Incentive Alignment through Shareholder Proposals on Management Compensation and its Bond Market Reaction: A Creditor’s Perspective

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ABSTRACT

Shareholders are increasingly submitting proposals to companies on top management compensation issues. Yet only some of them are focused on firm performance. Using a natural setting of performance-focused shareholder proposals (PSPs) on top management compensation, we document that: (1) shareholders successfully identify firms that suffered from a misalignment of managers and shareholders’ interests; (2) within two years of receiving those proposals, CEOs’ equity-based (restricted stocks and stock-options) pay-for-performance sensitivity increases; (3) shareholders benefit from those proposals, as evidenced by the positive abnormal stock returns surrounding proposal filing dates; while (4) bondholders suffer economically and statistically significant negative returns, and even more so for high leverage firms. We also document an increase in stock return volatility, but find no significant changes to the annual earnings forecasts by analysts, surrounding proposal filling dates. These results imply that perceived risk increase is the main driver of the observed negative abnormal bond return. Collectively, our results indicate that shareholders benefit from performance-focused executive-pay proposals, but probably at the expense of bondholders. This paper casts doubt on the overall benefits of the new “say-on-pay” regulation and could be interesting to financial market regulators.

Keywords: Incentive Compensation, Shareholder Proposal, Bond Market Reaction.

JEL Classifications: M4, G30, M52.

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1. INTRODUCTION

Corporate boards are conscious of the role of executive pay practice in improving corporate governance and increasing shareholder wealth (Gammeltoft 2010). Economic theory suggests that the key to aligning managerial compensation with shareholders’ interests is that companies increase the sensitivity of executive compensation to firm performance (Jensen and Meckling 1976; Core et al. 2005). But firms finance their operation with funds from both shareholders and creditors (e.g., bondholders). Thus the agency theory also discusses shareholders-bondholders agency conflict, and the difficulty in concurrently aligning the interest of shareholders, bondholders, and managers (Jensen and Meckling 1976; Ahmed et al. 2002; Ortiz-Molina 2007). In the past decade, business media mainly focused on the excessive CEO pay as exposed during the 2001 Enron/Worldcom scandals as well as during the recent 2007-2008 credit crisis (e.g., AIG). Critics contend that the contracting between CEOs and boards has been shadowed by pervasive managerial influence (Bebchuk and Fried 2005; Crystal 1992).

Consistent with these concerns, shareholders have begun using the “shareholder proposal rule” (Rule 14a-8), established by the Securities and Exchange Commission (SEC), to defend their interests. They sent hundreds of proposals to many of the largest U.S. corporations. Some of those proposals are related to executive compensation issues, which can be further divided into two types: proposals that ask for better pay-for-performance sensitivity (performance-focused compensation proposals, PSPs) vs. proposals that only call for CEO pay constraint or certain social and environmental actions (non-performance-focused shareholder proposals,
NPSPs). The appendix provides examples of both types. Our study is centered on performance-focused compensation proposals that demand directors to tie executive compensation more closely to performance, thereby realigning managers’ interests with those of shareholders. The proposed compensation schemes include performance-vested stock option or restricted stock grants, and indexed stock options.

There has been significant research into the effects of different types of shareholder proposals (without distinguishing between PSPs and NPSPs) on stock price, financial reporting and executive compensation (e.g., Cai and Walking 2011; Ferri and Sandino 2009). From a rational shareholder’s perspective, performance-focused proposals should be the most relevant proposals beneficial to shareholder’s interests. However, little is known about the determinants and equity market impact of performance-focused shareholder proposals.

Our second and more important research question is related to the probable negative side effect of PSPs on bondholders and thus the regulatory implications. Equity-linked compensation (esp., those packages heavy with stock options), amongst other effects, increases risk-taking incentives for managers (Jensen and Meckling 1976; Jensen and Murphy 1990). For example, DeYoung et al. (2009) show that, after the deregulation in 1999 that liberalized the scope of operation for the U.S. financial service industry, top management were heavily rewarded with various option-based incentive pay to achieve “pay-for-performance”, much more than their counterparts in the non-bank industries. This phenomenon was captured by a significant divergence in vega, executive compensation sensitivity to stock price volatility, between the bank and non-bank executives after 1999. Reflecting upon the crisis between 2007 and 2009, Bebchuk and Spamann (2009) attribute bankers’ excessive risk-taking behavior to the high
equity component in executive compensation. They point out that with increased executive pay sensitivity to stock price as well as price volatility, management may serve the interests of shareholders more through further risk-taking and finally at the expense of the whole society: bondholders (creditors), depositors (creditors), government and taxpayers. From a bondholder’s perspective, the rationale behind the recent SEC regulation on “Say-on-Pay” deserves a second thought, since increased manager-shareholder alignment might create new shareholder benefits with unintended negative consequence for bondholders.

By constructing a sample of 136 S&P 500 companies receiving at least one PSP between 1996 and 2006, we first test whether or not targeted firms that receive PSPs has, ex ante, pay practices that are sub-optimal from an alignment perspective compared to non-targeted firms. Here, our control group consists of 262 S&P 500 companies which were never targeted by PSP between 1996 and 2006. Next, we study the changes in equity-based pay for performance sensitivity for the targeted firms compared to non-targeted firms and compared to the targeted firms themselves in the earlier period (one year before receiving PSP), to test for improved management incentive realignment. Finally, we examine stock returns surrounding the proposal day to determine the effect of proposals on shareholders, which we expect to be positive, and the bond market reaction around the proposal day, which we expect to be negative. We test our bond results at both the firm and bond levels and results are robust under both settings. We further examine the changes in return volatility as well as annual earnings forecasts around the proposal day to pin down the driving factor for the negative bond reaction.

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1 The S&P 500 firms are selected based on the S&P 500 list in the fiscal year 2005. We deleted 102 firms because either they received the non-performance-focused shareholder proposals (NPSPs) between 1996-2006 or they lacked required compensation data.
Our results suggest that firms with higher excess CEO compensation (that is, CEO compensation that is not explained by firm performance) are more likely to receive PSPs. Second, following these proposals, firms receiving PSPs see their equity-based pay-for-performance sensitivity increase significantly following the proposal year, compared to a set of control firms that did not receive proposals and compared with themselves in the earlier period (one year before receiving the PSP). Third, shareholders react positively to this expected realignment, as evidenced by the positive abnormal stock returns documented for firms receiving a PSP. Fourth, as we hypothesized, an unfortunate consequence is the impact on bondholders, who seem to bear some of the cost of this realignment, as evidenced by the significant negative abnormal bond returns we observed around PSPs. We provide exploratory evidence that suggests that this is consistent with the realignment leading to more risk-taking behavior by target firms, as their return volatility significantly increases following proposal dates. Before and after the proposal date, we fail to find significant change in consensus annual earnings forecasts, a proxy of future cash flow for target firms. Therefore, we conclude that volatility change after receiving PSP explains the negative bond reaction.

We contribute to the literature as well as the ongoing regulatory debates in several ways. First, we present ground-breaking evidence of bondholder reaction to shareholder proposals. Unfortunately, the realignment of manager and shareholder interests is not without consequences to the firm’s other stakeholders, as it is associated with a decrease in bond returns. Because there is a trade-off between shareholder-manager interest alignment and shareholder-bondholder conflict (DeFusco et al. 1990; Klein and Zur 2010; Ortiz-Molina 2007), our results suggest that boards of directors and regulators should adopt a balanced approach in dealing with activist
shareholder campaigns, particularly those on top management incentive compensation. The SEC was established in the 1930s with a mandate to protect investors in securities (both stock and bonds). To fulfill its duty towards public bondholders, the second SEC chairman William Douglas lobbied to pass the Trust Indenture Act of 1939 and established the bond trustee system in America. Recently, in response to the Dodd-Frank Act of 2010, the SEC released the new “say-on-pay” regulation in January 2011. From a bondholder’s perspective, the SEC might bring in unintended consequence and potentially compromise its duty towards bondholders.

Second, insights of our paper could also be informative to the ongoing debate on executive compensation regulation. Our PSP sample covers both financial service firms (8% in the sample) and non-financial service firms. The business press blames poor incentive as “one of the most fundamental causes” of the recent economic crisis (Blinder, 2009). According to Solomon and Paletta (2009), the Obama administration clearly believes that to “to more closely align pay with long term performance” is the lesson from the recent recession. But based on results from DeYoung, Peng and Yang (2009), for both non-bank and bank firms, delta², the measure of executive pay-for-performance sensitivity, increased between 1994-1998 and has been hovering at high level above $800,000 between 2002 and 2006. For both bank and non-bank firms, delta demonstrates a mild increase during 2002-2006. Therefore, lack of pay-for-performance sensitivity seems to be a true cause for the excessive risk-taking between 2002-2007. What’s more, for any high-leverage business³, such as banking, its collapse implies larger losses in absolute dollars for bondholders and average depositors⁴ than for shareholders. The

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² Delta measures the change in dollar amount of CEO wealth for a 1% change in equity price.
³ It is very common for a commercial bank to have 90% of their assets financed by debt.
⁴ The U.S. government provides insurance coverage to depositors for certain amount of deposit. Deposits above thresholds are exposed to losses from bank bankruptcy. Some rich depositors of IndyMac did suffer loss during the
most recent examples include IndyMac Bank, Washington Mutual Bancorp and Lehman Brothers, etc\(^5\). Interestingly, these anecdotal results are consistent with our un-tabulated test results, showing that among all 84 PSP firms (a subsample of the 136 PSP firms due to bond price limitation), the bonds of high leverage firms suffer more negative returns than those of low leverage firms. In summary, we are concerned that more shareholder activism, as further encouraged by the Dodd-Frank Act of 2010, could generate unintended side effect rather than fix the current problem from the last recession.

