

# **‘Low-Cost’ Shareholder Activism: A Review of the Evidence**

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## **1. Introduction**

Over the last decade, a series of corporate governance scandals have given rise to an intense wave of shareholder activism. In this article, I focus on two particular tools of shareholder activism—namely shareholder proposals filed under Rule 14a-8 and shareholder votes on uncontested director elections. These tools share an appealing feature. Their cost is quite modest and they do not require a significant equity stake in the company—hence, they are referred to as “low-cost” tools of activism. But their easy accessibility comes at a price. Both shareholder proposals and shareholder votes on director elections are essentially non-binding on the target firm, casting doubts on their effectiveness as a driver of change.

Low-cost activism can be contrasted with “activism via large ownership” where the power to influence the firm derives from the (costly) acquisition of a significant equity stake. This equity stake can then be used to press for changes in governance and strategy (through the threat of “exit” or the threat of gaining control). This power may be quietly exerted behind the scenes (large shareholder activism) or in a more confrontational and public manner (e.g. proxy fights, hedge funds activism)<sup>1</sup>. In the case of low-cost activism, the power to influence the firm is predicated

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<sup>1</sup> For a review of the literature on hedge fund activism, see Brav, Jiang and Kim (2009). The literature on the effect of large shareholders is extensive; for a recent study and references, see Cronqvist and Fahlenbrach, (2010). For a recent study on proxy fights (and references to earlier studies), see Listokin (2009) and Alexander, Chen, Seppi and Spatt (2010).

upon the ability of the activist to build consensus among a broad spectrum of shareholders—crystallized in a symbolic, non-binding vote—and the assumption that boards will respond because “symbols have consequences” (Grundfest 1993, p. 866)—for example, in terms of reputation costs.

In view of these differences, it is important to understand the effectiveness of low-cost activism tools since “activism via large ownership” is not an option for a large class of investors (e.g. diversified funds) and it is prohibitively costly to implement in large firms.<sup>2</sup> The evidence indicates that until a decade ago the answer was clear: with rare exceptions, low-cost activism was also “low-impact” (e.g. Gillan and Starks 2007). Activists were rarely able to rally significant voting support around their initiatives and, even when successful, were largely ignored by boards. However, following a series of high profile accounting scandals in 2001-2002 (e.g. Enron and Worldcom), the quality of corporate governance has become a central concern for institutional investors and low-cost activism seems to have gained more steam.

In this article I review a recent body of research that (re)examines low-cost activism in the post-Enron period and offer suggestions for future studies.<sup>3</sup> Collectively, these studies suggest that low-cost activism has become a more powerful tool, capable of driving governance changes at target firms, promoting market-wide adoption of governance practices, and influencing key policy reforms. They provide insights into the reasons for this enhanced effectiveness and shed light on specific settings. Future research should be directed at understanding whether, when, and how low-cost activism results in value creation and improved performance—a question of utmost importance as regulators further empower shareholders through proxy access and “say on pay.”

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<sup>2</sup> Targets of proxy fights and hedge fund activism tend to be small firms (Bebchuk 2007; Brav *et al.* 2009), while low-cost activism usually targets large S&P 500 firms.

<sup>3</sup> The article only reviews research related to shareholder proposals and uncontested director elections (with a focus on the work I am more familiar with, including my own). A related form of low-cost activism is shareholder voting on *management-initiated* proposals. Examples of studies on this topic are Morgan and Poulsen (2001), Martin and Thomas (2005), Listokin (2008) and Bebchuk and Kamar (2010), among others.

## 2. Director elections

Boards play a central role in the legal structure of the modern publicly traded corporation with dispersed ownership, selecting top management and its compensation, advising on strategy, monitoring performance, and deliberating on major corporate decisions. In doing so, boards are supposed to ensure that the firm is run in the best interest of shareholders. For this board-centric corporate governance system to function well, shareholder power to remove directors is a key requisite. The threat of replacement is intended to lead to the selection of directors with the appropriate skills and to keep these directors accountable to the shareholders who elected them. The notion that shareholders can resort to replacing the board when dissatisfied with its performance underlies the legal system's choice to insulate the merits of directors' decisions from judicial review.

In practice, however, a rival team seeking to replace incumbents faces significant impediments (Bebchuk 2007). Perhaps the major one is that while challengers incur the full cost of a proxy contest (regardless of the outcome),<sup>4</sup> they only receive a fraction of the expected benefits—a classic 'free rider' problem. Proxy contests are even costlier when the target firm has a staggered board, because challengers need to win two elections held at least one year apart (in a typical three-class staggered board)—not to mention the difficulty of winning other shareholders' support when victory of the challenger implies one year with a divided board and significant uncertainty. These impediments may explain the paucity of electoral challenges<sup>5</sup>, which, in turn, means that almost all director elections are uncontested.

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<sup>4</sup> Challengers cannot put their director candidates on the corporate ballot. Hence they have to incur the cost of mailing proxy cards to shareholders and have them mailed back, in addition to other legal expenses and the cost of campaigning for their candidates. In contrast, incumbents can afford to over-invest in campaigning against the rival team, since the cost is borne by the firm's shareholders.

<sup>5</sup> Citing data compiled by Georgeson Shareholders, Bebchuk (2007) reports that the number of proxy contests aimed at replacing the director team at the helm of the company (i.e. aside from takeover-related proxy contests) averaged only 12 per year between 1996 and 2005 (14 between 2001 and 2005), mostly targeting small firms and resulting in the

In addition, until recently (see Section 2.3), under the default arrangements established by state law, the outcome of director elections was determined according to a *plurality voting* standard: that is, the candidate with the most votes “for” is elected—a system that helps avoid the disruptive effects of failed elections. In uncontested elections, the plurality voting standard means that each nominee will always be elected as long as she receives one vote “for,” no matter the number of votes “withheld” (under SEC rule 14a-4(b) shareholders cannot vote “against” a director nominee, they can only vote “for” or “withhold” support).

The paucity of contested elections, combined with the plurality voting standard, has led to the following observation: “corporate democracy in America has most often been a lot like Soviet democracy: the votes didn’t really matter, because only one candidate was on the ballot and was assured of winning, whatever the voters thought” (Norris 2004).<sup>6</sup>

However, in a 1990 speech to the Council of Institutional Investors,<sup>7</sup> former SEC commissioner Joseph Grundfest argued that a high percentage of votes withheld from the board in uncontested elections, while unlikely to affect the outcome of the election under plurality voting, could have economic consequences and act as a catalyst for governance and operating changes. Faced with a formal expression of shareholders’ discontent (or just the mere threat of it), directors concerned with their reputational capital would stand up to powerful CEOs and become more responsive to shareholders’ interests. Hence, Grundfest proposed a new shareholder activism tool—“just vote no” campaigns—organized efforts to persuade other shareholders to withhold

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challengers’ victory only in one third of the cases. Proxy contests were similarly rare in earlier periods (Grundfest 1993).

<sup>6</sup> In almost every circumstance, (the few) directors failing to win a majority vote do not lose their seat (Lublin 2009).

<sup>7</sup> Grundfest, J. A., (1990), *Just Vote No or Just Don’t Vote: Minimalist Strategies for Dealing with Barbarians Inside the Gates*, Presentation Before the Fall Meeting of the Council of Institutional Investors (Nov. 7, 1990) (on file with the Stanford Law Review).

votes from directors up for election in an effort to communicate shareholder dissatisfaction to the board.<sup>8</sup>

In this section, I will review recent studies examining the determinants (Section 2.1) and economic consequences (Section 2.2) of shareholder votes in uncontested director elections. I will then discuss two studies analyzing the recent trend toward a *majority voting* standard (as opposed to plurality voting) (Section 2.3) and conclude with a brief discussion of recent legislative and regulatory developments, including the introduction of a “proxy access” rule (Section 2.4).

### *2.1 Determinants of votes withheld from directors and the role of proxy advisors*

Cai, Garner and Walkling (2009) examine the determinants of the percentage of votes withheld from directors in a sample of 13,384 uncontested director elections (corresponding to almost 2,488 meetings) between 2003 and 2005. The study presents two major findings. First, the vast majority of directors are elected with almost unanimous support (mean and median votes “for” are 94% and 97%, respectively)—hence, opposition to directors is relatively rare, though increasing over time.<sup>9</sup> Second, essentially only three factors appear to have an economically significant effect on the percentage of votes withheld: a “withhold” recommendation issued by the influential proxy advisory firm ISS/RiskMetrics (resulting in 19% more votes withheld), the presence of a vote-no campaign (7% more votes withheld), and poor attendance at board meetings (14% more votes withheld). All the other factors analyzed, even when statistically significant, have little economic impact (1-2% change in votes withheld).<sup>10</sup> Hence, to understand the determinants

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<sup>8</sup> In a follow-up article, Grundfest (1993) noted that their modest costs, combined with the significant potential benefits, made vote-no campaigns perhaps the most cost-effective means for exercising responsible shareholder voice, “without the *sturm und drang* of tender offers and proxy contests.” By then, some institutional investors, like CalPERS, had begun using vote-no campaigns, often triggering a response from the board.

