the pre-proposal period.

Note that Hypotheses 5 and 6 are not inconsistent with the situation where both the sample firms and control firms have negative changes so long as the changes in the sample firms are more positive than the changes in the control firms. This is because other unobservable economic shocks may affect the firm choices in pay-performance relations or in pay structures. Nevertheless, given the same effect of such unobservable shocks on both the sample firms and the control firms, the hypothesized change is greater for the sample firms than for the control firms in Hypotheses 5 and 6.

CHAPTER 5

RESEARCH DESIGN

5.1 Sample Selection

I collect shareholder executive-pay proposal data – proposal types, voting outcomes, and sponsors – mainly from corporate proxy statements. If the details for shareholder proposals are not available for some firms and some years in proxy statements, I search the quarterly filings (10-Q), or filings for important events (8-K) in the Lexis-Nexis and SEC Edgar database. The proposal dataset is from fiscal 1993 to 2005 for the shareholder executive-pay proposals in S&P 500 companies⁶¹.

Figure XI shows the timeline for issuing corporate proxy statements. Proxy materials typically become available months after the fiscal year end. For example, if December 2001 is a firm’s fiscal-year-end month, the proxy statements generally become publically available in March or April 2002. I label the year “Proposal Year” (or “Year 0”) when a shareholder proposal becomes available. I label the fiscal year before the proposal year as “Year -1”, and the year after the proposal year as “Year 1”.

⁶¹ The member firms of the S&P 500 index are based on the 2005 index. Such construction of the sample tends to underestimate the number of proposals filed in earlier years. However, this dataset is reasonable representative compared with leading governance data providers such as IRRC. For example, the number of proposals each year is roughly one third of the number reported by other researchers using IRRC data, which tracks S&P 1500 index firms. The data only considers shareholder proposals that were included in the proxy statement, and does not account for those proposals that were excluded by the management or withdrawn by the sponsors.

Executive compensation and top management ownership data are from ExecuComp database. I obtain CEO data as well as the data for other top executives provided by ExecuComp. Stock prices and returns data are from CRSP. Firm accounting data is from COMPUSTAT⁶². Andrew Metrick generously provided the Governance Index (“G”).

5.2 Performance-Oriented Proposals

The main sample of shareholder proposals will be grouped into two categories – performance-oriented group and non-performance-oriented group. As discussed in Chapter 3, performance-oriented proposals include those related to large severance/pension packages, stock options, or peer performance. Non-performance-oriented proposals include those recommend at least a portion of the executive pay based on labor standards, environmental issues, inequality of pay, political contribution, diversity, or other social and political issues. This design is consistent in spirit with Thomas and Martin (1999)’s finding that proposals restricting executive pay receive more support than proposals simply asking for more disclosure. However, the categorization based on whether a proposal is performance-oriented is an important departure from prior literature for three reasons.

First, agency theory (Jensen and Meckling, 1976; Jensen and Murphy, 1990)’s incentive alignment mechanism between the principal (shareholder) and the agent is

⁶² Stock price, return, and accounting data are from ExecuComp whenever available.

essentially performance-oriented. Compared to politically or socially centered shareholder proposals, performance-oriented ones can be tested more directly for their economic consequences.

Second, shareholders are more receptive of the concept of pay-for-performance now than in early 1990s since Jensen and Murphy (1990) first argued that it is not *how much* but *how* top management is paid. This shareholder perception is supported by Rappaport and Nodine (1999)'s comment that "shareholders will applaud changes in pay schemes that motivate companies to deliver more value," and by recent voting guidelines of ISS and influential pension funds and investment groups⁶³.

Third, performance-oriented shareholder executive-pay proposals were rare before 1999 whereas they are prevalent today. For example, about a mere 6.5 percent were performance-oriented proposals in Thomas and Martin's data sample (1993-1997) and less than 15% in my sample in the same period. However, that percentage increased from an average of less than 15 percent in 1993-1997 to an average of more than 60 percent in 2001-2006 in my sample of S&P 500 firms.

63 For example, the voting guidelines of ISS and Goldman Sachs Asset Management consider on a "CASE-BY-CASE basis ... company performance, pay level versus peers, pay level versus industry, and long-term corporate outlook." ISS also positions to "vote FOR shareholder proposals advocating the use of performance-based awards like indexed, premium-priced, and performance-vested options or performance-based shares, unless" the proposals are overly restrictive or might impose excessive risks on management. (Source: ISS 2006 US Proxy Voting Guidelines Summary. www.issproxy.com) TIAA-CREF's guidelines state that "aligning the rewards of employees with those of shareholders will enhance the long-term performance of the corporation, and compensation programs that are based on performance can play the critical role in this alignment." (Source: TIAA-CREF Policy Statement on Corporate Governance)

In addition, the performance-oriented group includes only shareholder proposals with potentially *direct* and *significant* economic consequences (if such proposals are implemented). For example, a proposal is classified as non-performance-oriented if the proposal recommends simply more disclosure or a board review of compensation practices because such a proposal even if implemented would have indirect (or very long term) and insignificant short-term economic consequences, and thus its effect would be very difficult to test or interpret.

5.3 Why Do Shareholders Submit Executive-Pay Proposals?

To test whether a firm with high agency cost, strong shareholder rights, and suboptimal incentive contracts is more likely to receive a shareholder executive-pay proposal, I use benchmark-adjusted firm performance and executive pay. This methodology is comparable in spirit to the one used by Core and Larcker (2002). The details of this methodology are as follows.

5.3.1 Benchmark-Adjusted Performance and Executive Pay

I compute the benchmark-adjusted firm performance as the stock return in the two years (year -2 and year -3) prior to the target year (year -1), less the median stock return in the same period and same industry (two-digit SIC code). I label this variable “prior_returns” and assume that the lower the prior_returns the more likely it is to attract shareholder monitoring. If the prior_returns is negative, I assign ‘1’ to an

indicator variable labeled “poor_indicator”. I assign ‘0’ to this indicator if prior_returns is positive or zero.

For the benchmark-adjusted executive pay, the aim is to obtain the residuals from the executive-pay benchmark model, and to logistically regress an indicator variable (1 if a firm received a proposal and 0 otherwise) on an interaction term for unexpected incentives, and on agency costs and shareholder rights variables⁶⁴.

First of all, I obtain an estimation sample by pooling test sample firms (that received performance-oriented shareholder executive-pay proposals) with Execucomp data for firm-years from 1993 to 2005, and construct a regression model [Equation (1)] as follows to obtain the residuals:

$$\begin{aligned} \text{Log}(\text{TotalComp})_{it} = & \beta_0 + \beta_1 \text{Log}(\text{Sales})_{it} + \beta_2 \text{market_to_book}_{it} + \beta_3 \text{ROA}_{it} + \beta_4 \text{stock_returns}_{it} \\ & + \beta_5 \text{ROA_volatility}_{it} + \beta_6 \text{stock_volatility}_{it} + \beta_7 \text{debt_ratio}_{it} \\ & + \gamma_{1..k} \text{year_indicators}_{it} + \gamma_{1..k} \text{industry_indicators}_{it} + u_{it} \end{aligned} \quad (1)$$

The dependent variable $\log(\text{TotalComp})$ is the log-normalized total compensation for each executive. The log-transformation helps to explain the residual as a percentage deviation of the actual from the expected total compensation. The independent variables are known to be associated with executive compensation – firm size, growth, firm risk, and agency cost of debt.

Secondly, since Hypotheses 1 through 3 predict differences between proposal firms and non-proposal firms, I then construct a set of control firms by deleting from

⁶⁴ The interaction term is the multiplication of the residuals interacting by the benchmark-adjusted firm performance modified as an indicator variable.

the sample described above all the data for firms receiving performance-oriented shareholder proposals.

Finally, I create an indicator variable PROPOSAL (1 if a firm received a proposal and 0 otherwise), assigned to the test sample and control sample respectively described above.

Following Core et al. (1999) and Mehran (1995), I expect that the executive pay will be higher in larger and more complex firms. I proxy firm size and complexity with the log form of sales. Since higher growth opportunities are associated with higher executive pay (Core et al., 1999; Gaver and Gaver, 1993; Hanlon et al., 2003), I proxy for growth with market-to-book ratio.

Because executive pay may vary with performance (Core et al., 1999) and firm risk (Banker and Datar, 1989; Core et al. 1999; Mehran, 1995; Smith and Watts, 1992), I proxy firm performance with ROA and stock returns, and proxy firm risk with the standard deviation of ROA and the standard deviation of stock returns. I label the standard deviation of ROA “ROA_volatility”, and the standard deviation of stock returns “stock_volatility”.

To proxy for the relation between executive pay and agency cost of debt (John and John, 1993; Mehran, 1995; Yermack, 1995), I use the ratio of total liabilities to total assets and label it “debt_ratio”. To control for potential temporal and industry differences, I use year and industry indicators.

5.3.2 The Probability of Receiving a Shareholder Executive-Pay Proposal

After obtaining the total compensation residuals from the benchmark model, I construct a group of control firms and run a logistic regression using the following model⁶⁵:

$$\begin{aligned}
 PROPOSAL_{it} = & \beta_0 + \beta_1 CEO_ownership_{it} + \beta_2 CEO_age_{it} + \beta_3 stock_volatility_{it} \\
 & + \beta_4 shareholder_rights_{it} + \beta_5 poor_indicator_{it} + \beta_6 TotalComp_residual_{it} \\
 & + \beta_7 (poor_indicator_{it} \times TotalComp_residual_{it}) \\
 & + \gamma_{1..k} year_indicators_{it} + \varepsilon_{it}
 \end{aligned} \tag{2}$$

PROPOSAL is 1 for a firm with a performance-oriented shareholder executive-pay proposal and 0 otherwise. CEO_ownership is the level of fractional stock ownership for CEOs. CEO_age is the actual CEO age. Stock_volatility is the standard deviation of stock returns. Shareholder_rights is a modified version of the Governance Index designed by Gompers et al. (2003). In Gompers et al. (2003)'s index, a higher value means weaker shareholder rights. For convenience of the interpretation in this paper, I time the index value by -1 to derive the Shareholder_rights variable which indicates stronger shareholder rights with a higher index value. Poor_indicator is one if the prior two-year industry-adjusted stock return is negative and zero otherwise. TotalComp_residual is the residual value obtained from the executive-pay benchmark model [Equation (1)].

Since the likelihood of shareholder monitoring increases with higher agency costs, I expect β_1 , β_2 , and β_3 to be negative, positive, and positive respectively. Lower CEO_ownership (β_1) means higher agency cost and higher probability of a firm

⁶⁵ The control firms will be all firms in ExecuComp database except the sample firms that received shareholder executive-pay proposals in any year in the sample period.

receiving shareholder executive-pay proposals. Higher CEO_age (β_2) means closer to retirement and more horizon problems, therefore higher probability of receiving shareholder executive-pay proposals. Higher stock volatility (β_3) indicates high monitoring cost, and higher likelihood of receiving shareholder executive-pay proposals. Because the stronger the shareholder rights, the more likely shareholder submit executive-pay proposals, I expect β_4 to be positive.

I expect positive signs for β_5 and β_6 because poor performance and larger pay deviation from the expected level are hypothesized to be associated with higher probability of a firm receiving shareholder executive-pay proposals. Since a value of one in poor_indicator means that the return is below industry median, I expect a positive sign for the coefficient (β_7) of the interaction term between poor_indicator and TotalComp_residual. A positive β_7 reinforces the notion that larger pay deviation from the expected level conditioning upon poor industry-adjusted performance is associated with higher likelihood of receiving a shareholder executive-pay proposal.

5.4 Shareholder Reactions to Shareholder Proposals

Following Gillan and Starks (2000), I test H2 that the shareholder reaction to shareholder executive-pay proposals varies depending proposal type and proposal sponsor. I expect positive signs for β_1 and β_2 .

$$VOTE = \beta_0 + \beta_1 TYPE + \beta_2 SPONSOR + \sum \beta_k (ControlVariables) \quad (3)$$

VOTE is the shareholder reaction as measured by the percentage vote in favor of a shareholder proposal. *TYPE* is an indicator variable: 1 for performance-oriented proposals and 0 otherwise. *SPONSOR* is an indicator variable: 1 for pension fund or labor fund sponsors and 0 otherwise.

Following prior literature, I control for variables that are associated with voting support. These variables include firm size, stock performance, governance structures (i.e. executive stock ownership, and governance index), period, and whether a similar proposal has been filed before.

Since larger firms are more likely to attract shareholder proposals (Karpoff, Malatesta, and Walking, 1996; Strickland, Wiles, and Zenner, 1996), firm size could influence the voting outcome. I also control for firm performance and insider ownership because shareholder proposals receive more voting support when stock performance is poor (Gordon and Pound, 1993; Strickland, Wiles, and Zenner, 1996) and insider ownership is low (Gordon and Pound, 1993).

In addition to insider ownership, I introduce another control variable to proxy for governance structure – a governance index representing the strength of shareholder rights. Gompers et al. (2003)'s Governance Index is constructed in principle that gives each point for a corporate governance provision that restricts shareholder activism. “Almost every provision gives management a tool to resist different types of shareholder activism, such as calling special meetings, changing the firm’s charter or bylaws, suing the directors, or just replacing them all at once (Gompers et al., 2003 – p.114).” Eliminating those provisions that restrict shareholder activism would allow shareholders to more easily gain support for their initiated proposals and to put more pressure on boards and management. I inverse their index to create mine in order to make an increase in my governance index corresponding to an increase in shareholder rights.

I add a time period variable controlling for other potential period specific factors.