Third, this paper extends findings of contemporary studies on shareholder non-binding votes reducing executive pay (e.g. Carter and Zamora 2009; Ertimur et al. 2010; Ferri and Maber 2009; Ferri and Sandino 2009) by showing the first evidence that receiving performance-focused shareholder proposals is associated with a subsequent increase in equity-based pay for performance sensitivity. In addition, this paper could also correct some misperception of shareholder activism in the general media.\(^6\) Shareholder proposals are often perceived to be submitted by less sophisticated investors, and to have little effect on important governance matters compared with activist campaigns by large investors such as hedge funds. Our results, however, suggest that PSP sponsors are sophisticated investors who understand the proper use of management compensation contracts in maximizing their own utility.

The remainder of this study is organized as follows: Section II provides an institutional background of shareholder-sponsored proposals and a brief literature review. Section III

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\(^6\) Shareholder activism includes ways in which shareholder can improve corporate boards and management, such as proxy contests, shareholder proposals, and private negotiation with the boards and managers.
develops the hypotheses to study the determinants of these proposals and consequences. We describe the sample selection procedure and research methodology in Section IV. Section V presents the results, and Section VI concludes.

2. SHAREHOLDER PROPOSAL BACKGROUND AND LITERATURE

The legal basis of shareholder proposal rests on the 1942 Securities Exchange Commission (SEC) Rule 14a-8. This rule allows eligible shareholders to make their proposals in a company’s proxy statement for a vote at shareholder meetings. The minimum eligibility requirement to make a proposal is low: ownership of at least $2,000 in market value or 1% of voting shares with a holding period of at least one year through the date of the annual meeting, and to attend (or authorize a qualified representative to attend) the meeting to present the proposal. In response, the firm can accept the proposal as stated, negotiate for changes, or exclude it by sending it to the SEC in a “no action” letter. Popular shareholder proposals include board-related policies, executive compensation schemes, elimination of anti-takeover devices, and declassification of a staggered board, among other important corporate governance concerns (Georgeson, 2009). We focus on one type of compensation-related proposals, the performance-focused shareholder proposals (PSPs) due to their importance to shareholder-manager interest alignment and their potential to impact bondholders negatively. Those kinds of proposals have strong theoretical support (Jensen and Murphy, 1990), and are most likely to gain traction with the boards and shareholders.

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7 We discuss more on this point in Hypothesis Development section.
Compared with other types of shareholder activism such as hedge fund activism, activism through shareholder proposals on executive pay is relatively less costly. First, as mentioned earlier, eligibility requirement is low. Secondly, the 1992 SEC-reformed proxy solicitation rules allow shareholders to publish, through various media, how they intend to vote and what their voting guidelines are, and also to shield the communications from antifraud prohibitions (Choi 2000; Heard 1995; Thomas and Martin 1999). This reform significantly increased communication between shareholders and enabled them to coordinate “in proxy contests against management … at a significantly reduced cost” (Thomas and Martin 1999). The SEC also changed other rules including Regulations S-K and S-B to require extensive disclosures about executive compensation. These new rules allow easy public access to compensation data and easier filing of compensation-related shareholder proposals at a much lower cost.

Although the new rules provided ample ammunition to shareholder activists to monitor company compensation practices, prior research finds mixed evidence on what kinds of firms receive shareholder executive-pay proposals. For instance, Karpoff et al. (1996) and Strickland et al. (1996) find that shareholder proposals are more common for large firms that have poor prior performance. But recent evidence (Cai and Walkling, 2011) indicates that target firms are just large firms, not those with management incentive misalignment, poor governance or poor performance. Institutional ownership is found to be positively associated with the probability of attracting a shareholder proposal (Strickland et al., 1996) and then the association is found to be negative in a more recent study (Ertimur et al. 2010). In fact, the only consistent result in prior literature is that firm size is positively related to attracting a proposal.
The impact of shareholder proposals on total executive pay level is even less clear. Thomas and Martin (1999) use 168 executive compensation proposals to determine what drives proposal filing decisions, voting outcomes, and the impact of these proposals on executive compensation. They failed to find relation between receiving a proposal, and executive compensation or the sensitivity of CEO pay to performance. Results from Karpoff, Malatesta and Walkling (1996) also imply that shareholder proposal on executive compensation is not likely to affect its level. In contrast, more recent studies with new samples reached the opposite conclusion. Ferri and Sandino (2009) and Ertimur et al. (2010) both find that shareholder proposals reduce executive pay.

Our study is distinguished from previous studies on three fronts. First, our paper fills in the literature void by reexamining the new popular corporate governance tool, shareholder proposal, with a completely new perspective from creditors (bondholders). Results could challenge the rationale of recent regulatory changes and be informative to the general public. Second, we focus on executive pay structure change for those targeted firms rather than the total dollar value impact of various shareholder proposals. Lastly, we are only interested in those performance-based shareholder proposals (PSPs). Unlike those studies based on pre-1995 data as well as some recent studies that examine all kinds of shareholder proposals, both PSPs and NPSPs, the proposals in our paper (between 1996 and 2006) explicitly tie executive compensation to performance, hence allow us to test whether shareholder proposals have an impact on firm pay-performance sensitivity.
3. HYPOTHESIS DEVELOPMENT

3.1. Lack of Alignment and Shareholder Proposals

It is unclear whether shareholders target firms randomly or have enough sophistication to identify firms that suffer from a misalignment of shareholders and managers' interest. Extant literature suggests that shareholders aim their proposals rather arbitrarily. For example, they most likely target larger-sized firms (Bizjak and Marquette 1998; Karpoff et al. 1996) rather than firms with more serious agency problems.

There exists a rich agency literature regarding the alignment of shareholder and manager interest through compensation contracts (Jensen and Meckling 1976; Holmstrom 1979; Jensen and Murphy 1990; Carter et al. 2007). If shareholders are sophisticated, then they should be more likely to target firms that suffer from more severe agency problems. Core et al. (2008) proposes a model to split CEO compensation between a "normal" portion justified by economic determinants, and an “excess” portion (that is, the actual compensation minus the predicted compensation). They argue that the excess portion indicates management incentives have exceeded what economic determinants warrant, and that the existence of excess compensation is evidence of the misalignment of management incentives with shareholder interest (Core et al. 2008). Similarly, we posit that the presence of excess compensation is an indication of misalignment. This leads to our first hypothesis, expressed in alternate form:

**H1: Firms with higher level of excess compensation are more likely to receive PSPs.**
3.2. Shareholder Proposals and Equity-Based Pay for Performance Sensitivity

Next, we turn to firm reactions to shareholder executive-pay proposals. When companies try to change managers’ compensation structures in order to align manager interests with those of shareholders, stock-based pay (mainly stock options) has been the major pay component used (Jensen and Murphy 1990; and Murphy 1999). Therefore, if boards adopt shareholder proposals to improve the pay-for-performance relationship, then stock-based pay should receive the most attention. However, shareholder proposals may lack the necessary influence to mandate changes in corporate behavior. Even majority-passed shareholder proposals are not necessarily binding on management because of conflicting court rulings on shareholder proposals.

Despite such seemingly insurmountable legal obstacles, a proposal with more than 10% of the vote would be allowed to file repeatedly year after year. If that occurs, boards of directors ignoring repeated and economically sound proposals could face proxy contests, votes held against them in elections (Del Guercio et al. 2008), or litigation by some shareholders (Brill 2004). For instance, Charles Elson, a Professor of Corporate Governance at the University of Delaware, advises the boards: “A sufficiently large number of votes in favor of the resolution … may provide the base for a potentially successful proxy fight” (Romanek and Young 2004). In fact, evidence also shows that shareholder votes would be able to influence firm behavior even if the favorable vote for a shareholder proposal is just around 30% (Del Guercio and Hawkins 1999), or if the unfavorable vote against a management proposal is greater than about 29% (Martin and Thomas 2005). Boards also implement a substantial portion of the requests made by
shareholder “vote no” campaigns during director elections if withholding votes exceed 20% (Del Guercio et al. 2008). In addition, directors give more weight to shareholder proposals receiving over 10% of the vote, a magnitude viewed as a significant level of shareholder dissatisfaction (Thomas and Martin 1999).