<sup>9</sup> Georgeson (2010) reports that from 2006 to 2009 the number of directors of S&P 1,500 firms receiving greater than 15% votes withheld increased steadily from 385 (at 189 firms) to 1,027 (at 378 firms).

<sup>10</sup> The authors examine a broad set of director- and firm-level variables, as well as their interactions (e.g. compensation committee membership and excess CEO pay). Importantly, to capture the effect of ISS/RiskMetrics recommendations *beyond* the effect of variables known to affect both recommendations shareholder votes and recommendations, they

of shareholder votes on director elections we need to understand the determinants of vote-no campaigns and withhold (WH) recommendations (poor attendance at board meetings is one of the triggers of WH recommendations). Two studies shed light on this issue.

Del Guercio, Seery and Woidtke (2008) analyze a sample of 112 vote-no campaigns between 1990 and 2003 and find that they typically target large, poorly performing firms. The campaigns are staged by institutional investors—mostly public pension funds (54% of the sample)—and are usually motivated by broad concerns with the firm’s strategy and performance (60% of the sample), with the other campaigns focusing on specific corporate governance issues (e.g. excess CEO pay or board’s lack of responsiveness to shareholder proposals). Three-fourths of the campaigns target the whole board, with the remaining 25% targeting individual directors or committees (e.g. the compensation committee).

Choi, Fisch and Kahan (2009) analyze the determinants of recommendations on director elections issued in 2005 and 2006 by four proxy voting firms: ISS/RiskMetrics (ISS/RM), Glass Lewis & Company (GL), Egan-Jones Proxy (EJ), and Proxy Governance (PG). Four findings are noteworthy. First, proxy advisors significantly differ in the propensity to issue WH recommendations, ranging from 3.7% of directors for PG to 18.8% for GL, with ISS/RM at 6.6% and EJ at 11.0%. Second, a set of common factors affects the likelihood of a WH recommendation across most or all proxy advisors. For example, all proxy advisors are more likely to issue a WH recommendation for directors with poor attendance at board meetings or with many other directorships, for outside directors with linkages to the firm (non ‘independent’), for directors in firms ranking high in terms of abnormal CEO pay, and (relatedly) for compensation committee members. Also, most proxy advisors are likely to exempt new directors from a WH

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include the residual from a logit regression of a ‘withhold’ recommendation issued by ISS/RiskMetrics against the same set of director- and firm-level variables.

recommendation. However, the weight given to these factors varies dramatically across proxy advisors. For example, attendance of less than 75% of the meetings increase the probability of a WH recommendation from GL by 56.7%, but one from PG by only 6.4%. Third, there are factors emphasized only by one or two proxy advisors. A noteworthy example is that if directors ignore a shareholder proposal supported by a majority of the votes cast, the probability of a WH recommendation from ISS/RM increases by 42.2%, while the probability of a WH recommendation from PG and EJ is unaffected. Finally, there are some factors—namely, the presence of anti-takeover provisions (classified board, poison pill)—which generally do not affect the recommendation of any proxy advisor. Overall, Choi *et al.* (2009) conclude from their analysis that ISS/RM seems to focus on board-related factors, PG on compensation-related factors, GL on audit-disclosure factors, and EJ on an eclectic mix of factors. These findings may be interpreted as evidence of a competitive market, where new entrants are challenging ISS/RM’s dominant position by developing a specific expertise and catering to clients focused on certain issues.

Another interesting finding in Choi *et al.* (2009) is that proxy advisors pay attention to relative accountability within the board. For example, proxy advisors issuing WH recommendations for directors of firms with abnormally high CEO pay tend to do so only for compensation committee members,<sup>11</sup> while those issuing a WH recommendation from directors of firms experiencing a restatement tend to do so only for audit committee members. Ertimur, Ferri and Maber (2010a) provide further (and more direct) evidence of relative accountability. In their analysis of ISS/RM recommendations on director elections at firms involved in the option backdating scandal, they find that proxy advisors (and voting shareholders) mostly penalized

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<sup>11</sup> Accordingly, Cai *et al.* (2009) find that directors sitting on the compensation committee receive significantly lower votes in firms with excess CEO compensation.

directors sitting on the compensation committee at the time when backdating took place (in most cases, 5-10 years preceding its public discovery).

Finally, a puzzling result in Choi *et al.* (2009) is that proxy advisors do not seem to take into account the conduct that led to a withhold recommendation for a director at firm A in issuing a recommendation for the same director at the annual meeting of firm B.<sup>12</sup> Consistent with this result, Ertimur *et al.* (2010a) report that none of the directors of firms involved in the backdating scandal received a WH recommendation from ISS/RM when up for election at another firm (and they were not penalized in terms of votes withheld), even when ISS/RM recommended to withhold votes from them at the backdating firm. If proxy advisors and shareholders do not take into account directors' conduct at other firms when, respectively, issuing recommendations and casting votes, then the reputation penalties for monitoring failures are limited. In turn, this implies that ex ante incentives to prevent those failures from occurring are reduced. A better understanding of how shareholders view (or should view) directors' actions at one firm when assessing the ability of that director to serve at another firm is an important question for future research.<sup>13</sup>

In addition to calling for a better understanding of proxy voting recommendations, the evidence of a strong correlation between 'withhold' recommendations and shareholder votes also raises a more subtle question about the direction of causality: are shareholders blindly following these recommendations? Or do proxy advisors simply aggregate independently formed shareholder

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<sup>12</sup> The authors find some correlation between voting recommendations for the same director on boards of different firms, but such correlation is not due to the actions taken for a director at a given firm but is instead consistent with a 'single factor' hypothesis (i.e. the same factor, not tied to service on a particular board, affecting all recommendations; e.g. director sits on too many boards) and a 'higher proclivity' hypothesis (a director ex ante more likely to have characteristics resulting in withhold recommendation).

<sup>13</sup> In informal conversations, RiskMetrics officials confirmed that their policy does not call for automatic carry-over of negative recommendations to a director's other boards, on the ground that, except in the most egregious cases, it is not reasonable to penalize a director for unacceptable actions arising at another company. This policy has been generally supported by RiskMetrics' clients (institutional investors). In recent years, as requested by some clients, any issue relevant to a director's qualifications is mentioned in the research reports, even though it does not imply a negative recommendation.

views? Establishing the incremental effect of ISS/RM recommendations is difficult, since ISS/RM forms its voting policies after seeking shareholder input through a yearly survey of its subscribers.

To tackle this question, Choi, Fisch and Kahan (2010) note that observable factors affecting shareholder votes on director elections (*after* controlling for ISS/RM WH recommendations) are similar to those affecting ISS/RM WH recommendations.<sup>14</sup> Hence, they reason, it is likely that unobservable factors affecting both will also be similar. If so, the coefficient on the ISS/RM WH recommendations might be a proxy for unobservable factors independently used by voting shareholders rather than capturing the incremental effect of ISS/RM on the voting outcome—as assumed in prior studies. To estimate such an effect, Choi *et al.* (2010) suggest an alternative methodology: interact the ISS/RM WH indicator with the percentage ownership by institutional investors and the percentage ownership by individual investors and look at the difference. Under the assumption that institutional investors would vote the same way as the individual investors (i.e. based on the same factors) in absence of ISS/RM and that individual investors do not have access to ISS/RM recommendations, this difference would capture the “true” independent effect of ISS/RM recommendations on shareholder votes. Choi *et al.* (2010) estimate this difference to range between 6% and 10% and conclude that the 20% ISS/RM effect reported in prior studies is likely to be overstated.

Ertimur et al. (2010a) explore the question of whether shareholders mechanically follow proxy advisors’ recommendations by comparing the voting response to WH recommendations triggered by different events. In particular, they first compare the effect of backdating-related and non-backdating-related ISS/RM WH recommendations and find that the former is significantly larger (27.1% vs. 18.2%). Then, they examine whether, *within* the set of backdating-related

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<sup>14</sup> For example, as discussed earlier, poor attendance at board meetings affects both shareholder votes (Cai et al. 2009) and ISS/RM recommendations (Choi *et al.* 2009).

ISS/RM WH recommendations, the response in terms of shareholder votes varies depending upon the specific reasons for the recommendation and find supporting evidence. They find that a substantial number of shareholders following a backdating-related recommendation to withhold votes from directors who sat on the compensation committee during the backdating period (“blamed” by ISS for their failure to prevent or detect backdating) did not follow an identical, backdating-related recommendation when issued against current compensation committee members who did not sit on the board during the backdating period (but nonetheless “blamed” by ISS for not responding properly to revelations of backdating). These results are not driven by cross-sectional differences in shareholder composition across firms. That is, it appears that the *same* shareholders (and a significant fraction of them) responded differently to ISS/RM WH recommendations depending on their rationale. The authors also present anecdotal evidence of backdating directors experiencing high votes withheld in spite of a “for” ISS RM recommendation— further evidence that shareholders do not mechanically follow proxy voting recommendations.

