A Japanese CalPERS or a New Model for Institutional Investor Activism? Japan's Pension Fund Association and the Emergence of Shareholder Activism in Japan

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A JAPANESE CALPERS OR A NEW MODEL FOR INSTITUTIONAL INVESTOR ACTIVISM? JAPAN’S PENSION FUND ASSOCIATION AND THE EMERGENCE OF SHAREHOLDER ACTIVISM IN JAPAN

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Abstract

If activist institutional investors are arguably the primary external monitors of management under leading corporate governance systems in the United States and the United Kingdom, who might assume that role in other countries? And, more importantly, what activist shareholder strategies may be possible under different corporate governance systems and operating environments that are generally less supportive of shareholder activism than the United States and the United Kingdom?

This Article seeks to address that question through a comparison of the well-known strategy of CalPERS with that of a rare, real-world example of institutional investor activism outside of the “Anglo-Saxon” model—Japan’s Pension Fund Association (the “PFA”). It examines how institutional investors adopt activist strategies to fulfill their corporate governance role within two important sets of constraints: (1) resource and expertise constraints, and (2) constituency constraints.

It finds that similar resource and expertise constraints lead to basically similar investment portfolio strategies: diversified, passive index investing and a corresponding reliance on proxy voting. However differences in constituency constraints produce corresponding differences in strategic focus and “style.” CalPERS, which is supported and encouraged by its members and broader constituencies, stands out as a high profile and sometimes adversarial activist that acts as a “catalyst” for management accountability. In Japan the PFA, which is less supported by its member corporate pension funds and broader constituencies, acts as a “reluctant activist.” It has adopted objective, performance-based proxy voting guidelines and non-adversarial measures that emphasize and promote good governance rather than criticize poor governance.

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The PFA’s ability to adopt an activist strategy within its operating environment has practical significance as a more realistic model for the “rest of the world” than the United States and the United Kingdom. The PFA’s model also has theoretical significance as a new third data point that contributes to a broader understanding of the role and strategies of activist institutional investors in different operating environments.

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I. INTRODUCTION

For a number of years comparative corporate governance experts have faced a perplexing conundrum: If activist institutional investors are arguably the primary external monitors of management under leading corporate governance systems in the United States and the United Kingdom, but they seemingly exist only in those two countries, who will assume that role in other countries? What would be the nature of that role within corporate governance systems and operating environments which look nothing like the United States and the United Kingdom? What kind of activist shareholder strategies are possible in systems which generally feature concentrated rather than disperse share ownership structures, greater governmental involvement in the economy, and, at least sometimes, an arguably “pro-business” emphasis on national champions to lead economic growth and development? In short, what can serve as a model for shareholder activism for “the rest of the world?”

Overseas’ interest in the potential role of activist institutional investors has been building for a number of reasons, despite long-standing debates in the United States concerning the effectiveness and desirability of institutional investor “activism.” Many countries now have an increasing number of large public companies and have encountered serious problems with corporate governance issues. However, the effectiveness of alternative monitoring institutions in other corporate governance systems,

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1 Shareholder “activism” is a concept which is broad and not clearly defined. See, e.g., Bernard S. Black, Shareholder Activism and Corporate Governance in the United States, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459 (Peter Newman ed., 1998) (defining shareholder activism as “proactive efforts to change firm behavior or governance rules”). This article focuses on the "traditional” activism of public pension funds, which has largely been limited to proxy voting and informal communications with portfolio companies on standard good governance issues, rather than on directly influencing corporate business strategies like “activist” hedge funds. However, part of this Article’s inquiry focuses on the reasons why public pension funds have adopted this limited form of activism. For the debate on the effectiveness of public pension fund activism, see Part IIA. infra.
such as banks in Germany and Japan, has been increasingly called into question; in
addition, many systems have no institution, other than a controlling shareholder, that is
consciously attempting to act as an external monitor of corporate management. For
some time a number of leading corporate governance experts in Asia have considered the
question of finding an “Asian model” of institutional investor activism to be the most
important issue facing their corporate governance systems.

A trend of increased interest in external monitoring generally, and in the potential
role of institutional investors in particular, gives rise to three related questions: First is
the normative question of what the role of institutional investors in corporate governance
ought to be in different corporate governance systems. Second is the identification of the
countries, conditions, and institutions which may give rise to activist institutional
investors. Third is the important question of the actual role of activist investors—the
specific activist strategies such institutions are realistically equipped and willing to
pursue within the conditions, constraints, and opportunities present in their operating
environment. While the literature has concentrated on the first two questions, this Article
deals mainly with the third question, i.e., a case study comparing the actual strategy of an
activist investor in a different operating environment, in this case the Pension Fund

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2 Although the U.S. literature associates external monitoring of management with reduction of agency costs
in the Berle- Means corporation, monitoring is also a means of addressing the fundamental problem which
is prevalent in concentrated ownership systems—protection of minority shareholders from abuse by
controlling shareholders. See, e.g., Marc Goergen et al., Recent Developments in German Corporate
Governance, 28 INT’L REV. L. & ECON. 175, 177 tbl.1 (2008). In addition, even systems with concentrated
ownership have begun to pay heed to the rhetoric of maximization of shareholder wealth, and such rhetoric
is reflected to a degree in corporate law reform.