Therefore, even if the boards are not legally bound to implement shareholder proposals, they may still be forced to take action in line with economically sound proposals. Since performance-focused proposals are especially well-grounded with a solid economic foundation, we posit that they should be supported by the boards. This suggests the stock-based pay would likely increase after firms receive PSPs.

The increase in equity-based pay is also consistent with the notion that directors, when facing shareholder pressure to improve pay-performance relations, may try to reach a certain level of managerial incentive by changing pay structures or shifting other pay components into stocks and stock options, and, at the same time, addressing concerns expressed in performance-focused shareholder proposals. Such structural shifts would increase the pay for performance sensitivity of stock-based compensation. This leads to the following hypothesis:\(^8\)

\[ H2: \text{The change in pay for performance sensitivity in equity-based compensation is greater for firms receiving PSPs than for control firms in the same period.} \]

3.2. Shareholder Proposals, Stockholder Returns, and Bondholder Returns

\(^8\) We do not differentiate between stocks and stock options in H2. The current practice of increasing incentives is seen in stock options or restricted stock. However, an emerging theory predicts that CEO’s should receive additional stocks and hold no stock options (Dittmann and Maug, 2007).
If PSPs have the effect of reducing excess compensation and realign management and shareholders' interests, they should be associated with a positive market reaction from shareholders. Renneboog and Szilagyi (2010) document positive abnormal returns for all shareholders proposals. However, Bizjak and Marquette (1998) and Del Guercio and Hawking (1999) show that some types of shareholders proposals are correlated to negative returns. We are not aware of any studies specifically documenting the market reaction to PSPs. Accordingly, we do not have a directional prediction for returns. This leads to our third hypothesis, expressed in null form:

**H3: Stock markets do not react to shareholder proposal announcements for firms receiving PSPs.**

Merton (1974)’s bond pricing model predicts that bond prices are positively associated with total firm value and negatively associated with firm return volatility (usually proxied by firm stock return volatility in empirical studies) and leverage. If a firm reduces total CEO pay after receiving a PSP, then the firm value should increase because of the reduction of expected future cash outflows. Thus, bond prices would rise along with firm value. Furthermore, the bond market may react positively if the bondholders expect the board and the CEO to re-contract in order to restrict value-destroying actions (e.g., excessive perks for CEOs; corporate jets from executives) when facing shareholder pressures on pay-for-performance (Watts and Zimmerman, 1986).

On the other hand, PSP proposals could also negatively impact bond prices by inducing more risk-seeking managerial actions, thus increasing firm return volatility (or even financial
leverage). As we posit, firms that receive a PSP may choose to increase CEO equity based compensation. With more stock and option holdings, Agrawal and Mandelker (1987) show that managers tend to take on riskier investment projects with riskier financing. They document a positive association between managerial stock holdings and change in firm return volatility and leverage. DeFusco et al. (1990) document that the board approval of an executive stock option plan is associated with significantly negative bond returns and positive stock returns. In sum, results from both studies are consistent with the notion that firms trade off between shareholder-manager alignment and shareholder-bondholder alignment (Ortiz-Molina 2007). If the market expects increased firm return volatility due to more risk-seeking behavior by the top managers after receiving PSPs, then there should be a negative bond market price reaction around PSP filing days.

Collectively, theories and past empirical studies are not clear in predicting positive or negative bond market reactions. Hence, our last hypothesis in the null form is:

**H4: Bond markets do not react to shareholder proposal announcements**

*for firms receiving PSPs.*

**4. RESEARCH DESIGN**

**4.1. Sample Selection**

We start with the S&P 500 firms in the 2005 list. We collect shareholder executive-pay proposal data and proxy filing dates from the corporate proxy statements of S&P 500 companies for the filing years 1996 through 2006. If the details of shareholder proposals are not available from the proxy statements, we collect information from the filings for important events (8-K)
through the Lexis-Nexis and SEC Edgar databases. We also cross-reference details from these two databases to ensure accuracy. Top management compensation and ownership data are from the Execucomp database. Firm accounting data are from Compustat. We obtain stock returns and U.S. Treasury bond data from CRSP, corporate bond prices from the Trade Reporting and Compliance Engine (TRACE), corporate bond maturity and ratings from the Mergent Fixed Income Securities Database (FISD), institutional blockholder ownership data from Thomson Reuters, and antitakeover vulnerability (G-Index) from Dr. Andrew Metrick’s website. Because we need to test the impact of shareholder proposals, we delete firms that were acquired during or immediately after the proposal year and proposals that do not have proxy filing dates. Our primary test sample has 136 firms. Our bond sample is reduced to 84 firms due to insufficient bond trading data in the TRACE database during the sample period or around the proxy statement filing dates.

We label the year “Proposal Year” (or “Year 0”) when a shareholder proposal becomes available. The sample of shareholder compensation proposals is classified as either PSP or NPSP. As discussed earlier, PSPs typically include those specifically linking pay to performance through stock options or stocks, and/or restrictions on severance/pension packages. NPSPs are primarily those that pressures for corporate support for certain social causes (e.g., environmental issues, constraint of economic activities in Africa or Latin America, or human rights issue, etc.) or call for a pure cap or reduction in total executive pay without any consideration for good or bad CEO performance. Since our focus is PSPs and their impact, we eliminate firms that received NPSPs, but no PSPs in the sample period. Our final PSP sample consists of 136 firms. 102 firms were deleted due to lack of compensation information or the fact that they received
NPSPs during 1996-2006. Following Core and Larcker (2002) and Cheng and Farber (2008), we construct a set of control firms using all remaining S&P 500 firm-years not targeted by shareholder proposals in 1996-2006. The control group consists of 262 firms (1,752 firm-years) that have never received any shareholder proposals between 1996 and 2006 and have all required compensation information. We provide industry distribution information for the PSP sample firms and control firms in Table 1. The summary statistics of Table 2 are based on firm-years, 136 for the PSP sample and 1,752 for the control group. Regression results for Table 4 and 5 are based on those 1,888 firm-years.

The dichotomy between PSP and NPSP is based on economic theory and institutional practice. First, agency theory’s incentive alignment mechanism between the principal (shareholder) and the agent is essentially performance-focused (Jensen and Meckling 1976; Jensen and Murphy 1990): an agent should receive higher compensation if she enables the principal to gain larger wealth. Compared to politically- or socially-centered shareholder proposals, performance-focused ones can be tested more directly for their economic consequences. Second, shareholders are more receptive to the concept of pay-for-performance now than in the early 1990s since Jensen and Murphy (1990) first argued that it is not how much but how top management is paid. This shareholder perception is supported by Rappaport and Nodine’s (1999) argument that shareholders want changes in “pay schemes that motivate companies to deliver more value.” In particular, they suggest that companies use indexed stock options, which is a primary goal of many of the performance-focused shareholder executive-pay proposals. Third, the pay-for-performance principle is widely supported by the largest public pension funds, investment groups, and Institutional Shareholder Services in their voting
guidelines (CalPERS 2010; ISS 2007; TIAA-CREF 2010). The voting support on average for our sample has reached the benchmarks (discussed previously) that the boards cannot afford to ignore.

Panel A of Figure 1 shows a substantial increase in the number of S&P 500 firms targeted by at least one PSP over the 1996-2006 period. The number of firms ranges from a trough of 14 in 1996 to a peak of 73 in 2004. Panel B displays the number of shareholder proposals for S&P 500 companies targeted by at least one PSP over the sample period. The number of PSPs is lower in 1996-2000 than that of NPSPs but higher than NPSPs in 2001-2006.

4.2. The Probability of Receiving PSPs

To test whether a firm with different levels of excess CEO pay relative to performance is more likely to receive a shareholder executive-pay proposal, we first find the deviations in executive pay from expected pay using a methodology similar to Core et al. (2008). The details of this methodology are as follows. We perform a pooled cross-sectional regression of all firms in the S&P 500 index with identified determinants for expected pay in the prior literature for the fiscal years between 1994 and 2005. The residuals from equation (1) provide us with the magnitude of the deviations of CEO pay from expected pay based on economic determinants:

\[
\log(\text{Total Comp}_{it}) = \beta_0 + \beta_1 \log(\text{Sales}_{it}) + \beta_2 \text{market-to-book}_{it-1} + \beta_3 \text{ROA}_{it-1} \\
+ \beta_4 \text{stock returns}_{it-1} + \beta_5 \text{ROA volatility}_{it-1} + \beta_6 \text{stock volatility}_{it-1} \\
+ \beta_7 \text{Leverage}_{it-1} + \gamma_1 \text{year indicators} + \gamma_2 \text{industry indicators} + u_{it-1}
\]

9 We do not include fiscal year 2006 because the latest proposal in our sample is in calendar year 2006, which means the targeted firm executive compensation is for fiscal year 2005 or prior years. We include fiscal years 1994 and 1995 because two-year lagged variables are needed.
The dependent variable log(TotalComp) is the log-normalized total of CEO compensation. The log-transformation helps to explain the residual as a percentage deviation of the actual from the expected total compensation. The independent variables firm size, growth opportunity, firm performance, firm risk, and agency cost of debt are known to be associated with executive compensation (Core et al. 1999; Smith and Watts 1992; Mehran 1995). Firm size is proxied by annual sales, growth by market to book ratio, firm performance by return on assets (ROA) or stock returns, firm risk by ROA or stock return volatilities, and cost of debt by the firm leverage.