Understanding the role of proxy advisors remains a priority for future research. Reforms empowering shareholders (see Sections 2.4 and 3.4) are likely to increase the influence of proxy advisors and magnify the concerns expressed by many critics with respect to their incentives, potential conflicts of interest, limited transparency and accountability (Choi *et al.* 2009; Gordon 2009). Tellingly, the role of proxy advisors and whether they should be subject to enhanced regulatory oversight is one of the topics that the SEC is soliciting comments upon in its recent “proxy plumbing” initiative (Section 3.3).

## *2.2 Consequences of vote-no campaigns and votes withheld from directors*

Anecdotal evidence suggests that, through their “power to embarrass” (Norris 2004), vote-no campaigns and ‘withhold’ votes have become a powerful tool of shareholder activism, with significant economic consequences.<sup>15</sup> A number of recent studies analyze these consequences in large-sample settings. Del Guercio *et al.* (2008) report improvements in firm operating performance and greater disciplinary CEO turnover in their sample of 112 vote-no campaigns.<sup>16</sup> The effects are stronger when the vote-no campaign is motivated by concerns with overall strategy and performance (rather than specific governance issues). For a subset of 54 cases where the campaign made specific requests, the board implemented 22% of proponents’ specific requests completely (and an additional 15% partially), with a higher rate of full implementation (37%) in firms with a larger showing of withheld votes at the annual meeting.<sup>17</sup> Ertimur, Ferri and Muslu (2010b) focus on a more recent sample of vote-no campaigns driven by compensation-related concerns and report a significant decrease in abnormal CEO pay subsequent to the campaign in target firms characterized by abnormal CEO pay before the campaign. Both studies conclude that vote-no campaigns appear more effective than shareholder proposals—consistent with directors being more responsive to the direct criticism implicit in a vote-no campaign.

Cai *et al.* (2009) focus on the effect of the percentage of votes withheld. While subsequent firm performance is not affected, they find: i) a significant decrease in abnormal CEO pay in firms with positive abnormal CEO pay where more votes are withheld from the compensation committee members; ii) a higher probability of CEO replacement with an outsider in firms where more votes

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<sup>15</sup> Perhaps the event that best represents the increased relevance of this form of activism is the 43% votes withheld from the powerful Disney CEO and Chairman Michael Eisner in 2004 (Norris 2004). Immediately after the vote, the board decided to split the Chairman and CEO role and give the chairmanship to another board member. The annual meeting vote marked the beginning of a crisis that eventually led Eisner to resign the CEO position a year later, ahead of the expiration of his contract.

<sup>16</sup> For example, the rate of forced CEO turnover at target firms is three times higher than for a size- and performance-matched sample of control firms. Also, the market reacts favorably to the announcements of these CEO turnovers.

<sup>17</sup> As a benchmark, Ertimur, Ferri and Stubben (2010c) report an implementation rate of 31% of shareholder proposals receiving a majority vote between 1997 and 2004. Brav, Jiang, Partnoy and Thomas (2008) report an implementation rate of 45% for governance changes requested by activist hedge funds.

are withheld from outside directors; and iii) a higher likelihood of subsequent removal of anti-takeover provisions in firms where more votes are withheld from governance committee members. In a similar vein, using a sample of S&P 500 firms between 2000 and 2004, Fischer, Gramlich, Miller and White (2009) find that higher votes withheld from board nominees are followed by greater CEO turnover, more positive price reaction to CEO turnover (particularly when the firm hires an outside CEO), lower abnormal CEO pay, fewer and better-received acquisitions, and more and better-received divestitures.<sup>18</sup>

In brief, all these studies suggest that shareholder dissatisfaction expressed through director elections is followed by value-enhancing choices and a reduction in agency costs. The causality interpretation of these findings is subject to the usual caveats concerning correlated omitted variables. The studies cited above try to control for other observable forms of shareholder pressure and employ useful econometric techniques (e.g. matched sample, propensity score), but ultimately recognize that unobservable forms of shareholder pressure (e.g. behind the scene negotiations) may explain some of their findings (ultimately, withheld votes indicate shareholder dissatisfaction, hence it is likely that dissatisfied shareholders will use multiple channels to push for change).<sup>19</sup> Strengthening the causality interpretation of the above results remains an important challenge and objective for future research.

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<sup>18</sup> It is not entirely clear whether these effects are driven by the vote-no campaigns per se or the voting outcome. Only one-fifth of the vote-no campaigns results in a high (>20%) percentage of votes withheld and there are numerous instances of high withheld votes even without a vote-no campaign. The higher CEO turnover in Del Guercio et al. (2008) and the decrease in abnormal CEO pay in Ertimur et al. (2010b) appear to be driven by the vote-no campaigns rather than the percentage of votes withheld (the two studies control for both). On the other hand, Fischer *et al.* (2009) exclude vote-no campaigns from their sample, suggesting that high votes withheld have economic consequences even in absence of a vote-no campaign.

<sup>19</sup> Fischer *et al.* (2009) emphasize that these findings are at least evidence that withheld votes are an informative measure of investors' perceptions of board performance, incremental to other performance measures which may affect the percentage of withheld votes (e.g. past stock and operating performance or change in institutional ownership). As such, they may be used in future research to complement other measures.

A puzzling ‘no-result’ in Cai *et al.* (2009) is that the percentage of votes withheld from a director is not related to the likelihood she will lose her seat or to the number of other seats held in the future,<sup>20</sup> in contrast with numerous studies documenting loss of directorships in cases of poor monitoring and poor performance (e.g. Coles and Hoi 2003; Yermack 2004; Srinivasan 2005; Fich and Shivdasani 2007; Ertimur *et al.* 2010c). If directors do not experience any penalty in the director labor market as a result of being the target of shareholder dissatisfaction, why would they take the actions that all these studies document (e.g. reducing CEO pay or changing governance provisions)? One possibility is that shareholders view casting votes and removing directors as substitute mechanisms, resorting to the latter approach only in the most extreme cases. Another, related possibility is that withheld votes act as a warning and are followed by a stronger penalty (loss of seat) only when the warning goes unnoticed.<sup>21</sup> Alternatively, it is possible that boards respond to vote-no campaigns and votes withheld not to protect their directorships, but to avoid damaging their public image and their social standing among their peers (Grundfest 1993; Dyck and Zingales 2002). Future research may shed more light on these questions.

### *2.3 The move toward a majority voting standard*

In October 2003, in the aftermath of the accounting scandals of 2001-2002, the SEC proposed the introduction of a proxy access rule, that is, a procedure to allow shareholders (under certain conditions) the ability to put their nominees on the proxy ballot along with the board’s nominees—a proposal aimed at increasing board accountability to shareholders.<sup>22</sup> The SEC proposal was abandoned amidst strong opposition from the business community, but changing the director election system remained a priority for activists. In 2004 union pension funds began to

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<sup>20</sup> However, Fischer *et al.* (2009) document a positive association between the average votes withheld at the *firm-level* and subsequent board turnover.

<sup>21</sup> In a similar spirit, Ertimur *et al.* (2010c) find that directors failing to implement shareholder proposals approved by a majority of votes cast suffer higher risk of losing their seat as well as other seats.

<sup>22</sup> Security Holder Director Nominations, Release No. 34-48626 (Oct. 15, 2003).

push for the adoption of a *majority voting* standard, under which a director would not be elected (even in uncontested elections) unless the majority of votes are cast in her favor. Between 2004 and 2007 hundreds of firms were targeted by shareholder proposals requesting the adoption of a majority voting standard. Most of these proposals received substantial shareholder voting support and firms began to adopt this new practice. In 2006 the Delaware Code and the Model Business Corporation Act, while preserving the plurality voting as the default system, were amended to facilitate the adoption of majority voting by corporations. By the end of 2007, two-thirds of S&P 500 firms had adopted some form of majority voting (Allen 2007).

