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Shareholder Influence over Director Nomination via Proxy Access: Implications for Agency Conflict and Stakeholder Value

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Abstract

Corporate governance research indicates that corporate boards of directors may be overly beholden to management, which can be detrimental to firm value creation. Drawing upon agency theory and the governance law literature, we examine the effects of a new SEC rule designed to lessen managerial power by increasing large, long-term shareholders' influence in the director nomination process. We predict and find support for a positive overall market reaction to the rule's announcement as well as a greater reaction for firms with characteristics that suggest compromised board independence or greater CEO control. Moreover, we examine the implications of greater shareholder voice for another key stakeholder group, firm bondholders, and find evidence that it is also value increasing. We conclude by discussing important implications for theory and practice.

Keywords: agency theory, board of directors, proxy, regulation, corporate governance

Introduction

Corporate governance occupies a central role in many academic disciplines. Management, accounting, economics, finance, and legal scholars, among others, examine the relationships between parties of interest to corporations, such as managers, owners, and creditors. To date, these collective efforts have concentrated around agency theory (Dalton *et al.*, 2007), which emphasizes the potential costs arising from the separation of management and ownership in public corporations (Jensen and Meckling, 1976; Eisenhardt, 1989). However, the empirical evidence related to agency theory and the efficacy of the specific alignment or policing mechanisms aimed at mitigating agency costs—the residual loss of firm value as a result of managerial opportunism—is weak (see Dalton *et al.*, 2003; Dalton *et al.*, 2007). Thus the debate related to our understanding and conceptualization of the agency problem and related policy mechanisms grows. In fact, the debate among legal scholars, which pits two different conceptualizations of corporate governance against one another (Lan and Heracleous, 2010), has more recently grown heated (see Bebchuk, 2007; Stout, 2007, 2008; Strine, 2006).

The theoretical foundations of this debate relate to the primacy of the various stakeholders in the corporation and the resulting role of the board of directors. In accordance with the traditional governance model, the so-called shareholder primacy model reasserts that shareholders are the legal owners of the firm in that they hold the rights to any residual value, and thus hold primacy over any other stakeholder in the corporation (Bebchuk, 2005; 2006; Eisenhardt, 1989). In this view, the role of the board of directors is to represent the interests of the owners and steer management into making decisions in the best interests of the shareholders, to whom they have fiduciary duty (Hart, 1993). As such, Bebchuk (2006) argues that shareholders must wield strong influence over directors, including their nomination and appointment to the board. The alternative model, dubbed the stakeholder or director primacy model (e.g., Bainbridge, 2003; Blair and Stout, 2001; Strine, 2006), asserts that all stakeholders (i.e., management, shareholders, creditors, employees, customers, etc.) join in team production; thus, the objective of the corporation is to maximize the "risk-adjusted returns" to all participants (Lan and Heracleous, 2010: 298). In this view, the board is viewed as a legally independent entity, which mediates the interests of all stakeholders (Blair and Stout, 2001). These two perspectives differ in several respects, yet they share a common interest: value creation. While the shareholder primacy view promotes value creation for the shareholder, the director primacy model argues for value creation for the corporation as a whole. However, we argue that neither approach will reach its goal if top management, arguably the most powerful of all stakeholder groups, is not adequately controlled. Evidence suggests that all other stakeholders are at a great disadvantage *vis-à-vis* management because of the board nomination process. Prior research suggests that the nomination (and thus election) of directors to the board is largely influenced by the firm's executives (Westphal and Zajac, 1995), and existing board members have limited influence on the selection of future nominees (Lorsch and MacIver, 1989). While recent regulatory changes now require nomination committees to be composed entirely of independent directors, the nomination of new directors is still susceptible to management's influence (see Worthen, 2011, for a recent example). Shareholders merely vote between different nominees, while any more aggressive action is quite difficult and costly (e.g., a proxy fight). Even further removed, other stakeholders simply have no voice in director nomination or election. As a result, nominated directors "run unopposed and their election is thus guaranteed" (Bebchuk, 2003: 44). In fact, Westphal and Zajac (1995: 60) argue that "[w]hile a variety of factors may facilitate management control over the board, the chief executive officer's (CEO's) dominance over the director selection process has often been considered a primary source of management control." As such, we propose that nonmanagement stakeholders suffer when the board fails to control management and, conversely, can benefit when the board nomination process allows more direct involvement of one key stakeholder group—the firm's shareholders.

As the debate among legal scholars has increased, more stringent regulatory policy has begun to take shape. On the heels of the recent near collapse of the financial sector, the Securities and Exchange Commission (SEC) took several decisive steps to redress public concerns over the vigilance and loyalties of directors. While the passage of the Sarbanes-Oxley Act of 2002 (SOX) increased the independence of directors, the primary means by which shareholders can counter the top managements' influence over board composition, proxy access, was not addressed by SOX. To remedy this, on 25 August 2010 the SEC passed a new proxy access rule, aiming to allow large, long-term shareholders—who own at least three percent of the firm's stock continuously for three years—to directly nominate potential directors, thereby providing shareholders greater influence in the nomination process and over the composition of the board.

Taking the rule's passage as an exogenous shock and using this setting as a natural experiment (Meyer, 1995), we investigate the stock market's reaction to this increase in shareholder influence. Beyond documenting the market's positive response to this event, we develop a theoretical model explaining why the market's reaction varies based on the firm's governance traits. Specifically, we draw upon agency theory to predict that the market's reaction will be contingent on the firm's board characteristics and the degree of managerial control. We find strong empirical support for our framework. Moreover, we investigate whether greater shareholder power over

director nomination is viewed positively by another important group of firm stakeholders—its creditors. If providing influence to shareholders is part of a zero-sum game and other stakeholder groups are likely to be hurt by greater shareholder control over the board, bondholders would react negatively. Contrary to this position, though, we predict and show that bondholders react positively to this change; as such, it appears that decreasing the power of management to co-opt the board benefits both shareholders and creditors.

In total, this research offers several contributions. First, we integrate the growing debate in legal studies with management's treatment of corporate governance. Beyond the approach of Lan and Heracleous (2010), who pertinently describe the director primacy model, our approach offers a more balanced treatment of this debate and provides data focused on proxy access as it pertains to board nominations. Second, this study contributes to the debate in law by showing that governance regulations that enhance shareholder voice are in fact value enhancing, as they help overcome managerial power. Specifically, we see that benefits to other stakeholders (i.e., creditors) accrue when shareholders gain greater control of director nominations, suggesting that this control increases "the size of the pie for all," rather than benefiting one nonmanagement stakeholder group at the expense of another. Third, our study offers important implications for agency theory. While the theory's empirical record has been questioned in recent years, we demonstrate that the theory continues to have predictive power. When shareholders gain greater influence in the nomination of directors, thereby limiting top management's influence over the board, additional value is created, and shareholder influence in nomination is most valuable when effective governance is challenged. Thus our work adds support to agency theory. Next, this work contributes important insights to the long stream of agency theory work on the shareholder-bondholder conflict (e.g., Black and Cox, 1976; Fama and Miller, 1972; Jensen and Meckling, 1976; Modigliani and Miller, 1958; Shleifer and Vishny, 1997). Finally, our theory and results provide insights that may aid policy makers in helping to determine the appropriate approach to governance regulations, especially as they relate to proxy access.

Theory and hypotheses

The role of the board, governance oversight, and board accountability

The agency problem arises when an organization's ownership and management are separated. The goals and desires of owners and managers conflict, and shareholders cannot effectively monitor managerial work (Eisenhardt, 1989). Jensen and Meckling (1976) provide a formal derivation of agency costs, which include the monitoring and alignment expenditures borne by the owner/principal, as well as the residual loss to firm value that results from the agency conflict. Corporate governance scholars have since focused on investigating a number of alignment and policing mechanisms aimed at reducing this residual loss to firm value. The three primary mechanisms are: 1) the external market for corporate control, 2) incentive alignment through executive compensation, and 3) monitoring by an independent board of directors (Dalton *et al*., 2007). Herein, we focus on the third mechanism— board monitoring.

