Analysis of the Wealth Effects of Shareholder Proposals - Volume II

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ABSTRACT

Every proxy season, companies receive proposals from shareholders representing a variety of demands. In recent years, researchers have documented increased involvement by institutional investors (*e.g.*, pension funds) in company affairs. When negotiations between companies and such activist shareholders fail, the result is often a shareholder proxy proposal, an action that causes both parties to incur costs in the form of time and expense. The Employee Retirement Income Security Act (ERISA), as clarified in recent guidance provided by the U.S. Department of Labor, stipulates that pension fund managers may only engage in such shareholder activism so as to promote the economic interests of the plan beneficiaries. In order to satisfy fiduciary requirements, pension fund managers may only take action if they can reasonably conclude the economic benefits outweigh the additional costs associated with shareholder activism. At the request of the U.S. Chamber of Commerce, we have performed such a cost-benefit analysis, and evaluated the wealth effects of shareholder proposals on target firms. After conducting a review of the academic literature and performing empirical tests for a sample of selected proposals, we have reached the following conclusions:

(1) There is no definite evidence in the academic literature that announcements related to shareholder proposals result in a material increase in companies' market value. In addition, there is no substantive evidence of long-run improvements in either operating or stock market performance for target firms.

(2) Our empirical results, based upon a sample of firm-year combinations, are consistent with these conclusions. We find no evidence of a statistically significant overall short-run or long-run improvement and some indication of a long-run decrease in market value for the firms in our sample.

(3) While there is limited information available in the public domain, anecdotal evidence confirms what is intuitively obvious – both target firms and the sponsors incur costs as a result of the proxy proposal process.

(4) Overall, we find no conclusive evidence that shareholder proposals tangibly improve firm value. Given the costs associated with the proxy process and the unproven impact on company value, some consideration should be given to the net benefits of such initiatives.

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I. INTRODUCTION

Proxy proposals are born out of conflict— between management and one or more shareholders— that center on a range of affairs from governance issues such as anti-takeover measures or director elections to environmental, political, and social concerns. They are generally filed after negotiations between shareholders and management have failed. As a result, it should come as little surprise that the debate over the effectiveness of such shareholder activism is a heated one. Those in favor of the process generally argue that the proposals provide an important mechanism for ensuring that shareholders' voices are heard. Conversely, those questioning the process have argued the proposals are costly (in terms of the direct costs of preparing proposals and gathering votes along with the indirect costs of lost value creation opportunities) without producing commensurate benefits.

ERISA establishes clear guidelines for the use of plan assets by pension fund managers. The law states that fiduciaries may engage in activism only when there is a reasonable expectation that such activism will result in an economic benefit to the plan. While researchers have shown that shareholders have achieved some success at getting proposals enacted, there has been no conclusive empirical evidence to demonstrate that this activism improves the stock market performance of target companies, or provides an economic benefit to those filing or supporting such proposals.

By way of background, Securities and Exchange Commission (SEC) Rule 14a-8 states that "a company must include a shareholder's proposal in its proxy statement and identify the proposal in its form of proxy when the company holds an annual or special meeting of shareholders", provided that the shareholder is eligible and the proposal meets certain requirements.[1]

To illustrate how the process works, consider the following example. Mr. X, a manager from the pension fund for government workers of Anyplace, USA, which owns 2,000,000 shares of Company ABC, has repeatedly asked management to provide a report disclosing its political contributions. On behalf of the pension fund, he has negotiated with management, requesting that it provide this information, but management has responded that this information is irrelevant, and that the preparation of such a report would cause an unnecessary expense to the shareholders. Thus, Mr. X submits a proposal requesting that the Board of Directors cause such a

[1] In order to be eligible, a shareholder must have continuously held the lesser of (a) $2,000 in market value, or (b) 1 percent of the company's securities entitled to be voted on the proposal at the meeting, for at least one year prior to submitting the proposal. In addition, there are several criteria by which the company can have the proposal excluded from the proxy statement. One such condition is that a proposal may not force a company to break state law. Since many types of proposals would violate state law if they mandated that the company take the requested action, some proposals are phrased as requests (referred to as "non-binding" proposals) and the company has the option whether or not to take the requested action. Other proposals are binding, meaning that the company must adopt the provisions of the resolution if it is approved. See SEC, "Final Rule: Amendments to Rules on Shareholder Proposals", Release No. 34-40018, http://www.sec.gov/rules/final/34-40018.htm, May 21, 1998 for the formal regulations concerning proposals.

report to be prepared. He is allowed up to 500 words in a statement supporting his resolution. This resolution appears in ABC's annual proxy statement, which is mailed to all shareholders. The company is also allowed to state why it is not in favor of the resolution. Shareholders are then given the opportunity to vote either in person or in absentia at the annual meeting, which occurs a month after ABC's proxy statement is filed. Since Mr. X's resolution is non-binding, the Board of Directors can decide whether or not to implement it if it is approved. If it is not approved—provided that the proposal received a certain threshold percentage (3 percent if it is the first such proposal) of the vote—Mr. X can resubmit the same proposal on behalf of the pension fund the next year.

It is worth noting that the companies bear "the costs of distributing these proposals to all shareholders, which means that Rule 14a-8 operates essentially as a tax on all shareholders to facilitate the voice of all shareholder proposals' proponents."[2]

This paper addresses the following questions regarding shareholder proposals:

(1) What have been the findings to-date in academic literature related to the economic impact of shareholder resolutions on target firms?

(2) What is the economic impact, if any, of selected shareholder proposals on target firm value?

(3) To the extent that they can be identified, what are the out-of-pocket costs associated with introducing and voting on shareholder proposals?

In order to answer these questions, we have, at the request of the U.S. Chamber of Commerce, conducted a review of the academic literature and have performed an empirical analysis for a sample of 166 firm-year combinations from a variety of industries and proposal types.[3] These proposals were selected because they were identified as "Key Votes" by the AFL-CIO in annual surveys from 2002-2008. We used analyses of stock market reaction to shareholder proposals to test and quantify potential impact on share price.