Sjostrom and Kim (2007) study a sample of 371 firms adopting majority voting and conclude that the versions of majority voting adopted in practice did not result in true shareholder veto power over candidates. About 60% of the sample firms, following the example of Pfizer, introduced a “plurality plus” standard (plurality plus mandatory resignation). Under this system, the plurality standard is maintained and, thus, a director failing to win a majority vote is still elected, but must resign and the board will decide whether to accept her resignation. The other firms, following the example of Intel, adopted a “majority plus” standard (majority plus mandatory resignation). Under this system, a director failing to win a majority vote is not elected and must also tender her resignation—else, a statutory holdover rule would still leave the director on the board until the next meeting— which the board may or may not accept. Sjostrom and Kim (2007) argue that in the end, under both versions of majority voting, discretion is left to the board, and if the board does not accept the resignation the director remains in office.<sup>23</sup> Hence, they argue that majority voting, as put into practice, is “little more than smoke and mirrors” since the election

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<sup>23</sup> Firms adopting majority voting argue that leaving ultimate discretion to the board is necessary to make sure that the director’s resignation does not have a negative effect on the functioning of the board (e.g. comply with independence requirements) and to assess whether the director was not elected for reasons unrelated to her performance on the board.

outcome ultimately is a board decision (protected by the business judgment rule).<sup>24</sup> Under this view, the rapid spreading of majority voting may have been a low-cost means for firms to appease shareholders and, perhaps, avoid more threatening regulatory reforms (e.g. proxy access). In support of their thesis, Sjostrom and Kim (2007) find no market reaction around the announcements of adoptions of majority voting, regardless of the version adopted and also regardless of whether adopted through bylaw amendments (more binding) or through changes in the corporate governance guidelines. Using a similar sample, Cai, Garner and Walkling (2007) also find no market reaction around the announcements of adoptions of majority voting. They also find that majority voting adopters tend to have poor performance, more independent boards and weak shareholder rights—consistent with boards adopting majority voting to appease shareholders.

Overall, these two studies cast doubt on whether investors view the majority voting standard (at least as adopted in practice) as value enhancing, although there are some concerns with the suitability of an event study to this setting.<sup>25</sup> Perhaps future research can shed more light on the effect of a majority voting standard by examining how boards behaved after its adoption.

#### *2.4 The future of director elections: proxy access and broker votes*

On July 21, 2010 President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (henceforth, the Dodd-Frank Act), a wide ranging set of financial market reforms. One of the provisions of the Dodd-Frank Act<sup>26</sup> explicitly authorizes the SEC to introduce a proxy access rule, which the SEC did on August 25.<sup>27</sup> Under the new rule, a

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<sup>24</sup> In a recent decision, the Delaware Supreme Court indicated that the refusal of a board of directors to accept the resignation of a director who fails to obtain a majority vote under a plurality-plus standard is largely immune from judicial review). *City of Westland Police and Fire Retirement System v. Axcelis Technologies, Inc.* 2010 WL 3157145 (Del. 2010).

<sup>25</sup> Targeted firms began embracing majority voting fairly quickly and mostly in response to a shareholder proposal. Hence, the actual announcements may have carried little information, except maybe for a few early adopters. Proxy filing dates are also of little use, since activists often release their list of target firms ahead of the proxy filing dates.

<sup>26</sup> Pub. L. 111-203, H.R. 4173, § 971.

<sup>27</sup> Facilitating Shareholder Director Nominations, Release No. 33-9136 (Aug. 25, 2010).

shareholder, or a group of shareholders, who owns—and has owned continually for at least the prior three years—at least three percent of the company's voting stock can put its nominees on the proxy ballot along with the board's nominees (borrowed shares do not count toward the 3% threshold). These shareholders will be limited to nominating candidates for no more than 25% of a company's board seats and will not be able to use proxy access for the purpose of changing control of the company. Smaller reporting companies (public float below \$75 million) are exempt from complying with the rule for three years as the SEC monitors its implementation at large firms.<sup>28</sup> The rule was intended to go into effect on November 15, 2010 (in time for the 2011 proxy season). However, on September 29 the Business Roundtable filed a petition challenging the new rule in court. On October 4, the SEC announced that it would delay implementation of the rule until the Business Roundtable challenge was resolved.

Proxy access has been the subject of a long and intense debate. Much of this debate has taken place in absence of direct empirical evidence, as often happens for untested reforms (Coates 2009). Recently, researchers have begun to explore the market reaction around the regulatory and legislative events related to proxy access.<sup>29</sup> Akyol, Lim and Verwijmeren (2010) find negative

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<sup>28</sup> The SEC also amended Rule 14a-8 to enable shareholders to submit proposals related to election and nomination procedures—hence removing elections of directors from the reasons for exclusion of a shareholder proposal (see footnote 27). The new rule also allows shareholders to adopt, through either a management recommendation or Rule 14a-8 shareholder proposal, access rules that provide for greater access — but they cannot limit the new proxy access rule. For details, see: <http://sec.gov/rules/final/2010/33-9136.pdf>.

<sup>29</sup> As discussed in Section 2.3, in 2003 SEC introduced a proxy access proposal (for a discussion, see Bebchuk 2003a and 2003b). After the proposal was abandoned, activists began to file shareholder proposals at a few firms requesting the introduction of a proxy access provision. The SEC allowed firms to exclude these proposals because they are related to the election of directors—one of the grounds for exclusion under Rule 14a-8 (see footnote 27). In 2006, though, a court ruling in *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) called into question the SEC's long-held view and essentially forced the SEC to clarify the interpretation of Rule 14a-8. On November 28, 2007, the SEC voted to let companies reject shareowner proposals that relate to board nominations or elections, while committing to reconsider a proxy access rule in the future. In April 2009, after Democratic victories in both the legislative and executive branches of government, the proxy access issue was revived. In April 2009, the Delaware code was amended, adding Section 112 to allow corporations to voluntarily adopt bylaws permitting shareholder proxy access. In May 2009, under the leadership of a new chair (Mary Schapiro) the SEC released a new proxy access proposal as well as a proposal allowing shareholders to submit (binding or advisory) proposals on proxy access under Rule 14a-8. The SEC proposals received a record number of comment letters and in December 2009 the SEC reopened the comment period for another 30 days, largely to ask for comments on the idea of a "private ordering"

(positive) market returns around events that increase (decrease) the probability of passage of proxy access legislation between 2007 and 2009. Larcker, Ormazabal and Taylor (2010) present similar results. Both studies cast doubts on the value of greater shareholder involvement in the director nomination process.

However, these findings need to be interpreted carefully. In addition to the usual concerns with event studies (e.g. contaminated events, signaling), a particular challenge with multi-event studies of regulation is the identification and interpretation of the relevant events. For example, both studies treat as an increase in the likelihood of a proxy access rule the April 2007 SEC announcement of a roundtable on proxy access and the subsequent June 2007 SEC release of a proxy access proposal. But the April 2007 decision by a (then Republican-controlled) SEC to re-open the proxy access debate was ‘forced’ by a court decision in a case brought by AFSCME (a union pension fund) against AIG. As for the July 2007 event, it should be noted that, along with the proxy access proposal, the SEC released a proposal that would allow companies to exclude from proxy statements shareholder proposals requesting proxy access (the issue debated in the AFSCME-AIG case). A reasonable interpretation of the July 2007 SEC action is that it made a proxy access rule *less* likely (indeed in November 2007 the SEC voted to explicitly allow companies to exclude proxy access shareholder proposals from proxy statements, while dropping the proxy access proposal). To further complicate things, the market reaction to proxy access proposals reflects not only the perceived value of greater shareholder involvement in the director nomination process, but also (perhaps, only) the perceived value of the specific proxy access proposal. For example, the Council for Institutional Investors, while supporting proxy access,

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approach to proxy access, in which companies and/or shareholders would be able to opt out of a federal access rule (for a discussion, see Bebchuk and Hirst 2010a and 2010b).

strongly opposed the version proposed by the SEC in July 2007 because too restrictive (further indication that the July 2007 SEC action did not increase the likelihood of proxy access legislation).<sup>30</sup>

To circumvent these problems, Becker *et al.* (2010) focus instead on the market reaction to October 4 SEC announcement of the suspension of the proxy access rule, calling it a “move that surprised most observers”. They find that the stock price of firms that would have been most exposed to proxy access (based on the level and type of institutional ownership) declined significantly compared to the stock price of firms that would have been most insulated from proxy access, consistent with the market perceiving the SEC-proposed proxy access rule as a value creating mechanism.

While useful, event studies may be misleading in that they assume that investors are able to correctly estimate the value effect of a new, untested mechanism, whose impact is likely to depend on hard-to-predict responses of the interested parties. Kahan and Rock (2010) present a comprehensive analysis of the likely effects of proxy access and conclude that it will have a marginal impact, if any. They argue that the entities most often engaged in activism (hedge funds and union-related funds) usually do not satisfy ownership and holding requirements of the proxy access rule; that the benefits of proxy access are limited (e.g. limited number of board seats) and the cost savings relative to proxy contests are overstated. In other words, they predict that proxy

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<sup>30</sup> Another controversial event is Delaware’s decision in 2009 to explicitly authorize proxy access bylaws. Both studies consider this event as decreasing the probability of proxy access *legislation*, on the ground that it was viewed by some observers as an attempt to prevent a federal proxy access regulation or at least to affect the SEC’s design of a new rule. A positive market reaction around Delaware’s decision is thus interpreted as investors reacting positively to the reduced likelihood of mandatory proxy access. Another interpretation is that investors reacted positively to the news that in the future they could submit proposals requesting proxy access bylaws which would have eventually created momentum for widespread adoption of proxy access. Indeed, some observers thought that the Delaware action gave *proxy access* “a dramatic boost” (Choi *et al.* 2010). There are also some questions as to what is the “right” event of interest regarding the Delaware’s decision (the vote of the Corporate Law section of the Delaware Bar Association vis-à-vis the introduction of the bill in the Delaware House of Representatives; see Becker, Bergstresser and Subramaniam 2010 for a discussion).

access will be rarely used, rarely successful (in terms of electing a dissident nominee) when used and of marginal effect when successful.