According to the shareholder primacy model of corporate governance, boards of directors have a fiduciary responsibility to the firm's shareholders and are thus charged with protecting and promoting shareholder interests. In order to better support this mandate, SOX increased the independence of corporate boards. As such, boards are now largely outsider-dominated, which—in theory—should make them independent of management and thus more vigilant monitors for shareholders.

However, more recent research suggests that independence alone does not dictate a board's effectiveness at monitoring (Tuggle *et al*., 2010a). And, as Bebchuk (2003: 44) argues, "(a)lthough shareholder power to replace directors is supposed to be an important element of our corporate governance system, it is largely a myth." Thus, some corporate law scholars argue that the next step in solving the problem of ineffective monitoring is greater shareholder voice in firm governance. One side of the debate—aligned with the shareholder primacy view of governance—argues that increasing the power and voice of shareholders in the matters of governance, including shareholder access to the proxy ballot (e.g., Bebchuk, 2003; 2005; 2006), would lead to long-term value maximization. It therefore argues that

shareholder voice-enhancing regulation adds value to the firm. The opposite side of the debate—aligned with the director primacy view of governance—advocates that shareholders in general lack both the information and the proper incentives to make the most optimal decisions for the firm (Bainbridge, 2006; Strine, 2006); as such, broad attempts at regulating governance via increased shareholder power are value destroying. However, as Bhagat and Romano note, "the goal of corporate law is to increase shareholder wealth;" thus the disagreements among legal scholars are not focused on the end but "over the means to achieve that end" (2002b: 380). In other words, what these two views share is the desire for value creation (Bratton and Wachter, 2008) supported by vigilant and effective boards. In reality, however, evidence of poor board monitoring abounds (Dalton *et al*., 2007). While extant research shows that directors are subject to various sociopolitical influences, such as social distancing (Westphal and Khanna, 2003), director ingratiation (Westphal and Stern, 2007), and friendship ties between directors and the CEO (Westphal, 1999)—all of which can undermine the independent stance of the board—it is likely that the initial nomination process compromises a director's independence from the outset, as the nomination of a potential director to the board can be strongly influenced by top management, and especially by the CEO (Chidambaran, Liu, and Prabhala, 2010).

Indeed, extant research suggests that the firm's top management plays a major role in determining the composition of the board (e.g., Lorsch and Maclver, 1989; Shivdasani and Yermack, 1999; Wade, O'Reilly, and Chandratat, 1990; Westphal and Zajac, 1995). As such, the stance of the board as either a shareholder advocate or an arbiter of all stakeholder interests is compromised, as directors may be prone to pursuing their own best interests (Certo *et al*., 2008), which are often tied to those of the CEO and other top managers due to the nomination system (Kumar and Sivaramakrishnan, 2008). Although in the post-SOX era nominating committees must be composed of independent directors, if "a group of current independent directors who are excessively amenable to management's wishes are on the nominating committee, and if they informally consult with and accede to the chief executive's preference about possible candidates, they may continue to nominate like-minded directors" (Clark, 2005: 268–269). In practice then, foregoing a costly proxy fight, shareholders have little choice but to vote for the proposed slate of directors.[1] Placed in an even weaker position, the firm's other stakeholders have no influence over the director nomination or voting process. As such, despite the legislative efforts to increase director independence, the struggle of stakeholders to create greater separation between the board and the firm's management is still limited by the nomination and renomination processes.

We contribute to the conversation on the role of law in corporate governance and extend agency theory by investigating the market's reaction to a new rule designed to increase large, long-term shareholders' influence in director selection. Specifically, we examine whether greater ability of some shareholders to nominate potential board members is important to firm value, explicate what firm characteristics suggest greater potential for additional value creation, and investigate whether granting such shareholders more influence over board nomination is value enhancing to another key group with a legal stake in the corporation— the firm's bondholders.

The empirical context

Because our study utilizes a natural experiment, it helps to summarize the context and the events leading up to the rule's passage. The SEC's 25 August 2010 adoption of a new proxy access rule is directly related to the recent U.S. financial crisis, which is commonly viewed as the result of a systemic failure of current governance systems. In 2006, a shareholder of the insurance giant American International Group (AIG) submitted a shareholder proposal to amend AIG's corporate bylaws so that a three percent shareholder could place a nominee in AIG's annual proxy materials. AIG contested this proposal in federal court arguing that corporations have traditionally been allowed to exclude proposals of this kind. The U.S. Federal Court of Appeals based in New York City, however, overruled AIG's objections, and thus opened up the possibility that broader director election proxy access could proceed on a case-by-case or company-by-company basis (AFSCME v. AIG, 2006).[2] Moreover, there also existed the possibility that individual states could

1. Bebchuk (2007) discusses in detail the dismal statistics regarding challenging the proposed slate of directors, including the relatively low number of challenges and the low chances of winning a proxy fight. One of the greatest impediments to proposing and electing an alternative slate of directors is very high costs to shareholders.

selectively alter proxy access rules for corporations subject to their state corporate codes.[3]

Fearful that this important issue would be addressed on a piecemeal and/or regional basis, Congress explicitly gave the SEC the power and authority to promulgate national rules on this subject in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was first introduced in the House in December 2009 and enacted in July 2010 (Dodd-Frank Act, section 971, 2010).[4] According to the SEC, the agency took decisive action because of severe concerns expressed by many shareholders about board accountability and responsiveness to shareholder interests (SEC, 2010). The regulators were also concerned about the extent to which public trust was damaged in the aftermath of the financial crisis. More pointedly, the SEC questioned "whether boards were exercising appropriate oversight of management" (SEC, 2010: 7); thus, it appears that the SEC acknowledged that if boards were to become true champions of shareholder and other stakeholder interests, the current corporate governance system needed further revision.

The SEC also recognized that "[a] *principal way* that shareholders can hold boards accountable and influence matters of corporate policy is through the nomination and election of directors" (SEC, 2010: 8; emphasis added). Taking into account the authority given to it by Congress, the SEC actively solicited public comments on proposed amendments designed to address this issue. Based on this feedback, the SEC ultimately voted to adopt proxy access rules that would allow three percent shareholders who have held their shares at least three years to nominate their own candidates for the board of directors (SEC, 2010). The passage of this rule represented an exogenous event, as the SEC did not approve nor announce the final rule until 25 August 2010. Moreover, the final vote in favor of the new rule was very close, 3–2, attesting to the lack of certainty surrounding this event before the announcement.

Next, we discuss our theoretical predictions regarding the impact of this ruling on shareholder value. In general, we expect the rule to have the most positive effect on shareholder value in firms with the following attributes: ownership structures that will allow multiple shareholders to benefit from proxy access, boards that are currently aligned with managers, and characteristics that imply a high degree of managerial control.

Director nomination and shareholder influence

Agency theory is fundamentally a theory about power and influence, and in order to understand corporate strategic leadership, it is important to identify the distribution of power and influence between corporate boards and CEOs (Finkelstein, Hambrick, and Cannella, 2009). The relationship between shareholders and the boards of directors is even more complex than often suggested by agency theory due to the CEO's influence over the director nomination process and the resulting loyalty dynamics between the board and the CEO. In theory, shareholders elect board members to represent the shareholders' interests. Board members then hire a CEO to lead and manage the firm under continuous and effective monitoring by the board. However, with the traditional nomination and renomination process in place, directors can be co-opted by the CEO, which compromises their ability to monitor effectively. Research shows that CEOs are prone to influence the election of directors who are sympathetic to their wishes and to whom they have other (e.g., social or familial) ties (Shivdasani and Yermack, 1999; Wade *et al*., 1990).

Moreover, the current system of director nomination allows CEOs to compromise the integrity of directors' allegiances, even those who are not initially sympathetic to management. Social exchange theory (Blau, 1964; Emerson, 1976) proposes that individuals feel obligated to repay the benefits they receive from others in the course of their relationship. Those who fail to provide a benefit in return may fall victim to various social sanctions, distrust, denial of future benefits, as well as decreased reputa-

2. AFSCME v. AIG. 462 F. 3D 121 (2nd Cir. 2006).

3. In 2009, the state of Delaware (where most firms are incorporated) passed an amendment to current law that allowed corporations to *voluntarily* permit shareholder proxy access, thereby ratifying the status quo. Shortly thereafter, the Delaware Bar Association communicated to the SEC that because of the new law, all action to introduce proxy access regulation at the federal level should be halted. Nevertheless, in May 2009, the SEC announced a draft of a new proposed national rule, which would allow shareholders to nominate their own director-candidates if they held one, three, or five percent of the firm's shares—depending on the size of a company—for at least one year.