Overall, our empirical results indicate that, consistent with the literature, shareholder proposals appear to have no impact on target firm value in either the short-run or the long-run. Furthermore, we find slight evidence of a negative long-run impact. These results imply that neither shareholders as a whole nor the specific sponsoring groups are likely to receive an economic benefit from the resolutions. While there is limited information available on the actual out-of-pocket costs incurred by shareholders in introducing and voting on shareholder proposals, in light of the above conclusions, the implication is that such expenditures produce little, if any, economic value.

The remainder of the paper is structured as follows: Section II offers a review of the relevant academic literature on shareholder resolutions; Section III describes our methodology for evaluating potential short-run and long-run effects; Section IV presents our empirical findings; Section V discusses the ERISA and Department of Labor guidelines and presents anecdotal evidence on out-of-pocket costs; and Section VI concludes.

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[2] Thomas and Cotter (2007).

[3] See Table 1 for additional detail about the selected companies and proposals.

II. REVIEW OF RELEVANT ACADEMIC LITERATURE

As a number of researchers have already observed, conclusions with respect to the effectiveness of shareholder proposals primarily depend upon how one measures the "impact" or "success" of a proposal.[4]

Many researchers have focused on short-term stock price movements around proxy mailing dates (when the text of the proposal is made available to the investing public) and/or investor meeting dates (when the outcome of the resolution almost always becomes certain). Others have looked for long-term effects in either stock market returns or operating performance (*e.g.*, financial ratios such as return on assets or return on sales). In each of these cases, "success" is defined quantitatively and is only achieved if one can observe a positive and statistically significant increase in market value or improvement in operating performance. In other words, a proposal must increase returns to shareholders or improve the profitability of the firm to be considered "effective". Using these quantitative measures, there is no conclusive evidence that shareholder proposals improve the overall performance of target firms or produce an economic benefit for the sponsors and supporters of such proposals.

Another common method in the literature is to examine voting outcomes, defining "success" by the number of votes the proposal receives. Since most resolutions are non-binding, the passage of a proposal does not always ensure that the company will implement it. As a result, some researchers only define "success" as the act of the company enacting the resolution. We will only briefly address this area of the literature, since our empirical framework does not address these more qualitative aspects. For purposes of our analysis, we test for the tangible impact of activism, which we define as an overall, *measurable* improvement in the target firms' financial performance.

SHORT-TERM MARKET REACTIONS TO PROPOSAL-RELATED DISCLOSURES

The vast majority of researchers have found either insignificant or negative and significant market reactions on dates surrounding proposal-related disclosures.[5] Gillan and Starks (2007) write that:

> In general, for the overall samples of shareholder proposals, the studies have found no significant abnormal returns around the assumed date of information release.[6] This result tends to be true regardless of whether the study used the announcement date of the target list [if a firm was placed on a list of targeted

[4] See *e.g.*, Gillan and Starks (2007) and Karpoff (2001).

[5] The measure of a market reaction used by all of the papers in this section is the abnormal return. See the Technical Appendix (Section VII) for a complete description of the event study methodology that is used to calculate these abnormal returns.

[6] In support of this statement, Gillan and Starks (2007) refer the reader to the following authors: Carleton, Nelson, and Weisbach (1998), Del Guercio and Hawkins (1998), Gillan and Starks (2000), Karpoff, et al. (1996), Prevost and Rao (2000), Song and Szewczyk (2003), and Wahal (1996). Thomas and Cotter (2007) also support this conclusion.

> companies by a particular group such as CalPERS or the Council of Institutional Investors], the mailing date of proxies, the annual meeting date, or the *Wall Street Journal* announcement date.

Exceptions to this conclusion include Nesbitt (1994), Smith (1996) and Wahal (1996), who observe positive and statistically significant increases in the stock prices of a number of companies that were targeted by CalPERS from 1987-1993.[7] While some later researchers have also suggested the continued existence of this "CalPERS Effect", Nelson (2006) calls into question the validity of the statistical results from later periods, and after correcting for certain methodological concerns, finds no evidence of such effect.

In a few other cases, researchers have found statistically significant market reactions to resolution-related disclosures for various sub-samples. For example, several researchers have looked at disclosures related to the proxy process but that occur outside the context of an actual proxy vote, namely targetings and negotiated settlements.[8] In some cases, studies have been able to demonstrate positive and significant market reactions.[9] However, as Black (1998) comments, these results may be questionable:

> There is no consistent evidence of short-term abnormal returns to targeted firms…There are a few exceptions to this general pattern, but they are scattered and could be due to chance…Taking these studies as a whole, one cannot conclude that activism has a large effect, and I am left in doubt as to whether it has any effect. The statistically significant results that exist lack an obvious pattern, and could reflect data mining.

Karpoff (2001) reaches a similar conclusion, stating that "subsample findings can be criticized as results of data-snooping -- non-zero average abnormal returns are likely to appear in some subsamples of any carefully partitioned sample." In the vast majority of cases, studies have demonstrated that the market fails to react at all.

LONG-TERM OPERATING AND STOCK MARKET PERFORMANCE

Given the results described in the section above, a number of researchers have concluded that the effects of proposals may take longer to manifest than can be captured by an examination of short-term market reactions alone.[10] As such, a number of studies have looked for improvements in the long-term operating and stock market performance of targeted firms relative to certain benchmarks.

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[7] Note that, in Wahal (1996), the set of firms targeted by CalPERS was a subset of a larger population for which no evidence of a significant overall wealth effect was found.
[8] Targetings are situations where individuals or organizations publicly announce their intent to address a specific issue (CalPERS, for example, issued Focus Lists) or multiple issues with a company. Negotiated settlements occur when companies agree to implement shareholder requests without the submission of a formal shareholder proxy proposal.
[9] See, *e.g.*, Smith (1996), Strickland, et al. (1996), and Wahal (1996).
[10] That said, many economists believe an efficient stock market will properly price expected future corporate conditions.