A second regulatory development with important implications for director elections is the June 2009 SEC decision to eliminate so-called “broker votes” for director elections (thus approving a NYSE proposal first advanced in 2006). Most shareholders (known as beneficial owners) hold shares through brokers in street name rather than in their own names (registered owners) (Dixon and Thomas 1998). Prior to this rule change, if brokers had not received voting instruction by the 10<sup>th</sup> day prior to the annual meeting, they were permitted to exercise discretionary voting authority with respect to these ‘uninstructed’ shares on “routine” matters (which included uncontested director elections)—a provision put in place to increase the probability of achieving the required quorum. Historically, brokers have cast these votes in favor of the board’s nominees. Previous studies estimate these broker votes to average 13% of outstanding shares and to have the potential to swing the outcome of some routine proposals (Bethel and Gillan 2002). In their sample of uncontested director elections, Cai *et al.* (2009) estimate that excluding the broker votes would have increased the percent of withheld votes by an average of 2.5% (with an impact greater than 10% on 10% of the director elections). In some cases, the effect may be much more significant. Choi *et al.* (2010) report that broker votes comprised 46% of the votes cast at the Citigroup 2009 annual meeting and that two nominees would not have won re-election without the broker vote.

Combined with the use of majority voting and the likely introduction of proxy access, the elimination of broker votes may have a significant impact on director elections.<sup>31</sup>

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<sup>31</sup> The elimination of broker votes has also triggered a series of proposals to facilitate voting by retail shareholders (e.g. the so-called client-directed voting; <http://blogs.law.harvard.edu/corpgov/2010/07/14/an-open-proposal-for-client-directed-voting/>). Voting participation by retail shareholders has received significant attention also because of

In view of all these developments, director elections are likely to become a central focus of future research in corporate governance.

### **3. Shareholder Proposals under Rule 14a-8**

Under Rule 14a-8, promulgated under the Securities Exchange Act of 1934, any shareholder continuously holding shares worth \$2,000 (or 1% of the market value of equity) for at least one year is allowed to include one (and only one) proposal with a 500-word supporting statement in the proxy distributed by the company prior to its annual shareholder meeting. These proposals request a vote on a particular issue from all shareholders and must be submitted at least 120 days before the proxy is mailed to shareholders. The company may ask the SEC to exclude a proposal if it violates certain conditions<sup>32</sup> or may persuade the proponent to withdraw it (e.g. by agreeing to it). Among other reasons, the proposals can be excluded if it is considered improper under the company's state laws. For for a long time proposals that would be binding on the board have been regarded as improper because inconsistent with Section 141 of the Delaware General Corporation Law (and similar provisions of corporate law in other jurisdictions) which vests the board of directors with the power to manage the business and affairs of a corporation. In recent years, the SEC and courts have allowed shareholder proposals in the form of binding bylaw

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research showing that it was negatively affected by the 'e-proxy' delivery system introduced by the SEC in 2006 (<http://blogs.law.harvard.edu/corpgov/2010/03/14/proxy-solicitation-through-the-internet-2/>).

<sup>32</sup> Rule 14a-8(i) stipulates that firms may request the exclusion of proposals that are not a proper action for shareholders under the company's state law, proposals that address ordinary business matters, proposals that would result in the violation of state or federal laws, proposals related to a personal claim or grievance, proposals that are materially false or misleading, proposals of limited relevance, proposals that the company has no authority to implement, and proposals that request specific amounts of cash and stock dividends. Proposals related to an election for membership on the company's board of directors could also be excluded before the new proxy access rule released on August 25, 2010 (see Section 2.4 and footnote 23), A proposal may also be excluded if it is i) similar to another proposal already included in the proxy, ii) already substantially implemented by the company, or iii) conflicts with a management proposals to be submitted to shareholders at the same meeting. Finally, the company may request an exclusion of proposals already submitted in the past that received less than a certain percentage of votes in favor. See <http://www.sec.gov/interps/legal/cfslb14.htm>.

amendments, under certain conditions.<sup>33</sup> These proposals remain rare, though, and the vast majority of shareholder proposals are written in the form of a non-binding recommendation, regardless of the voting outcome.

Using data from the 1980s and 1990s, a number of studies conclude that shareholder proposals have been a weak governance mechanism.<sup>34</sup> Most proposals were filed by individuals (so-called gadflies), few won a majority vote, and even those were often ignored by boards, given their advisory nature.<sup>35</sup> Not surprisingly, then, generally firms targeted by this type of activism did not experience performance improvements, and their stock price did not move around the time these proposals were filed or voted upon.

During the last decade, though, in the aftermath of Enron-type scandals, corporate governance has become a central theme for many institutional investors, giving rise to an intense wave of shareholder activism, symbolized by hedge funds' aggressive strategies. The landscape for shareholder proposals has changed accordingly, with a rise in the number of shareholder proposals, an increasing role of union pension funds, and the emergence of new types of proposals gaining widespread support among many institutional investors. Faced with this new governance-oriented environment, boards have been under greater pressure to respond to shareholder requests. These changes have spurred a series of studies re-examining the effectiveness of shareholder proposals as a governance mechanism. In this section, I will review the main findings of such studies with respect to characteristics of targeted firms (Section 3.2), determinants of voting outcome (Section 3.2), and economic consequences (Section 3.3) of shareholder proposals. I will then conclude with

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<sup>33</sup> For a detailed account of the emergence of binding bylaw proposals see A. Goodman and J. Olson, *A Practical Guide to SEC Proxy and Compensation Rules*, Fourth Edition, Aspen Publishers.

<sup>34</sup> Comprehensive reviews of the evidence are Black (1998), Gillan and Starks (1998, 2007), Karpoff (2001), and Romano (2001).

<sup>35</sup> At Bristol-Myers Squibb, for example, a proposal to declassify the board was ignored despite obtaining a majority vote for six consecutive years (Business Week 2002).

a brief discussion of recent regulatory developments, such as the mandatory adoption of “say on pay” votes (Section 3.4).

### *3.1 Characteristics of targeted firms and the motives of union pension funds*

Similar to earlier periods, recent studies conclude that in general targeted firms continue to be large, poorly performing firms, with weaker governance structures (Thomas and Cotter 2007; Ertimur *et al.* 2010c),<sup>36</sup> with other characteristics depending on the specific type of proposal (e.g. the level of CEO pay for compensation-related proposals, Ertimur *et al.* 2010b).

The increased activism by union pension funds has generated interest in whether their targeting criteria reflect a conflict of interest between their dual role as shareholders (the union pension fund) and as representatives of labor in collective bargaining negotiations (the unions)—as suggested by some highly publicized examples (e.g. the governance campaign of AFL-CIO at Safeway during labor negotiations). Ertimur *et al.* (2010b) examine this question in a sample of about 1,200 compensation-related shareholder proposals between 1997 and 2007, concluding that: (i) relative to other sponsors of shareholder proposals, union pension funds are not more likely to target unionized firms; (ii) among unionized firms, union pension funds are not more likely to target unionized firms with a higher percentage of unionized employees, involved in renegotiating their collective bargaining agreements or in labor-related disputes.

While Ertimur *et al.* (2010b) do not detect labor-related motives in the *targeting* criteria of union pension funds, Agrawal (2008) finds that these motives play a role in their *voting*

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<sup>36</sup> Activists target larger firms to gain visibility for their initiatives and thus, exert more pressure on the targeted firms, generate spillover effects and, in some cases, send a message to regulators (see discussion in Section 3.3). The focus on poorly performing firms is not surprising, though a casual examination of the greatest governance scandals indicates that most of these firms had (or reported) stellar performance in the past. Such performance may cause a decrease in the level of outside monitoring which in turn may lead to the governance crisis. Perhaps for this reason activists seem to increasingly put greater emphasis on governance issues regardless of performance.

decisions.<sup>37</sup> Understanding activists' motives and conflicts of interest remains a central question as new regulations empower minority shareholders (Anabtawi and Stout 2008). Translating these motives in large sample analyses is not trivial. In-depth case studies and surveys may be used to complement those analyses.