4. The Act did not in any way require the SEC to adopt new rules or regulations permitting shareholder proxy access to nominate directors; it did, however, clearly and directly place the issue in the SEC's jurisdiction.

tion (Gouldner, 1960). Thus, once an individual receives critical resources from another, he or she will attempt to reciprocate, resulting in a *quid pro quo* relationship. Because directors largely owe their positions to the top management, especially the CEO, it is likely that such social exchange relationships exist between directors and the managers whom they are supposed to monitor. As board appointment leads to greater status within the corporate elite, a director likely feels obligated to reciprocate for the directorship opportunity, which may result in showing executives more considerate treatment. Shareholders, then, may often be engaged in a "tug-of-war" with the CEO for the loyalty of directors. Historically, the CEO has wielded the power to most strongly influence this struggle.

However, allowing shareholders to directly nominate director candidates provides an important tool in fighting cronyism between the CEO and the board (Ryan and Schneider, 2002). Not only is the shareholder-nominated candidate not ingratiated to the CEO, she/he is unlikely to be sympathetic to management's agenda unless that agenda is aligned with shareholder interests. Providing more power and influence to the owners of the firm to nominate corporate directors helps enact relationships that better serve owners' interests, reducing agency costs, and leading to more effective governance, which enhances value creation. Thus, we predict that greater influence over the process of new director nomination via proxy access will elicit a positive response from the market. We also expect that the change in shareholder value will be especially pronounced for firms where multiple owners are able to benefit from this enhanced sphere of influence—that is, where a greater number of shareholders meet the two requirements for proxy access (3% ownership and three-year holding period).[5] Therefore:

> Hypothesis 1a: Granting owners greater influence in the process of director nomination will elicit a positive market reaction.
>
> Hypothesis 1b: As the number of owners receiving greater influence in the process of director nomination increases, the greater the change in shareholder value in reaction to the new rule.

Board characteristics and value creation

One of the firm characteristics indicative of lower shareholder rights and weak governance is the firm's use of a classified ("staggered") board structure. A classified board provision usually only allows one-third of the board to be elected each year for a three-year term. This is an important "delay" provision in the event of a corporate takeover (Gompers, Ishii, and Metrick, 2003), and, as such, limits the effectiveness of the market for corporate control. In fact, a number of firms turned to this provision in the 1980s during the wave of corporate takeovers; since then, the adoption of this provision has been widely criticized by shareholders, who view it as a mechanism for director and management entrenchment (Sundaramurthy, Rechner, and Wang, 1996). Studies show that the adoption of classified board amendments has a significant negative effect on stock prices and suggest that this provision increases the bargaining power of management to the detriment of shareholder wealth (Pound, 1987). A recent study provides further evidence implying "that staggered boards at least partly cause, and not merely reflect, a lower firm value" (Bebchuk and Cohen, 2005: 411).

The presence of a classified board serves as a negative signal of the firm's governance quality; because of this, firms with classified boards have often been featured on the CalPERS' "Reform Focus List" of companies targeted for poor governance practices. Sundaramurthy *et al*. (1996) found that institutional ownership significantly reduces the likelihood of adoption of a classified board, suggesting that major shareholders are opposed to this practice. In fact, despite increasing numbers of advisory shareholder resolutions recommending the dismantling of existing staggered boards, boards overwhelmingly choose not to implement these majority-passed resolutions (Bebchuk, 2005). As such, viewing board structure through the lens of agency theory as the outcome of a

5. We thank a thoughtful reviewer for pointing out that ownership concentration may make the firm easier to monitor. However, including a measure of, for example, percentage of firm shares held by institutions (as a proxy for ownership concentration) would mask the effect of how many owners would be eligible to gain proxy access and thus benefit from the new rule. Moreover, if concentrated ownership *per se* indeed makes the firm easier to monitor, making the impact of the rule smaller, we would expect the opposite finding—a greater number of three percent owners leading to lower (less positive) change in shareholder value.

bargaining process between shareholders, managers, and the board, firms with a staggered board structure reflect the primacy of managerial interests over the owners' interest. Such structures suggest higher director entrenchment and greater loyalty of directors toward management rather than shareholders. Therefore, we expect that granting owners greater influence over the process of director nomination will be received even more positively if the firm has a classified board structure, as the rule is expected to bring more salutary changes in firms with entrenched directors and/or managers. Formally:

> Hypothesis 2: The presence of a classified or "staggered" board will be positively related to the change in shareholder value in reaction to the new rule.

Another important factor affecting the strength of board monitoring is the composition of the board in terms of the affiliation of each director. Although "[b]oard composition has been recognized as one of the most significant board dimensions for some time," (Finkelstein *et al*., 2009: 231), the majority of extant research has adopted a simplified categorization of "insider" (i.e., employee of the firm) and "outsider" directors (Finkelstein *et al*., 2009). Outside directors are assumed to be more vigilant, as they are not under the direct influence of the CEO; as such, they are more willing to make independent decisions and, if necessary, take action against management. However, as discussed previously, ample evidence suggests that CEOs exert major influence over the process of new director selection (Westphal and Zajac, 1995). Thus, independence alone may not prevent ingratiation between the CEO and directors. In fact, some research suggests that the percentage of directors who were appointed after the CEO began his or her tenure reflects an aspect of CEO power (Takacs Haynes and Hillman, 2010). By extension, boards with a greater percentage of outside directors who were appointed *before* the CEO assumed position (i.e., "true outsiders") have a lower potential for agency costs due to lower CEO influence over the board, and are thus more effective at monitoring and controlling the CEO. As such, increasing shareholder power and influence to nominate future directors will be comparatively less beneficial to shareholders of firms with a high proportion of true outsiders on the board—where a large proportion of the board was elected before the CEO, the directors are unlikely to feel indebted to the CEO for their positions. Therefore, firms with a higher percentage of true outsiders on the board will experience smaller changes in shareholder value in reaction to the proxy access provision. Formally:

> Hypothesis 3: The percent of true outsiders on the board will be negatively related to the change in shareholder value in reaction to the new rule.

CEO control, agency costs, and shareholder value

Ownership dispersion lies at the heart of the agency problem (Jensen and Meckling, 1976). The agency theory literature recognizes that shareholders are not a uniform group, and there may be a divergence of interests among shareholders, in addition to the divergence of interests between owners and managers. This is perhaps most prominent in the case of shareholders who are also top managers and those who are not. Certainly the majority trend is for firms to issue equity compensation to top executives, which creates a separate class of manager-owners, who can use this granted status to exert their power over other owners, and more directly, over corporate directors. While firm equity is aimed to serve as an alignment mechanism when managers make firm strategic decisions, "stock ownership can also be an important source of power for the CEO" (Westphal and Zajac, 1995: 71). In the context of board nomination, it creates an unintended consequence of granting managers additional influence.

Consistent with this argument, CEO equity ownership has been proposed as an indicator of CEO power (Finkelstein, 1992; Takacs Haynes and Hillman, 2010; Weisbach, 1988), and recent research points to negative firm outcomes associated with high CEO ownership (Walters, Kroll, and Wright, 2008). In large public corporations, even relatively low levels of ownership can translate into significant influence (directly or indirectly) over firm decision making. CEOs with relatively large equity stakes may have the necessary power to engage in behaviors that limit board involvement and allow such CEOs to become entrenched in their executive position (Fama and Jensen, 1983; Lorsch and MacIver, 1989). As Fiegener (2005: 634) notes, CEOs "holding larger ownership

stakes may feel empowered" to protect their discretion over firm decisions from board interference. Managers have a unique advantage over other owners, as they have access to private information and are shielded by mechanisms that promote information asymmetry between themselves and other owners. Thus, if an owner is also a top manager, he or she can use his or her ownership share to motivate key decisions and keep board involvement at arm's length. Thus, somewhat paradoxically, firm ownership can create a secondary set of agency costs related to the additional power it grants the manager, while preserving information asymmetry, resulting in CEOs being better able to pursue their desires. This effect is compounded by the fact that top managers are routinely able to influence who monitors them. As such, increasing owners' power and influence in director nomination should result in greater positive change in shareholder value when CEO ownership power is higher.[6] Therefore:

> Hypothesis 4: CEO ownership power will be positively related to the change in shareholder value in reaction to the new rule.