In looking for improved operating performance, these studies compare a sample of targeted firms against a control group of firms with similar characteristics in order to evaluate the extent to which the former group outperformed the latter. Often, researchers look at financial ratios such as return on assets or return on sales. We did not find any studies that demonstrated an improvement in operating performance of targeted firms when compared with control firms.[11] Results are mixed as far as long-term stock price reactions are concerned. Several researchers—Nesbitt (1994), Opler and Sokobin (1997), and Smith (1996)—find positive long-run returns. However, Black (1998) raises methodological concerns that challenge the validity of these results.[12] Karpoff (2001) identifies two studies that do not suffer from these weaknesses. The first, conducted by Del Guercio and Hawkins (1998), finds no evidence of "significant effects on stock returns or accounting measures of performance in the three years following an initial targeting, and only sketchy evidence of positive effects in the short term." The second, conducted by Prevost and Rao (2000), finds that "firms receiving proposals for the first time experience a transitory decrease in shareholder wealth, while firms targeted repeatedly exhibit negative wealth effects over much wider event windows. Long-run changes in the firms' operating performance and stock price returns are consistent with these results."

In general, the literature suggests that there is no evidence that shareholder proposals have a positive impact on targeted companies' stock market performance (in both the short and long-term) or operating performance.

ANALYSIS OF VOTING OUTCOMES AND ORGANIZATIONAL CHANGE RESULTING FROM PROPOSALS

Given our focus on quantitative changes in firm performance, our comments on voting outcomes and organizational changes are brief.[13] While researchers' findings regarding stock price and operating performance have not changed significantly over time, this is not the case with respect to voting outcomes and organizational change. Previously, very few proposals were able to garner a significant amount of shareholder support, but in more recent periods a larger number of proposals are receiving approval. However, this increased support does not apply to all types of proposals. Thomas and Cotter (2007) ask the following:

> Are Rule 14a-8 proposals frivolous or substantive? Here we find, as in earlier studies, that corporate governance proposals receive significant shareholder voting support, while social responsibility proposals get much lower levels of shareholder votes cast in their favor. This is consistent with the claim that shareholders view corporate governance proposals as connected to firm value

[11] See, *e.g.*, Del Guercio and Hawkins (1998), Karpoff, et al. (1996), and Wahal (1996). Our findings are consistent with Gillan and Starks (2007), who point out that "[v]irtually all studies of long-term operating performance have reported no statistically significant changes in the operating performance of targeted companies." They also suggest Smith (1996) and Strickland et. al (1996).
[12] Black (1998) suggests that mean reversion, market inefficiency, and improper selection of control firms call into question the validity of these results.
[13] See Gillan and Starks (2007), Thomas and Cotter (2007), and Karpoff (2001) for a more in-depth review of the literature related to these topics.

> and therefore worthy of support, whereas their beliefs about social responsibility proposals are precisely the opposite. Next, we ask whether shareholder proposals and related votes have an effect on firm management's actions. Here we find that, unlike studies of earlier time periods, for corporate governance proposals, there are an increasing number of majority vote supported proposals and a trend toward increased board responsiveness to these proposals over the 3 years in our sample. This trend is particularly marked with respect to the removal of firm anti-takeover defenses, such as the poison pill and classified board.

In the same report, the authors examine voting outcomes for 1,454 shareholder proposals from 2002-2004. Out of 106 proposals related to environmental/social issues and 297 proposals in the "other social responsibility" category, not a single proposal received more than 50 percent of the shareholder vote. In contrast, 236 out of 329 proposals (over 70 percent) in the "External corporate control/governance" category received a majority vote, and 83 (approximately 25 percent) were adopted by the Board of Directors.

III. METHODOLOGY EMPLOYED

SELECTION OF PROPOSALS

The sample was selected using the shareholder proposal sections of the AFL-CIO "Key Votes" surveys from 2002-2008. The AFL-CIO describes these surveys as follows:

> The proposals included in the Key Votes Survey are submitted by a variety of union-sponsored and public pension funds, employee shareholders and other investors and are consistent with the AFL-CIO Proxy Voting Guidelines. These proposals represent a worker/owner view of value that emphasizes management accountability and good corporate governance. Percentage scores and tier groups are assigned to each firm to assist trustees in evaluating the relative proxy voting performance of competing investment managers.[14]

We believe that this sample of proposals provides an excellent litmus test for the proxy proposal process in general for two reasons. First, organized labor has been a large proponent of increased shareholder access and of using the shareholder proposal process to influence corporate behavior in recent years, and our sample consists of proposals which were highlighted as being particularly important by that group. Second, these proposals were likely to have had investment managers' attention, since these managers were assigned grades based upon their votes. It also has regulatory implications, given that many of these proposals involved the use of pension fund assets regulated by ERISA.

[14] AFL-CIO, "Key Votes Survey", 2007. All of the surveys are available at http://www.aflcio.org/corporatewatch/capital/corporategovernance.cfm

The seven surveys yielded 175 proposals from 104 different companies. From this population, three proposals were excluded because reliable price data were unavailable, and two proposals were excluded because we could not identify the correct proxy mailing date. Our final sample consists of 166 firm-years, corresponding with 170 distinct shareholder proposals.[15]

The following table (Table 1) provides summary statistics related to the proposals in the sample:

TABLE 1

SUMMARY STATISTICS FOR PROPOSALS IN SAMPLE

Summary Statistics by Year

Survey Year	Number of Firms
2002	30
2003	18
2004	21
2005	24
2006	26
2007	23
2008	24
Number of Firm-Years	166

Frequency of Targetings in Sample

Targeting Frequency	Number of Firms
1 year	67
2 years	15
3 years	10
4 years	7
5 years	1
6 years	1
Number of Firms	101

Summary Statistics by Industry Sector

Industry Sector	Number of Firms	Number of Firm-Years
Basic Materials	3	6
Communications	6	13
Consumer, Cyclical	25	42
Consumer, Non-cyclical	14	22
Energy	10	22
Financial	16	21
Industrial	9	20
Technology	7	8
Utilities	11	12
Total	101	166

[15] The number of proposals exceeds the number of firm-year combinations because, in four instances, the AFL-CIO identified two proposals as key votes for the same company and in the same year.