### *3.2 Determinants of voting outcome and voting patterns of mutual funds*

As the number of shareholder proposals increased, the percentage of votes in favor of these proposals also went up over time, with the fraction of proposals winning a majority increasing from 10% in 1997 to over 30% in 2003-2004 (Ertimur *et al.* 2010c).<sup>38</sup> The type of proposal remains the key determinant of shareholder votes, with proposals to remove-anti-takeover defenses continuing to receive the highest support and a number of new types of proposals achieving high approval rates—e.g. proposals to expense stock options (Ferri and Sandino 2009); to adopt majority voting (Cai *et al.* 2007); to adopt a say on pay vote (Burns and Minnick 2010; Cai and Walkling 2010). Proxy advisors' recommendations continue to be a major factor in 'determining' the voting outcome (the discussion in Section 2.2 applies to shareholder proposals as well).<sup>39</sup>

One interpretation of this evidence is that, by and large, aggregate shareholder votes tend to support value-enhancing proposals, or at least proposals with a reasonable potential to create value. For example, between 2005 and 2009 proposals to declassify the board have averaged between 60% and 70% votes in favor (Georgeson 2010), consistent with a large body of research

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<sup>37</sup> Agrawal (2008) uses the 2005 AFL-CIO breakup as a source of exogenous variation in the union affiliations of workers across firms and finds that AFL-CIO affiliated shareholders are less likely to vote against director nominees once the AFL-CIO no longer represents workers. He also documents that AFL-CIO funds are more likely to vote against directors of firms with greater frequency of plant-level conflict between labor unions and management during collective bargaining and union member recruiting, but less so once the AFL-CIO no longer represents workers.

<sup>38</sup> The percentage has oscillated above 30% in most of the subsequent years, leveling off at 32% in 2009 (Georgeson 2010).

<sup>39</sup> For example, ISS/RM favorable recommendations are associated with a 25% increase in voting support for compensation-related proposals (Ertimur *et al.* 2010b) and a 14-18% increase in voting support for majority voting proposals (Cai *et al.* 2007). As for the other determinants, similar to prior studies, voting support is generally lower in larger firms—reflecting the higher cost of collective action in these firms and the greater resources they invest in campaigning against the proposal—and is higher in poorly performing firms (Thomas & Cotter 2007). Proposals by institutional proponents receive greater support than those filed by individuals (Ertimur *et al.* 2010c).

suggesting that staggered boards are associated with lower firm value (e.g. Bebchuk and Cohen 2005; Bebchuk, Cohen and Ferrell, 2009). Another example is the voting outcome for compensation-related proposals. Ertimur *et al.* (2010b) find significant voting support for proposals aimed at affecting the pay setting process (e.g., proposals requesting shareholder approval of large severance payments), lower support for proposals aimed at micromanaging pay (e.g. proposals to adopt specific levels and structure of pay) and almost no support for more ‘radical’ proposals arguably reflecting objectives other than shareholder value (e.g., proposals to link executive pay to social criteria or to abolish incentive pay).<sup>40</sup>

While this evidence may suggest that aggregate shareholder votes exhibit a certain degree of sophistication, more research is required to determine to what extent or under what circumstances we can interpret the degree of voting support for a proposal as a reasonable proxy for its effect on value.<sup>41</sup>

Another major challenge in the analysis of shareholder votes is that for a long time shareholders were not required to disclose how they actually cast their votes.<sup>42</sup> In 2003, however, the SEC mandated that one class of investors—mutual funds—disclose, on an annual basis, their

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<sup>40</sup> Ertimur *et al* (2010b) also find that while activists submit compensation proposals at firms with higher raw levels of CEO pay, voting shareholders only support these proposals at firms with ‘excessive’ CEO pay—that is, in excess of the level of pay predicted by standard economic determinants, such as size, performance, and industry. This finding suggests that aggregate shareholder votes are able to “filter out” the lack of sophistication or the social equity objectives of activists.

<sup>41</sup> Listokin (2009) argues that if the median voting shareholder and the price-setting shareholder share similar information, then close proxy contest outcomes should have no systematic effect on stock prices. Since stock prices instead move around victories of dissidents or management in such contests, Listokin (2009) concludes that voting and market pricing aggregate information in a very different way. While the study relies on a number of assumptions that need further analysis, it represents a novel attempt to examine the relation between shareholder votes and shareholder value.

<sup>42</sup> Researchers have typically drawn inferences from the correlation between voting outcome and aggregate percent ownership by institutional investors (or types of institutional investors) and insiders, generally concluding that institutional ownership is positively associated to the voting support for shareholder proposals, while insiders ownership shows a negative association (unsurprisingly—else the proposal would not be put up for a vote in the first place).

voting policies as well as how they voted on each item on the ballot at the annual meeting.<sup>43</sup> The new requirement—opposed unanimously by the mutual fund industry—was driven by the concern that mutual funds were not voting their proxies in the best interest of shareholders, due to their potential conflicts of interests (business ties with the firm; e.g. managing employee benefit plans). The availability of these new data has spurred a significant amount of research on the voting behavior of mutual funds—the largest shareholder category in U.S. public markets, holding 28.9% of all publicly-traded equity securities as of 2008 (Cotter, Palmiter and Thomas 2010).

A first group of studies has focused on whether potential or actual business ties with the firm affects mutual funds' voting decisions—the premise of the SEC disclosure rule. Rothberg and Lilien (2006) compare the voting records of fund companies that are primarily mutual funds (i.e., non-conflicted), to the voting records of fund companies that are a small part of larger financial services companies (and, thus, potentially conflicted because the funds' parents' business is principally the provision of financial services) and do not find a difference in how often they vote against management, inconsistent with a conflict of interest hypothesis. Ashraf, Jayaraman and Ryan (2009) focus on shareholder proposals related to executive compensation and find no relation between mutual fund votes and pension-related business ties between the mutual fund and the firm (nor between votes and fees for mutual funds with pension-related business ties). Consistent with these results, Davis and Kim (2007) find that funds are no more likely to vote with management of client firms than management of non-clients. However, they also find that aggregate votes at the fund family level indicate a positive relation between business ties and propensity to vote with management, at least for some shareholder proposals.<sup>44</sup> The authors conjecture that the mandatory disclosure may have led fund families with a larger client base to adopt pro-management voting

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<sup>43</sup> Proxy Voting by Investment Advisers, Release No. IA-2106 (Jan. 31, 2003).

<sup>44</sup> In a related vein, Taub (2009) finds that voting support for shareholder proposals at large fund families is negatively related to the amount of defined contribution assets under management.

policies at all firms, to avoid the appearance of voting based on client relationships. This would be an ironic effect of the SEC disclosure rule, since its proponents argued that disclosure of votes would force mutual funds with conflicts of interests to exert their monitoring role and, thus, vote more often in support of shareholder proposals. In the absence of data on mutual funds' votes pre-2003, to test whether mutual funds' voting behavior was affected by the 2003 rule, Cremers and Romano (2007; 2010) analyze the relation between voting outcome and mutual fund ownership before and after the rule change for firms facing similar proposals in both periods, and conclude that mutual funds' voting support for management did not decrease after the new disclosure requirement (and actually increased for management proposals related to executive pay plans).

A number of other studies have focused on understanding other determinants of mutual funds' voting behavior, concluding that type of proposal and ISS/RM recommendations are the key determinant of mutual funds' votes, as for shareholder votes in aggregate.<sup>45</sup> However, they also show that both firms' characteristics (governance, ownership, performance) and funds' characteristics (investing style and horizon, size, performance, expense ratio, holdings, own governance, geographical proximity to management) matter (Rothberg and Lilien 2006; Ashraf and Jayaraman 2007; Chou, Ng and Wang 2007; Das 2007; Ng, Wang and Zaiats 2007; Morgan, Poulsen, Wolf and Yang 2009; Cotter *et al.* 2010).

Collectively, these studies lead to the following inferences regarding mutual funds' voting behavior. First, mutual funds vote depending on the proposal type (i.e. they do not follow a mechanical rule such as "vote always with management"), with much greater support for governance-related shareholder proposals over social and environmental issues. Second, funds differ significantly in terms of which governance-related shareholder proposals to support, with the

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<sup>45</sup> Morgan *et al.* (2009) report that in their sample of about 1300 funds, 349 always vote with ISS/RM. Cotter *et al.* (2010) document that mutual funds tend to vote consistently with ISS/RM more often than all other shareholders on average.

exception of proposals to remove anti-takeover defenses, supported by most mutual funds.<sup>46</sup> Third, while some funds always support or oppose a type of proposal across all firms where they vote, for some types of proposals the votes of a given fund differ across firms. Fourth, while for a given proposal most large fund families vote their funds as a block—often as a policy—there is some variation across individual funds within a fund family, particularly on certain topics (e.g. poison pills). Overall, these studies reveal a complex and nuanced voting process.