Some environments and circumstances allow top managers more discretion than others (Carpenter and Golden, 1997). According to Hambrick and Finkelstein (1987), managerial discretion has three distinct sources: industry and external environment characteristics, organization characteristics, and the executives' personal characteristics. We restrict our examination to the organizational characteristics that serve as a source of discretion (i.e., firm-level discretion), which can be defined as "the degree to which the organization is amenable to an array of possible actions" (Finkelstein and Hambrick, 1990: 489). Shen and Cho (2005: 844) further refine managerial discretion as the latitude of actions—"the range of strategic options available to managers as they strive to bring about organizational outcomes"—and the latitude of objectives, or the freedom of managers to pursue personal goals. The strategic management literature has predominantly discussed and treated discretion from a neutral or positive standpoint, which corresponds to the view of discretion as the latitude of actions (e.g., Hambrick and Abrahamson, 1995). In this view, higher discretion simply provides managers greater range of strategic options. However, the economics and agency literatures conceptualize managerial discretion as the latitude of objectives (e.g., Williamson, 1963; Jensen and Meckling, 1976).

According to agency theory assumptions, managerial discretion often leads to shirking and self-serving behaviors on the part of managers to the detriment of shareholders (Phillips *et al.*, 2010). High discretion allows managers to pursue personal goals and objectives with a low probability of getting caught (Shen and Cho, 2005). As Finkelstein and Boyd (1998: 180n4) note, "agency theory perspective on managerial discretion focuses on the potential decision-making freedom of high discretion CEOs and implies that such freedom will promote non-profit-maximizing choices by the CEO." Therefore, a CEO's level of discretion can be viewed through an agency theory lens as an indicator of agency costs—the higher the managerial discretion, the higher the potential for agency costs; that is, the potential for self-interested behavior is higher when the CEO's discretion is high. The agency perspective suggests that when CEO discretion is higher, the presence of uncompromised and vigilant monitors is especially important, as more vigilant directors will be more likely to engage in closer monitoring/control behaviors. Thus, we expect the change in shareholder value to be greater when a CEO has a high level of discretion.

Moreover, we do not expect this effect to be entirely linear or monotonic; specifically, we expect an even higher market reaction for firms led by CEOs with relatively high levels of discretion. This is because when CEO discretion reaches high levels, CEO actions become less observable; as such, directors may not be able to engage in effective oversight. If this ability gets significantly impaired, the board may be able to intervene only when inappropriate conduct and managerial opportunism is uncovered. When this occurs, the presence of monitors who act on behalf of shareholders and are willing to punish executives (e.g., through pay cuts or even termination from the firm) is required. Research shows that boards are

6. If the incentive effect of equity ownership dominates the effect of increased CEO power, we would make the opposite prediction—that a less positive change in shareholder value will occur when CEO ownership is higher. While based on prior literature we expect that the power effect will dominate in this context, our empirical tests will help to determine if this is, in fact, the case. We thank a thoughtful reviewer for pointing out this possibility.

generally unwilling to engage in the types of actions that threaten managerial interests (e.g., Westphal and Khanna, 2003), which is perhaps not surprising given that the current director nomination process relies heavily on top management's selection of director candidates. Thus, the ability to nominate monitors to the board will be even more critical when the CEO has a high level of discretion.

> Hypothesis 5: CEO discretion will be positively related to the change in shareholder value in reaction to the new rule, and even more so at high levels of CEO discretion.

In addition to high CEO power and discretion, other firm characteristics related to CEO control can be indicative of higher potential agency costs, such as the type of resources controlled. While the strategic management literature often highlights the positive results of resources (e.g., Sirmon, Gove, and Hitt, 2008; Sirmon *et al*., 2010; Sirmon, Hitt, and Ireland, 2007), governance scholars recognize that certain types of resources can create oversight problems, resulting in increasing agency costs. For example, Jensen (1986) highlights the agency costs of free cash flow, which can allow managers to engage in gratuitous expansion of the firm referred to as "empire building." Agency theory also points to the downside of high levels of intangible resources within a firm: as the tangibility of the firm's assets decreases, agency costs increase (Bathala, Moon, and Rao, 1994; Gompers, 1995). Specifically, the less tangible the rent-generating resources, the higher the potential for agency costs related to CEO opportunistic behavior: shirking and misappropriating company funds. Moreover, firms with comparatively less tangible resources are subject to greater information asymmetries (Harris and Raviv, 1991). Due to these information asymmetries and the difficulty in finding appropriate benchmarks, CEOs of firms with higher levels of intangible resources enjoy greater latitude for decision making, which makes board monitoring more difficult. Because "intangible assets are harder to monitor and easier to steal," firms with relatively higher levels of intangibles require stricter governance standards (Durnev and Kim, 2005: 1474). As such, the potential for agency costs is higher as resource intangibility increases, making shareholder power and influence over director nomination and selection all the more important. Therefore, we propose:

> Hypothesis 6: Resource intangibility will be positively related to the change in shareholder value in reaction to the new rule.

Shareholder voice and bondholder value

Proponents of the director primacy model tend to argue that granting shareholders greater influence over the board will be detrimental to all other stakeholders' interests. Greater shareholder voice through proxy access may thus have important implications for another key group of nonmanagement stakeholders—the firm's bondholders. Similar to shareholders, bondholders are external stakeholders with a legal claim against the firm, making the two groups similar "in kind." As Shleifer and Vishny (1997: 737) note in their seminal review, "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." Questions dealing with the value of claims of shareholders and bondholders, the two key suppliers of firms' financial capital, are then central to corporate governance theory. Importantly, although shareholders and bondholders are similar "in kind," the two groups are fundamentally different in their rights—stockholders have the right to residual claims, but have the lowest priority in bankruptcy, while bondholders only receive a fixed payment, but have priority when the firm goes into default. The tension these different rights create has often been highlighted as shareholder-bondholder conflict in the agency theory literature (e.g., Black and Cox, 1976; DeFusco, Johnson, and Zorn, 1990; Fama and Miller, 1972; Jensen and Meckling, 1976; Modigliani and Miller, 1958; Subramaniam, 1998). In general, the literature usually argues that—when given opportunity— each group will prefer actions that benefit themselves, even at the cost of the other group's welfare. For example, shareholders may opt for pursuing risky projects because they share in the upside, while creditors are forced to disproportionately bear the costs of failure (Shleifer and Vishny, 1997). This suggests that bondholders would be sensitive to regulatory changes that benefit the position of shareholders *vis-à-vis* bondholders. However, if rule changes allow some shareholders a tool to reign in management—who are arguably the most powerful of stakeholders—bondholders are likely to react positively, as this decreases management's ability to extract firm value at the expense of all other stakeholders.

As Bebchuk (2003: 63) points out in reference to the relative distribution of power, "there is no reason to expect that reduced accountability to shareholders would translate into increased attention to stakeholders." In fact, reduced accountability is likely to lead to less attention paid by management to the concerns of non-management stakeholders. If, as we argue, the current governance system is compromised, the distribution of claims between shareholders and bondholders is not Pareto efficient; this means that creating greater separation between the board and management can reduce agency costs and be value enhancing, thereby benefiting both share- and bondholders. Thus, balancing the influence of management by granting shareholders greater voice in the director nomination process will be perceived favorably by creditors. Therefore:

> Hypothesis 7: Granting shareholders greater influence in the process of director nomination will elicit a positive bondholder reaction.

Methods

Sample and data

Our sampling frame is publicly traded firms from Standard & Poor's (S&P) 500. Consistent with event study methodology, we eliminated firms that experienced other major events during the study period (McWilliams and Siegel, 1997). Using Lexis-Nexis, we identified firms with confounding events.[7] Firms with missing data were also excluded. The final sample consists of 392 firms.