This is an indicator variable used to capture the possible regulatory and economic changes around 2002: 1 for the period after 2002 and 0 otherwise. As mentioned earlier, the corporate scandals in the late 1990s and the early 2000s prompted sweeping regulatory changes (i.e. Sarbanes-Oxley Act of 2002) which in turn increased the accountability of corporate directors (Brill, 2004) and the responsiveness of corporate management to shareholder proposals (Eisenhofer and Barry, 2006). Considering the transformation in the regulatory environment and investors’

adaptation, it would be plausible that shareholders react more favorably to shareholder executive-pay proposals after 2002 than before 2002. This proposition is consistent with Gillan and Starks (2000)'s finding that shareholder reactions as measured by voting outcomes for corporate governance proposals vary across time. However, given that there were many economic and political events around 2002, it would be hard to disentangle which events were driving what effects. Therefore, the time period variable only serves a control purpose.

Finally, if a proposal has been filed before, it may affect the voting outcome when such a proposal is refilled at the target company (Gillan and Starks, 2000). I include an indicator variable (1 if a proposal has been filed before; 0 otherwise) to control for such effects.

5.5 Firm Reactions to Shareholder Proposals

5.5.1 Measuring Pay-Performance Sensitivity

I use three measures for pay-performance sensitivity to test H5. For clarity, I label the first one "Delta Measure", second one "Indirect Measure", and the third one "Direct Measure".

Calculated according to the methodology suggested by Yermack (1995) and Hartzell and Starks (2003), the first pay-performance sensitivity measure is the delta of each grant for each executive's option-grant sensitivity multiplied by the number of shares represented by the grant and divided by the number of shares outstanding of the

firm at the start of the year⁶⁶. To be able to compare with prior literature, I multiply the resulting number above by 1,000 and label it as “OPTION_SENSITIVITY”. The detailed calculation is in Appendix III. I name this first sensitivity measure as “Delta Measure” after the calculated “deltas” for option grants.

There are two advantages of using this measure. First, stock option has been a major component in executive pay since late 1990s (Hall and Murphy, 2002). Second, stock option sensitivity provides the largest portion of the total increase in pay-performance sensitivity (Hall and Liebman, 1998). Finally, using this measure can avoid “noise inherent in using slope coefficients as sensitivity estimates” (Hartzell and Starks, 2003).

The second measure is used in Jensen and Murphy (1990) and Hartzell and Starks (2003) for cash pay and total pay sensitivities, which are the coefficient estimates when the change in pay is regressed on the change in shareholder wealth: $\Delta Pay_{it} = \beta_0 + \beta_1 \Delta Shareholder Wealth + \varepsilon$. The cash pay includes salary and bonus and other annual compensation. The total pay includes cash pay, stock option grants, equity awards, long-term incentive awards, and other components reported in ExecuComp database. I name this second sensitivity measure as “Indirect Measure” because its indirect nature of estimating slope coefficients (β_1) as sensitivities.

⁶⁶ The delta of each option grant is $\partial C / \partial P$, where C is the Black-Scholes value of the option modified for dividends and P is the stock price. This measure does not consider executive wealth changes from exercising vested stock options.

Since there are “noise inherent in using slope coefficients as sensitivity estimates” (Hartzell and Starks, 2003), I construct the third measure similar in spirit as the sensitivities (both implicit and explicit) estimated in Jensen and Murphy (1999; p. 2527-2531) for cash pay and total pay sensitivities. Because this measure has relatively less noise, particular for total pay sensitivities, I call it the “Direct Measure”⁶⁷. Figure XII shows the average pay-performance sensitivities for CEOs in Execucomp firms using this Direct Measure for the period of 1993-2005.

Implicit sensitivities for cash compensation are determined by first estimating pay-performance elasticities for each year. These elasticities are then converted into firm-specific pay-performance sensitivities by multiplying by the executive’s salary, bonus and other compensation, and dividing by the firm’s market value (in \$1000s). The pay-performance sensitivity for long-term incentive plans is calculated by dividing the LTIP payment received by the executive in each year by the change in shareholder wealth.

The explicit sensitivity for stock options is calculated as described in the previous page. The explicit sensitivity for restricted stock is the dollar change of the executive’s restricted stock grants as a fraction of total shareholder value (in \$1000s). For example, if an executive is granted 2% of the total shareholder value in restricted stock, his compensation from restricted stock increases by \$20 for every \$1,000

⁶⁷ Strictly speaking, the “Direct Measure” is not without “noise” of estimating coefficients as sensitivities, especially for the cash pay sensitivity component. However, this measure allows the estimated sensitivity to be used “directly” as a potential dependent variable, making subsequent tests on the change in sensitivity more straightforward and the test results much easier to interpret than the “Indirect Measure”.

increase in shareholder value. The sum of all explicit and implicit sensitivities for an executive is the total pay sensitivity. All sensitivities are scaled to the change in executive pay per \$1,000 in shareholder wealth.

To test whether the pay-performance relation changes more favorably for the firms receiving shareholder executive-pay proposals than for control firms, I obtain at the year (Year -1) before the Proposal Year a set of control firms matching the targeted firms by industry, firm size, and pay-performance sensitivity⁶⁸. The groups of control firms vary depending on the types of pay-performance sensitivity tested. For example, in testing the change in stock option grant sensitivity, the matching criteria will be industry, firm size, and Year -1 stock option grant sensitivity. In testing the change in cash pay (total pay) sensitivity, the matching criteria will be industry, firm size, and Year -1 cash pay (total pay) sensitivity⁶⁹.

Industry and firm size are known to affect pay-performance sensitivity (Murphy, 1999; Harzell and Starks, 2003). Requiring the same sensitivity level in the year before the Proposal Year for both the test firms and the control firms is critical to analyze whether there are any changes in the sensitivities after the Proposal Year. This requirement mitigates potential omitted variable problems for unknown firm

68 A proxy date is usually after a fiscal year end. Therefore, the proxy date in Year 0 indicates that the shareholder proposal is for Year -1. When a firm receives multiple performance-oriented shareholder executive-pay proposals in consecutive years, I consider the most recent year the proposal year.

69 When using the SECOND sensitivity measure for cash pay and total pay, I run time-series regression suggested by Murphy (1985) and Jensen and Murphy (1990) using the observations from year -6 to year -1. When using the THIRD sensitivity measure for cash pay, I use the implicit cash sensitivity in year -1. When using the THIRD sensitivity measure for total pay, I sum the implicit cash sensitivity and the explicit sensitivities of restricted stock and stock option grants as the total pay sensitivity in year -1.

characteristics that might have influenced pay-performance sensitivities of either the sample firms or the control firms.

5.5.2 Modeling Pay-Performance Sensitivity in Stock Option Grants

First, I perform univariate tests for the differences in *OPTION_SENSITIVITY* between sample firms and control firms in year -1, and year 1 respectively. I expect the difference (sample minus control) will be insignificant in year -1 and statistically positive in year 1.

Second, I use the data in year -1 and year 1 to run the following ordinary least squares regression for the sample firms and the set of control firms described earlier:

$$\begin{aligned} \Delta OPTION_SENSITIVITY_{it} = & \beta_0 + \beta_1(POST \times PROPOSAL) + \beta_2 PROPOSAL + \beta_3 POST \\ & + \gamma_1 \Delta(ShareholderWealth)_{it} + \gamma_2 \Delta(ShareholderWealth)_{it-1} \\ & + \sum \gamma_k (OtherControlVariables) + \varepsilon_{it} \end{aligned} \quad (4a)$$

where $\Delta OPTION_SENSITIVITY$ is the difference between t and t-1 on the stock option sensitivity; *PROPOSAL* is 1 for a firm with a shareholder proposal and 0 otherwise; *POST* is 1 for the year after proposal year and 0 for the year before proposal year; and control variables include firm size (market capitalization) and growth (Tobin's Q) that are known to potentially influence the pay-performance sensitivity (Hartzell and Starks, 2003). $\Delta(ShareholderWealth)$ is the change in shareholder wealth.

I expect a positive sign for the coefficient β_1 for the interaction term *POST* × *PROPOSAL*, which means that receiving a performance-oriented shareholder

executive-pay proposal is associated with subsequently (in Year 1) higher change in stock option grant sensitivity than control firms *ceteris paribus*.

I control firm size (Smith and Watts, 1992; Murphy 1999) with market capitalization; and control growth opportunities (Smith and Watts, 1992; Harvey and Shrieves, 2001) and expected performance (Hartzell and Starks, 2003) with Tobin's *q* ratio. For the tests of CEO's pay-performance sensitivities, I use an indicator variable *NEWCEO* (1 if new CEO for current year and 0 CEO for current year is the same as for last year) to control for CEO turnovers. For the tests of pay-performance sensitivities for all top executives available in Execucomp, I use an indicator variable *IFCEO* (1 if the executive is CEO and 0 CEO otherwise) to control for differences between CEOs and non-CEO executives. These same control variables will be used in all the other tests for the change in pay-performance sensitivities.

5.5.3 Modeling Pay-Performance Sensitivity in Cash and Total Compensation

I follow Murphy (1999), Yermack (1995) and Hartzell and Starks (2003) to build two ordinary least squares models in Equations (4a), and follow Jensen and Murphy (1990) and Hartzell and Starks (2003) to construct two other models in Equations (5) for pay-performance sensitivity reflected in cash pay and total compensation respectively. Equation (4b) employs the "Direct Measure" and Equation (5) the "Indirect Measure" of sensitivity.

5.5.3.1 Direct Measure

Equations (4b) are two equations with the same set of independent variables and two dependent variables – change in cash pay sensitivity ($\Delta CASH_SENSITIVITY_{it}$) and change in total pay sensitivity ($\Delta TOTAL_SENSITIVITY_{it}$) respectively.

$$\begin{aligned} & \Delta CASH_SENSITIVITY_{it} (\Delta TOTAL_SENSITIVITY_{it}) \\ & = \beta_0 + \beta_1 (POST \times PROPOSAL) + \beta_2 PROPOSAL + \beta_3 POST + \gamma_1 \Delta(ShareholderWealth)_{it} \\ & \quad + \gamma_2 \Delta(ShareholderWealth)_{it-1} + \sum \gamma_k (OtherControlVariables) + \varepsilon_{it} \end{aligned} \quad (4b)$$

POST is one for the year (Year 1) after proposal year and zero for the year (Year -1) before proposal year. *PROPOSAL* is one if a firm receives a performance-oriented shareholder executive-pay proposal and zero otherwise. $\Delta(ShareholderWealth)_{it}$ is the change in shareholder's wealth in year t. $\Delta(ShareholderWealth)_{it-1}$ is the change in shareholder's wealth in year t-1. *OtherControlVariables* are the same as those in Equation (4a).

I expect this coefficient (β_1) of the interaction term *POST* × *PROPOSAL* to be positive, which means receiving a performance-oriented shareholder proposal would increase the pay-performance sensitivity of cash pay (or total pay) from Year -1 to Year 1 ceteris paribus.

5.5.3.2 Indirect Measure

Equations (5) are two equations with the same set of independent variables and two different dependent variables – $\Delta CashComp$ and $\Delta TotalComp$ respectively, representing the change in cash compensation and the change in total compensation.

$$\begin{aligned}
& \Delta CashComp_{it} (\Delta TotalComp_{it}) \\
& = \beta_0 + \beta_1 PPW + \beta_2 \Delta(ShareholderWealth)_{it} + \beta_3 \Delta(ShareholderWealth)_{it-1} + \gamma_0 POST \\
& \quad + \gamma_1 PROPOSAL + \gamma_2 (POST \times PROPOSAL) + \gamma_3 (PROPOSAL \times \Delta ShareholderWealth_{it}) \\
& \quad + \gamma_4 (POST \times \Delta ShareholderWealth_{it}) + \sum \gamma_k (OtherControlVariables)_{it} + \varepsilon_{it} \quad (5)
\end{aligned}$$

$POST$ is one for the year (Year 1) after proposal year and zero for the year (Year -1) before proposal year. $PROPOSAL$ is one if a firm receives a performance-oriented shareholder executive-pay proposal and zero otherwise. $\Delta(ShareholderWealth)_{it}$ is the change in shareholder's wealth in year t . $\Delta(ShareholderWealth)_{it-1}$ is the change in shareholder's wealth in year $t-1$. $OtherControlVariables$ are the same as those in Equation (4a).

The focus here is on the coefficient (β_1) of the interaction term PPW , which is $(POST \times PROPOSAL \times \Delta ShareholderWealth_{it})$. Since we can interpret the interaction term $(PROPOSAL_{it} \times \Delta ShareholderWealth_{it})$ as the effect of receiving a shareholder executive-pay proposal on the pay-performance sensitivity ceteris paribus, the interaction term PPW is the differential effect of changing Year -1 to Year 1 on the interaction term $(PROPOSAL \times \Delta ShareholderWealth_{it})$. I expect this coefficient (β_1) to be positive, which means receiving a performance-oriented shareholder proposal

would increase the pay-performance sensitivity of cash pay (or total compensation) from Year -1 to Year 1 ceteris paribus.

Alternatively, we can interpret $(POST \times \Delta Shareholder Wealth_{it})$ as the effect of changing Year -1 to Year 1 on the pay-performance sensitivity ceteris paribus. Then, the interaction term PPW is the differential effect of receiving a shareholder executive-pay proposal on the interaction term $(POST \times \Delta Shareholder Wealth_{it})$. In other words, if the coefficient (β_1) of PPW is positive, it means that a firm receiving a shareholder proposal would have a higher change of pay-performance sensitivity from Year -1 to Year 1.