All of the sampled proposals were submitted for a shareholder vote in the companies' proxy statements.[16] We calculate abnormal returns around the proxy statement mailing date and the date of each company's investor conference. This method is widely accepted in the literature. All financial data were taken from Bloomberg, LP.

EMPIRICAL FRAMEWORK: SHORT-TERM MARKET REACTIONS

In order to measure short-term price impacts of the proposals in question, we use an event study methodology. The event study has been widely accepted by academia and courts for evaluating the stock price impact of an event.[17] In particular, we use a form of the event study referred to as a two-factor market model, which controls for both economy-wide and industry-specific factors.[18] If an event causes a movement in the broad market (*e.g.*, a change in the Federal Reserve Bank's target rate), or if some other piece of news came out that impacted the specific industry in which the company operates (*e.g.*, changes in Food and Drug Administration regulations for the pharmaceutical industry), the model takes these impacts into account.

The event study compares the actual stock price movements during a period of interest (the event window) with the predicted values generated by the model. The difference between actual and expected return is referred to as the abnormal return.[19] One then performs a test in order to determine whether the abnormal return is statistically significantly different from zero at the 95 percent confidence level.[20] For purposes of this analysis, we consider a number of event windows for each proposal, ranging from a one-day window on the day of the announcement to a four-day window beginning at the announcement day and including the next three trading days.[21]

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[16] The proxy statement is Form DEF-14A filed with the SEC. In some cases, companies filed preliminary proxy statements (Form PRE-14A) prior to their proxy statement. When this occurs, we use the PRE-14A filing date instead of the proxy mailing date. These filings can be located on the SEC website (www.sec.gov). The surveys already contained the investor meeting dates.

[17] MacKinlay (1997) writes: "Using financial market data, an event study measures the impact of a specific event on the value of a firm…Thus a measure of the event's economic impact can be constructed using security prices." See also, Fama et al. (1998) and Brown and Warner (1985).

[18] Additional detail about the specification of each of the models used is provided in the Technical Appendix (Section VII).

[19] Note that the abnormal return is defined as the difference between the expected return as predicted by the event study model and the actual observed return. Consequently the abnormal return is not equivalent to the simple percentage change between the closing prices on the event date and the prior date.

[20] Given that our model only estimates returns, on a given day it is highly unlikely that the predicted return equals the actual return. As such, it is important to test whether the abnormal return is significantly different from the fluctuations that one could observe at random.

[21] Event windows are denoted in the following way: [beginning of window, end of window]. The first trading day in which the market could react to the announcement is defined as day zero. A [0,1] window, for example, would consist of the announcement day and the subsequent trading day.

EMPIRICAL FRAMEWORK: LONG-TERM MARKET REACTIONS

To measure long-term market reactions, we use the methodology employed in Liu, Szewczyk, and Zantout (2008), in which the authors conduct a battery of tests in order to calculate and test the significance of long-run abnormal returns for a sample of dividend-omitting or dividend-reducing firms. They argue that since the results often can be sensitive to the choice of benchmark, the best way to ensure the robustness of one's findings is to consider a variety of benchmarks before drawing any conclusions.

First, we employ the rolling portfolio method. For each calendar month, we compute the returns on equally-weighted portfolios of all firms that were targeted by a proposal identified as a "key vote" during the preceding 12, 24, or 36 calendar months. We then calculate long-run abnormal returns by regressing the post-event daily excess returns (defined as portfolio returns in excess of a risk-free rate of return, quantified by the daily equivalent of the one-month T-Bill rate) for each portfolio on a market factor, a size factor, and a book-to-market factor.[22] Following Liu et al., we estimate the regressions using both ordinary-least-squares (OLS) and weighted-least-squares (WLS), with the number of firms in the portfolio as the weight.[23] We estimate these abnormal returns separately for post-event years one, two, and three as well.

Second, we employ the matching method, in which we compare the stock returns of targeted firms with those of non-targeted benchmark firms over a specified holding period.[24] This difference between the two firms is referred to as the buy-and-hold abnormal return (BHAR). We calculate BHARs for all applicable firms in the sample and then compute the buy-and-hold average abnormal return (BHAAR) for each holding period. There are two statistical tests for the significance of the BHAAR, the parametric t-test and the non-parametric Wilcoxon signed-rank test. We consider the same seven matching criteria as Liu et al.: (1) firm size, (2) firm size and industry affiliation, (3) firm size and prior common stock price performance, (4) industry affiliation and prior common stock price performance, (5) firm size and book-to-market ratio, (6) percentage change in earnings, and (7) firm size and percentage change in earnings. The use of multiple matching criteria allows us to evaluate the sensitivity of the benchmark criteria and the robustness of the results.

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[22] See Technical Appendix (Section VII) for the full specification of the model used. Also, see Fama (1998) for a more detailed description of the rolling portfolio method and Fama and French (1993) for a more detailed description of the factors and calculation of returns.

[23] One of the assumptions in an OLS regression is that the variance of the error term is constant across observations (homoskedasticity). Since the number of companies included in each portfolio is not constant across every month, there is some likelihood that this assumption will be violated (heteroskedasticity). WLS is an econometric technique which may yield more efficient parameter estimates in the presence of heteroskedasticity.

[24] See Technical Appendix (Section VII) below for a more detailed description of the methodology used. Also, see Liu et al. (2008) and Barber and Lyon (1997) for more detail about the matched firm method and calculation of the associated test statistics.

IV. PRESENTATION OF FINDINGS

EMPIRICAL RESULTS: SHORT-TERM MARKET REACTIONS

Turning first to our analysis of the short-term market reactions to the proposals on the proxy mailing dates, the results from our event study models are presented in Table 2 (below):

TABLE 2

EVENT STUDY RESULTS FOR ALTERNATIVE TIME WINDOWS

ALL FIRM-YEARS IN SAMPLE

Average abnormal returns are generally negative and not statistically significantly different from zero at the 95 percent confidence level.