Daily equity and bond returns, both for the sample firms and additional firms that were used to construct the market index (as explained below), were collected from Datastream. Next, institutional ownership data were collected from Thompson Financial's Institutional Ownership database. Lastly, data reflecting the firms' governance characteristics were obtained from Risk Metrics (formerly IRRC). Other firm-level variables were collected from Compustat.

Dependent variables

The market's reaction to the new SEC proxy access rule (Hypothesis 1) and the change in shareholder value for each individual firm (remaining hypotheses) serve as the dependent variables. The *change in shareholder value* "is the unexpected percentage change in the stock price surrounding the event, or the abnormal return" (Godfrey, Merrill, and Hansen, 2009: 433) for each firm. The average of all abnormal returns in the sample represents the *market reaction*.

Abnormal returns enable investigators to isolate the impact of an event by controlling for the expected return. The expected return, by definition, is the return that would be expected *without* the event. However, because the SEC rule change impacts all public firms in the United States, an expected return cannot be calculated based on U.S. markets; instead, we require a market index not be influenced by the event. Following Zhang (2007), who studied the U.S. market's reaction to the passing of SOX, which also affected the entire U.S. market, we use a market index of Canadian firms to calculate expected returns. Because Canadian firms are not subject to the new SEC rule, they should not react to the announcement of the new rule; at the same time, they are influenced by a similar set of worldwide macroeconomic conditions and are exposed to a substantial proportion of common economic news (e.g., Eun and Shim, 1989). Moreover, of all large stock markets, the Canadian market is the most closely related to the U.S. market.[8] As such, publicly traded Canadian firms are utilized to calculate the expected return. Specifically, we calculate the market index as an equally weighted portfolio of all Canadian firms with nonmissing returns in Datastream for both the estimation and event periods.

Next, we identify the appropriate "event window." While a two-day window is commonly used to address information leaking into the market, for several reasons, a one-day event window is better suited for this research. First, the SEC neither

7. Specifically, we dropped firms that announced: dividends, repurchases, or earnings (seven firms), gaining or losing large contracts (five firms), merger and acquisition events (nine firms), newly issued patents (three firms), naming a new executive/ officer (six firms), or major legal issues (two firms).
8. The correlation has been estimated at 0.62, and the next highest correlation at 0.27, with the U.K. stock market (Roll, 1992). More recently, Zhang (2007) reports a U.S.-Canadian return correlation of 0.78.

approved nor announced the rule until 25 August 2010. Second, there was no widely held expectation of the outcome of the vote in advance. Competing arguments for and against the measure were well known, and thus the outcome was uncertain. In fact, the vote was tight (3–2 in favor), indicating a lack of consensus on the part of the decision makers. In total then, the outcome was an exogenous event that was not predictable before the announcement. Finally, because as the length of the announcement window increases so does the noise-to-information ratio, a one-day event window is strongly recommended for use in event studies in corporate law (Bhagat and Romano, 2002a). As such, we restrict our event window to the day of the announcement,[9] which reduces noise and potential bias, providing a conservative yet accurate estimate of the market's reaction. Following convention, the return on firm *i*'s share price on day *t* is calculated as:

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}$$

where a_i is the intercept term (reflecting the average return for the firm's stock with no market movement; Godfrey *et al*., 2009), β measures the stock performance relative to the market, $R\mathrm{m}_t$ is the rate of return on a market portfolio on day t , and ε_{it} is the error term, or the abnormal return. Therefore, the abnormal return or *change in shareholder value* is represented by:

$$AR_{it} = R_{it} - (\alpha_i + \beta_i R_{mt})$$

where a_i and β_i are coefficient estimates from an ordinary least squares regression of R_{it} on the market model over the estimation period before the event; using an approach similar to Godfrey *et al*. (2009), we use the daily returns over the period beginning 130 days prior to the event, ending 10 days before the event date. The abnormal return reflects the market's reaction to the announcement, adjusting for the predicted or "normal" return for that day.

To test the hypothesis regarding bondholder reaction, we gathered bond return data on our final sample of 392 firms; 330 firms had sufficient data to be included in the analysis. We then adjusted the returns based on comparable bonds in the Canadian market. Following Bessembinder *et al*. (2009), who focused on measuring abnormal bond returns, we calculated abnormal bond returns using the returns to similarly rated bonds as the benchmark. We adjusted the returns based on whether the firm has a rating of A or above, or a BBB and below rating.[10]

Independent variables

Given that the new regulation provides some owners (i.e., with 3% or more ownership over three years) the right to nominate directors, we include a count variable of the total *number of owners* holding at least three percent of the firm's outstanding stock at the end of 2009 (the previous calendar year). This represents the potential number of discrete share owners who would receive the benefit of proxy access for the purpose of director nomination. We proxy for the total number of these large shareholders using data on institutional investor ownership.[11]

Next, two sets of variables were theorized to drive the firm-level heterogeneity in the reaction to the announcement. These variables address: 1) the independence/effectiveness of the board, and 2) the costs associated with CEO control. First, we address factors that are related to board characteristics. The "staggering" of boards, which limits the number of directors up for election in any given year, is reflective of the level of shareholder power over board structure and director entrenchment. Governance scholars argue that staggered boards allow managers to extract rents and reduce shareholder value (e.g., Bebchuk and Cohen, 2005; Larcker, Ormazabal, and Taylor, 2011). We identify a staggered or *classified board* with a dummy variable. Next, board independence is measured by *true outsider percentage*, calculated as the ratio of outside directors appointed before the CEO assumed the position to the total number of directors (Takacs Haynes and Hillman, 2010).

9. The day after the event, unrelated negative information regarding the nation's economic outlook was released; thus, we could not investigate the momentum effect on the following day.

10. The results are substantively unchanged if we make the adjustments based on whether the firm has investment grade or speculative grade bonds.

11. We cannot identify all private individuals who own at least three percent but less than five percent, the level at which they would be required to report as blockholders of the firm. This proxy thus offers a more conservative test of our hypotheses, as it may only underestimate of the number of owners who benefit from the rule change.

The second set of factors address CEO control, which can affect agency costs, and specifically, the portion of agency costs that arise due to CEO shirking or opportunism. As Godfrey and Hill (1995) discuss, agency costs are inherently "unobservable"; thus, various attempts have been made to capture these costs. For example, Ang, Cole, and Lin (2000) measured agency costs as organizational expenses. Instead of relying on such distal outcomes, we chose more proximal proxies of the conditions that give rise to agency costs. Agency theory proposes that managers will pursue their own interests to the degree that they will be able to do so. This suggests that high managerial power or discretion provides the potential for agency costs. *CEO ownership power* is measured as the percentage of the firm's outstanding stock owned by the CEO (Finkelstein, 1992) at the end of the firm's 2009 fiscal year (last year available). We measure *CEO discretion* based on firm characteristics, using the firm's capital intensity as a proxy (Hambrick and Finkelstein, 1987), which can be viewed as a firm-level indicator of the CEO's task environment (Boyd and Gove, 2006). Calculated as the ratio of net property, plant, and equipment to the total number of employees at the end of the previous year, it measures the lack of discretion, thus we multiply it by -1 to ease interpretation. Finally, because intangible resources also grant managers more discretion, implying greater potential for agency costs, we proxy for resource tangibility with estimates of the tangibility of the particular firm's resources, and conduct robustness checks based on industry characteristics as discussed later. Following Surroca, Trib´o, and Waddock (2010), *resource intangibility* is measured as the ratio of research and development expenses to the total number of employees.