3 Interview with Professor Joongi Kim, Yonsei University, in Seoul, Korea (July 5, 2006). Also see, e.g.,
ASSOCIATION FOR SUSTAINABLE & RESPONSIBLE INVESTMENT IN ASIA, THE TIME TO
LEAD IS NOW: THE ADOPTION OF ESG ANALYSIS BY ASIAN GOVERNMENT PENSION
FUNDS (July 2009). This report, supported by the Asian Development Bank is intended to encourage
Asian pension funds to emphasize environmental, social, and governance practices in their investments.
Two of its five findings relate to proxy voting as a fiduciary duty and corporate information disclosure. Id.
at 5.
Association ("PFA") in Japan, with the more familiar strategy of The California Public Employees Retirement System (CalPERS") in the United States.

The limited comparative literature in this area to date focuses primarily on contrasting the styles of institutional investor activism in the United States and the United Kingdom and utilizes legal rules as an important criterion for evaluating the role of activist institutional investors in differing corporate governance systems. In their seminal work on activist institutional investors in the United States and the United Kingdom, Black and Coffee conclude that “collaborative” English institutional investors are more effective than their “adversarial” American counterparts. However, they also point out that path dependent historical development means that it is unlikely that the arguably more effective activist strategies of English institutional investors would be fully adopted by institutional investors in the United States, even assuming that legal rules would fully permit an identical strategy. This raises the significant question of the differences in operating environments among corporate governance systems and the interrelationship between activist shareholder strategies and such operating environments.

The few studies that venture beyond the U.S./U.K. comparison are greatly hampered by a paucity of real-world examples of activist institutional investors in other countries. These studies address the limited question of identifying which institutions might potentially play an activist role by categorizing institutional investors and

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5 Id. at 2082-84. The authors conclude that U.K. institutions are more actively involved in corporate governance of portfolio companies than their U.S. counterparts. Id. at 2086. However, U.K. institutional investors still pursue passive investment strategies and their actual degree of monitoring remains a subject of debate. See, e.g., Marc Goergen et al., Do UK Institutional Shareholders Monitor Their Investee Firms?, (Discussion Paper, April 2008), available at SSRN.com abstract+1120204 (arguing that their event study on directors’ trades and other empirical evidence suggests that institutional investors in the UK do not monitor portfolio companies).
examining various transaction costs and other obstacles, *e.g.*, legal rules and market conditions, which discourage or prevent the emergence of institutional investors to fulfill such an activist role.⁶

This Article seeks to contribute to the literature in two ways. First, it presents a case study of the activist strategy of the PFA in Japan, which is a rare real-world example of an activist institutional investor outside of the “Anglo-Saxon” model. It thus highlights a practical example of institutional investor activism which is likely more relevant to the rest of the world than the existing models in the United States and the United Kingdom. Second, it compares and contrasts the PFA’s strategy with that of CalPERS. This Article thus highlights theoretical considerations relevant to, and seeks to stimulate further research on, a broader comparative framework and general model for examining the role and strategies of activist institutional investors in different operating environments.

Japan is both a likely and a surprising place to find such an activist institutional investor. It is a likely place due to the size of its economy, pension assets (see Appendix 1), and public pension funds (see Appendix 2). Japan is a mature economy with a large number of public corporations which are not dominated by a family or the state.⁷ However, it is also an unlikely place due to obstacles common to many countries: (1) public pension funds are generally national funds in a unitary system and are often closely tied to the national government, (2) there are few, if any, domestic activists

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⁷ However, it is generally classified, together with Germany, as a concentrated shareholder system due to cross-shareholding by friendly corporations (“stable shareholders”) which reduces the public float.
potentially available for coordinated activities as in the United Kingdom, and foreign activists are problematic due to their general portrayal as being overly aggressive and threatening towards domestic companies, and (3) there is a lack of history or model for shareholder activism. It is therefore questionable if CalPERS’ style of adversarial activism would be widely embraced or successful. In such a seemingly unpromising operating environment, who would assume the role of institutional investor activist and, more importantly, what would be a workable activist strategy when neither the English strategy nor CalPERS’ strategy may realistically be available?

The PFA has emerged as a somewhat unlikely activist institutional investor since 2002. The PFA is a public pension fund which acts as an umbrella organization for corporate pension funds in Japan. It has managed to go beyond its corporate roots and become the leading, and arguably the only, activist institutional investor in Japan.  

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8 For a discussion of the activities and impact of foreign institutional investors in Japan, see Christina Ahmadjian, Foreign Investors and Corporate Governance in Japan, in CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY 125 (Masahiko Aoki et al. eds., 2007) For a discussion of CalPERS own activities in Japan which helped launch the idea of investor activism, See generally Sanford M. Jacoby, Convergence by Design: The Case of CalPERS in Japan, 55 AM. J. COMP. L. 239 (2007).