Date Type	Number of Firm-Years[1]	Statistic[2]	Event Window [0,0]	[0,1]	[0,2]	[0,3]
Proxy Mailing Date	166	Average Abnormal Return	-0.025%	-0.112%	0.033%	-0.102%
		Z-Statistic	0.013	-0.248	0.152	-0.122
		P-Value	0.990	0.804	0.879	0.903
Proxy Voting Date	165	Average Abnormal Return	0.061%	-0.038%	-0.002%	-0.079%
		Z-Statistic	0.936	-0.138	-0.092	-0.113
		P-Value	0.349	0.890	0.926	0.910

[1] We exclude one company/year combination (Sprint-Nextel, 2002) from the results on the voting date because the company had an extremely large and highly significant abnormal return on the day of its investor meeting that was likely associated with a concurrent earnings announcement.

[2] Dodd and Warner (1983) note that, in some cases, it is possible for the average abnormal return and the associated Z-statistic to have different signs.

Average abnormal returns are generally negative and not statistically significantly different from zero, though the magnitudes of these returns (with the largest return having an absolute value of only 0.11 percent) are not economically meaningful.[25] We find similar results for the market reactions on both proxy mailing and voting dates. Thus, our results are consistent with the academic literature and provide no evidence of positive wealth effects or economic benefits to the sponsors or supporters of proposals in the short-run.

At the request of the U.S. Chamber of Commerce, we perform the same analysis for the subset of proposals from the most recent (2008) proxy season. Table 3 (below) presents these results:

[25] Note that it is possible that a particular abnormal return (*e.g.* five percent) could be highly significant for a company with very little volatility in its stock price returns, but insignificant for a company with a high level of volatility. The Z-statistics (which are used to determine statistical significance) account for these differences. This difference can explain the occasional difference in sign between the average abnormal return and the Z-statistic, though this generally occurs in situations when both values are very close to zero.

TABLE 3

EVENT STUDY RESULTS FOR ALTERNATIVE TIME WINDOWS
2008 PROPOSALS ONLY

Average abnormal returns are generally negative and not statistically significantly different from zero at the 95 percent confidence level.

Date Type	Number of Firm-Years	Statistic[1]	Event Window [0,0]	[0,1]	[0,2]	[0,3]
Proxy Mailing Date	24	Average Abnormal Return	-0.048%	-0.482%	-0.690%	-0.826%
		Z-Statistic	0.126	-0.460	-1.196	-1.382
		P-Value	0.899	0.645	0.232	0.167
Proxy Voting Date	24	Average Abnormal Return	-0.571%	-0.395%	-0.662%	-0.944%
		Z-Statistic	-1.469	-0.509	-1.291	-1.571
		P-Value	0.142	0.611	0.197	0.116

[1] Dodd and Warner (1983) note that, in some cases, it is possible for the average abnormal return and the associated Z-statistic to have different signs.

Our results are similar for the 2008 sample. Average abnormal returns are negative and larger in magnitude across all event windows considered, suggesting a weak negative impact. However, these results remain insignificant at customary levels. Once again, these findings support the general conclusion in the literature that the short-term share price impact of the resolutions, measured on either the mailing or voting date, does not produce any proven increase in value.

EMPIRICAL RESULTS: LONG-TERM MARKET REACTIONS

Turning to our analysis of the long-run impacts, we find similar results when using the rolling portfolio method, as presented in Table 4 (below):

TABLE 4

LONG-RUN AVERAGE ABNORMAL MONTHLY RETURNS AFTER PROXY MAILING DATES ESTIMATED USING THE ROLLING PORTFOLIO METHOD

Average abnormal returns are generally negative and not statistically significantly different from zero at the 95 percent confidence level.

Parameter Estimation Method	Statistic	Post-announcement period 1 year	2 years	3 years	Post-announcement year 1st year	2nd year	3rd year
OLS	Abnormal Return	-0.540%	-0.532%	-0.500%	-0.540%	-0.026%	-0.326%
	t-statistic	-1.020	-1.044	-0.998	-1.020	-0.054	-0.708
	P-Value	0.311	0.300	0.321	0.311	0.957	0.482
WLS	Abnormal Return	-0.650%	-0.439%	-0.378%	-0.650%	-0.039%	-0.263%
	t-statistic	-1.187	-0.887	-0.800	-1.187	-0.080	-0.554
	P-Value	0.239	0.378	0.426	0.239	0.937	0.582
Number of Observations (months)		82	82	82	82	70	58

We observe abnormal returns that are negative but not statistically significant. Though statistically insignificant, we note that these results are consistent across multiple event windows and parameter estimation methods.

Our results for our second long-run approach are presented in Table 5 (below):

TABLE 5

LONG-RUN BUY-AND-HOLD AVERAGE ABNORMAL RETURNS AFTER PROXY MAILING DATES ESTIMATED USING THE MATCHING METHOD

Results in boxes marked with ** are statistically significant at the 95 percent confidence level.