After obtaining the total compensation residuals from the benchmark model, we combine the control group and our PSP sample group and run a logistic regression using the following model:

\[
PROPOSAL_{it} = \beta_0 + \beta_1 \text{ExcessComp}_{it-2} + \beta_2 \text{InternalGov}_{it-1} \\
+ \beta_3 \text{ExternalGov}_{it-1} + \beta_4 \text{Poor}_\text{indicator}_{it-1} + \epsilon_{it}
\]

\(PROPOSAL\) is 1 for a firm with a PSP and 0 if a firm did not receive any shareholder proposals. \(\text{ExcessComp}_{it-2}\) is the one-year lagged residual value prior to the proposal year obtained from the executive-pay benchmark model in Equation (1).\textsuperscript{10} We control for other governance factors that may affect the likelihood of a firm being targeted by a shareholder proposal. \(\text{InternalGov}_{it-1}\) is the percentage of shares held by the large prior institutional blockholders, whose ownership is higher than 5% of a firm’s outstanding shares (Duchin 2010; Eisenhofer and Barry 2006). Normally a company’s proxy statement for Year T-1 is filed with the SEC around March or April (87% in our sample) in Year T, whereas a board’s compensation decision for T-1 is around February in Year T. Thus, shareholders are mostly informed about CEO’s Year T-2 compensation but not T-1’s by the time proposals are submitted for Year T-1.

\textsuperscript{10} We use the one year lagged excess compensation prior to the proposal year because a shareholder must send the proposal to the management office at least 120 days before the company proxy statement is sent to shareholders (Eisenhofer and Barry 2006).
Yun 2009). \( \text{ExternalGov}_{it-1} \) is a modified version of the Governance Index designed by Gompers et al. (2003). In Gompers et al.’s (2003) index, as interpreted in Cremers and Nair (2005), a higher value means lower anti-takeover vulnerability and thus weaker external governance (Dittmar and Mahrt-Smith 2007; Klock et al. 2005). For convenience, we multiply the index value by -1 to derive a \( \text{ExternalGov}_{it-1} \) variable indicating a stronger external governance with a higher index value. \( \text{Poor}_{-\text{indicator}}_{it-1} \) is 1 if the five-year industry-adjusted stock return is negative and 0 otherwise.\(^{11}\) We augment this model with other control variables in sensitivity analyses.

Consistent with the prediction in H1, we expect a positive sign for \( \beta_1 \).

### 4.3. Impact of PSPs on Equity-Based Pay for Performance Sensitivity

We measure CEO incentive alignment (or pay-for-performance sensitivity) as the change in the dollar value of annual stock options and restricted stock grants for a 1% change in the stock price (Core and Guay 1999; Baker and Hall 2004). Since we want to know whether boards of directors take action after receiving PSPs to improve pay-for-performance sensitivity, we use the measure from Core and Guay (1999), in its logarithmic transformation, to proxy for CEO annual incentive alignment. We test our results with two settings, change from T-1 year to T+1 year and change from T-1 to T+2 year.

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\(^{11}\) The reason for measuring five-year stock return is primarily because PSP is a new kind of shareholder proposal that focuses on pay-for-performance. Given the fundamental changes in the regulatory and economic environment, investors need time to adapt. According to Nell Minow, former president of Institutional Shareholder Services and cofounder of The Corporate Library, “it takes at least three to five years for a new kind of proposal to seep into the consciousness of the institutional investor community deeply enough to become a part of their standard proxy voting guidelines” (Romanek and Young 2004).
Following Core and Larcker (2002) and Cheng and Farber (2008), we construct a set of control firms using all S&P 500 firm-years not targeted by shareholder proposals in the sample period. Similar to Hartzell and Starks (2003), we use an ordinary least squares regression model in Equation (3) to control for factors that might affect compensation incentives:

\[ \Delta \log(\text{AnnualIncentive}) = \beta_0 + \beta_1 \text{PROPOSAL} + \gamma_1 \Delta(\text{ShareholderWealth})_{it} + \gamma_2 \Delta(\text{ShareholderWealth})_{it-1} + \sum \gamma_k (\text{OtherControlVariables}) + \varepsilon_{it} \]  

(3)

where \( \Delta \log(\text{AnnualIncentive}) \) is the change in pay-for-performance sensitivity of restricted stocks and stock options from the pre-proposal period to the post-proposal period. We use the difference in the sensitivity because the selection of control firms itself may be insufficient to eliminate totally any differences in pay structures between sample firms and control firms.

\( \text{PROPOSAL} \) is 1 if a firm receives a PSP and 0 if a firm does not receive any executive pay proposals throughout the sample period. \( \Delta(\text{ShareholderWealth}) \) is the change in shareholder’s wealth for the two year period prior to the proposal year. This is the control for shareholder wealth change that is associated with CEO compensation (Hartzell and Starks, 2003). Firms may award CEOs large sums of equity compensation in some years but not in subsequent years. Because we test the change in equity-based compensation, prior year compensation may confound our results. We control for that using unexpected prior year total compensation calculated from Equation (1). Finally, we use an indicator variable \( \text{NEWCEO} \) (1 if new a CEO takes office during the proposal year or following the proposal year, and 0 otherwise) to control for CEO turnover (Hartzell and Starks 2003).

Other control variables include firm size (proxied by market capitalization) and growth opportunities (proxied by Tobin’s q) since they potentially influence the equity compensation
ratio (Mehran 1995) measured at the beginning of the proposal year. Hartzell and Starks (2003) find that higher institutional ownership concentration is associated with subsequent increases in pay-performance sensitivity. Therefore, we include institutional blockholder ownership as an independent variable.¹²

We hypothesize a positive sign for the coefficient $\beta_1$, implying that we expect the equity-based pay for performance sensitivity to increase following the proposal year for firms receiving a PSP.¹³

### 4.4. Impact of PSPs on Stock Markets

To test the stock market reactions around the proposal filing dates, we compute the abnormal stock return around proxy filing dates based on a one-factor market model with a CRSP equal-weighted index (Brown and Warner 1985; Lie 2005). The event window is between the 5th trading days prior to day zero, proposal filing date, and the first trading day after day zero. Put in another way, the event window is $[-5,+1]$. We test the abnormal returns using the full proposal sample as well as the sample of firms with available bond trading data.

---

¹² We use our InternalGov as the control variable here because it represents institutional blockholder ownership. We also control for external governance (ExternalGov) because it may be related to CEO pay-for-performance sensitivity (Shaw and Zhang 2010).

¹³ Similar to Hartzell and Starks (2003), none of the measures above include change in compensation due to an increase or a decrease in the value of stock and options that the CEO already holds. We do this for two reasons. One, the consequence of this underestimation of the equity portion of a manager’s pay depends on the manager’s activities with respect to his own portfolio. CEOs can change their personal portfolios by trading and change their equity portion in response to the composition of their pay packages (Ofek and Yermack 2000), independent of the proposal. Two, the board is only able to control the current compensation granted to CEOs and not any activities the CEOs control related to their own personal portfolios. Hence, we believe that using current compensation is more appropriate for our study.
4.5. Impact of PSPs on Bond Markets

We measure bondholder returns around proxy filing dates following methodologies similar to prior literature using daily bond prices (e.g. Hand et al. 1992; Bessembinder et al. 2009). We use the total bond return approach (price change plus accrued interest) to calculate buy-and-hold (BHR) bond return as follows:

\[
BHR = \frac{[(P_{t+1} - P_{t-5}) + AI]}{P_{t-5}}
\]

(4)

where \( P_{t+1} \) is the bond price on the first trading day after day zero. \( P_{t-5} \) is the earliest available trading price for the same bond within the 5 trading days prior to day zero. AI is the accrued interest. Our event window design also allows us to capture the effect of any possible information leakage prior to the proxy statement filing with the SEC. We eliminate the observation if the bond did not trade within five calendar day after day 0.\(^{14}\) The adjusted bond return is the holding period BHR of a sample firm bond less the same period BHR of a treasury bond (Hand et al. 1992) matched by maturity as follows:

\[
ABHR_{ijt} = BHR_{ijt} - TBHR_{ijt}
\]

(5)

where \( ABHR_{ijt} \) is the adjusted bond buy-and-hold return. \( BHR_{ijt} \) is the corporate bond buy-and-hold return between day \( t-5 \) and day \( t+1 \) for bond \( j \) at firm \( i \). \( TBHR_{ijt} \) is the treasury buy-and-hold return in the same period.\(^{15}\)

\(^{14}\) We calculate a weighted-average price if there is more than one trade during the trading day, and also eliminate non-institutional trades to increase the power of the test (Bessembinder et al. 2009). We test the sensitivity of event windows of bond market reactions by using different windows such as \((-4, +1)\) or \((-10, +10)\). The results are invariant to these different choices.