As discussed later (Section 3.4), new vote disclosure requirements may allow for an equally careful examination of the voting decisions of other classes of institutional shareholders.

### *3.3 Economic consequences of shareholder proposals*

A number of studies analyze the economic consequences of shareholder proposals, either by focusing on a specific proposal or across a broad set of proposals. Essentially, they yield three main insights. First, shareholder proposals have become an effective activism tool in prompting firms to modify their governance practices. Firms are more likely to expense stock options (Ferri and Sandino 2009), declassify boards (Guo Kruse and Noel 2008; Cai *et al.* 2009), and remove poison pills (Akyol and Carroll 2006; Cai *et al.* 2009) after receiving a shareholder proposal requesting these actions. Second, the impact of shareholder proposals crucially depends on the degree of voting support they receive. Across a broad set of proposals between 1997 and 2004, Ertimur *et al.* (2010c) report an implementation rate of 31% for proposals winning a majority vote and only 3% for proposals receiving between 30% and 50% of the votes cast.<sup>47</sup> Within proposals winning a majority vote, the likelihood of implementation increases with the percentage of votes

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<sup>46</sup> The widespread support for anti-takeover proposals among mutual funds is generally interpreted as an indication that mutual funds tend to support wealth increasing proposals (Ashraf and Jayaraman 2007; Davis and Kim 2007; Morgan *et al.* 2009).

<sup>47</sup> Similarly, in a sample of shareholder proposals related to executive pay, Ertimur *et al.* (2010c) report an implementation of 40.3% (3.8%) for proposals winning (failing to win) a majority vote. Ferri and Sandino (2009) find that a majority vote on a proposal to expense stock options increases the likelihood of its adoption.

cast for the proposal (as well as other measures of shareholder pressure, e.g. proponents' ownership).<sup>48</sup> The third finding is a marked increase in the rate of implementation of shareholder proposals receiving a majority vote in the post-Enron period (Akyol and Carroll 2006; Thomas and Cotter 2007; Morgan *et al.* 2009). For example, Ertimur *et al.* (2010c) report a rate of implementation of 40-42% in 2003-2004 versus 16%-24% in 1997-2002.

These data are likely to understate the impact of shareholder proposals on governance practices, for three reasons. First, they focus on proposals voted upon at the annual meetings. Many proposals are withdrawn before the meeting because the company agrees to implement them (though there may be other reasons; e.g. the issue becomes moot due to changes in regulation or the firm agrees to other concessions). For example, numerous shareholder proposals to adopt a majority voting standard in 2006-2008 were withdrawn because the firm agreed to adopt majority voting (Sjostrom and Kim 2007). Expanding the analysis to withdrawn proposals (as well as proposals excluded from the proxy because in violation of Rule 14a-8) may be a fruitful endeavor for future studies.

Second, most studies on shareholder proposals focus on their impact on targeted firms. However, another objective of activism is to generate spillover effects on non-targeted firms.<sup>49</sup> Recent studies suggest that these effects may be at work. Ferri and Sandino (2009) find that non-targeted firms were more likely to expense stock options if a peer firm was targeted by a shareholder proposal requesting the expensing of stock options. Ertimur *et al.* (2010c) find that firms are more likely to implement a shareholder proposal supported by a majority vote if a peer

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<sup>48</sup> Morgan *et al.* (2009) find that greater voting support by mutual funds also increases the likelihood of implementation.

<sup>49</sup> Black (1990) argues indeed that activists should focus on systemic- market-wide issues with a potential for spillover effects, so as to increase the benefits and limit the cost of their initiatives. Spillover effects are particularly important for indexed funds (Del Guercio and Hawkins 1999). Union pension funds tend to be indeed highly diversified (Scwhab and Thomas 1998; Agrawal 2008) and claim that a goal of their activism is to generate market-wide adoption of best practices (Ferri and Weber 2009).

firm implemented a similar proposal. Cai *et al.* (2007) find that firms are more likely to adopt a majority voting standard if their directors sit on another firm which has already adopted majority voting—consistent with evidence that overlapping directors contribute to the spreading of governance practices (Bouwman 2008).

Third, shareholder proposals are increasingly being used as a lobbying mechanism to influence regulatory reforms—beyond any immediate effect on targeted firms. Ferri and Sandino (2009) note that activists used shareholder proposals to expense stock options as a means to influence standard setters. Arguably, shareholder proposals to adopt a majority voting standard for director elections (Sjostrom and Kim 2007) and proposals requesting a “say on pay” vote (see Section 3.4) also aimed at influencing the policy debate. As more of these initiatives develop, future research may shed light on the characteristics of this form of “reform-oriented” activism, which is likely to have different traits.<sup>50</sup>

Further indirect evidence of the growing influence of shareholder votes is the existence of an active market for votes within the U.S equity loan market, as documented by Christoffersen *et al.* (2007), who show that vote trading corresponds to support for shareholder proposals and opposition to management proposals;<sup>51</sup> and the emergence of low-cost, low-transparency techniques that allow the decoupling of economic ownership from voting rights, resulting for example in the possibility of holding more votes than shares—so-called “empty voting” (Hu and Black 2007).

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<sup>50</sup> For example, in the case of proposals to expense stock options, activists targeted large firms (to exploit their visibility) but did not focus on heavy option users or poor performers, to show to standard setters that support for expensing was widespread across firms and industries (Ferri and Sandino 2009). This may explain why Cai and Walkling (2010) find that proposals to adopt say on pay targeted large firms, but not firms with excess CEO pay, poor governance and poor performance.

<sup>51</sup> Bethel, Hu and Wang (2009) show that institutional investors buy shares and hence voting rights before merger record dates, and that such trading is positively related to voting turnout and negatively related to shareholder support of merger proposals.

In view of all the above evidence, there is little doubt that shareholder proposals and shareholder votes have become a more effective tool in the post-Enron period (see also Section 2.2), with boards listening to shareholder “voice” more than ever before. However, two fundamental questions remain unanswered and call for more research. The first is why boards have become more responsive. Is it because the cost of ignoring shareholder requests’ has increased?<sup>52</sup> : Or because activists have become more sophisticated in identifying value-enhancing governance changes, causing boards to become more willing to adopt the proposed changes? This leads me to the second and arguably most important unanswered question: is shareholder activism through Rule 14a-8 ultimately associated with value creation?

As mentioned earlier, studies from the 1980s and 1990s largely concluded that shareholder proposals had no effect on shareholder value. While this result was consistent with the fact that most proposals received low voting support and were rarely implemented, it was not clear that the methodologies adopted would have detected any effect on value even if there was such an effect. For example, event studies around proxy filing dates or annual meetings have been recognized to be plagued by numerous problems, making them ill-suited to address the question of the value impact of shareholder proposals (Gillan and Starks 2007).<sup>53</sup>

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<sup>52</sup> A number of factors may have increased the cost of ignoring shareholders’ requests: the underlying threat of hedge funds’ activism or vote-no campaigns, the desire to prevent regulatory intervention, greater reputation penalties for unresponsive directors in the director labor market (Ertimur *et al.* 2010c), the emergence of governance ratings and proxy advisors, greater scrutiny and influence of the media (Dyck, Volchkova and Zingales 2008; Joe, Louis and Robinson 2009; Kuhnen and Niessen 2010).

<sup>53</sup> Gillan and Starks (2007) note the following problems. First, identifying the date when the market learns about the submission of a proposal is extremely difficult. Proxy mailing dates are of limited use. Many proponents release their list of target firms well ahead of the proxy season and some firms announce the receipt of the proposal before its inclusion in the proxy. Also, proponents resubmit most proposals that receive reasonable support but are not implemented. Hence, the re-submission of these proposals (even if the exact date was identified) is largely expected and may not convey any news. Second, the proxy contains other information, making it difficult to ascribe any return around its mailing to the analyzed proposal. This ‘contaminated’ event problem also affects annual meeting dates, which have been used to study the reaction to the voting outcome. The third issue is that the submission of a proposal may also be interpreted as a negative event in that it means that the shareholder and firm did not reach an agreement, making it difficult to ascribe any price movement to the quality of the proposal itself. Given these problems, it may be not surprising that Thomas and Cotter (2007) find generally insignificant market reactions around proxy filing dates

In a recent study Cuñat, Gine and Guadalupe (2010) adopt a novel approach to address this question. As discussed earlier, there is a large difference in implementation rates depending on whether or not a proposal achieves a majority vote (Ertimur *et al.* 2010c). Cuñat *et al.* (2010) note that such difference in implementation rates persists if one compares proposals winning a majority vote by a small margin to proposals failing by a small margin. For these ‘close-call’ proposals, it is reasonable to assume that there were similar expectations about the likelihood of passage. If so, the passage of some but not others should contain significant information (akin to an exogenous shock). Applying a regression discontinuity technique to a sample of all shareholder proposals between 1997 and 2007, Cuñat *et al.* (2010) find that approved shareholder proposals yield an abnormal return of 1.3% over the ones not approved, with a more pronounced price reaction for proposals related to anti-takeover provisions (consistent with the evidence on the value relevance of such provisions). They also try to estimate the full value of the proposal taking into account its likelihood of implementation, concluding that adopting a governance proposal increases value by 2.8%. Finally, they find evidence of superior long-term performance after the passage those proposals. While the authors view these results as supporting the notion that better governance creates value, their findings also (perhaps, mainly) speak to the value of shareholder activism, in that they indicate that, in aggregate, shareholder votes tend to support value-creating proposals. More research is needed, though, to strengthen this conclusion.