Control variables

We include a number of control variables for the firm's governance characteristics, which might affect the market's reaction to the new regulation. *Duality*, as a proxy for CEO power relative to the board (e.g., Tuggle *et al*., 2010a; Takacs Haynes and Hillman, 2010), is an indicator variable equal to 1 if the CEO is also the chair of the board and 0 otherwise. *CEO tenure*, as a proxy for CEO entrenchment and control over internal monitoring mechanisms (Berger, Ofek, and Yermack, 1997), is measured as the number of years the CEO has held the position at the firm at the end of the firm's 2009 fiscal year. *Board size* is the total number of directors on board, and is an important governance-related predictor of firm value (e.g., Coles, Daniel, and Naveen, 2008). We also control for *average director age*, a proxy for general experience, and *average director tenure* on the board (Tuggle, Schnatterly, and Johnson, 2010b), a proxy for directors' firm-specific experience. *Board percentage ownership* is the total percentage of the firm's outstanding stock held by board members (excluding the CEO), and controls for board financial incentives. We include indicators for whether the firm has a *cumulative voting, secret ballot, special meeting*, or *written consent* provision (Gompers *et al*., 2003), all of which can be indicative of the level of shareholder power at the firm. Finally, we include variables that represent the current level of diversity on the board, which can affect board dynamics (Westphal and Stern, 2007). *Female director percentage* is the percentage of female directors on the board and *ethnic minority percentage* is the percentage of directors on the board listed as non-Caucasian.

Analysis

We utilize both nonparametric and parametric methods to test our theory. First, to determine the stock and bond market reaction to the new regulations, we perform a number of t-tests and alternative nonparametric tests (as detailed below). We test the remainder of our hypotheses using weighted least squares regression, where observations with lower error in the first stage (market model estimation) are weighted more heavily in the analysis.[12] We also use robust standard errors to mitigate concerns about heteroskedasticity.

Results

Table 1 presents descriptive statistics and correlations. Multicolinearity diagnostics showed that the value inflation factor (VIF) was below 3.0 for all

12. The observations are weighted by the inverse of the standard deviations of the residuals from the market model. This provides better estimates by adjusting for market model reliability and placing more weight in the analysis on observations that have less noisy first-stage estimates. However, our conclusions are substantively unchanged if we perform standard ordinary least squares regressions.

Table 1. Descriptive statistics and correlations

	Variable	Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19
1	Abnormal return	0.01	0.01																			
2	Duality	0.72	0.45	−0.06																		
3	CEO tenure	6.17	5.69	0.01	0.23																	
4	Board size	10.93	2.54	−0.01	0.02	−0.10																
5	Avg. director age	62.16	3.08	−0.17	0.14	0.10	0.09															
6	Avg. director tenure	8.09	3.21	−0.07	−0.06	0.28	−0.03	0.38														
7	Board % ownership	0.05	0.12	0.05	−0.15	0.07	0.00	−0.08	0.08													
8	Cumulative voting	0.06	0.24	−0.10	0.04	0.06	−0.01	0.07	0.07	−0.05												
9	Secret ballot	0.30	0.46	−0.02	0.08	−0.04	0.13	0.06	−0.07	0.06	−0.03											
10	Special meeting	0.41	0.49	0.03	−0.04	0.04	−0.02	−0.07	0.15	0.06	0.17	0.00										
11	Written consent	0.25	0.43	0.06	−0.07	0.08	−0.06	−0.02	0.01	0.05	0.15	−0.08	0.20									
12	Female director %	0.15	0.09	0.17	0.04	−0.15	0.21	−0.15	−0.11	0.01	−0.02	0.18	0.03	0.02								
13	Ethnic minority %	0.10	0.09	−0.04	0.12	−0.12	0.21	−0.05	−0.13	−0.04	0.03	0.22	−0.02	−0.02	0.26							
14	Number of owners	6.89	2.00	0.12	−0.06	0.06	−0.15	−0.05	0.04	−0.12	−0.02	−0.11	−0.10	−0.01	−0.01	−0.13						
15	Classified board	0.50	0.50	0.07	−0.07	0.01	0.03	0.01	0.02	−0.10	−0.09	−0.09	−0.22	−0.19	−0.08	−0.08	0.11					
16	True outsider %	0.41	0.27	−0.09	−0.17	−0.66	0.14	0.10	0.17	−0.09	−0.03	0.01	−0.01	−0.09	0.14	0.10	0.00	0.03				
17	CEO owner. power	0.01	0.02	0.15	0.02	0.40	−0.09	−0.01	0.12	0.19	−0.04	0.06	0.08	0.06	−0.03	−0.10	−0.08	−0.02	−0.26			
18	Low discretion	−407.07	1047.43	0.18	−0.11	−0.09	0.09	−0.20	−0.03	0.09	−0.01	−0.01	0.02	−0.01	0.18	0.11	0.00	0.02	0.04	0.04		
19	High discretion	−35.37	7.78	0.15	−0.03	0.03	−0.13	−0.07	0.10	0.07	−0.10	−0.13	0.03	−0.01	0.00	−0.02	0.12	−0.02	0.08	−0.00	0.18	
20	Resource intangibility	0.01	0.03	0.08	−0.05	0.05	−0.11	−0.01	−0.01	−0.02	0.05	0.02	−0.06	0.03	−0.06	−0.06	0.04	−0.09	−0.07	0.01	0.12	−0.16

N = 392; All correlations greater than the absolute value of 0.10 are significant at a = 0.05 level.

Table 2. Tests for whether the stock abnormal return on the day of the event is greater than zero

Test name	Testing	Statistic	Significance
T-test for abnormal return	Mean AR >0	t= 14.860	Pr(T > t) = 0.000
Patell (1976) T-test for standardized abnormal return	Mean SAR >0	t= 8.195	Pr(T > t) = 0.000
Boehmer, Musumeci, and Poulsen (1991) T-test for standardized abnormal return	Mean SAR >0	t= 15.119	Pr(T > t) = 0.000
Wilcoxon signed-rank test	AR >0	z= 11.367	Prob > |z| = 0.000
Binomial Z statistic	Proportion of observed positive ARs>0.50	k= 291 Observed proportion = 0.74235	Pr(k >= 291) = 0.000

variables and mean VIF was below 1.5 for all regression models, which suggests no multicolinearity issues.

Hypothesis 1a predicted that giving owners greater power over director nomination will elicit a positive market reaction. Table 2 presents five alternative tests of this hypothesis—three parametric tests and two nonparametric tests. The t-test for the market's reaction indicates that the return is significantly greater than zero, supporting Hypothesis 1a. This conclusion is unchanged if we use: 1) standardized abnormal returns, and 2) a test which accounts for the first-stage error (Patell, 1976; Boehmer, Musumeci, and Poulsen, 1991), 3) a Wilcoxon signed rank test, which accounts for both the sign and the magnitude of abnormal returns, or 4) the binomial Z-statistic, which indicates that 291 out of 392 individual returns were positive (74.2% compared to the expected proportion of 50%). Moreover, the economic magnitude of the reaction is also consequential—the mean abnormal return is 0.83%, or 83 basis points. For comparison, the average daily return on the S&P 500 in 2010 was 5 basis points, or 0.05%, per day. Thus, the return in our study over a single day is over 16 *times* greater than the average daily return that year. Additionally, studies in finance have shown returns from a well-documented trading strategy, momentum trading, to be about 100 basis points (or 1%) *per month* (Jegadeesh and Titman, 2002). As illustrated, the reaction we detect is economically large.

Model 1 in Table 3 shows regression results with only the control variables. Model 2 in Table 3 includes our independent variables. Hypothesis 1b predicted that the number of owners receiving influence over director nomination will be positively related to the change in shareholder value. The coefficient on the number of institutional owners holding three percent or more of the firm's stock in Model 2 is positive and statistically significant, supporting Hypothesis 1b. This result is consistent with Hypothesis 1a and supports the idea that the positive market reaction is driven by the increase in shareholder power over director nomination.

Table 3. Regression models of firm-specific predictors on the abnormal return

	Model 1: Control	Model 2: full model
Constant	0.031∗	0.025+
Duality	−0.001	−0.000
CEO tenure	0.000	−0.000
Board size	0.000	0.000
Average director age	−0.000+	−0.000
Average director tenure	−0.000	−0.000
Board % ownership	0.010	0.005
Cumulative voting	−0.004+	−0.003
Secret ballot	−0.000	−0.000
Special meeting	0.000	0.001
Written consent	0.001	0.001
Female director %	0.018∗	0.018∗
Ethnic minority %	−0.015∗	−0.011+
Number of owners		0.001∗
Classified board		0.002∗
True outsider %		−0.007∗
CEO ownership power		0.087∗∗
Low discretion		0.001∗
High discretion		0.226∗∗
Resource intangibility		0.041∗∗
F	2.53∗∗	3.77∗∗∗
R^2	0.07	0.16
Adj. R^2	0.04	0.12
N	392	392

+ $p < 0.10$; ∗ $p < 0.05$; ∗∗ $p < 0.01$; ∗∗∗ $p < 0.001$

Hypothesis 2 predicted that the use of a classified or "staggered" board will be positively related to the change in shareholder value in reaction to the new

rule. The coefficient on the classified board indicator in Model 2 is positive and marginally significant, offering marginal support for Hypothesis 2.