5.5.4 Measuring and Modeling the Changes in Pay Structure

The structural change in stock-based pay within total compensation is measured as the change in the ratio of equity-based pay (stock option grants and restricted stock grants) to the total compensation, or as the change in the ratio of equity-based sensitivity to the total sensitivity (using the “Direct Measure”). I construct an ordinary least squares regression model in Equation (6) as follows:

$$\begin{aligned} \Delta ET(\Delta ESTS) = & \beta_0 + \beta_1(POST \times PROPOSAL) + \beta_2 PROPOSAL + \beta_3 POST \\ & + \gamma_1 \Delta(Shareholder Wealth)_{it} + \gamma_2 \Delta(Shareholder Wealth)_{it-1} \\ & + \sum \gamma_k (Other Control Variables) + \varepsilon_{it} \end{aligned} \quad (6)$$

where ΔET is the change in the ratio of Equity-based compensation to Total compensation and $\Delta ESTS$ is the change in the ratio of Equity Sensitivity to Total Sensitivity. $POST$ is one for the year after proposal year and zero for the year before proposal year.

PROPOSAL is one if a firm receives a performance-oriented shareholder executive-pay proposal and zero otherwise. $\Delta(\text{ShareholderWealth})$ is the change in shareholder's wealth. *OtherControlVariables* are the same as those in Equation (4a).

I expect this coefficient (β_1) of the interaction term $POST \times PROPOSAL$ to be positive, which means receiving a performance-oriented shareholder proposal would increase the ratio of equity-based pay to the total compensation or the ratio of equity-based sensitivity to the total sensitivity from Year -1 to Year 1 ceteris paribus.

CHAPTER 6

ANALYSIS OF RESULTS

6.1 Descriptive Statistics

Table I summarizes the industry distribution for proposal firms compared to the other firms in the ExecuComp database. There are 199 firms distributed in ten industry groups based on S&P two-digit industry classification. The three groups with the highest proportions for proposal firms are retail (18.6%), financial (15.6%), and high-tech (14.1%) industries. Retail and high-tech are also among the three industries with the highest proportions for non-proposal firms. Firms in the agricultural, financial, and utilities industries seem to have a higher frequency of receiving shareholder executive-pay proposals.

Table II presents descriptive statistics of the data sample⁷⁰. Compared to the other firms in ExecuComp database, the proposal firms are much larger in terms of size and compensation. For example, the mean (median) market capitalization is about \$34,253 (\$12,404) million for proposal firms and about \$2,705 (\$870) million for the other firms in ExecuComp. The mean (median) total compensation for proposal firm

⁷⁰ I present the descriptive statistics and principal test results using data for CEOs only, while I perform additional analysis in Section 6.5 using data for the other top executives.

CEOs is about \$10,408 (\$7,258) million, more than three times the \$2,905 (\$1,629) million for the other firms in ExecuComp.

In addition, the mean (median) return is about 6% (5.9%) for proposal firms, lower than the 17% (10.9%) for the other firms. The mean (median) CEO stock ownership (excluding stock options) is lower for proposal firms than for the other firms: 0.7% (0.1%) vs. 2.8% (0.4%). The fact that CEO stock ownership is lower for proposal firms is consistent with the notion that firms with lower level of managerial stock ownership may have higher agency cost, therefore attracting shareholder executive-pay proposals.

Table III presents the benchmark model [Equation (1)] obtaining the total compensation residuals used in the logistic regressions in the next section 6.2. All coefficients are significant at conventional levels.

6.2 Analysis of Why Shareholders Submit Proposals

Table IV presents the logistic regression results of Equation (2) where the dependent variable PROPOSAL is equal to one if a firm receives a performance-oriented shareholder executive-pay proposal and zero otherwise. The sample period is from 1995 to 2005. There are four models in the table. CEO stock ownership in models (1) and (2) does not include stock options, whereas the CEO ownership includes stock options in models (3) and (4). Models (1) and (3) use a control sample

that includes all ExecuComp firms other than the proposal firms. Models (2) and (4) use a control sample matched to the proposal firms by industry and firm size.

PROPOSAL is 1 for a firm with a shareholder proposal and 0 otherwise. The independent variable poor_indicator is an indicator variable. Its value is 1 if a firm's prior two-year industry-adjusted return is negative; and 0 otherwise. TotalComp_residual is the value of the residual from the executive-pay benchmark model [Equation (1)]. CEO_ownership is the level of fractional stock ownership for CEOs. CEO_age is the actual CEO age. Stock_volatility is the standard deviation of stock returns. Shareholder_rights is the inverse of the values in the governance index designed by Gompers et al. (2003)⁷¹.

I expect positive signs for poor_indicator and TotalComp_residual because poor performance and larger pay deviation from the expected level are hypothesized to be associated with higher probability of a firm receiving shareholder executive-pay proposals. In Table IV, "ΔPred.Prob." shows the change in the predicted probability that occurs when the independent variable increases one unit in its value and is evaluated at the mean values of the remaining independent variables. Take model (2) for example, when TotalComp_residual increases one unit of its value, the predicted probability of a firm receiving a performance-oriented shareholder executive-pay proposal increases by about 89.0%. This indicates that firms with larger unexpected

⁷¹ In the governance index designed by Gompers et al. (2003), a higher value means weaker shareholder rights. For convenience of the interpretation, I inverse the index values to derive the Shareholder_rights variable.

total compensation are more likely to receive performance-oriented shareholder executive-pay proposals.

Since a value of one in `poor_indicator` means that the return is below industry median, I expect a positive sign for the coefficient of the interaction term between `poor_indicator` and `TotalComp_residual`. The positive coefficient in model (2) (0.755; $p\text{-value}=0.023$) reinforces the notion that larger pay deviation from the expected level conditioning upon poor performance is associated with higher likelihood (112.7%) of receiving a shareholder executive-pay proposal.

Because the likelihood of shareholder monitoring increases with higher agency costs, I expect the coefficients for `CEO_ownership`, `CEO_age`, `shareholder rights`, and `stock_volatility` to be negative, positive, positive, and positive respectively. Lower `CEO_ownership` means higher agency cost and higher probability of a firm receiving shareholder executive-pay proposals. Higher `CEO_age` means closer to retirement and more horizon problems, therefore higher probability of receiving shareholder executive-pay proposals. The stronger the shareholder rights, the more likely shareholder submit executive-pay proposals. Higher stock volatility indicates high monitoring cost, and higher likelihood of receiving shareholder executive-pay proposals. Table IV shows that the predicted probability increases when firms have stronger shareholder rights (24.1%) or when CEOs are close to retirement (6.3%) but decreases when firms have higher CEO stock ownership (-75.7%) or higher

monitoring cost although the latter is statistically insignificant in model (2). All results are consistent with H1, H2, and H3 except for monitoring cost.

The overall results suggest that an S&P500 company is more likely to receive a performance-oriented shareholder executive-pay proposal when the CEO has lower level of stock ownership, is closer to retirement, or receives larger unexpected total compensation despite the company's poor stock price performance,. The results also indicate that the probability of a company receiving a shareholder proposal is higher when the company has stronger shareholder rights.

6.3 Analysis of Shareholder Reactions

Table V presents the regression results on how shareholders react to shareholder proposals of different types, sponsors, and periods. There are six different models in the table denoted by (1) through (6) using different performance measures as control variables. Models (1) through (3) control for industry fixed effects while models (4) through (6) do not. The results for the hypothesized variables are unchanged.

VOTE is the dependent variable measuring shareholder reaction by the percentage vote in favor of a shareholder proposal. TYPE is an indicator variable: 1 for performance-oriented proposals and 0 otherwise. SPONSOR is an indicator variable: 1 for pension fund or labor fund sponsors and 0 otherwise. YEAR represents an indicator variable used to control for potential regulatory and economic

environment changes around 2002: 1 for the period after 2002 and 0 otherwise. I predict positive coefficients for TYPE, SPONSOR.

Table V indicates that shareholders garner more voting support for executive-pay proposals sponsored by pension funds and labor funds than by other parties, increasing the “for” votes by about 2.8 percentage points in model (1) *ceteris paribus*. This result is consistent with the findings of Gillan and Starks (1998, 2000) and Gordon and Pound (1993). The large coefficient on TYPE suggests that shareholders give the strongest support to performance-oriented than non-performance-oriented shareholder executive-pay proposals. *Ceteris paribus*, a performance-oriented executive-pay proposal receives about 19.7 [model (1)] percentage points more voting support than a non-performance-oriented one. The positive coefficient for YEAR indicates that shareholders gave more support to shareholder executive-pay proposals in the period after 2002 than in the period before 2002.

The positive coefficient for G-Index appears to indicate that shareholders are more concerned about executive pay issues when the governance is weak in a target company. The negative coefficients for CEO stock ownership indicates that firms with lower stock ownership by executives receive higher voting support on shareholder executive-pay proposals, consistent with Bizjak and Marquette (1998)’s argument that shareholders are more likely to take action when the incentives of insiders and shareholders diverge.

6.4 Analysis of Firm Reactions

After receiving performance-oriented shareholder executive-pay proposals, do firms take actions to resolve the issues raised by shareholders? Or, do the boards of directors simply ignore the proposals and go back to “business as usual”? To answer the questions I test the post-proposal changes in pay-performance sensitivity (H5) and the changes in pay structures (H6).

6.4.1 The Change in Stock Option Sensitivity

Figure XIII shows that the stock option sensitivities for the test firms and control firms were similar at the year (Year -1) before the Proposal Year but drastically different after the Proposal Year in Year 1.

To control for extraneous sources of variability, I match each proposal sample firm with a control firm based on its industry, firm size, and stock option sensitivity in Year -1, and then run regression according to Equation (4a). I predict that β_1 will be positive.

Table VI shows the regression results, for which Model (1) is for stock option grants of all top executives available and Model (2) is for CEO stock options only. The coefficient for $POST \times PROPOSAL$ (β_1) is positive and statistically significant for both models ($\beta_1=0.1443$, $p=0.002$ in model (1); $\beta_1=0.8553$, $p=0.018$ in Model (2)). This result indicates that executive stock option sensitivities in target firms

increase more than in control firms one year after the year when corporate proxy statements included performance-oriented shareholder executive-pay proposals.

6.4.2 The Change in Sensitivity of Cash and Total Compensation

For pay-performance sensitivity in cash and total compensation, I run two sets of regressions – one using the Direct Measure and the other using the Indirect Measure.

6.4.2.1 Direct Measure

For the Direct Measure, I match each proposal sample firm with a control firm based on industry, firm size, and the pay-performance sensitivity derived with the Murphy (1999) methodology at year -1, and then run regressions according to Equations (4b), following Hartzell and Starks (2003). The dependent variables are $\Delta CASH_SENSITIVITY_{it}$ and $\Delta TOTAL_SENSITIVITY_{it}$, representing the dollar change in cash and total compensation respectively per \$1,000 change in shareholder wealth. The focus is on the coefficient (β_1) of the interaction term $POST \times PROPOSAL$. I predict that β_1 will be positive, which means receiving a shareholder proposal would increase the pay-performance sensitivity of cash pay (or total compensation) to shareholder wealth from Year -1 to Year 1 more than for firms without shareholder proposals ceteris paribus.

Table VII presents the regression results for Equations (4b). The dependent variable for models (1) and (2) is $\Delta CASH_SENSITIVITY_{it}$ and the dependent variable

for models (3) and (4) is $\Delta TOTAL_SENSITIVITY_{it}$. Models (1) and (3) are for all top executives. Models (2) and (4) are for CEOs only. All coefficients for the interaction term $POST \times PROPOSAL$ are positive and statistically significant (except just barely significant in Model (2)). This result indicates that the changes in cash or total compensation sensitivities for proposal firm executives increase more for the test firms than for the control firms.

6.4.2.2 Indirect Measure

For the Indirect Measure, I match each proposal sample firm with a control firm based on industry and firm size in Year -1, and on the pay-performance sensitivity derived by estimating $\Delta Pay_{it} = \beta_0 + \beta_1 \Delta Shareholder Wealth + \varepsilon$ for year -6 to Year -1, and then run regressions according to Equations (5), following Jensen and Murphy (1990) and Hartzell and Starks (2003). The dependent variables are $\Delta CashComp$ and $\Delta TotalComp$, representing the change in cash compensation and the change in total compensation respectively. The focus is on the coefficient (β_1) of the interaction term PPW which is $POST \times PROPOSAL \times \Delta Shareholder Wealth_{it}$. I predict that β_1 will be positive, which means receiving a shareholder proposal would increase the pay-performance sensitivity of cash pay (or total compensation) to shareholder wealth from Year -1 to Year 1 more than for firms without shareholder proposals ceteris paribus.

Table VIII presents the regression results for Equations (5). The dependent variable for models (1) and (2) is $\Delta CashComp$ and the dependent variable for models (3) and (4) is $\Delta TotalComp$. Models (1) and (3) are for all top executives. Models (2) and (4) are for CEOs only. All four coefficients for the interaction term PPW are positive and statistically significant. This result indicates that the changes in cash or total compensation sensitivities for proposal firm executives increase from Year -1 to Year 1 more for firms with performance-oriented shareholder executive-pay proposals than for firms without similar shareholder proposals *ceteris paribus*.

6.4.3 The Change in Equity-based Compensation Structure

For the change in pay structures, I match each proposal sample firm with a control firm based on industry, firm size, and the ratio of equity-based pay to total compensation (or the ratio of equity-based sensitivity to total sensitivity) for each executive in year -1, and then run regressions according to Equations (6).