		Post-announcement buy-and-hold period			Post-announcement buy-and-hold year		
Matching Criteria	**Statistic**	**1 year**	**2 years**	**3 years**	**1st year**	**2nd year**	**3rd year**
Firm size	BHAAR (%)	-4.22%	-6.84%	-0.88%	-4.22%	0.79%	4.81%
	t-statistic	-1.321	-1.321	-0.09	-1.321	0.199	1.06
	W-test p-value	0.19	0.308	0.95	0.19	0.849	0.163
	Number of Obs	142	120	93	142	120	93
Size and industry affiliation	BHAAR (%)	-0.06%	-3.51%	-6.83%	-0.06%	-3.68%	-0.86%
	t-statistic	-0.021	-0.71	-0.756	-0.021	-0.663	-0.228
	W-test p-value	0.885	0.725	0.232	0.885	0.973	0.553
	Number of Obs	142	120	93	142	120	93
Size and prior stock performance	BHAAR (%)	-3.30%	-5.05%	1.63%	-3.30%	-3.97%	5.52%
	t-statistic	-0.851	-0.78	0.152	-0.851	-0.579	1.294
	W-test p-value	0.504	0.57	0.494	0.504	0.991	0.135
	Number of Obs	139	118	91	139	118	91
Industry and prior stock performance	BHAAR (%)	-8.32%	-16.15%	-32.00%	-8.32%	-2.52%	-7.27%
	t-statistic	-2.127**	-2.005**	-2.729**	-2.127**	-0.413	-1.411
	W-test p-value	0.196	0.199	0.007**	0.196	0.904	0.109
	Number of Obs	141	119	92	141	119	92
Size and book-to-market ratio	BHAAR (%)	0.68%	3.28%	10.26%	0.68%	3.28%	6.54%
	t-statistic	0.199	0.528	0.965	0.199	0.809	1.601
	W-test p-value	0.371	0.462	0.2	0.371	0.599	0.106
	Number of Obs	140	119	92	140	119	92
Percent change in earnings	BHAAR (%)	-1.12%	-4.89%	-22.99%	-1.12%	0.56%	-4.73%
	t-statistic	-0.285	-0.61	-1.625	-0.285	0.113	-0.891
	W-test p-value	0.802	0.961	0.18	0.802	0.578	0.144
	Number of Obs	129	108	84	129	108	84
Size and percent change in earnings	BHAAR (%)	-1.08%	2.76%	12.95%	-1.08%	0.53%	4.79%
	t-statistic	-0.328	0.446	1.239	-0.328	0.116	1.006
	W-test p-value	0.962	0.939	0.311	0.962	0.667	0.205
	Number of Obs	126	106	82	126	106	82

Again, we observe abnormal returns that are generally negative but not statistically significant, though these returns are sensitive to the matching criteria selected. In particular, we observe a number of negative and statistically significant abnormal returns when we match on industry and prior stock price performance. Looking at these results as a whole and in conjunction with

those from Table 4, we find no evidence of an increase and some evidence of a decrease in shareholder value in the long-run.

V. ERISA AND OUT-OF-POCKET COSTS

ERISA establishes strict guidelines for the fiduciary obligations of benefit fund managers, such as pension plans. In a recent guidance, the U.S. Department of Labor stated:

> In creating an investment policy, a fiduciary shall consider only factors that relate to the economic interest of participants and their beneficiaries in plan assets, and shall not use an investment policy to promote myriad public policy preferences…Plan fiduciaries risk violating the exclusive purpose rule when they exercise their fiduciary authority in an attempt to further legislative, regulatory or public policy issues through the proxy process…The mere fact that plans are shareholders in the corporations in which they invest does not itself provide a rationale for a fiduciary to spend plan assets to pursue, support, or oppose such proxy proposals. Because of the heightened potential for abuse in such cases, the fiduciaries must be prepared to articulate a clear basis for concluding that the proxy vote, the investment policy, or the activity intended to monitor or influence the management of the corporation is more likely than not to enhance the economic value of the plan's investment before expending plan assets.[26]

In other words, pension plan managers risk violating their fiduciary duty by incurring the costs associated with shareholder activism, unless they can demonstrate that the benefits associated with such activism (*i.e.* increased shareholder value) can be reasonably expected to outweigh the costs. The Department's guidance also encourages fiduciaries to keep records of cost-benefit analyses performed to ensure that they have met the standards of ERISA.

> [T]he responsible fiduciary shall consider only those factors that relate to the economic value of the plan's investment and shall not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives. Votes shall only be cast in accordance with a plan's economic interests. If the responsible fiduciary reasonably determines that the cost of voting (including the cost of research, if necessary, to determine how to vote) is likely to exceed the expected economic benefits of voting, or if the exercise of voting results in the imposition of unwarranted trading or other restrictions, the fiduciary has an obligation to refrain from voting.[27] In making this determination, objectives, considerations, and economic effects unrelated to the plan's economic interests cannot be considered.

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[26] U.S. Department of Labor, "Interpretive Bulletin Relating to Exercise of Shareholder Rights", October 17, 2008. See also U.S. Department of Labor, Interpretive Bulletin 08-2, October 17, 2008; ERISA Advisory Opinion No. 2007-07A, December 21, 2007; and letter from Alan D. Lebowitz, Deputy Assistant Secretary for Program Operations, Employee Benefits Security Administration, U.S. Department of Labor, to Jonathan P. Hiatt, General Counsel, AFL-CIO, May 3, 2005.

[27] See ERISA Advisory Opinion No. 2007-07A, December 21, 2007.

With these guidelines in mind, the U.S. Chamber of Commerce has requested that we research available information regarding costs incurred by activist institutional shareholders and target companies in connection with introducing and voting shareholder proposals. In general, our research yields limited information available in the public domain. Nevertheless, we have included some anecdotal evidence below.

Del Guercio and Hawkins (1999) report that the estimates provided by five of the largest and most activist pension funds of the annual cost of their entire activist programs range from $50,000 to $1 million, noting that the annual cost estimates are generally "less than half of a basis point for these funds." Smith (1996) reports that CalPERS spends approximately $500,000 annually on all activism activities while Carleton, et al. (1998) report that College Retirement Equities Fund (CREF) spends $1 million annually. While it is difficult to calculate the exact costs of shareholder activism without access to internal financial records from proxy proposal sponsors, it is easy to conclude that they must be greater than zero.

With respect to the costs to target companies related to the introduction of shareholder proposals, Bainbridge (2003) observes that, based on data gathered by the SEC, the cost per company of determining whether or not a 14a-8 proposal should be included in the proxy statement is $37,000[28] and the direct cost per company of including a proposal is $50,000.[29] Bainbridge estimates the total annual expenditures on shareholder proposals to be $90.654 million.[30]

In addition to the direct costs to the parties involved, there are indirect costs that are much more difficult to quantify. One argument is that management is required to expend time and effort defending against proposals that it deems to be detrimental to the firm. If that same amount of time and energy could be used instead for other activities that would create shareholder value, then shareholders suffer the opportunity cost of that lost value.[31] In addition, if management becomes hesitant to make certain strategic decisions in order to avoid costly and time-consuming negotiations with specific shareholders, this could potentially harm shareholders as a whole. Thus, it is possible that the opportunity costs that result from shareholder proposals significantly exceed the direct expenses of the voting process itself. Such costs could theoretically help explain

[28] Average of $37,000 is based on 80 respondents to a SEC questionnaire reporting costs greater than zero and reflects internal costs as well as any outside legal and other fees. Reported costs ranged from a low of $10 to a high of approximately $1.2 million. The median cost was $10,000. Responses may have accounted for consideration of more than one proposal. See Securities and Exchange Commission, "Final Rule: Amendments to Rules on Shareholder Proposals", Release No. 34-40018, http://www.sec.gov/rules/final/34-40018.htm, May 21, 1998.