Hypothesis 3 predicted that the proportion of true outsiders on the board will be negatively related to the change in shareholder value. The coefficient on the true outsider percentage in Model 2 is negative and statistically significant, supporting Hypothesis 3.

Hypothesis 4 predicted that CEO ownership power will be positively related to the change in shareholder value in reaction to the new rule. The coefficient on CEO ownership power in Model 2 of Table 3 is positive and statistically significant, supporting Hypothesis 4.

Hypothesis 5 predicted that CEO discretion will be positively related to the change in shareholder value in reaction to the new rule, and even more so at high levels of discretion. Following prior research (e.g., Greve, 2003; Sirmon and Hitt, 2009), we utilize a spline function to test this hypothesis. A spline function is appropriate when testing hypotheses that suggest a continuous relationship that changes slope at a critical threshold, referred to as a "knot." Instead of dividing the sample and modeling various subsamples individually, which would disrupt the continuity of the function, or forcing a continuous and symmetric solution (as a curvilinear term renders), spline functions allow for more accurate modeling of nonlinear relationships where the slope changes at a certain value for one of the variables. In the absence of a prespecified theoretical threshold of what value constitutes high firm-level discretion based on the firm's capital intensity, we follow Fiss (2011) in setting the knot at the seventy-fifth percentile in our sample,[13] which represents a high level of discretion. Thus, the spline function creates two variables from the single continuous variable—*low discretion* (modeling the relationship below the seventy-fifth percentile), and *high discretion* (the relationship above the seventy-fifth percentile).

The coefficient on low discretion in Model 2 is positive and statistically significant, and the coefficient on high discretion is also positive and statistically significant; moreover, the coefficient on high discretion is significantly larger compared to the low discretion coefficient ($p < 0.05$). This shows evidence of a positive linear relationship, with an increase in the impact of discretion at high levels of firm discretion, providing strong support for Hypothesis 5.[14]

Hypothesis 6 predicted that resource intangibility will be positively related to the change in shareholder value in reaction to the new rule. The resource intangibility coefficient in Model 2 of Table 3 is positive and significant, offering support for Hypothesis 6.

Finally, Hypothesis 7 predicted that giving shareholders greater power over director nomination will elicit a positive bondholder reaction. The three tests presented in Table 4 indicate strong statistical support for this hypothesis. The results show that, contrary to the zero-sum game prediction, bondholders perceive the shareholder proxy access rule to also create value for creditors and react positively, albeit the economic magnitude of the positive reaction is smaller compared to the stock market's reaction (44 basis points). This is an expected outcome, given that the benefit of the new rule to bondholders is less direct compared with the benefit it provides to shareholders.

Robustness checks and additional analysis

We performed a number of additional analyses to ensure the robustness of our results. First, we performed all analyses using a global baseline for calculating abnormal returns, created from all non- U.S. stocks with available data in Compustat's Global database, in lieu of the Canadian baseline. All of our results were substantively unchanged from those reported.

Second, we used alternative measures of CEO discretion (used to test Hypothesis 5). We first considered a measure based on sales growth. Because our argument is based on discretion at the firm level, we used the firm's industry-adjusted sales growth over the previous five years as a proxy for discretion (Boyd, 1990; Finkelstein and Boyd, 1998); this approach takes into account both firm-level and industry-related variance (Boyd and Gove, 2006). Managers at firms with relatively high growth would be expected to have greater discretion, and thus shareholders at such

13. Our conclusions remain unchanged if we set the fiftieth percentile in our sample as the knot, and are robust to a number of other specifications between the fiftieth and eightieth percentiles.

14. If we model the change in the impact of discretion as a 'change-in-intercept' as opposed to 'change-in-slope,' using the full range of the continuous variable and an indicator variable for levels above the seventy-fifth percentile, the results and conclusions remain unchanged.

Table 4. Tests for whether the bond abnormal return on the day of the event is greater than zero

Test name	Testing	Statistic	Significance
T-test for abnormal return	Mean AR >0	t= 6.540	Pr(T > t) = 0.000
Wilcoxon signed-rank test	AR >0	z= 5.819	Prob > |z| = 0.000
Binomial Z statistic (*N* = 330)	Proportion of observed positive ARs>0.50	k= 208 Observed proportion = 0.63030	Pr(k >=208) = 0.000

The Patell (1976) and Boehmer *et al*. (1991) t-test are not available for bond abnormal returns because they require regression residuals in order to be calculated, and the proper method for calculating bond abnormal returns is not a regression-based technique (please see Bessembinder *et al*., 2009).

firms would benefit more from the announcement of the new rule. Our results using this alternate measure continue to provide strong support for Hypothesis 5. Secondly, we used the firm's free cash flow (Jensen, 1986) as a measure of the value that the manager would have the ability to extract from the firm. Results using this measure again provide general support for our hypothesis. We find that discretion continues to have a significant impact on the change in shareholder value when discretion is high.[15]

Third, we used an alternative measure of firm resource intangibility (Hypothesis 6), based on the nature of the firm's primary industry. Firms in service industries create value mainly from intangible resources, such as knowledge (Williams, 2007) and human capital (Hitt *et al*., 2001). We created a service industry indicator variable equal to 1 if the firm's primary industry is classified as service industry based on the 48 industry Fama-French classification (Fama and French, 1997), and 0 otherwise. This classification of service industries is largely based on the classification used by the U.S. Department of Labor and the U.S. Census Bureau (SIC codes with prefix 70–89, based on the 1987 SIC Manual), with three additional industries: commercial printing, advertising specialty, and warehousing/storage. The findings show that firms in industries with less tangible resources do indeed experience significantly greater change in shareholder value (the coefficient on the service industry dummy variable is positive and highly significant), providing further support for Hypothesis 6. Finally, we investigated whether the relationship between CEO ownership and the change in shareholder value is in fact nonlinear, because our theory suggests that the relationship could be driven primarily by high levels of CEO equity that provide the CEO with powerful leverage. We used a spline function to let the coefficient vary above and below the seventy-fifth percentile ownership, and the results suggest that the relationship is indeed stronger (i.e., the coefficient is larger and statistically significant) at high equity levels; all of our other conclusions are unaltered if we model CEO ownership in this fashion. Also, the results remain substantively unchanged if we set the threshold at the seventieth or eightieth percentile.

Discussion

This study examines the complex relationships between the corporation's stakeholders from an agency theory perspective. Drawing from an ongoing debate among legal scholars that juxtaposes two perspectives related to who the board "works for," we examine the effects of giving shareholders greater influence in the nomination of directors. We provide answers to the following questions: Does such power create value? If so, what is this value creation contingent upon? Finally, does such power benefit other stakeholders? We utilize the SEC's announcement of a new proxy access rule as a natural experiment to answer these questions. More specifically, we investigated the market's reaction to the SEC's announcement of the new rule, which grants large, long-term shareholders greater rights in the process of director nomination. Under the new rule, shareholders owning at least three percent of the firm's traded stock for three consecutive years will be able to nominate

15. Small amounts of free cash might help the firm to maintain enough liquidity for opportunities requiring immediate investment, but are more easily monitored by shareholders. On the other hand, high amounts of free cash would likely be unnecessary to maintain reasonable liquidity and would be more difficult to monitor, leading to higher potential agency costs, which should lead to greater positive shareholder reaction to the new rule.

at least one new director candidate (and up to 25% of the board size) per election. Following our theory, the results show that regulatory oversight that balances out the power between shareholders and management with respect to affecting board composition plays an influential role in increasing firm value. Our results show that the market reacted in a significant and positive manner to the passage of this new rule, and that the magnitude of the reaction was positively related to the number of owners who would be eligible to benefit from the new rule. The reaction was not only statistically significant but also economically significant. Thus, the first contribution of this study is showing that additional value is created when owners are granted greater voice in the firm's governance, and thus supporting the argument put forth by "shareholder democracy" advocates that shareholder voice helps reduce agency losses (e.g., Bebchuk, 2005; 2006).