\(^{15}\) As a sensitivity check, we test abnormal return using a matching portfolio model (Bessembinder et al. 2009). The results are qualitatively the same.
5. ANALYSIS OF RESULTS

5.1. Descriptive Statistics

Table 1 summarizes the industry distribution. The sample distribution is similar to that of the control firms in the S&P 500 as well as the distribution of firms in the Compustat universe, with one exception: the sample has a larger percentage of energy and utility companies (two-digit SIC code of 49).

Table 2 presents descriptive statistics of the data sample. Compared to the control firms in the S&P 500 index, the target firms are much larger in terms of size. For example, the mean (median) market capitalization for firms with at least one PSP is $29,366 ($14,395) million, compared with $11,191 ($6,358) million for control firms. The mean (median) CEO total compensation for firms with at least one performance-focused pay proposal is $12.0 ($9.2) million compared to $7.2 ($5.2) million for control firms. The mean (median) CEO stock ownership (including exercisable and unexercisable stock option holdings) is 1.45% (0.53%) for sample firms compared to 2.16% (0.98%) for control firms. The results are significantly different at least at the 0.05 level. In general, we find that all the sample firms are significantly different from control firms in terms of firm size, which is consistent with prior literature (Bizjak and Marquette, 1998; Karpoff et al., 1996).

5.2. Probability of Receiving PSPs

Table 3 presents the benchmark model, Equation (1) to determine the total compensation residuals as a proxy for excess pay used in the logistic regressions in Table 4. All coefficients in Table 3 are significant at conventional levels except for ROA Volatility. Following Core and
Larcker (2002) and Cheng and Farber (2008), we create a control sample using all firm-years of the control firms for Equation (2). This results in a sample of 136 firm-years from 136 PSP firms, and 1,752 firm-years from 262 control firms.

In Table 4 we present the results of the regression for Equation (2). As predicted by H1, the probability of receiving PSPs increases when CEOs enjoy excess compensation, with a positive and significant coefficient ($p<0.01$) for $ExcessComp$, excessive compensation derived from previous regression. Control variables show the expected signs and are significant at conventional levels.

### 5.3. The Change in Equity-Based Pay for Performance Sensitivity

Table 4 results suggests that firms receiving PSPs are correlated with underperforming firms with overpaid CEOs. In the next step, we test whether boards make changes to their compensation incentives using Equation (3) and present the results in Table 5.

The coefficient for variable $PROPOSAL$ is positive and significant for both settings (at 0.01 level and 0.05 level respectively), as reported in column (1) and column (2). It indicates that pay-for-performance sensitivity for PSP firms increases significantly following the PSP filings compared with the control firms without receiving a PSP shareholder proposal, providing empirical support to H2.

To ensure that the results are not driven by firm size, we shuffle the original sample into a size-truncated sample, following Pittman and Fortin (2004) and Blackwell et al. (1998). In this size-truncated sample, each firm's total assets are less than the largest of the control firms and
greater than the smallest of the PSP firms. Then, we rerun the regression in Table 5 for both settings. The results are similar.

In our first round of test for Table 5, the equity-based compensation used in pay-for-performance sensitivity calculation (Core and Guay, 1999) includes both stock option and restricted stock. We recognize that the measure we use represent the sensitivity of equity-based pay to stock prices (delta) that may not properly capture the impact of managerial risk-taking behavior. Therefore, we compute the sensitivity of equity-based pay to stock return volatility (vega) and rerun the test for Table 5 and still get qualitatively similar results.

In sum, our results are consistent with the hypothesis that boards of firms receiving PSPs change their compensation structure by increasing pay-for-performance sensitivity following the proposals more than those control firms that have not received any shareholder proposals.

One possible explanation for the result above is that pay-for-performance sensitivity for both PSP firms as well as control group firms have declined between T-1 year to T+1 year, while the sensitivity of the former declines less than the sensitivity of the later.

In a robustness test, we also use the pay-for-performance sensitivity of those PSP firms in the T-1 year as the benchmark and compare that with the pay-for-performance sensitivity in the year of T+1. The mean sensitivity in year T-1 for all 136 sample firms is $9.40 million, while the mean sensitivity in year T+1 for all 136 sample firms is $10.47 million. The two means are significant different from each other with a t-value of -2.53 (p-value=0.013). We repeat the same test for the control group and get insignificant result (p=0.215). Therefore, it is concluded for the 136 firms receiving PSPs, the executive pay-for-performance sensitivity does increase from the T-1 year to T+1 year.
5.4. Impact of PSPs on Stock Markets

Given that the robustness test above has confirmed the increase in pay-for-performance sensitivity between T-1 year and T+1 year, a rational stock market might anticipate the potential benefit derived from improved manager-shareholder alignment and react positively around the publication of such a PSP. Table 6 presents the cumulative abnormal equity returns of firms surrounding the date they receive PSPs. Results are reported for the full sample of 136 targeted firms as well as the 84 targeted firms with available bond prices. The mean cumulative abnormal stock return is 0.67% and the median is 0.57% for the full sample. For the smaller 84-firm sample with available bond trading price information, the mean cumulative abnormal stock return is 0.78% and the median is 0.57%. Our abnormal returns are statistically significant at the 0.10 to 0.05 level for the full sample and the bond sample, therefore, we reject the null hypothesis of H3 and conclude that stock prices of PSP firms react positively to shareholder proposal filings.

5.5. Impact of PSPs on Bond Markets

Table 7 illustrates the treasury-adjusted bond returns for 541 bonds of 84 targeted firms with available bond prices from TRACE. The average (median) abnormal bond return is -10 basis points\(^{16}\) (-4 basis points), significant at the 0.01 level for both the t-test and the z-test.\(^ {17}\) For our 84 PSP firms in the bond sample, the average amount of outstanding bonds per firm is about

\(^{16}\) 1 basis point = 0.0001 or 0.01%

\(^{17}\) Since non-parametric z-tests have more power than parametric t-tests in daily bond returns tests (Bessembinder et al. 2009), we present both parametric and non-parametric test results as suggested by Bessembinder et al. (2009) and Klein and Zur (2010). We emphasize more the results based on average abnormal bond return, since Bessembinder et al. (2009) specifically point out that “mean returns more accurately reflect the aggregate experience of investors.”
$835 million (based on separate calculation of the authors and on information from TRACE).
Here the outstanding bonds are outstanding bonds with valid trading information from TRACE),
and the average economic loss per firm for the 84 firms’ bondholders is about $5.38 million\(^{18}\) in
the 7 days surrounding the proxy filings of PSPs (with a total market value loss of $451.92
million). Therefore, the negative impact on bondholder wealth is not only statistically significant,
but also economically significant.

Similar to prior research, we test the robustness of treasury-adjusted bond returns using
the firm-level (Bessembinder et al. 2009) and representative bond-level approaches (Dhillon and
Johnson 1994). Firm level bond return is the average bond return weighted by the issuing value
of each bond for the same firm\(^{19}\). A representative bond is the bond with the highest average
number of daily trades within ninety days prior to day zero. If two bonds of the same firm have
the same average daily trades, we pick the bond with the highest number of trading days in the
nine days prior to day zero. Firm-level and representative bond results are reported in Table 7
too.

Table 7 shows that the means and medians of abnormal returns at firm-level and
representative bond-level are both significantly negative, at less than the 0.05 level. At the firm
level, the average (median) abnormal bond return is -19 basis points (-7 basis points).
Representative bond result is slightly stronger and the average (median) abnormal bond return is
-23 basis points (-8 basis points). Bessembinder et al. (2009) surveyed about 20 prior bond event

\(^{18}\) We first derive the cumulative abnormal return rate for each bond, then multiply it with outstanding bond value to
get cumulative abnormal loss for each bond and then each firm. Here we might actually underestimate the abnormal
losses for PSP firms since some privately placed bonds or long-maturity bonds might not have infrequent trading,
therefore, are missing from TRACE. We emphasize more the results based on average abnormal bond return,
following recommendation from Bessembinder et al. (2009) that “mean returns more accurately reflect the aggregate
experience of investors.

\(^{19}\) Value-weighted averaging is better than equal-weighted averaging, according to the methodology study by
Bessembinder et al. (2009).
studies and conclude that (-2 basis points, -50 basis points) and (+2 basis points, +50 basis points) are typical ranges for abnormal bond returns. They use these ranges for their simulation studies. In another well-cited bond event study with the largest bond sample size ever in published papers, Billet et al. (2004) find that during the merger and acquisition announcement period, acquirer firm bonds experience negative mean and median abnormal bond returns of -17 and -3 basis points. In sum, the magnitude of our results is comparable to that in published studies that conclude observing a significant bond market reaction. In conclusion, results at all levels, the bond level, the firm level as well as the representative bond level, are consistent with each other and are all significant at least at the 0.05 level. We can reject the null hypothesis of H4 and conclude that bond market reacts negatively to shareholder PSP proposals filings. Bond market does react negatively to the anticipated pay-for-performance sensitivity improvement between T-1 year and T+1 year for the PSP firms, as documented in section 5.3.