[29] Average of $50,000 is based on 67 respondents to SEC questionnaire reporting costs greater than zero and reflects printing costs (plus any directly related costs, such as additional postage and tabulation expenses). Reported costs ranged from a low of $200 to a high of nearly $900,000. The median cost was $10,000. Responses may have accounted for printing of more than one proposal. See note above.

[30] Implied cost of $87,000 per proposal based on the assumption that corporations seek to exclude all proposals, multiplied by the 1,042 shareholder proposals tracked by Institutional Shareholder Services (ISS) during the 2003 proxy season.

[31] Note that opportunity costs are still incurred when a corporation agrees to accept a proposal. The corporation's executives must take the time and incur the costs associated with evaluating the proposal, regardless of whether the company agrees to its terms.

negative abnormal returns to targeted companies as well as an increased willingness of target companies to concede to shareholder requests, regardless of whether these requests are likely to actually improve firm value. Potential opportunity costs would likewise exist for sponsoring shareholders to the extent expenditures of either time or money could be more productively employed.

VI. CONCLUSION

The U.S. Chamber of Commerce has asked us to evaluate the potential impact of selected shareholder proposals on target firm value and (to the extent possible) to assess the out- of-pocket costs associated with introducing and voting on shareholder proposals. In performing our analysis, we have conducted a review of the available literature and have performed an empirical analysis for a sample of 166 firm-years with which we test for both short-term and long-term wealth effects.

The primary conclusion resulting from our literature review is that there is no conclusive evidence of measurable improvements in (short-term or long-term) stock market or (long-term) operating performance in target companies as a result of shareholder proposals. In other words, while proposals may be successful in making qualitative changes in companies' actions, there is little to no evidence that those changes have an impact on the bottom line of target firms.

Next, we conduct our own empirical analysis for a sample of 166 firm-years, using techniques that are well-supported in the literature. Our findings are consistent with previous research in that we find no evidence of an improvement in companies' stock market performance in either the short-run or the long-run, along with some indication of a decrease in the long-run. Taken as a whole, these results provide no evidence that shareholder proposals increase target firm value or produce any economic benefit to sponsors or supporters of shareholder resolutions.

In addition, we have sought to identify available information regarding the costs incurred by the proponents of the proposals and the target companies. While there is little information available on the subject in the public domain, anecdotal evidence combined with the above conclusions suggests that such expenditures produce little if any value, especially when one considers the potential opportunity costs arising in connection with the introduction, analysis and voting of shareholder proposals.

VII. TECHNICAL APPENDIX

EMPIRICAL FRAMEWORK: SHORT-RUN

In this section, we provide additional detail on the mechanics and specification of the event study models which we use to generate the results in Tables 2 – 3. As discussed earlier, the event study model simultaneously controls for the effects of both economy-wide and industry-specific factors when evaluating security prices of a company by applying the linear regression model (referred to as a "two-factor market model") defined below:

$$R_t = \alpha + \beta_1 \cdot Market_t + \beta_2 \cdot Industry_t + \varepsilon_t$$

The dependent variable R_t is the daily stock return of the company, measured as the natural log of the ratio of the prices on the ending and beginning dates. β_1 and β_2 denote estimated coefficients of the factors.

Using the two-factor market model, one can determine which residual daily returns are "statistically significant" in the sense that they are "abnormal" for the company in question as predicted by the two-factor model. Daily abnormal returns (AR) surrounding the event in question are defined as:

$$AR_t = R_t - PR_t$$

where R_t is the actual observed return and PR_t is the predicted daily return based on the two-factor model. When measuring a multi-day event window, multiple days' abnormal returns are combined to assess the impact of the event. Cumulative abnormal returns (CAR) are defined as:

$$CAR_T = \sum_{t=1}^{T} AR_t$$

Proper statistical tests can be carried out to determine whether the event had a material effect on the company's share prices and to test the significance of the average abnormal return for a panel of companies.[32]

The process of estimating a two-factor market model involves the specification of several principal inputs and assumptions: 1) the event of interest; 2) the choice of market and industry indices (the two factors); 3) the "estimation window" or the period over which the model should be estimated; and 4) "event window" or the period of impact when share prices reacted to the event of interest.[33]

(1) *Event of interest:* The events of interest in our case are shareholder proposal proxy mailing dates and investor conference dates when votes are cast and finalized.

[32] See, *e.g.*, Dodd and Warner (1983).
[33] See, *e.g.*, MacKinlay (1997).

(2) *Choice of market and industry indices:* For each company, we test the event study model using three different market indices: the S&P 500 Index, the CRSP Equal Weighted Index, and the CRSP Value Weighted Index. We also map each company to a Bloomberg index associated with its industry (there are 38 different industry subgroups in our sample) so as to control for any industry-specific factors. For each company, we select the indices from the model that results in the highest adjusted-R^2 (a measure of goodness-of-fit).

(3) *Estimation window:* The estimation window is the period prior to the event window that is used to estimate the relationship between the target company's stock price and the market/industry indices. The event period itself is not included in the estimation period to prevent the event from influencing the parameter estimates. In conducting our empirical analysis, we tested estimation windows of 100, 150, 200, 252 and 300 trading days.[34] In addition, we tested these estimation windows ending 5, 10, 20 and 30 trading days before the event date. The combination of estimation windows and cutoff dates provides 20 iterations of the event study. The results we discuss in the body of this report are the results of the best-fitting model for each company as measured by adjusted-R^2.