In Table IX, models (1) and (3) are for all top executives. Models (2) and (4) are for CEOs only. ΔET is the change from year t-1 to year t in the ratio of Equity-based compensation to Total compensation and $\Delta ESTS$ is the change in the ratio of Equity Sensitivity to Total Sensitivity from year t-1 to year t. I predict that β_1 will be positive. Table IX shows that the coefficients for PROPOSAL (β_1) is significantly positive for CEOs only ($\beta_1=0.1199$, $p=0.055$ in Model (2); $\beta_1=0.1675$, $p=0.031$ in Model (4)) yet insignificant for the other top executives (models (1) and (3)). This result indicates that CEOs' but not other top executives' compensation structures shift more toward

equity-based in target firms than in control firms after the year corporate proxy statements included the performance-oriented shareholder executive-pay proposals.

The overall test results in Tables VI, VII, VIII, and IX suggest that, comparing to a non-proposal control firm, for an S&P500 company that receives a performance-oriented shareholder executive-pay proposal,

- 1) executive stock option pay-performance sensitivities increase more after the Proposal Year;
- 2) executive cash and total pay sensitivities increase more after the Proposal Year;
- 3) CEOs' but not the other top executives' pay-structure shift more toward equity-based after the Proposal Year.

The above evidence is consistent with the notion that firms do respond to performance-oriented shareholder executive-pay proposals by increasing CEO pay-performance sensitivities in stock option grants, cash compensation and total compensation.

CHAPTER 7

SUMMARY AND CONCLUSIONS

This thesis studies potential theoretical explanations on why firms receive performance-oriented executive-pay proposals, explores influential factors that could sway the voting outcome of shareholder executive-pay proposals, and probes subsequent changes in pay-performance relations and compensation structures at the targeted firms. Table X presents the primary findings.

Results suggest that firms with horizon problem, lower managerial ownership, stronger shareholder rights, or higher unexpected CEO compensation conditioning on poor industry-adjusted performance are more likely to receive performance-oriented shareholder executive-pay proposals. On the other hand, high monitoring cost seems to decrease the probability of a firm receiving these shareholder proposals. This contradicts the prediction yet consistent with the notion that shareholders may have diverse motivations for submitting performance-oriented executive-pay proposals.

Several factors appear to influence the voting outcome of shareholder executive-pay proposals. The percentage of votes that are “for” a shareholder executive-pay proposal increases significantly if the proposal is performance-oriented or sponsored by pension funds or union funds. Results indicate that target firms’ pay-

performance sensitivity in stock option grants, cash and total compensation increases more than control firms after the Proposal Year. Additionally, CEO compensation structures shift more toward equity-based for the target firms than for control firms.

The implications of the findings are three-fold. First, if theories in managerial ownership alignment, CEO horizon problem, corporate governance, and optimal contracting can explain why firms receive performance-oriented shareholder executive-pay proposals, then it suggests that shareholder executive-pay activism is not “gadfly” any more but sophisticated value-maximizing monitoring in the 1995 to 2005 period. This corroborates The Wall Street Journal’s claim that “executive-pay activism” has been turned “into a potent mainstream force” (Lublin and Dvorak, 2007).

Second, if shareholder executive-pay proposals that are performance-oriented or sponsored by pension and union funds receive more voting support, then shareholders may gain advantage in voting by structuring their proposals as performance-oriented and by seeking alliance with pension and union funds.

Third, Warren Buffett once laments during an interview with CNN, “Somebody said CEO pay has the honor system. The shareholders have the honor and the CEOs have the system.” (Lisovicz, 2007) The finding that the pay-performance relations improve after firms receive performance-oriented shareholder executive-pay proposals suggests that these proposals could enable the shareholders to better monitor

executive pay and align managerial interests, and to have both the “honor” and the “system”.

The above implications, however, are subject to some limitations and caveat. For example, union funds and pensions funds have different motives than regular shareholders. Since most performance-oriented shareholder executive-pay proposals in this study are sponsored by union funds and pensions funds, the results need to be interpreted with caution when generalized to all shareholders.

Furthermore, many shareholder proposals are withdrawn due to various reasons before reaching the annual meeting for a vote. These withdrawn proposals are not examined in this thesis⁷². The regression coefficient estimates for Equation (3) would be underestimated if most withdrawn proposals were due to management agreement to take the proposed actions, and overestimated if most withdrawn proposals were due to insufficient support from shareholders recognized by the proposal sponsors prior to the vote.

In addition, factors other than shareholder proposals can increase a firm’s pay-performance sensitivity. Institutional ownership, for instance, is one. Higher institutional ownership concentration is associated with subsequent increase in pay-performance sensitivity (Hartzell and Starks, 2003). To the extent that institutional ownership is not controlled for in Equations (4) to (6), the results for the hypothesized variables may be overestimated.

⁷² Most withdrawn proposals are not available in public sources but available at the Institutional Shareholder Services.

Finally, the classification of shareholder proposals in this study is subjective. The variation of the types of proposals may not be fully captured in the test results.

Some of these limitations may be addressed in future research. There are other potential research areas worth further investigation. For example, this study tests the subsequent changes one year after the Proposal Year. What would be the long-run economic consequences for the target firms in three to five years? Moreover, the test results focuses on target firms only. Would firms in the same industry encounter some kind of “ripple effect”? Future research can also incorporate some new development. In recent year, hedge funds have become more active on shareholder proposals. It would be interesting to see whether and how they monitor corporations through shareholder executive-pay proposals. All sample firms in this study are U.S. firms. It would have a lot of policy implications if the sample includes firms from the UK, Japan, and other countries where shareholder executive-pay activism has some leadership roles⁷³.

I hope this thesis can become a part of a growing body of research in shareholder executive-pay activism, which may help turn Finseth and Carlson’s (2007) prediction into a reality:

“The days when academics could describe a corporate landscape in which shareholders no longer exercised effective control over the managers of major enterprises may soon be drawing to a close.”

73 For instance, UK shareholders can have an advisory vote on executive compensation. Similar regulation is being debated in the U.S.

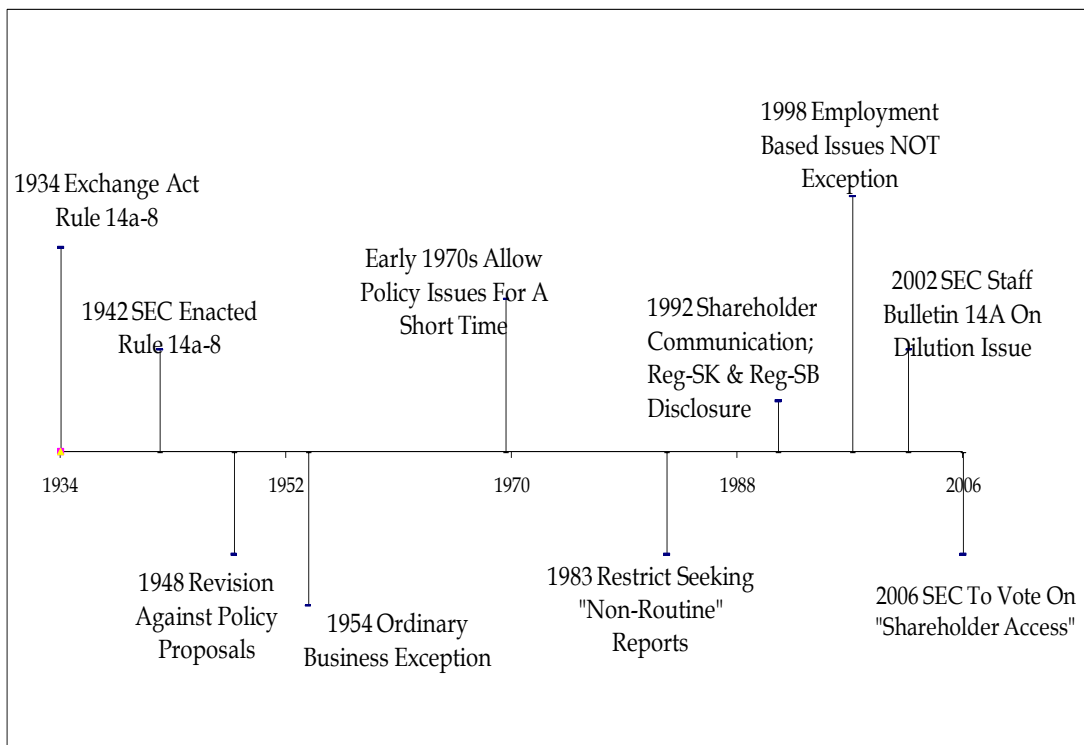


Figure 1 Timeline for Shareholder Proposal Rule

Proposal Type	2002	%	2003	%	2004	%	2005	%	2006	%
Board-Related	58	21.2%	52	12.2%	82	19.8%	109	29.1%	166	43.1%
Executive Compensation	43	15.8%	179	41.9%	167	40.3%	133	35.5%	92	23.9%
Repeal Classified Board	39	14.3%	38	8.9%	36	8.7%	44	11.7%	46	11.9%
Elim. Supermajority Provision	10	3.7%	8	1.9%	7	1.7%	13	3.5%	24	6.2%
Cumulative Voting	18	6.6%	19	4.4%	22	5.3%	18	4.8%	23	6.0%
Poison Pill Rescission	50	18.3%	76	17.8%	50	12.1%	23	6.1%	12	3.1%
Other	55	20.1%	55	12.9%	50	12.1%	35	9.3%	22	5.7%
Total	273	100.0%	427	100.0%	414	100.0%	375	100.0%	385	100.0%

Figure 2 Corporate Governance Shareholder Proposals (2002-2006).
(Source: Georgeson Inc. 2006 Annual Corporate Governance Review)

Labor Unions	159	152
AFL-CIO	20	4
AFSCME	9	15
Amalg. Bank of New York's Labor Oriented Long View Collective Inv. Fund	10	12
Bricklayers	8	5
Communications Workers of America (CWA)	1	3
Hotel Employees & Restuarant Employees Int'l Union (HERE)	1	0
Independent Association of Publishers' Employees (IAPE)	1	1
International Brotherhood of Dupont Workers	1	1
International Brotherhood of Electrical Workers (IBEW)	8	11
International Union of Operating Engineers	2	0
Laborers	5	10
Plumbers & Pipefitters	7	0
Service Empteotes International Union (SEIU)	2	4
Sheet Metal Workers	28	14
Teamsters	7	7
Telephone Coordinating Counsel	0	1
United Brotherhood of Carpenters and Joiners Of America (UBCJA)	49	64
Public Pensions	16	19
California Public Employees' Retirement System	3	2
Central Laborers' Pension Fund	1	0
Connecticut Retirement Plans	2	1
Massachusetts Laborers' Pension Fund	1	7
NY City Employees Retirement System	0	2
NY City Fire Department Pension Fund	0	1
NY State Retirement Fund	9	6
Religious Organizations	24	16
Capuchin Province of St. Joseph	1	0
Catholic Funds	11	5
Catholic Healthcare West	0	1
Christian Brothers Investment Services	1	1
Community of The Sisters of St. Dominic Of Caldwell	1	0
General Board of Pensions of The United Methodist Church	1	0
Interfaith Center on Corporate Responsibility	9	7
School Sisters of Notre Dame	0	1
Sisters of Mercy Investment Program	0	1
Sisters of St. Joseph of Nazareth	0	0
Other Shareholder Groups	16	17
Association of Bell Telephone Retirees	1	1
Association of Retired Xerox Employees	0	1
Calvert Asset Management Co.	1	0
Catalysis Partners, LLC	0	1
Gamco Investors	4	0
Global Exchange	1	0
Harrington Investments	2	2
Jolly Roger Fund, LP	0	1
Liberation Investments, LP	0	4
North Star Partners LP	0	2
Opportunity Partners	1	0
Pardus Capital Management LLC	0	1
RAM Trust	0	1
Santa Monica Partners LP	0	1
Schultze Asset Management	1	0
Steel Partners II LLP	2	0
UNITE Here	3	2
Individual Shareholders	158	180
Not Disclosed	2	1
Total	375	385

Figure 3 Sponsorship of Shareholder Proposals (2005-2006).
(Source: Georson Inc. 2006 Annual Corporate Governance Review)

Year	Market value of total outstanding equity (\$ billions)	Market value of total institutional equity holdings (\$ billions)	Institutional equity %
1950	142.7	8.7	6.1%
1960	421.2	52.9	12.6
1970	859.4	166.4	19.4
1980	1,534.7	571.2	37.2
1990	3,530.2	1,463.1	41.4
1995	8,345.4	4,070.3	48.8
1999	19,522.8	9,301.7	47.6
2000	17,627.0	9,059.6	51.4
2001	15,310.6	8,257.8	53.9
2002	11,900.5	6,600.6	55.5
2003	15,618.5	8,745.0	56.0
2004	17,389.3	10,190.4	58.6
2005	17,547.8	10,733.9	61.2

Figure 4 Institutional Investor Holdings (1950 – 2005)

This figure shows the values of total outstanding equity held by institutional investor, 1950-2005. (Source: The Conference Board Governance Center)