In un-tabulated robustness tests, we separate the 84 PSP firms into 2 groups based on the median leverage. The first group is called “higher leverage group”, with a mean abnormal bond return of -14.9bp, while the second group is called “the lower leverage group” with a lower negative mean abnormal bond return of -6bp. The two means are marginally significant with a p-value of 0.11 (if we pick only one representative bond for each firm, then the two mean abnormal bond returns are significantly different from each other at p=0.037). If we separate the 84 PSP firms into 3 groups based on firm-level leverage, the three groups, highest leverage group, medium leverage group, and lowest leverage group, have monotonically increasing mean abnormal bond returns at -36bp, -3bp and -1bp respectively. The mean abnormal returns of the highest leverage group is significantly different from the means of the medium leverage group.
(p=0.004) and the lowest leverage group (p=0.003). In sum, our results are largely consistent with the notion that higher leveraged firms' bondholders will suffer more from the news with respect to a further increase in equity-based pay-for-performance sensitivity. This result could be informative to legislators as well as market regulators.

**5.6. Determinant of the Shareholder-Bondholder Conflict**

In the second stage, we report exploratory tests of a potential factor\(^\text{20}\) that would explain our observed evidence of positive shareholder reaction to PSPs, and negative bondholder reaction. One of the consequences of an incentive alignment of shareholders and managers may be an expected increase in risk-taking behavior by managers. While shareholders benefit from risk-taking, bondholders usually suffer negative effects. We examine stock return volatility surrounding PSP filing dates to determine if the market provides evidence of a shift in firm risk during this period. Bondholders are not directly subject to equity volatility. In fact, bond value depends on total firm risk (asset), as opposed to the riskiness of the residual equity claim. Unfortunately, total firm risk is not observable, and while stock return volatility is not a perfect proxy for total firm risk, it should be correlated to the theoretical construct and is widely used in the accounting and finance literature.

In Table 8, we compute stock return volatility in the 30 days before and after the filings of PSPs. Panel A compares return volatility based on stock raw returns. In order to refute the

\(^{20}\) Another possible factor is the change in expected future cash flow. Since earnings has better predictive power for future cash flows than current operating cash (Dechow et al. 1998), we track changes in the I/B/E/S mean earnings per share forecast by analysts for the two closest months around PSP filing dates. For the 84 firms with valid bond trading information, we find that changes in analyst forecasts are insignificant (p-value=0.94). We perform z-test for the changes in median of analyst EPS forecasts for the two closest months and reach similar conclusion. Therefore, the negative bond return around PSP proposal filings can not be attributed to changes in expected future cash flows.
competing explanation that return volatility for our PSP target firms are mainly driven by increasing overall market volatility, we recalculate market-adjusted return volatility in Panel B. We perform volatility calculation for two time periods (-30, -1) and (0, +29) and for all PSP targeted firms (136 firms) as well as the subset of 84 firms with available bond trading information. We document a statistically significant (at less than 0.01 level) increase in stock return volatility after PSP proposal filings and Panel B further demonstrates that our result is not driven by the volatility change in the equity market. This is consistent with our presumption that the shareholder-bondholder agency issue may be due to a shift in risk-taking behavior following the reception of PSPs. We also test the stock return volatility for the 60-day window before and after the filing of PSPs. Results (untabulated) are robust under the alternative window length.

In sum, we do not find significant changes in analyst mean earnings forecast around PSP proposal filing, but do document a statistically significant increase in stock return volatility. The latter is consistent across samples and not driven by the overall market volatility change. In conclusion, the volatility result is consistent with our prediction that PSPs could induce managers to become more risk-seeking in future actions, and that the stock market anticipates their changes in behavior and signals it through rising return volatility. Finally, the increase in firm risk hurts bond prices.

5.7. Additional Robustness Tests

As a robustness check for the measure of pay-for-performance sensitivity, we also use the change in proportion of equity compensation as an alternative proxy of change in pay-for-performance sensitivity. We rerun Table 5 using change in equity compensation proportion as
the new dependent variable and still get positive and significant coefficient for \textit{PROPOSAL} for column (1) (coefficient =0.86, \(p< 0.01\)) and column (2) (coefficient = 0.081, \(p<0.01\)). We also find that the proportion of equity compensation is higher for firms with greater growth opportunities, consistent with Mehran (1995). An alternative way to select control firm is through matching based on industry, size and some key factors to rule out their impact. We repeat the tests in Table 5 by replacing the control firms with a one-to-one matched set of control firms based on the same industry, and on similar size and prior differences in the equity compensation ratio in the pre-proposal period\textsuperscript{21}. We still reach the same conclusions. Therefore, our result is robust with respect to alternative way to define control firms.

Finally, we conduct sensitivity tests to address potential contamination from confounding events. A proxy statement is usually distributed several months after the end of last fiscal year. Often, annual reports have been filed with the SEC a few weeks before proxy statements are filed and publicly distributed. There may be also new information from the quarterly 10-Q filing, earnings announcements, or merger/acquisition announcements after a fiscal year end and surrounding the proxy statement filing dates. To ensure our stock and bond return results are not driven by confounding effects, we rerun stock return and bond return tests for Table 6 and Table 7 respectively after eliminating proposals that have the above potentially confounding events within five days before or after the proxy statement filing dates. The results are qualitatively similar (all p-values are less than 0.06 for t-tests and less than 0.03 for z-tests).

\textsuperscript{21} First, we match each performance-focused pay proposal firm with a control firm based on industry, firm size, and the ratio of equity-based pay to total compensation in the pre-proposal year. If our matching process is good, then we only need to compare the differences in pay-for-performance sensitivity and equity pay ratios between performance-focused pay proposal firms and those with no proposal in the post-proposal period (Model 1). However, it is possible that our matching process may be inadequate in capturing all of the differences between firms in the pre-proposal year. In our second test, we take the difference between the post-proposal equity pay ratio to the pre-proposal ratio for each sample and control firm (Model 2). The independent control variables are measured in the pre-proposal period.
6. SUMMARY AND CONCLUSIONS

Boards of directors are concerned about CEO compensation and firm performance. Our findings show that one special type of proposal – performance-focused shareholder executive-pay proposal (PSP) – has the potential impact of increasing targeted firms’ equity-based (mostly stock options) incentive compensation and aligning shareholder-manager interests.

Results suggest that shareholders have enough sophistication to target firms that pay excess compensation to their managers when filling performance-focused shareholder executive-pay proposals. Boards react to these economically-supported proposals, resulting in significant increases to CEO pay-for-performance sensitivity following the receipt of a PSP. While shareholders react positively, more importantly, bondholders react negatively surrounding the filing dates of those proposals. We find no significant change in expected future cash flows, but document a significant increase in total firm risk surrounding proposals, which is consistent with the differential reaction of shareholders and bondholders.

The implications of the findings are three-fold. First, our study is the first that explores the impact of shareholder’s executive compensation proposals on the wealth of bondholders. We point out a probable conflict of mandates for the SEC when it passes regulation only favoring the interests of equity investors, possibly at the expense of bond investors. We argue that a more balanced approach might be a better choice. What’s more, insights are also relevant to the Canadian securities regulators since they are still contemplating imposing the same “say-on-pay” rules.
Second, activist shareholders who focus on firm performance appear to understand compensation disclosure and the lack of alignment between managers and shareholders induced by a compensation scheme. The results also corroborate The Wall Street Journal’s claim that “executive-pay activism” has been turned “into a potent mainstream force” (Lublin and Dvorak 2007), and is consistent with extant research that shareholder activism has increased its impact on corporate governance and performance (Del Guercio et al. 2008; Ertimur et al. 2010).