(4) *Event window:* An assumption implicit in the event study methodology is that of market efficiency. There are different forms of market efficiency, although it is generally believed that its implication is that share prices change rapidly in response to the arrival of new information. We have looked at [0,0], [0,1], [0,2], and [0,3] event windows, where 0 is the day of the event, and the second number refers to the number of trading days subsequent to the event day. For example, a [0,0] window refers to the day of the event only.

EMPIRICAL FRAMEWORK: LONG-RUN

Following Liu et al. (2008), we employ two methods for calculating long-run abnormal returns. In both cases, we calculate abnormal returns after the proxy mailing date. First, we consider the rolling portfolio method, in which we construct portfolios of targeted companies and test for a statistically significant abnormal return using the Fama-French three-factor model. Second, we calculated buy-and-hold abnormal returns (BHARs) by matching each targeted company with a non-targeted control firm based on seven different criteria.

The Rolling Portfolio Method

We employ a procedure outlined in Liu et al. (2008) and Fama (1998). For each month, we calculate equally-weighted returns on a portfolio of all firms that were targeted in the preceding 12, 24, or 36 months.[35] In order to calculate average abnormal returns for individual years, we also construct equally-weighted portfolios of firms that were targeted in the previous 1 to 12, 13 to 24, or 25 to 36 calendar months. We use the Fama-French three-factor model to calculate

[34] See, *e.g.*, Marais and Schipper (2003). One year of trading data covers approximately 252 days.
[35] We also consider value-weighted portfolios and find similar results—namely that the average abnormal returns are not significantly different from zero.

average monthly abnormal returns, regressing the post-event monthly excess returns for each portfolio on a market factor, a size factor, and a book-to-market factor[36]:

$$R_t - R_{ft} = \alpha + \beta \cdot (R_{mt} - R_{ft}) + s \cdot SMB_t + h \cdot HML_t + \varepsilon_t ,$$

Where,

- R_t represents the return for the portfolio in month t,
- R_{ft} represents the monthly risk-free return, measured by the 1-month T-Bill rate,
- R_{mt} represents the monthly value-weighted return on all NYSE, AMEX, and NASDAQ stocks (from CRSP),
- SMB_t measures the monthly return on a value-weighted portfolio of smaller stocks less the return on a value-weighted portfolio of larger stocks,
- HML_t measures the monthly return on a value-weighted portfolio of high book-to-market stocks less the return on a value-weighted portfolio of low book-to-market stocks, and
- ε_t is a normally distributed error term.[37]

The intercept (α) can be interpreted as the average monthly abnormal return for the portfolio. Since the number of companies included in the portfolio varies over time, we estimate α using both ordinary least squares (OLS) and weighted least squares (WLS). The weight used for each month is the number of firms included in the portfolio. Its statistical significance can be tested using the standard parametric t-test.

The Matching Method

The matching method involves matching each targeted firm with a non-targeted firm with similar characteristics and then comparing the performance of the two firms over a specified holding period. The difference between these returns is called the buy-and-hold abnormal return (BHAR), and is calculated as:

$$BHAR_{i,a,b} = \prod_{t=a}^{b} (R_{it} + 1) - \prod_{t=a}^{b} (R_{mt} + 1)$$

Where ,

- $BHAR_{i,a,b}$ is the excess return for targeted firm i over the period from day a to day b,
- R_{it} is the return on common stock of targeted firm i on day t, and
- R_{mt} is the return on common stock of the matched firm on day t.

As with the rolling portfolio method, we calculate abnormal returns for one-, two-, and three-year holding periods, as well as for each individual year. We begin each holding period on the third day following the announcement date. Matched firms were selected from the pool of all companies that were traded on the NYSE that had data available within the Bloomberg database.

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[36] See Fama and French (1993). The factors are available for download on Kenneth French's website: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html.

[37] For both long-run methods, returns are defined as (Price $_t$ – Price $_{t-1}$) / Price $_{t-1}$. This differs from the calculation of returns in the short-run analysis.

No matched firm had a proposal identified as a "key vote" in the period from three years before to three years after the proxy mailing date (event date) of the firm with which it was matched.

We consider the same seven matching criteria used by Liu et al. (2008):

(1) *Firm size*: We identify the firm with the closest market value of equity, measured twenty trading days (approximately one month) prior to the event date.

(2) *Firm size and industry affiliation*: We identify the firm with the closest size (as defined above) that was also a member of the same industry subgroup (as identified within the Bloomberg database).

(3) *Firm size and prior common stock price performance*: We identify the firm with the closest common stock price performance in the previous year whose market value of equity was between 60 percent and 140 percent of that of the target firm.

(4) *Industry affiliation and prior common stock price performance*: We identify the firm within the same industry subgroup with the closest common stock price performance in the previous year.

(5) *Firm size and book-to-market ratio*: We identify the firm with the closest book-to-market ratio (book value of equity / market value of equity, measured twenty trading days prior to the event date) whose market value of equity was between 60 percent and 140 percent of that of the target firm.

(6) *Percentage change in earnings*: We identify the firm with the closest percentage change in earnings from the previous year.

(7) *Firm size and percentage change in earnings*: We identify the firm with the closest percentage change in earnings from the previous year whose market value of equity was between 60 percent and 140 percent of that of the target firm.

When a matched firm is delisted prior to the end of the holding period, we substitute the returns of the next best matching firm. When the target firm is delisted prior to the end of the holding period, we assume that it earns the same returns as the matched firm for the remainder of the holding period. No firms from the 2008 sample were included in this analysis, because a full year of data was not available. Firms from the 2007 and 2008 samples were only included in calculations involving holding periods of one year and two years or less, respectively.

The parameter of interest, the buy-and-hold average abnormal return (BHAAR), is simply the average of the BHARs for all of the companies in the sample. We test the significance of the BHAAR using both the parametric *t*-test and the non-parametric Wilcoxon signed-rank, which accounts for any skewness in the distribution of the BHARs.

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