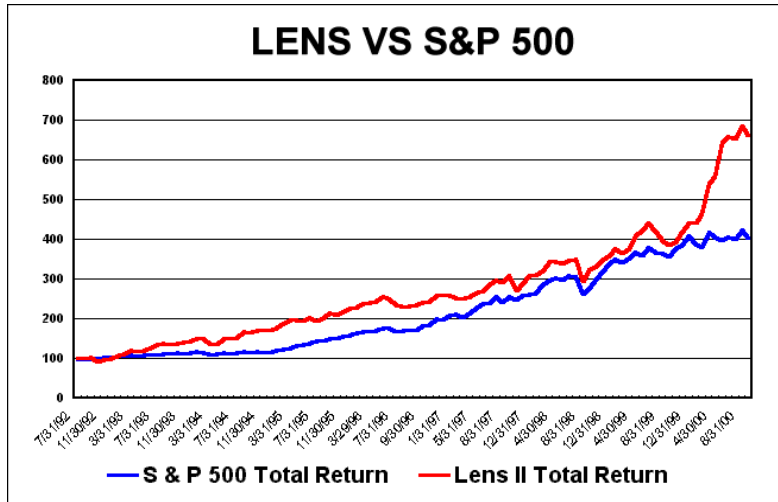


Figure 5 Performance of LENS vs. S&P 500

The performance of LENS' stocks from 7/92 through 8/96 was calculated by assembling an equally weighted portfolio of the stocks in which LENS was invested, rebalancing at the time of LENS' beginning or ending involvement with a company. Returns dating from 8/96 to present reflect actual client returns. The upper curve indicates the Lens return; the lower curve is the S & P 500 return. (Source: <http://www.lens-inc.com/returns.html>)

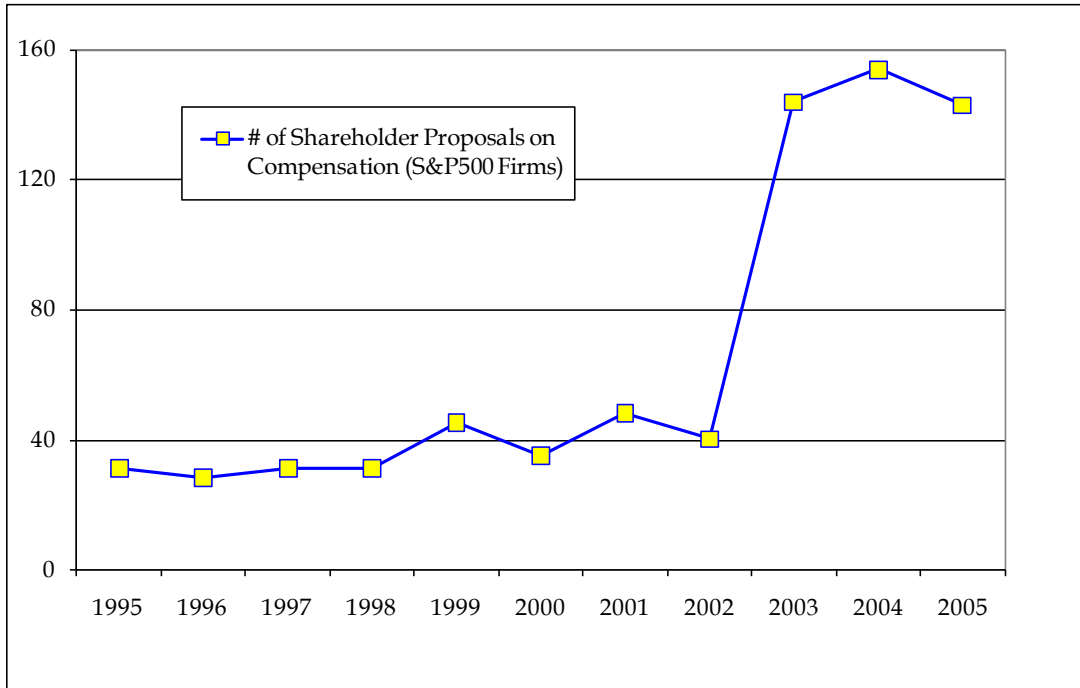


Figure 6 Shareholder Executive-Pay Proposals (1995-2005)

This figure shows the number of shareholder executive-pay proposals related to executive and director compensation over the period of 1995-2005. The shareholder proposals are collected from proxy statements issued by S&P 500 companies from 1995 to 2005.

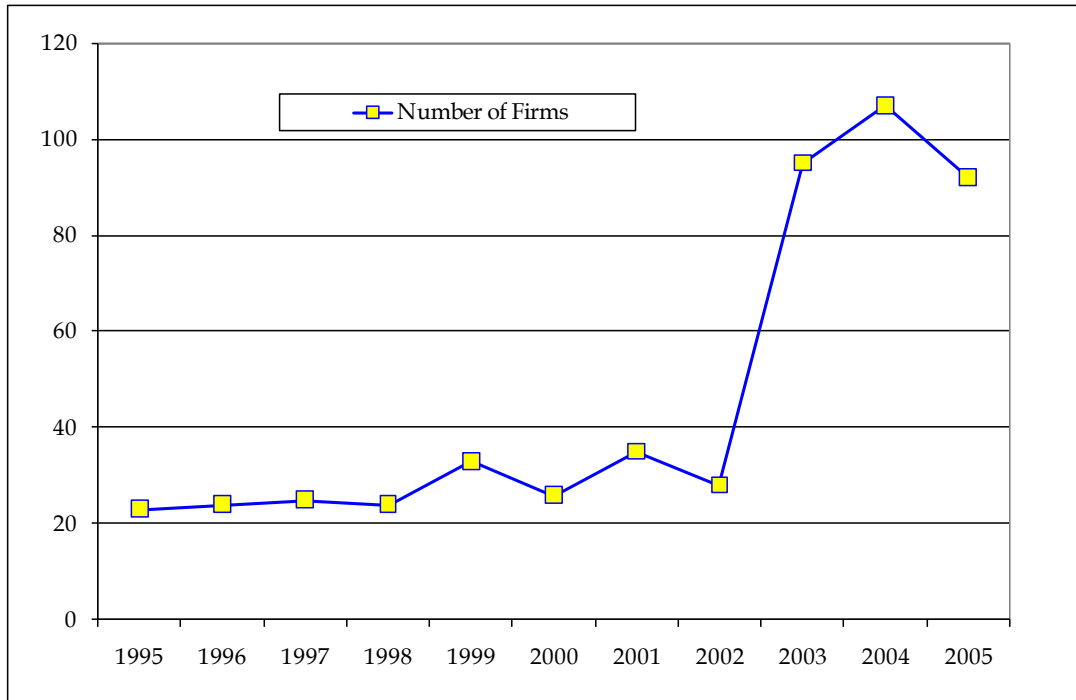


Figure 7 Number of Firms Targeted Each Year (1995-2005)

This figure shows the number of S&P 500 firms target by at least one executive-pay shareholder proposal. The proposals are collected from proxy statements issued by S&P 500 companies from 1995 to 2005.

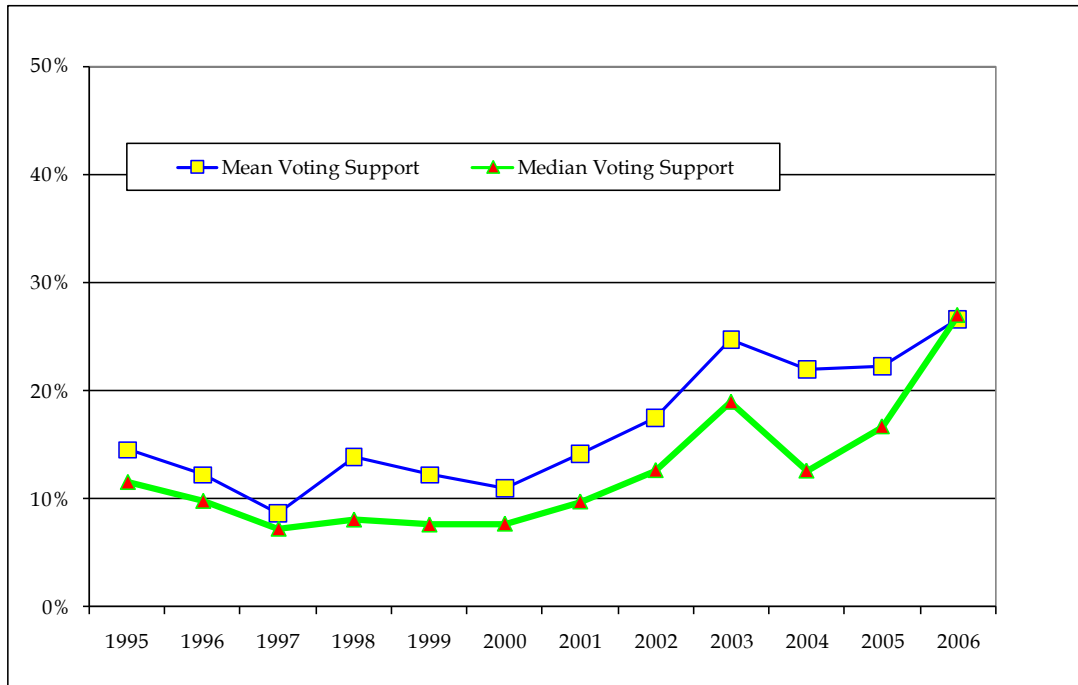


Figure 8 Voting Support for All Shareholder Executive-Pay Proposals (1995-2006)

This figure shows the voting support (the number of “for” votes divided by shares outstanding). The voting support is in mean or median percentage without differentiating the types of shareholder executive-pay proposals. Shareholder proposals are collected from proxy statements issued by S&P 500 companies from 1995 to 2006.

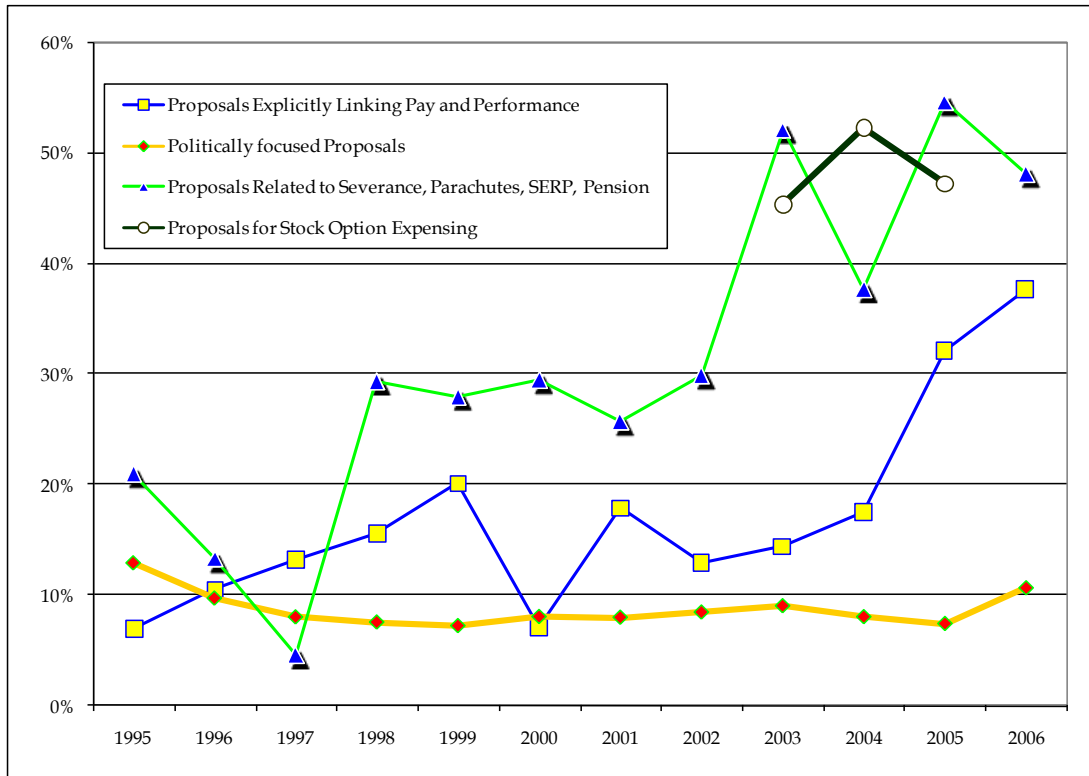


Figure 9 Voting Support Variations by Proposal Type (1995-2006)

This figure indicates the median voting support (the number of “for” votes divided by shares outstanding) in percentage terms by differentiating the types of shareholder executive-pay proposals. Shareholder proposals are collected from proxy statements issued by S&P 500 companies from 1995 to 2006.