Finally, our approach of delineating PSPs and NPSPs sheds new light on shareholder proposal activism and compensation regulation. Collectively, the results of this study and prior studies (e.g. Cai and Walkling 2010) suggest that performance-focused shareholder proposals have influence on boards and top management, while non-performance-focused proposals may not.
REFERENCES


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Figure 1  Shareholder Executive-Pay Proposals (1996-2006)

Panel B: The number of shareholder proposals for S&P 500 companies targeted by at least one performance-focused executive-pay shareholder proposal over the period of 1996-2006. NPSP represents the non-performance-focused proposals. PSP represents the performance-focused proposals.
<table>
<thead>
<tr>
<th>SIC</th>
<th>Industry Description</th>
<th>Sample Firms</th>
<th>Control Firms</th>
<th>Compustat Firms</th>
</tr>
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<tr>
<td></td>
<td></td>
<td>N</td>
<td>%</td>
<td>N</td>
</tr>
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<td>13</td>
<td>Oil and Gas Extraction</td>
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<td>13</td>
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<td>36</td>
<td>Electronic And Other Electrical Equipment And Components, Except Computer Equipment</td>
<td>7</td>
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<td>37</td>
<td>Transportation Equipment</td>
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<td>5.1</td>
<td>5</td>
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<tr>
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<td>Measuring, Analyzing, And Controlling Instruments; Photographic, Medical And Optical Goods; Watches And Clocks</td>
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<td>2.9</td>
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<td>40</td>
<td>Railroad Transportation</td>
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<td>Electric, Gas, And Sanitary Services</td>
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<td></td>
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This table shows the industry distribution of sample firms, control firms, and all Compustat firms. The sample consists of 136 firms that received PSPs over the 1996 to 2006 period. The control firms are all of the remaining S&P 500 firms (262 firms) that did not receive any shareholder executive-pay proposals during the same period. 102 firms from the remaining S&P 500 list are deleted for insufficient compensation data or the fact that they are targeted by non-performance-based shareholder proposals (NPSPs).
<table>
<thead>
<tr>
<th></th>
<th>Mean Sample Firms</th>
<th>Mean Control Firms</th>
<th>Median Sample Firms</th>
<th>Median Control Firms</th>
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</tbody>
</table>

This table summarizes the descriptive statistics for the 136 sample firm-years with at least one PSP, and 1,752 firm-years from the 262 control firms that did not receive any shareholder executive-pay proposals over the 1996 to 2006 time period. Total Compensation is the sum of the CEO’s salary, bonus, stock option grants, restricted stock, and other compensation. ROA is the net income before extraordinary items and discontinued operations divided by total assets. Market Capitalization is the closing price for the fiscal year times the number of common shares outstanding. Leverage is calculated as total liabilities divided by total assets. Shares Outstanding is the number of common shares outstanding as reported by the company. CEO Stock Ownership is the percentage of total shares outstanding, including stock options held by the CEO. Means and medians are provided. T-test (Z-test) is for the differences in means (medians) with significance at the 0.01, 0.05, 0.10 level given by ***,**,* . We follow Cheng and Farber (2008) to examine the difference in means.
Table 3

OLS Regression to Determine Excess CEO Compensation

<table>
<thead>
<tr>
<th>Variable</th>
<th>Estimate (p-value)</th>
<th>Statistical Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>4.486 (&lt;.001)</td>
<td>***</td>
</tr>
<tr>
<td>Log(Sales)</td>
<td>0.380 (&lt;.001)</td>
<td>***</td>
</tr>
<tr>
<td>Market-to-book</td>
<td>0.028 (&lt;.001)</td>
<td>***</td>
</tr>
<tr>
<td>ROA</td>
<td>0.004 (0.095)</td>
<td>*</td>
</tr>
<tr>
<td>Stock returns</td>
<td>0.002 (&lt;.001)</td>
<td>***</td>
</tr>
<tr>
<td>ROA volatility</td>
<td>0.005 (0.233)</td>
<td></td>
</tr>
<tr>
<td>Stock volatility</td>
<td>0.684 (&lt;.001)</td>
<td>***</td>
</tr>
<tr>
<td>Leverage</td>
<td>-0.182 (0.035)</td>
<td>**</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.361</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>5188</td>
<td></td>
</tr>
<tr>
<td>Control of year and industry effects</td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

This table summarizes regression results from estimating Equation (1). The sample consists of 5,188 firm-year observations for all the S&P 500 firms in the period of study, 1996-2006. We compute all the explanatory variables at or for the period ending at year t. Log(TotalComp) is the dependent variable and is the natural logarithm of the CEO total compensation. Log(Sales) is the natural logarithm of Sales. Market-to-book is defined as the market value of equity divided by the book value of equity. ROA is the net income before extraordinary items and discontinued operations divided by total assets. Stock returns is the total stock return in the last year less the median stock return in the same period and same industry (two-digit SIC code). ROA volatility is the standard deviation of ROA over five years. Stock volatility is the standard deviation of daily stock returns over 6 months. Leverage is the total liabilities divided by the total assets.

Coefficients are significant at the 0.01, 0.05, 0.10 level as indicated by ***, **, * respectively.
<table>
<thead>
<tr>
<th>Independent</th>
<th>Predicted sign</th>
<th>(1) Estimate</th>
<th>ΔPredicted Prob.</th>
<th>(2) Estimate</th>
<th>ΔPredicted Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>ExcessComp</td>
<td>+</td>
<td>0.480***</td>
<td>61.62%</td>
<td>0.462***</td>
<td>58.70%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(&lt;.001)</td>
<td></td>
<td>(0.002)</td>
<td></td>
</tr>
<tr>
<td>InternalGov</td>
<td>-</td>
<td>-0.022**</td>
<td>-2.14%</td>
<td>-0.021**</td>
<td>-2.04%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.035)</td>
<td></td>
<td>(0.045)</td>
<td></td>
</tr>
<tr>
<td>ExternalGov</td>
<td></td>
<td>0.157***</td>
<td>17.00%</td>
<td>0.168***</td>
<td>18.32%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(&lt;.001)</td>
<td></td>
<td>(&lt;.001)</td>
<td></td>
</tr>
<tr>
<td>Poor_Indicator</td>
<td>+</td>
<td>0.671***</td>
<td>95.62%</td>
<td>0.674***</td>
<td>96.28%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.001)</td>
<td></td>
<td>(0.001)</td>
<td></td>
</tr>
<tr>
<td>CEO Stock</td>
<td></td>
<td>-0.071</td>
<td>-6.86%</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.190)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CEO Age</td>
<td></td>
<td>0.011</td>
<td>1.13%</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.468)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Log Likelihood</td>
<td></td>
<td>-367.46</td>
<td></td>
<td>-366.17</td>
<td></td>
</tr>
<tr>
<td>Pseudo R²</td>
<td></td>
<td>24.82%</td>
<td></td>
<td>25.08%</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td></td>
<td>1888</td>
<td></td>
<td>1888</td>
<td></td>
</tr>
</tbody>
</table>

The industry and year effects are controlled. Coefficients on the intercept, year and industry indicators are not shown. This table summarizes the logistic regression results of Equation (2), where the dependent variable is equal to one if a firm receives a PSP and zero for all firm-years of the S&P 500 companies that did not receive any shareholder executive-pay proposals during our sample period. There are 136 sample firms and 1752 control firm years. ExcessComp is the prior year residual value obtained from the executive-pay benchmark model in Equation (1). InternalGov is percentage of shares held by the large prior institutional blockholders, whose ownership is higher than 5% of a firm’s outstanding shares. ExternalGov is a Gompers et al. (2003)’s G index, multiplied by -1. Poor_Indicator is 1 if the five-year industry-adjusted stock return is negative and 0 otherwise. ΔPredicted Prob. is the change in the predicted probability that occurs when the independent variable increases one unit in its value and is evaluated at the mean values of the remaining independent variables. The p-values (in parentheses) are based on maximum likelihood standard errors. CEO Stock Ownership is the percentage of total shares outstanding held by the CEO, excluding options. CEO Age is the historical CEO age. Coefficients are significant at the 0.01, 0.05 and 0.10 level as indicated by ***, **, * respectively.
Table 5
Impact of PSP on CEO Annual Equity-Based Compensation Incentives

<table>
<thead>
<tr>
<th>Independent</th>
<th>Predicted Sign</th>
<th>(1) T-1 to T+1</th>
<th>(2) T-1 to T+2</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROPOSAL</td>
<td>+</td>
<td>1.332 ***</td>
<td>1.093 **</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.001)</td>
<td>(0.012)</td>
</tr>
<tr>
<td>Δ(ShareholderWealth)</td>
<td>+/ –</td>
<td>22.377</td>
<td>26.615</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.264)</td>
<td>(0.206)</td>
</tr>
<tr>
<td>Δ(ShareholderWealth_{t-1})</td>
<td>+/ –</td>
<td>-5.994</td>
<td>2.158</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.731)</td>
<td>(0.906)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.345)</td>
<td>(0.528)</td>
</tr>
<tr>
<td>TobinQ</td>
<td>+/-</td>
<td>0.236 ***</td>
<td>0.157 *</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.009)</td>
<td>(0.092)</td>
</tr>
<tr>
<td>NEWCEO</td>
<td></td>
<td>1.029 ***</td>
<td>0.766 ***</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(&lt;0.001)</td>
<td>(0.002)</td>
</tr>
<tr>
<td>ExcessComp</td>
<td>–</td>
<td>-2.292 ***</td>
<td>-2.284 ***</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(&lt;0.001)</td>
<td>(&lt;0.001)</td>
</tr>
<tr>
<td>InternalGov</td>
<td></td>
<td>-0.001</td>
<td>-0.005</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.947)</td>
<td>(0.614)</td>
</tr>
<tr>
<td>ExternalGov</td>
<td></td>
<td>-0.006</td>
<td>-0.054</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.882)</td>
<td>(0.233)</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td></td>
<td>0.145</td>
<td>0.137</td>
</tr>
<tr>
<td>N</td>
<td></td>
<td>1888</td>
<td>1840</td>
</tr>
</tbody>
</table>