#### *3.4 Recent regulatory developments: mandatory say-on-pay votes*

The Dodd-Frank Act mandates that publicly traded firms must let shareholders have an up-or-down non-binding vote on executive pay—known as “say on pay” vote— at least once every

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and annual meeting dates (regardless of the level of support for the proposal) for shareholder proposals filed between 2002 and 2004, in spite of the fact that these proposals were more likely to win majority votes and be implemented than in earlier periods. Gillan and Starks (2007) also discuss the problems in designing tests of the effect of shareholder proposals on long-term performance.

three years<sup>54</sup> (the SEC has the authority to exempt firms based on size or other criteria).<sup>55</sup> A similar, non-binding vote must be held to approve any golden parachute triggered in connection with mergers and acquisitions (separate from the vote on the transaction itself) and not already subject of a say on pay vote. The Act also extends the prohibition of broker votes for uninstructed shares (recently approved by the SEC for director elections; see Section 2.4) to say on pay and golden parachute votes. Finally, the Act requires institutional investors to disclose how they voted their shares on say on pay and golden parachutes matters.

The first country to mandate an annual non-binding say on pay vote was the UK in 2002. Ferri and Maber (2009) examine the effect of say on pay legislation in the UK by first analyzing observable changes to compensation contracts and then estimating unobservable changes through a regression of CEO pay on its economic determinants. Across both sets of analyses, they find that say on pay resulted in greater penalties for poor performance. In particular, the analysis of explicit contractual changes in response to the first say on pay votes shows that a high fraction of firms facing high voting dissent responded by removing or modifying controversial provisions that investors viewed as “rewards for failure” (e.g. large severance contracts, provisions allowing the retesting of unmet performance conditions in equity grants), often in response to institutional investors’ explicit requests.<sup>56</sup> These actions do not appear to reflect a general trend but rather the effect of say on pay votes, since their frequency among ‘high dissent’ firms after the vote is significantly higher than before the vote and also significantly higher than among ‘low dissent’ firms after the vote. Notably, a substantial number of ‘low dissent’ firms took similar actions

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<sup>54</sup> Pub. L. 111-203, H.R. 4173, § 951.

<sup>55</sup> At their first meeting, firms also must let shareholders vote on whether to hold the say on pay vote every 1, 2 or 3 years.

<sup>56</sup> In particular, 75-80% of the firms facing voting dissent greater than 20% reduced the notice periods from 24 to 12 months (implying a 50% reduction in severance pay) and removed retesting provisions from option grants after the vote. This percentage is extremely high when compared to the implementation rate of nonbinding proposals in the US (Ertimur et al. 2010c).

ahead of the say on pay vote, suggesting that proactive changes helped firms avoid voting dissent. Consistent with this conjecture, the authors also find that the ‘high dissent’ firms that removed controversial provisions experienced a substantial decrease in voting dissent at the second say on pay vote. The study also concludes that the (ex ante and ex post) effect of say on pay votes differed across different compensation provisions, suggesting that concerns with say on pay votes being used to promote “one-size-fits-all” compensation practices may be overstated (Gordon 2009).

The UK experience with say on pay soon captured the attention of US activists, who between 2006 and 2008 filed more than 150 shareholder proposals requesting the adoption of say on pay at large US firms, often winning significant voting support. While few firms agreed to adopt say on pay, legislators took notice. In April 2007, the U.S. House of Representatives approved a bill seeking to mandate say on pay. Shortly thereafter, an analogous bill was introduced in the Senate by then Senator Barack Obama. Cai and Walkling (2010) study the market reaction around the passage of the say on pay bill in the House and document positive returns for firms with excessive CEO pay and lower pay-for-performance. Larcker et al. (2010), however, find no significant effect around a broader set of legislative and regulatory events related to say on pay between 2007 and 2009. As noted earlier, event studies around regulatory actions need to be interpreted with caution.<sup>57</sup> The introduction of say on pay will offer an opportunity for more direct

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<sup>57</sup> For example, it is unclear whether the approval of a say on pay bill had any impact on the likelihood of a say on pay legislation, since at that time chances of approval at the Senate appeared slim and the Bush administration had already made clear its opposition to the bill before the House approval (Associated Press, 2007). Arguably, the only ‘event’ truly increasing the likelihood of mandatory adoption of say on pay was the explosion of the financial crisis and the consequent outrage over Wall Street bonuses. A say on pay vote was mandated for firms receiving TARP funds and presidential candidates of both parties expressed support for say on pay legislation.

research into its costs and benefits for US firms as well as into the role of proxy advisors' recommendations.<sup>58</sup>

The requirement that institutional investors disclose their votes on say on pay and golden parachutes matters will offer an opportunity to examine the voting decisions of institutional investors other than mutual funds (Section 3.2). Absent a (not immediately obvious) rationale for limiting the disclosure requirement to these two compensation matters, this provision may eventually lead to a broader disclosure requirement for all institutional investors' votes on any matter voted upon at the annual meetings (e.g. director elections, shareholder proposals, approval of option plans, etc.). Availability of such data would allow researchers to substantially deepen our understanding of how different types of institutional investors use “exit” and “voice” strategies.

Finally, another important regulatory development is the SEC issuance in July 2010 of a concept release seeking public comment on the US proxy voting system, the first step of a project aimed at revamping and modernizing an outdated proxy voting infrastructure—loosely referred to as the “proxy plumbing” project.<sup>59</sup> The concept release focuses on three broad categories: accuracy, transparency, and efficiency of the voting process (e.g. imbalances in broker votes leading to over-voting and under-voting); communications with shareholders and shareholder participation (e.g. means to facilitate retail investor participation), and the relationship between voting power and economic interest (e.g. “empty” voting” practices, the role of proxy advisors).<sup>60</sup> The broad scope of the project is a further example of the importance assumed by shareholder votes over the last decade.

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<sup>58</sup> Gordon (2009) warns that if say on pay is mandated for all publicly traded firms institutional investors will outsource the evaluation of most compensation plans to proxy advisors who, in turn, will seek to economize by developing quasi “one-size-fits-all” guidelines instead of performing a custom-tailored evaluation, resulting in worse compensation practices.

<sup>59</sup> For details, see <http://www.sec.gov/rules/concept/2010/34-62495.pdf>.

<sup>60</sup> For a description of the system of shareholder voting in the US and its problems, see Kahan and Rock (2008).

#### **4. Beyond the empirical evidence**

The empirical evidence on the enhanced impact of low-cost activism—summarized in this article—calls for more analytical work to model and better understand this phenomenon. An important step in this direction is Levit and Malenko (2010). Motivated by the evidence on management’s responsiveness to non-binding shareholder proposals and building on prior work in economics and political sciences on the efficiency of binding voting mechanisms, Levit and Malenko (2010) examine under what conditions *non-binding* votes are effective in conveying shareholder expectations. Their model shows that in the most basic setting—when the preferences of shareholders and managers are not aligned (the interesting case) and management suffers no consequences from ignoring majority votes—non-binding votes fail to convey shareholder expectations and are rationally ignored by management. The presence of an activist investor (a proxy for disciplinary mechanisms) improves information aggregation, but only when the activists’ interests are in conflict with those of the other shareholders. The model also shows that non-binding votes are often superior to a binding vote mechanism in terms of ability to aggregate shareholders’ information. These insights offer a series of testable predictions for future empirical work on the effects of non-binding votes as well as a starting point for other analytical studies.

#### **5. Conclusions**

Over the last decade, low-cost, non-binding tools of shareholder activism—such as shareholder proposals and shareholder votes on director elections—have proven increasingly effective at influencing firms’ governance practices as well as the policy debate. In this article, I reviewed the growing body of research that documents this enhanced effectiveness. Recent regulatory reforms that expand shareholder rights (via proxy access, say on pay, elimination of broker votes on certain matters, and greater disclosure of shareholder votes), combined with the

trend toward majority voting and de-classified boards, are likely to further increase the effectiveness of these tools. Whether low-cost activism ultimately results in value creation and improved performance remains an open question and one of utmost importance in view of these reforms.

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