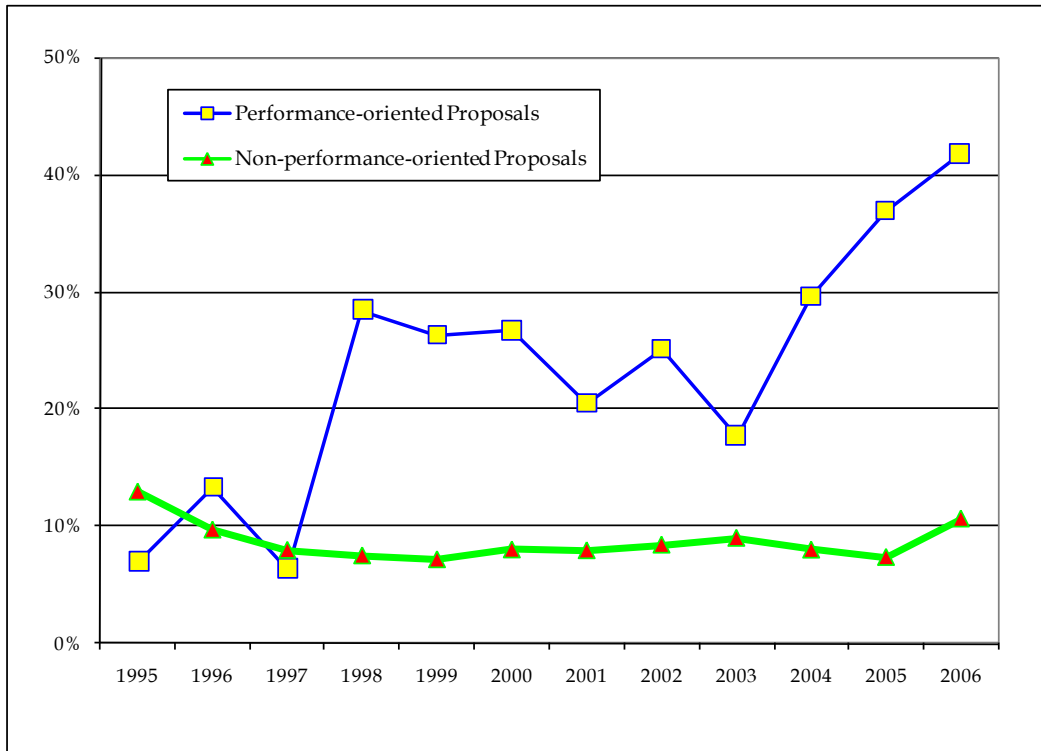


Figure 10 When Do Shareholder Proposals Matter (1995-2006)?

This figure shows differential voting supports between “performance-oriented” and “non-performance-oriented” shareholder proposals. Performance-oriented proposals include those that explicitly linking pay and performance, or those that implicitly linking pay and performance by recommending shareholder approval for large severance payments, golden parachute, executive and director pension and retirement plans, SERP, etc. Because stock option expensing is a unique issue, the figure here does not include proposals on this topic, which usually draw significantly more support than the other proposals. Shareholder proposals are collected from proxy statements issued by S&P 500 companies from 1995 to 2006.

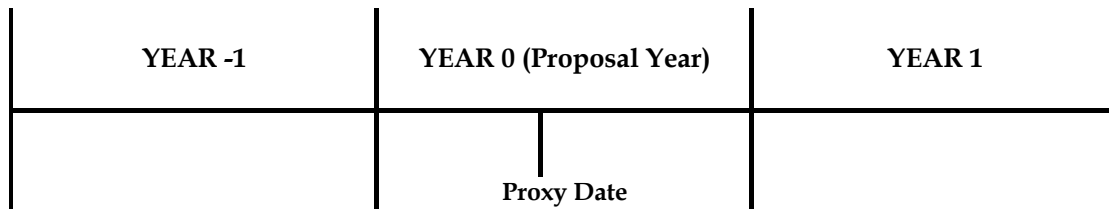


Figure 11 Timeline of Statistical Tests

Proxy materials in which shareholder proposals are included typically become available months after the fiscal year end. For example, if December 2001 is a firm's fiscal-year-end month, the proxy statements could become available in March or April 2002. I label the year "Proposal Year" (or "Year 0") when a shareholder proposal becomes available. I label the fiscal year before the proposal year as "Year -1", and the year after the proposal year as "Year 1".

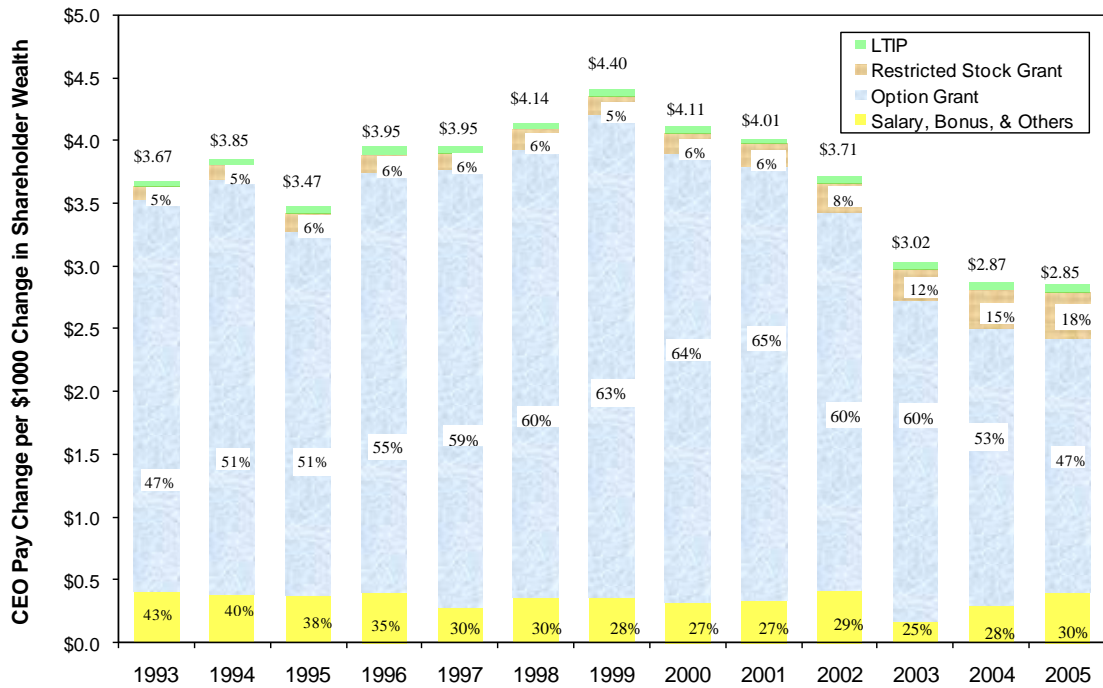


Figure 12 CEO Pay-Performance Sensitivities for Execucomp Firms

This figure shows the average pay-performance sensitivities for CEOs in Execucomp firms, 1993-2005. Pay component percentages are derived by computing the percentages for each CEO, and averaging across CEOs. Percentages for LTIP are not shown for lack of space. The bar height indicates average pay-performance sensitivity.

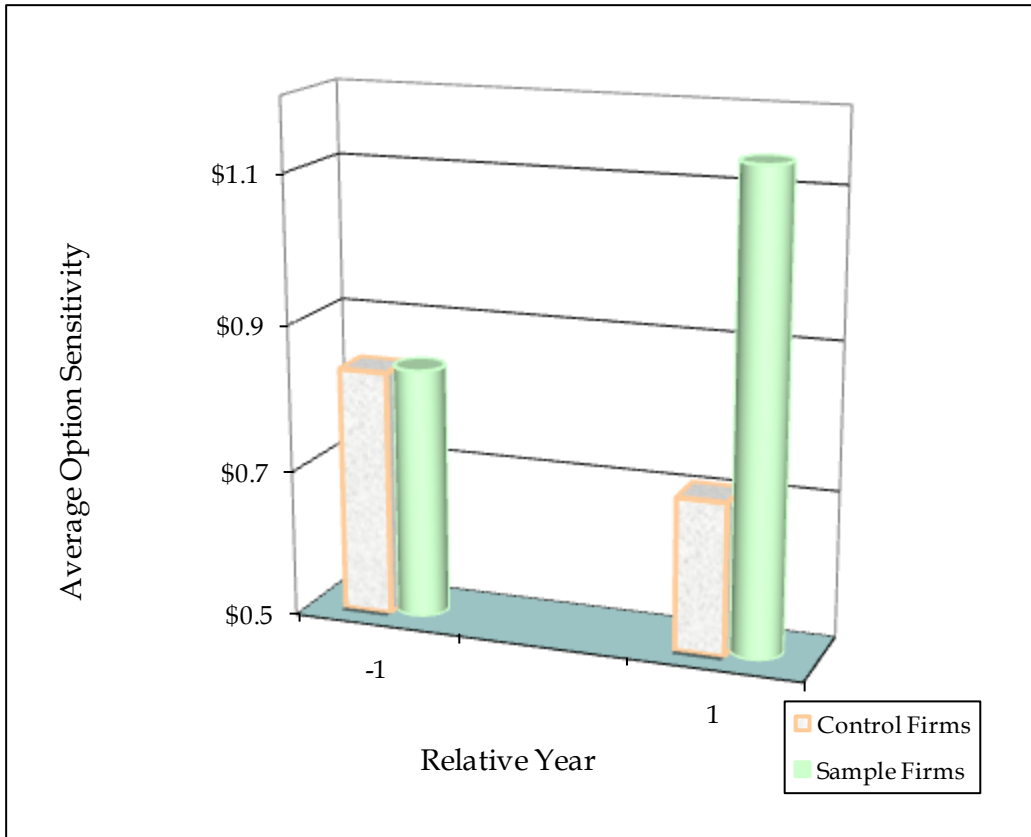


Figure 13 Average CEO Option Grant Sensitivities around Proposal Year

This figure shows the average CEO option grant sensitivities around Proposal Year, samples firms vs. control firms. Option grant sensitivity is computed as 1,000 times the delta of every option grant multiplied by the number of options granted and divided by the number of shares outstanding, and then aggregated for a CEO in a given year. Relative Year -1 is the fiscal year targeted by the shareholder proposal. Sample firms are denoted as the cylinder shape. Control firms are denoted as the box shape. Control firms are one-to-one matched to sample firms based on industry, option grant sensitivity, and firm size in year -1.

Table 1
Industry Distribution

The sample consists of 199 firms that received shareholder executive-pay proposals over the 1995 to 2005 time period. This table lists the number and percentage of sample firms (and all the other firms in the Execucomp database) in each two-digit Standard and Poor's industry classification code, and a description of that industry.

	S&P 2-Digit Industry Groups	Sample Firms		Execucomp Firms	
		N	%	N	%
10	Oil and Gas	10	5.0%	117	5.0%
15	Mining, Forest, and Chemicals	9	4.5%	156	6.7%
20	Aerospace, Defense, Construction, Engineering, and Industrials	19	9.5%	349	15.0%
25	Retail, Automobiles, Media, and Distributors	37	18.6%	449	19.3%
30	Agricultural, Food, Drink, and Household Products	20	10.1%	105	4.5%
35	Life Sciences, Health Care, and Biotechnology	21	10.6%	240	10.3%
40	Banks, Insurance, Brokerage, and REITs	31	15.6%	319	13.7%
45	Software, Computer, Data Processing, and Outsourcing Services	28	14.1%	433	18.6%
50	Telecommunications	5	2.5%	44	1.9%
55	Utilities, and Power Producers and Traders	19	9.5%	117	5.0%
	Total	199	100.0%	2329	100.0%

Table 2
Summary Characteristics

This table summarizes the descriptive statistics for the sample firms and the Execucomp firms over the 1995 to 2005 time period. I define Total Compensation as the sum of the CEO's salary, bonus, stock option grants, restricted stock, and other compensation. ROA is the net income before extraordinary items and discontinued operations divided by total assets. Return is the one year total return (dividends reinvested) to shareholders. I define CEO Age as the CEO age at the year a variable is measured. I define Market Cap as the closing price for the fiscal year times the number of common shares outstanding and Debt-to-Asset Ratio as the total liabilities divided by total assets. Shares Outstanding is the number of common shares outstanding as reported by the company. CEO Stock Ownership is the percentage of total shares outstanding held by the CEO, excluding options.

Variable	Mean		Median	
	Sample Firms	Execucomp Firms	Sample Firms	Execucomp Firms
Total Compensation (\$K)	10,408	2,905	7,258	1,620
Salary (\$K)	874	475	804	446
Bonus (\$K)	1,789	476	1,154	268
Stock Options (\$K)	4,350	1,350	2,416	434
ROA	5.0%	2.4%	3.6%	3.9%
Return	6.0%	17.1%	5.9%	10.9%
CEO Age	55	55	56	54
Market Cap (\$MM)	34,253	2,705	12,404	879
Debt-to-Asset Ratio	0.7	0.6	0.7	0.6
Shares Outstanding (MM)	1,041	100	444	45
CEO Stock Ownership	0.7%	2.8%	0.1%	0.4%

Table 3
OLS Regression Model of Log(TotalComp)

$$\begin{aligned} \text{Log(TotalComp)}_{it} = & \beta_0 + \beta_1 \text{Log(Sales)}_{it} + \beta_2 \text{market_to_book}_{it} + \beta_3 \text{ROA}_{it} + \beta_4 \text{stock_returns}_{it} \\ & + \beta_5 \text{ROA_volatility}_{it} + \beta_6 \text{stock_volatility}_{it} + \beta_7 \text{debt_ratio}_{it} \\ & + \gamma_{1..k} \text{year_indicators}_{it} + \gamma_{1..k} \text{industry_indicators}_{it} + u_{it} \end{aligned} \quad (1)$$

This table summarizes regression results from estimating Equation (1). The sample consists of 12,107 firm-year observations for years 1993–2005 for the proposal firms and for firms included on Execucomp. I present p-values (in parentheses) based on OLS standard errors. Log(TotalComp) is the natural logarithm of the CEO total compensation. We compute all the explanatory variables at or for the period ending at year t. Log(Sales) is the natural logarithm of Sales. I define market-to-book as the market value of equity divided by the book value of equity. ROA is the net income before extraordinary items and discontinued operations divided by total assets. I define stock_returns as the total stock return (dividend reinvested) in the last two years less the median stock return in the same period and same industry (two-digit SIC code). ROA volatility is the standard deviation of ROA over five years. Stock volatility is the standard deviation of stock returns over 60 months. I define debt-ratio as the total liabilities divided by the total assets. Coefficients on year and industry indicators are not shown.