Importantly, beyond investigating the primary effect, we presented theory and evidence explicating *when* shareholder voice is most critical. By examining two sets of factors that help explain the magnitude of change in shareholder value, we contribute to our understanding of how agency conflicts between owners, directors, and managers reduce firm value. First, we focused on factors that signify weak governance; specifically, certain characteristics of the board. As hypothesized, the change in shareholder value was more positive for firms with less independent boards, indicated by factors such as a staggered board structure and a low proportion of true outsider directors. Second, we investigated factors related to the CEO control, which can affect agency costs, and specifically agency costs due to CEO shirking or opportunism. Here, we again find support that the change in shareholder value is greater for firms with higher levels of potential agency costs due to greater CEO control. We show that the ability of owners to nominate directors is more critical when the CEO is a powerful owner, has higher levels of discretion, and the firm possesses greater levels of intangible resources, as these are conditions that lead to increased potential for top managers to pursue their own agendas and extract private benefits at the expense of shareholders. As such, a second contribution of this study is identifying firm-specific factors that are detrimental to firm value in the absence of effective board oversight.

Lastly, we investigated whether providing shareholders greater voice in director nomination appears to be value increasing or value reducing to another key stakeholder group—the firm's creditors. Director primacy advocates often argue that granting shareholders greater influence in the firm's governance will be to the detriment of all other stakeholder groups. Contrary to this position though, and in further support of shareholder primacy advocates' arguments (e.g., Bebchuk, 2003; 2005), we find that reducing management's singular influence over board composition benefits both shareholders and bondholders, supporting the idea that "the enemy of my enemy is my friend." Overly powerful management is perceived as value destroying by both groups, despite their differences. As such, this study contributes to the decades-old debate on the shareholder-bondholder conflict by illuminating conditions under which the interests of these two very different groups are aligned.

In total, then, we show that greater shareholder voice in matters of board nomination increases market value, especially where ownership structures allow multiple shareholders to benefit from proxy access, where boards are currently aligned with managers rather than shareholders, and where firm characteristics imply a high degree of managerial control. However, extreme positions on proxy access by shareholders could undermine this apparent benefit. For example, the positive results we found were based on a proxy rule that could be construed as "balancing" the concerns of both the shareholder and director primacy perspectives, in that access was provided to heavily vested, long-term shareholders (3% ownership for three years). On the other hand, if access is eased via requirements of lower ownership and/or a shorter holding period, the results may lead to negative outcomes, as short-term owners could manipulate the firm for their direct benefit. This is suggested by the findings of Larcker *et al*. (2011), who show that a proposed version of a proxy rule related to as little as one percent ownership for one year negatively affected value creation. It seems that the concerns of both perspectives—too much shareholder power over the board is bad per the director primacy view and too little or no control is bad per the shareholder perspective—are valid. Thus the last contribution of our study is the integration of corporate law literature into strategic management research, which can lead to a better

understanding of how governance impacts firm performance and firm value.

This study is also unique in its design, which uses an event study in the context of a natural experiment—an external event that was not under the firms' control. Employing event study methodology in these types of settings—new rules, laws, and regulations—allows for powerful inferences as it eliminates the threat of endogeneity, commonly present in strategic management research. As such, natural experiments present a great opportunity to test theories, such as agency theory, which have received mixed support in prior work.

Limitations and future research

Given that we test our hypotheses using a natural experiment—an exogenous shock, which impacts the population of publicly traded firms—the validity of our findings is high. However, given that we limit our investigation to a sample of large (S&P 500) firms, future studies should test whether the results hold in a wider sample of firms. Furthermore, future research can examine the impact of industry context on the market's reaction to greater proxy access. For example, was the reaction more positive in highly dynamic industries where firms may benefit from a greater diversity of director background and experience? Conversely, was the reaction smaller in highly munificent industries? It is also possible that greater power in the process of director nomination, and hence greater control over the board, may be more important to shareholders of firms in regulated or controversial (e.g., polluting) industries.

We limited our investigation of firm characteristics to agency problem-related issues. An interesting extension may explore how previous firm strategy affects shareholder reaction to greater director nomination access. For example, does high merger and acquisition activity lead to greater shareholder appreciation of proxy access? Also, how does stakeholder strategy affect it? Some firms (and, by extension, corporate boards) put much greater emphasis on broader stakeholder issues; it could be interesting to examine how these efforts are differentially valued by different stakeholder groups, such as shareholders and bondholders. Moreover, future research should further investigate not only whose interests the board usually represents, providing important insights to the largely normative corporate law debate, but also when director attention shifts from one group to the other (shareholder to stakeholder issues, and vice versa).

Our results suggest that greater shareholder voice, when it acts to reign in managerial power and help prevent opportunism, may in fact be beneficial to other stakeholder groups. While our study limits the analysis to bondholders, future research can investigate whether greater shareholder voice translates to positive outcomes for additional stakeholders. It is possible that firms where shareholders yield substantial influence, sometimes referred to as "democracies," also tend to invest in other stakeholder-focused initiatives and exhibit high corporate social performance. On the other hand, it may be that too much shareholder power sways the focus on shareholder-only benefits, especially in the case of powerful short-term owners, as research suggests that stakeholder management is likely to pay off in the long run.

Implications for practice

While strongly grounded in extant theory, this study is, by its natural experiment design, closely tied to its empirical context. We examined the market's reaction to a specific event—the initial passing of the new SEC proxy access (director nomination) rule on 25 August 2010. This new rule has stirred up substantial controversy. Indeed, the U.S. Chamber of Commerce and Business Roundtable almost immediately brought a lawsuit in the federal appeals court in the District of Columbia (i.e., D.C. Circuit) against the SEC to challenge this rule. To represent them in their fight against the SEC, and perhaps to signal their seriousness about it, these groups hired a prominent Washington D.C. attorney, Eugene Scalia.[16]

On 22 July 2011, it became apparent that the group's efforts were successful, with the D.C. Circuit overturning the SEC's adoption of the proxy access rule as "arbitrary," "capricious," and an "abuse of discretion" (Business Roundtable and Chamber of Commerce v. SEC, 2011: 6). In its opinion, the D.C. Circuit explicitly adopted an "anti-Bebchuk" view of extant legal scholarship, going to the extent of explicitly quoting from and citing a 2006 law review article, which directly attacked Bebchuk (Strine, 2006;

16. Scalia is the son of U.S. Supreme Court Justice and former D.C. Circuit Judge Antonin Scalia.

Business Roundtable and Chamber of Commerce v. SEC, 2011: 14–15). In addition, the D.C. Circuit chided the SEC for not fully analyzing the costs and benefits of the rule, and in particular for not doing sufficient "economic analysis" with regard to the purported "shareholder value creation" related to the rule. The federal appeals court stated that it felt that the SEC "relied upon insufficient empirical data when it concluded that the proxy access rule (14a–11) will improve board performance and increase shareholder value" (Business Roundtable and Chamber of Commerce v. SEC, 2011: 11).

On 6 September 2011, SEC Chair Mary L. Schapiro issued a statement that said that the SEC had decided, for now, not to appeal the D.C. Circuit's decision. She did, however, reiterate her support for the proxy access rule, simply noting that the SEC wanted to "carefully consider and learn" from the D.C. Circuit's objections before the agency determined "the best path forward." She then ordered the SEC staff to conduct a careful review of the issue (SEC, 2011).

In this context, our study seems unusually timely. In providing clear empirical evidence with respect to shareholder value creation and the SEC's proxy access rule, we provide direct assistance to policy makers as they respond to the federal appeals court's objections to the rule. Importantly, we show that the rule appears to benefit another key stakeholder group, firm bondholders, addressing the objections of some its opponents. As such, we help to empirically inform the discourse on the role of public policy in corporate law (Bhagat and Romano, 2002b).

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