This table summarizes the OLS regression results of Equation (4). There are 136 sample firms and 1,752 control firm years in Model (1). There are 131 sample firms and 1,709 control firm years in Model (2). The lost firm years are due to firms that have T+1 yet do not have T+2 compensation data. The dependent variable is the logarithmic transformation of the dollar change in annual stock options and restricted stock grants for a 1% change in the stock price. PROPOSAL is one if a firm received at least one PSP and zero for control firms. Δ(ShareholderWealth) is the change in shareholder wealth for the two year period prior to Year 0. MarketCap is the market value of equity. TobinQ is the market value of equity plus the book value of debt and divided by the book value of assets. We measure these three variables at the beginning of the proposal year. NEWCEO is one if the CEO changed either in the proposal year or the following year and zero otherwise. ExcessComp is the prior year residual value obtained from the executive-pay benchmark model in Equation (1). InternalGov is the sum of the prior institutional blockholder ownership that is higher than 5% of the firm’s outstanding shares. ExternalGov is a Gompers et al. (2003)’s G index, multiplied by -1. Coefficients for intercepts, and year and industry indicators are not shown. ***, **, * significant at a 0.01, 0.05, 0.10 level.
Table 6
Stock Market Reactions to PSPs

<table>
<thead>
<tr>
<th>Sample</th>
<th>N</th>
<th>Mean</th>
<th>Median</th>
<th>t-tests</th>
<th>z-tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full PSP sample</td>
<td>136</td>
<td>0.67</td>
<td>0.57</td>
<td>0.056*</td>
<td>0.029**</td>
</tr>
<tr>
<td>Subsample with valid bond return information</td>
<td>84</td>
<td>0.78</td>
<td>0.57</td>
<td>0.031**</td>
<td>0.038**</td>
</tr>
</tbody>
</table>

This table shows cumulative abnormal stock returns for the full PSP sample (136 firms) as well as its subsample of 84 firms with valid bond return information. The event window is between the 5th trading days prior to day zero, proposal filing date, and the first trading day after day zero. Therefore, the event window is [-5,+1]. The cumulative abnormal stock returns are computed according to the standard event study one-factor model with the CRSP market index.

***, **, * indicate significance at a 0.01, 0.05, 0.10 level.
### Table 7
**Bond Market Reactions to PSPs**

#### Panel A: Bond Returns

<table>
<thead>
<tr>
<th>Sample</th>
<th>Basis Points (1 basis point = 0.01%)</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Median</td>
</tr>
<tr>
<td>Bond Level</td>
<td>541</td>
<td>-10</td>
</tr>
<tr>
<td>Firm Level</td>
<td>84</td>
<td>-19</td>
</tr>
<tr>
<td>Representative Bond</td>
<td>84</td>
<td>-23</td>
</tr>
</tbody>
</table>

This table shows the treasury-adjusted abnormal bond returns for 541 bonds of 84 PSP receiving firms with available trading data in TRACE. The event window is between the 5th trading days prior to day zero, proposal filing date, and the first trading day after day zero. Therefore, the event window is [-5,+1]. We eliminate the observation if the bond did not trade within five calendar days after day 0. We use the latest event date for each firm if the firm has multiple performance-focused proposals in multiple years during the sample period. Firm level bond return is the weighted average of all bond returns for each firm weighted by the issuing amount of each bond for the same firm. A representative bond is the bond with the highest average daily trades within ninety days prior to day zero. If two bonds of the same firm have the same average daily trades, we pick the bond with the highest number of trading days in the nine days prior to day zero. We follow the methodology as recommended in Bessembinder et al. (2009).

***, **, * indicate significance at a 0.01, 0.05, 0.10 level.
Table 8
Change in Stock Return Volatility around PSPs

Panel A: Raw Return Volatility

<table>
<thead>
<tr>
<th>Sample</th>
<th>N</th>
<th>(-30, -1)</th>
<th>(0, +29)</th>
<th>Significance of Difference, P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full sample</td>
<td>136</td>
<td>0.2473</td>
<td>0.2628</td>
<td>0.02**</td>
</tr>
<tr>
<td>Bond sample</td>
<td>84</td>
<td>0.2135</td>
<td>0.2388</td>
<td>&lt;0.01***</td>
</tr>
</tbody>
</table>

Panel B: Market-adjusted Return Volatility

<table>
<thead>
<tr>
<th>Sample</th>
<th>N</th>
<th>(-30, -1)</th>
<th>(0, +29)</th>
<th>Significance of Difference, P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full sample</td>
<td>136</td>
<td>0.2165</td>
<td>0.2346</td>
<td>&lt;0.01***</td>
</tr>
<tr>
<td>Bond sample</td>
<td>84</td>
<td>0.1908</td>
<td>0.2131</td>
<td>&lt;0.01***</td>
</tr>
</tbody>
</table>

Panel A shows the stock return volatility during the 30 trading days before and after the date when firms receive PSPs. The full sample is the proposal sample. The bond sample includes all firms with available bond trading data in TRACE.

Panel B shows the market-adjusted stock return volatility during the 30 trading days before and after the date when firms receive PSPs. The market-adjusted return is defined as the firm’s stock return minus the CRSP equal-weighted market return. The full sample is the proposal sample. The bond sample includes all firms with available bond trading data in TRACE.

***, **, * indicate significance at a 0.01, 0.05, 0.10 level.
APPENDIX
Samples of Shareholder Proposals on Executive Compensation

1. Performance-focused Proposals – Knight Ridder Inc (KRI) 1999

On behalf of the Newspaper Guild, Robert Laramie, 36 Revere Avenue, Moorestown, New Jersey 08057, owner of 590 shares of common stock, has informed the Company that he intends to present the following resolution at the Annual Meeting and has submitted the following statement of his reasons.

RESOLVED: That the shareholders of Knight Ridder Inc urge the Board of Directors to adopt an executive compensation policy that all future stock options grants shall be performance-based. For purposes of this resolution, performance-based stock options are defined as either: (1) stock options with the exercise price indexed to an appropriate S&P 500 peer group index (such as the index used in the Company's annual proxy statement); or (2) premium-priced stock options, which set the exercise price of the option above the current market value of the stock.

SUPPORTING STATEMENT: Compensation policies for senior executives should provide challenging performance objectives and serve to motivate executives to achieve long-term shareholder value. However, stock options grants without performance-based targets can excessively compensate executives for stock increases due solely to a general stock market rise, rather than improved or superior performance. By tying stock option grants to performance goals, such as specific stock price targets or exceeding group indexes, senior executives will be motivated to achieve superior performance, rather than merely meeting the market average. In fact, Knight Ridder stock has consistently under performed its peers over the five-year period between 1992 and 1997.

... Stock options are supposed to align the interests of management with those of the stockholders. But when the options are numbered in the tens of thousands, a relatively small increase in the price of the stock could permit Mr. Ridder to reap millions of dollars, without providing material benefits to the stockholders.

In response to shareholder concern about the lack of strong performance-based forms of executive compensation, companies are increasingly adopting stock option plans that require premium pricing or links to market indexes. According to Executive Compensation Reports, about 16% of the biggest U.S. businesses are granting options with attached performance targets, up substantially from 7% in 1993. Masco, DuPont, Monsanto and Bank of America have recently adopted performance-based stock option plans. Prominent compensation firms, including Pearl Meyer, have also endorsed the concept.

Shareholders of Knight Ridder will be best served if future stock option grants are performance-based, motivating senior executives to achieve superior shareholder returns. For these reasons, we urge a vote FOR this resolution.

RESOLVED, shareholders urge the Board of Directors to adopt a formal policy that a majority or all future stock option grants to senior executives be performance-based on core business operating results. Consistent with this topic, the amount of company pension income is to be subtracted from the financial results that are used to determine future stock option grants, and pension income is to be reported annually on the primary company web site for verification. Performance-based stock options are defined as:
1) Indexed options, whose exercise price is linked to the S&P Aerospace Index shown in the graphs on pages 26 and 27 in the 2002 proxy;
2) Premium-priced stock options, whose exercise price is above the market price of the grant date; or
3) Performance vesting options, which vest when the market price of the stock exceeds a specific target.


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


Walden Asset Management, One Beacon Street, Boston, MA 02108, has notified us that its representative intends to present the following proposal at this year’s meeting:

RESOLVED: that shareholders of General Electric request the board of directors to adopt a policy that provides shareholders the opportunity at each annual shareholder meeting to vote on an advisory resolution, proposed by management, to ratify the compensation of the named executive officers (“NEOs”) set forth in the proxy statement’s Summary Compensation Table (the “SCT”) and the accompanying narrative disclosure of material factors provided to understand the SCT (but not the Compensation Discussion and Analysis). The proposal submitted to shareholders should make clear that the vote is non-binding and would not affect any compensation paid or awarded to any NEO.