Independent Variable	(1) (N=12107)	
	Estimate	
Intercept	3.953	***
	(<.0001)	
Log(Sales)	0.502	***
	(<.0001)	
market_to_book	0.044	***
	(<.0001)	
ROA	0.004	***
	(0.0001)	
stock_returns	0.000	**
	(0.0300)	
ROA_volatility	0.007	***
	(<.0001)	
stock_volatility	0.715	***
	(<.0001)	
debt_ratio	-0.294	***
	(<.0001)	
R-Square	0.473	

***, **, * significant at a 0.01, 0.05, 0.10 level (two-tailed)

Table 4
Logistic Regression Results on the Determinants of Performance-Oriented Shareholder Executive-Pay Proposals

$$PROPOSAL_{it} = \beta_0 + \beta_1 CEO_ownership_{it} + \beta_2 CEO_age_{it} + \beta_3 stock_volatility_{it} + \beta_4 shareholder_rights_{it} + \beta_5 poor_indicator_{it} + \beta_6 TotalComp_residual_{it} + \beta_7 (poor_indicator_{it} \times TotalComp_residual_{it}) + \gamma_{1,t,year_indicators_{it}} + \epsilon_{it} \quad (2)$$

This table summarizes logistic regression results of Equation (2), where the dependent variable is equal to one if a firm receives a performance-oriented shareholder executive-pay proposal and zero otherwise. I define poor_indicator as equal to one if the prior two-year industry-adjusted stock return is negative and zero otherwise. TotalComp_residual is the residual value obtained from estimating Equation (1). CEO_ownership is the level of fractional stock ownership for a CEO. CEO_age is the actual CEO age. Stock_volatility is the standard deviation of stock returns over 60 months. Shareholder_rights is the product of -1 and the value in the governance index designed by Gompers et al. (2003). ΔPred.Prob.is the change in the predicted probability that occurs when the independent variable increases one unit in its value and is evaluated at the mean values of the remaining independent variables. The p-values (in parentheses) are based on maximum likelihood standard errors. CEO stock ownership in models (1) and (2) does not include stock options, whereas the CEO ownership includes stock options in models (3) and (4). Models (1) and (3) use a control sample that includes all Execucomp firms other than the proposal firms. Models (2) and (4) use a control sample matching the proposal firms by two-digit SIC code and firm size. Coefficients on the intercept and year_indicators are not shown.

Independent	(1) (N=5273)		(2) (N=372)		(3) (N=5273)		(4) (N=372)	
	Estimate (p-value)	Δ Pred. Prob.	Estimate (p-value)	Δ Pred. Prob.	Estimate (p-value)	Δ Pred. Prob.	Estimate (p-value)	Δ Pred. Prob.
CEO_ownership	-0.751 (<.0001)	*** -52.80%	-1.416 (<.0001)	*** -75.73%	-0.682 (<.0001)	*** -49.44%	-1.138 (<.0001)	*** -67.96%
CEO_ownership (with options)								
CEO_age	0.039 (<.0001)	*** 4.00%	0.061 (0.0008)	*** 6.33%	0.038 (<.0001)	*** 3.86%	0.056 (0.0016)	*** 5.73%
stock_volatility	-1.893 (<.0001)	*** -84.93%	-0.048 (0.4720)	-4.67%	-1.676 (<.0001)	*** -81.30%	-0.054 (0.4682)	-5.26%
shareholder_rights	0.107 (<.0001)	*** 11.27%	0.216 (<.0001)	*** 24.13%	0.104 (<.0001)	*** 11.01%	0.219 (<.0001)	*** 24.46%
poor_indicator	0.046 (0.3342)	4.66%	0.519 (0.0217)	** 67.96%	0.064 (0.2742)	6.60%	0.528 (0.0190)	** 69.62%
TotalComp_Residual	0.346 (0.0003)	*** 41.34%	0.637 (0.0079)	*** 89.04%	0.376 (<.0001)	*** 45.68%	0.657 (0.0061)	*** 92.95%
poor_indicator x TotalComp_Residual	0.282 (0.0234)	** 32.56%	0.755 (0.0225)	** 112.73%	0.278 (0.0251)	** 32.07%	0.696 (0.0286)	** 100.61%

***, **, * significant at a 0.01, 0.05, 0.10 level (one-tailed)

Table 5
Regressions of Voting Outcome for Shareholder Executive-Pay Proposals
 $VOTE = \beta_0 + \beta_1 TYPE + \beta_2 SPONSOR + \sum \beta_i (ControlVariables)$ (3)

This table summarizes ordinary least squares regression results of Equation (3), where VOTE is the dependent variable measuring shareholder reaction by the percentage vote in favor of a shareholder proposal. TYPE is 1 for performance-oriented proposals and 0 otherwise. SPONSOR is 1 for pension fund or labor fund sponsors and 0 otherwise. YEAR is 1 for the period after 2002 and 0 otherwise. G-index is the value in the governance index designed by Gompers et al. (2003). Size(t-1) is the log of market value of equity at year t-1. CEO stock ownership is the level of fractional stock ownership for a CEO. REPOSAL is 1 if the proposal has been filed by the same sponsor at year t-1 and 0 otherwise. I define prior_ROA as industry-adjusted ROA in the previous year, and prior_ret3 (prior_ret5) as prior three (five) year industry-adjusted stock return. Models (1) through (3) control for industry fixed effects. Coefficients on the intercept and industry indicators are not shown.

Independent	(1) (N=477) Estimate	(2) (N=475) Estimate	(3) (N=477) Estimate	(4) (N=477) Estimate	(5) (N=475) Estimate	(6) (N=472) Estimate
SPONSOR	0.028** (0.0320)	0.029** (0.0312)	0.035** (0.0121)	0.020* (0.0829)	0.020* (0.0826)	0.023* (0.0535)
TYPE	0.197*** (<.0001)	0.196*** (<.0001)	0.192*** (<.0001)	0.206*** (<.0001)	0.206*** (<.0001)	0.202*** (<.0001)
G-index	0.006* (0.0823)	0.006* (0.0634)	0.008** (0.0200)	0.004 (0.1342)	0.005 (0.1081)	0.005* (0.0776)
Size(t-1)	0.013 (0.1081)	0.014* (0.0760)	0.020** (0.0113)	0.004 (0.4805)	0.005 (0.3830)	0.007 (0.1986)
CEO stock ownership	-0.004 (0.1201)	-0.004 (0.1141)	-0.004 (0.1381)	-0.004** (0.0465)	-0.004** (0.0335)	-0.004** (0.0379)
YEAR	0.032** (0.0242)	0.031** (0.0344)	0.021 (0.1478)	0.034*** (0.0080)	0.035*** (0.0084)	0.030** (0.0228)
REPOSAL	-0.001 (0.9645)	-0.001 (0.9659)	0.003 (0.9193)	0.001 (0.9550)	0.002 (0.9374)	0.005 (0.8213)
prior_ROA	-0.019 (0.8748)			0.081 (0.4190)		
prior_ret3		-0.025 (0.5777)			0.006 (0.8855)	
prior_ret5			-0.122** (0.0470)			-0.054 (0.3098)
R-Square	0.473	0.472	0.477	0.413	0.410	0.408

***, **, * significant at a 0.01, 0.05, 0.10 level (one-tailed for the hypothesized variables – TYPE and SPONSOR; two tailed for the other independent variables).

Table 6
Changes in Stock Option Sensitivity Subsequent to Shareholder Proposals

$$\begin{aligned} \Delta OPTION_SENSITIVITY_{it} = & \beta_0 + \beta_1(POST \times PROPOSAL) + \beta_2 PROPOSAL + \beta_3 POST \\ & + \gamma_1 \Delta(ShareholderWealth)_{it} + \gamma_2 \Delta(ShareholderWealth)_{it-1} \\ & + \sum \gamma_k (OtherControlVariables) + \varepsilon_{it} \end{aligned} \quad (4a)$$

This table summarizes OLS regression results of Equation (4a), where $\Delta OPTION_SENSITIVITY$ is the difference between t and $t-1$ on the change in executive stock options grant value per a \$1,000 change in shareholder wealth. $POST$ is one for the year after proposal year and zero for the year before proposal year. $PROPOSAL$ is one if a firm receives a performance-oriented shareholder executive-pay proposal and zero otherwise. $\Delta(ShareholderWealth)$ is the change in shareholder's wealth. $MarketCap_{(t-1)}$ is the lagged market value of equity. I define $TobinQ_{(t-1)}$ as the market value of equity plus the book value of debt and divided by the book value of assets. $IFCEO$ is one if an executive is CEO and zero otherwise. $NEWCEO$ is one if the CEO in t is not the same as the CEO in $t-1$ and zero otherwise. Model (1) tests for all top executives. Model (2) tests for CEO only. ***, **, * significant at a 0.01, 0.05, 0.10 level (one-tailed for the hypothesized variable - $POST \times PROPOSAL$; two tailed for the other independent variables).

	(1)		(2)	
Intercept	0.1270 *** (<.001)		0.3023 (0.279)	
<i>POST</i> × <i>PROPOSAL</i>	0.1443 *** (0.002)		0.8553 ** (0.018)	
<i>PROPOSAL</i>	-0.0874 *** (0.010)		-0.4680 (0.108)	
<i>POST</i>	-0.0768 ** (0.025)		-0.2350 (0.409)	
$\Delta(ShareholderWealth)_{it}$	0.0009 (0.566)		0.0093 (0.477)	
$\Delta(ShareholderWealth)_{it-1}$	0.0016 (0.293)		0.0086 (0.432)	
$MarketCap_{(t-1)}$	0.0016 *** (<.001)		0.0057 * (0.068)	
$TobinQ_{(t-1)}$	-0.0963 *** (<.001)		-0.3662 *** (0.002)	
IFCEO	-0.1241 *** (<.001)			
NEWCEO			0.5878 ** (0.045)	
N	1577		247	
Adjusted R ²	0.044		0.063	

Table 7
Changes in Cash (Total) Sensitivity (Direct Measure)
Subsequent to Shareholder Proposals

$$\Delta CASH_SENSITIVITY_{it} (\Delta TOTAL_SENSITIVITY_{it}) = \beta_0 + \beta_1 (POST \times PROPOSAL) + \beta_2 PROPOSAL + \beta_3 POST + \gamma_1 \Delta(ShareholderWealth)_{it} + \gamma_2 \Delta(ShareholderWealth)_{it-1} + \sum \gamma_k (OtherControlVariables) + \varepsilon_{it} \quad (4b)$$

This table summarizes ordinary least squares regression results of Equation (4b), where $\Delta CASH_SENSITIVITY_{it} (\Delta TOTAL_SENSITIVITY_{it})$ is the difference between t and t-1 on the change in cash pay (total pay) sensitivity per a \$1,000 change in shareholder wealth. POST is one for the year after proposal year and zero for the year before proposal year. PROPOSAL is one if a firm receives a performance-oriented shareholder executive-pay proposal and zero otherwise. $\Delta(ShareholderWealth)$ is the change in shareholder's wealth. $MarketCap_{(t-1)}$ is the lagged market value of equity. I define $TobinQ_{(t-1)}$ as the market value of equity plus the book value of debt and divided by the book value of assets. IFCEO is one if an executive is CEO and zero otherwise. NEWCEO is one if the CEO in t is not the same as the CEO in t-1 and zero otherwise. Models (1) and (3) test for all top executives. Models (2) and (4) test for CEO only. ***, **, * significant at a 0.01, 0.05, 0.10 level (one-tailed for the hypothesized variable - $POST \times PROPOSAL$; two tailed for the other independent variables).

Independent	Δ Cash Sensitivity		Δ Total Sensitivity	
	(1)	(2)	(3)	(4)
Intercept	0.0013 (0.322)	0.0002 (0.987)	0.0187 (0.659)	0.1030 (0.717)
$POST \times PROPOSAL$	0.0046 ** (0.015)	0.0206 (0.104)	0.1196 ** (0.038)	0.8451 ** (0.030)
$PROPOSAL$	0.0049 *** (0.001)	0.0118 (0.316)	-0.0652 (0.169)	-0.5089 (0.113)
$POST$	-0.0003 (0.846)	-0.0023 (0.845)	0.0597 (0.202)	-0.1131 (0.720)
$\Delta(ShareholderWealth)_{it}$	-0.0003 *** (<.001)	-0.0009 * (0.072)	-0.0006 (0.781)	0.0040 (0.774)
$\Delta(ShareholderWealth)_{it-1}$	-0.0001 (0.115)	-0.0002 (0.609)	0.0012 (0.536)	0.0088 (0.444)
$MarketCap_{(t-1)}$	-0.0001 *** (0.002)	-0.0001 (0.585)	0.0015 *** (0.003)	0.0065 * (0.058)
$TobinQ_{(t-1)}$	-0.0001 (0.718)	-0.0010 (0.753)	-0.0641 *** (<.001)	-0.2220 *** (0.007)
IFCEO	0.0032 ** (0.021)		-0.1080 ** (0.014)	
NEWCEO		-0.0137 (0.249)		0.2150 (0.525)
N	1406	247	1423	243
Adjusted R ²	0.048	0.022	0.033	0.039

Table 8
Changes in Cash (Total) Sensitivity (Indirect Measure) Subsequent to Shareholder Proposals

$$\begin{aligned} & \Delta CashComp_{it} (\Delta TotalComp_{it}) \\ & = \beta_0 + \beta_1 PPW + \beta_2 \Delta(ShareholderWealth)_{it} + \beta_3 \Delta(ShareholderWealth)_{it-1} + \gamma_0 POST + \gamma_1 PROPOSAL \\ & \quad + \gamma_2 (POST \times PROPOSAL) + \gamma_3 (PROPOSAL \times \Delta ShareholderWealth_{it}) \\ & \quad + \gamma_4 (POST \times \Delta ShareholderWealth_{it}) + \sum \gamma_k (OtherControlVariables)_{it} + \varepsilon_{it} \quad (5) \end{aligned}$$

This table summarizes OLS results of Equations (5), where $\Delta CashComp$ ($\Delta TotalComp$) is the change in CEO cash (total) compensation. PPW is $POST \times PROPOSAL \times \Delta ShareholderWealth_{it}$. $POST$ is one for the year after proposal year and zero for the year before proposal year. $PROPOSAL$ is one if a firm receives a performance-oriented shareholder executive-pay proposal and zero otherwise. $\Delta(ShareholderWealth)$ is the change in shareholder's wealth. $MarketCap_{(t-1)}$ is the lagged market value of equity. I define $TobinQ_{(t-1)}$ as the market value of equity plus the book value of debt and divided by the book value of assets. $IFCEO$ is one if an executive is CEO and zero otherwise. $NEWCEO$ is one if the CEO in t is not the same as the CEO in $t-1$ and zero otherwise. Models (1) and (3) test for all top executives. Models (2) and (4) test for CEOs only. ***, **, * significant at a 0.01, 0.05, 0.10 level (one-tailed for the hypothesized variable - PPW ; two tailed for the other independent variables).

	$\Delta CashComp$		$\Delta TotalComp$	
	(1)	(2)	(3)	(4)
Intercept	0.1455 *** (0.001)	0.1841 (0.376)	0.5060 ** (0.014)	1.2975 (0.333)
PPW	0.0200 *** (0.010)	0.0815 ** (0.018)	0.1302 *** (0.002)	0.4154 * (0.065)
$\Delta(ShareholderWealth)_{it}$	0.0086 ** (0.023)	0.0286 (0.110)	0.1110 *** (<.001)	0.1079 (0.465)
$\Delta(ShareholderWealth)_{it-1}$	-0.0034 ** (0.044)	-0.0175 ** (0.026)	0.0330 *** (<.001)	0.0548 (0.367)
$POST$	-0.3284 *** (<.001)	-0.6386 *** (0.008)	0.2507 (0.276)	-0.1974 (0.894)
$PROPOSAL$	-0.0576 (0.236)	-0.0694 (0.761)	-0.3578 (0.111)	-1.9503 (0.190)
$POST \times PROPOSAL$	0.0410 (0.571)	-0.2364 (0.475)	0.3843 (0.237)	2.1310 (0.308)
$PROPOSAL \times \Delta ShareholderWealth_{it}$	0.0069 ** (0.014)	0.0065 (0.630)	-0.0798 *** (<.001)	-0.0711 (0.463)
$POST \times \Delta ShareholderWealth_{it}$	-0.0418 *** (<.001)	-0.1197 *** (0.001)	-0.0634 (0.142)	-0.1769 (0.518)
$MarketCap_{(t-1)}$	-0.0027 *** (<.001)	-0.0076 *** (0.001)	0.0075 *** (0.002)	0.0297 * (0.054)
$TobinQ_{(t-1)}$	0.0483 *** (0.001)	0.1338 * (0.054)	-0.3816 *** (<.001)	-1.2267 ** (0.011)
$IFCEO$	-0.0256 (0.574)		0.0441 (0.834)	
$NEWCEO$		-0.0442 (0.855)		1.6077 (0.287)
N	1933	353	1923	349
Adjusted R ²	0.0985	0.1483	0.0611	0.0315

Table 9
Changes in Compensation Structure Subsequent to Shareholder Proposals

$$\begin{aligned} \Delta ET(\Delta ESTS) = & \beta_0 + \beta_1(POST \times PROPOSAL) + \beta_2 PROPOSAL + \beta_3 POST \\ & + \gamma_1 \Delta(ShareholderWealth)_{it} + \gamma_2 \Delta(ShareholderWealth)_{it-1} \\ & + \sum \gamma_k (OtherControlVariables) + \varepsilon_{it} \end{aligned} \quad (6)$$

This table summarizes ordinary least squares regression results of Equation (6), where ΔET is the change in the ratio of Equity-based compensation to Total compensation and $\Delta ESTS$ is the change in the ratio of Equity Sensitivity to Total Sensitivity. POST is one for the year after proposal year and zero for the year before proposal year. PROPOSAL is one if a firm receives a performance-oriented shareholder executive-pay proposal and zero otherwise. $\Delta(ShareholderWealth)$ is the change in shareholder's wealth. $MarketCap_{(t-1)}$ is the lagged market value of equity. I define $TobinQ_{(t-1)}$ as the market value of equity plus the book value of debt and divided by the book value of assets. IFCEO is one if an executive is CEO and zero otherwise. NEWCEO is one if the CEO in t is not the same as the CEO in t-1 and zero otherwise. Model (1) and (3) test for all top executives. Model (2) and (4) test for CEOs only. ***, **, * significant at a 0.01, 0.05, 0.10 level (one-tailed for the hypothesized variable - $POST \times PROPOSAL$; two tailed for the other independent variables).

Independent	ΔET		$\Delta ESTS$	
	(1)	(2)	(3)	(4)
Intercept	0.0182 (0.247)	0.0039 (0.935)	-0.0117 (0.563)	0.0015 (0.979)
$POST \times PROPOSAL$	-0.0007 (0.979)	0.1199 * (0.055)	-0.0268 (0.394)	0.1675 ** (0.031)
$PROPOSAL$	-0.0561 *** (0.001)	-0.0735 (0.174)	-0.0425 * (0.053)	-0.0887 (0.165)
$POST$	0.0206 (0.239)	-0.0432 (0.417)	0.0290 (0.197)	-0.0861 (0.175)
$\Delta(ShareholderWealth)_{it}$	0.0023 *** (0.002)	0.0020 (0.359)	0.0041 *** ($<.001$)	0.0026 (0.328)
$\Delta(ShareholderWealth)_{it-1}$	0.0009 (0.188)	0.0044 ** (0.023)	-0.0011 (0.238)	0.0039 * (0.084)
MarketCap	0.0005 *** (0.008)	0.0008 (0.160)	0.0003 (0.281)	0.0005 (0.486)
TobinQ	-0.0285 *** ($<.001$)	-0.0215 (0.113)	-0.0183 *** (0.004)	-0.0095 (0.593)
IFCEO	0.0017 (0.920)		-0.0029 (0.891)	
NEWCEO		0.1373 *** (0.007)		0.0891 (0.160)
N	1571	244	1576	244
AdjRsquare	0.0426	0.0561	0.0201	0.0138

TABLE 10
Testable Hypotheses and Primary Findings

Theory	Testable Hypotheses	Findings
Alignment (H1a)	Lower managerial ownership >>> receive performance-oriented proposals.	negative as predicted.
Horizon Problem (H1b)	CEOs closer to retirement >>> receive performance-oriented proposals.	positive as predicted.
Monitoring Cost (H1c)	Higher stock return volatility >>> receive performance-oriented proposals.	negative, contrary to prediction.
Shareholder Rights (H2)	Higher shareholder rights >>> receive performance-oriented proposals.	positive as predicted.
Optimal Contracting (H3)	Unexpected level of total compensation conditioning on poor prior performance >>> receive performance-oriented proposals.	positive as predicted.
Shareholder Voting and Proposal Type (H4a)	Prefer performance-oriented than non-performance-oriented proposals.	positive as predicted.
Shareholder Voting and Proposal Sponsor (H4b)	Prefer proposals sponsored by pension/labor funds than by other parties.	positive as predicted.
Pay-Performance Relations (H5a, 5b, 5c)	The change in pay-performance relation greater for target firms than for control firms.	positive as predicted.
Compensation Structure (H6)	The change of the proportion of stock-based pay in total compensation greater for target firms than for control firms.	positive as predicted for CEOs but insignificant for top5.

APPENDIX A

**NON-PERFORMANCE VS. PERFORMANCE-ORIENTED SHAREHOLDER
EXECUTIVE-PAY PROPOSALS**

1. A 1999 proposal motivated by political/social concerns at Bank of America.

BE IT RESOLVED that shareholders urge the Board of Directors to address the issue of runaway remuneration of CEOs and the widening gap between highest and lowest paid workers by: 1) Establishing a cap on CEO compensation expressed as a multiple of pay of the lowest paid worker at BankAmerica; 2) Preparing a report for shareholders explaining the factors used to determine the appropriate cap.

2. A 2002 proposal linking pay to performance at Raytheon.

RESOLVED, shareholders urge the Board of Directors to adopt a formal policy that a majority or all future stock option grants to senior executives be performance-based on core business operating results. Consistent with this topic, the amount of company pension income is to be subtracted from the financial results that are used to determine future stock option grants, and pension income is to be reported annually on the primary company web site for verification. Performance-based stock options are defined as:

1) Indexed options, whose exercise price is linked to the S&P Aerospace Index shown in the graphs on pages 26 and 27 in the 2002 proxy; 2) Premium-priced stock options, whose exercise price is above the market price of the grant date; or 3) Performance vesting options, which vest when the market price of the stock exceeds a specific target.

3. A 2002 proposal urging the board to seek shareholder approval for large severance packages at Raytheon.

RESOLVED: The shareholders of Raytheon Company ("Raytheon" or the "Company") urge the Board of Directors (the "Board") to seek shareholder approval for future severance agreements with senior executives that provide benefits in an amount exceeding 2.99 times the sum of the executive's base salary plus bonus. "Future severance agreements" include employment agreements containing severance provisions; retirement agreements; change in control agreements; and agreements renewing, modifying or extending existing such agreements. "Benefits" include lump-sum cash payments (including payments in lieu of medical and other benefits) and the estimated present value of periodic retirement payments, fringe benefits and consulting fees (including reimbursable expenses) to be paid to the executive⁷⁴.

⁷⁴ Proposal 1 is from excerpts of Bank of America's 1999 proxy statement. Proposals 2 and 3 are from excerpts of Raytheon's 2002 proxy statement.

APPENDIX B
IN SEARCH OF CAMOUFLAGE – EXECUTIVE PENSION VALUES

“The discussion above indicates that estimating the dollar value of each of the components of Raines’s retirement package requires some time and effort as well as certain information that is not readily available to investors. Even for those accustomed to reading SEC filings, coming up with these estimates requires a bit of work. The Black-Scholes value of the options must be calculated. The ages of Raines and his spouse must be determined. The annuity value must be estimated. The medical coverage for Raines and his family, as well as the life insurance, must be valued. It certainly would have made more sense for Fannie Mae to provide values for the components of the retirement packages rather than forcing investors to estimate the value of the packages based on incomplete information. But, Fannie Mae, like other companies, chose not to make the value of the retirement package transparent.

While the value of the retirement package was not transparent to investors even after Fannie Mae provided details of this package upon the executives’ departures, it would have been even more difficult for investors to determine at earlier points in time what these executives would receive upon termination. It is important for investors to know the value of retirement packages as soon as executives vest in them, not only when they actually retire, which might be much later and too late for investors to react or apply pressure on the board.

Suppose, for example, investors had attempted to determine, one month before Raines “retired,” the amount of options that would automatically vest upon his retirement. One would need to locate Raines’s employment contract in the SEC database, check for any subsequent modifications, and read and interpret the provisions relating to options vesting upon termination. Whether particular options vest depends on the retirement date and the date the options were granted. The dates of prior year option grants can be determined by scouring previous years’ annual proxy statements (which are released in the spring of the following year). Other forms can be searched to determine the date of any options granted in the current year (and the previous year, if the proxy statement for that year has not yet been released). Once the options have been identified, we would know what ended up being reported in the post-retirement disclosure of the company: that, if Raines were to retire in December 2004, he would enjoy automatic vesting of 360,000 previously unvested options. Of course, the Black-Scholes value would still need to be calculated. It goes without saying that most shareholders and outside observers are unlikely to attempt to figure out which of Raines’s options would automatically vest should he retire at the end of 2004, and the value of those options.

Determining the amount of Raines’s pension payments one month before he retired would also have taken a significant amount of work. An investor reading only the discussion of retirement plans in the annual proxy statement could have well received the impression that, based on Raines reported salary of \$992,000 and the formula generally used to calculate executives’ pension payouts, Raines’s pension would start only when he reached the age of 60 and would amount to approximately \$900,000 per year. But a discussion of Raines’s compensation in another part of the proxy statement indicated that, for purposes of pension calculations, his salary would be deemed to be approximately \$1.14 million. And his compensation contract,

which was not filed with the annual proxy but rather with another form at another time, indicated that Raines's pension would be calculated under a more generous formula. Thus, the actual annual retirement payment is almost \$1.4 million per year. Moreover, a close reading of Raines's employment contract indicates that Raines, unlike other employees, could begin receiving full retirement payments even if he retired at age 55.⁷⁵

⁷⁵ Bebchuk and Fried (2005a).

APPENDIX C

PAY-PERFORMANCE SENSITIVITY IN STOCK OPTION AWARDS

$$OPTION_SENSITIVITY = \Delta \times \left(\frac{NUMBER_OF_OPTION_GRANTS}{NUMBER_OF_SHARES_OUTSTANDING} \right) \times 1,000$$

where

$$\Delta = \frac{\partial C}{\partial P} = e^{-dt} \Phi \left(\frac{\ln(P/E) + T(r - d + \sigma^2 / 2)}{\sigma \sqrt{T}} \right)$$

Φ : cumulative probability function for normal distribution

E: exercise price

P: stock price

T: time to expiration

R: risk-free interest rate

d: expected dividend rate

σ : expected stock return volatility

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