9 As recently as the 1990s one of the major goals of Japanese corporate law reform was to reduce the influence of so-called sokaiya, the racketeer shareholders utilized by corporate management to dominate annual shareholder meetings and ensure that any dissenting shareholder views would be suppressed. See generally Mark D. West, Information, Institutions, and Extortion in Japan and the United States: Making Sense of Sokaiya Racketeers, 93 NW U. L. REV. 767 (1999).

10 See Panel Discussion, Tipping the Scales: The Evolution of Shareholder Rights in Japan (Speaker: Marc Goldstein, at Japan Society, New York, May 6, 2009), available at http://www.japansociety.org/tipping_the_scales_the_evolution_of_shareholder_rights_in_japan (speaker: Marc Goldstein, at Japan Society, New York, May 6, 2009), available at http://www.japansociety.org/tipping_the_scales_the_evolution_of_shareholder_rights_in_japan (speaker: Marc Goldstein, at Japan Society, New York, May 6, 2009), available at http://www.ipe.com/asia/SRI_in_Japan%E2%80%93_it%E2%80%99s_a_must_30613.php (quoting Jonathan Schuman, the Tokyo-based head of SRI for AIG, stating with respect to the slow development of SRI in Japan that “…we don’t have any leading responsible investors showing the way like, for example, the Childrens’ Fund, the Petroleum fund in Norway or CalPERS. The Pension fund Association, with its corporate governance guidelines, was a start, but it’s an isolated example.”). But see Jacoby, supra note 8, at 274 (citing Japan’s Pension Fund for Local Government Officials, the world’s 10th largest pension fund (see table 2) as another potential activist institutional investor with which CalPERS has had a relationship).
The PFA’s activist strategy is formulated to fit within its operating environment. In broad terms, it is neither adversarial like CalPERS, nor collaborative like English institutional investors, but rather independently pursues its role as a voice for shareholders.\textsuperscript{11} Compared to CalPERS, the PFA pursues a similar portfolio investment strategy and similarly relies on proxy voting and informal communications with portfolio companies. However, the PFA characterizes itself as a “reluctant activist” that is interested in improved economic performance of portfolio companies rather than acting as a corporate adversary. Consistent with this approach, it utilizes objective standards for proxy voting. The PFA does not utilize focus lists, shareholder proposals, or litigation to attack individual corporations for “bad” corporate governance, but rather emphasizes examples of “good” corporate governance.

Although there is a potential objection to using the atypical CalPERS as the model of U.S. activism in a comparative context,\textsuperscript{12} the comparison between the PFA and CalPERS was by no means created for the purpose of this Article. The PFA has been widely cited in the media, in both Japan and the United States, as being the “Japanese CalPERS,”\textsuperscript{13} and, in fact, the PFA and other Japanese pension funds have studied and


\textsuperscript{12} CalPERS may not be typical of activist institutional investors in the United States, although other institutional investors have generally become more vocal in recent years. However, even if not typical, CalPERS is certainly stereotypical, as it nevertheless represents to many people the strategy of American shareholder activism. See id.

\textsuperscript{13} See, e.g., Martin Fackler, An Investor Activism Uncommon in Japan, N.Y.TIMES, Aug. 30, 2007 (That combination of activism and respect has led many here to call Mr. Yano and his fund, the Pension Fund Association, Japan’s answer to the California Public Employees’ Retirement system…”); “…although their approaches are different, the PFA may be in Japan what CalPERS (the California Public Employees’ Retirement System) was in the United States 10 years ago—a strong voice for everyday savers.” See Knowledge@Wharton, Japan’s Own Brand of Corporate Governance: Shareholders Don’t Rule, Nov. 29, 2006, available at http://knowledge.wharton.upenn.edu/article.cfm?articleid=1614 (quoting Sarah Mclellan,
consulted with CalPERS as an important source for learning about and formulating strategies for shareholder activism. Some cite the PFA as CalPERS’ “heir” to shareholder activism in Japan.

As for the important theoretical question of the criteria utilized to examine the relationship between institutional investor activism and operating environments in a comparative context, this Article focuses on two important sets of related constraints which directly influence and shape activist strategy once an institutional investor has made the decision to be an activist: (1) resource and expertise constraints, and (2) constituency constraints. The former includes a lack of in-house expertise to actively manage investments and pressure to minimize investment costs. This set of constraints influences portfolio investment strategy and both the form and level of activist activities. The latter set of constraints, composed of pension fund members and beneficiaries, government, and the media/public, exerts significant influence over the manner (e.g., selection of issues, proxy voting standards, degree of coordination with other institutional investors, and “style” of pursuing activism) in which an activist institutional investor fulfills its role.

This Article finds that resource and expertise constraints are similar for the PFA and CalPERS, and results in similarities in portfolio investment strategy, i.e., the use of

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14 See generally Jacoby, supra note 8, at 269-74.
15 See Sanford M. Jacoby, Principles and Agents: CalPERS and Corporate Governance in Japan, 15 CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW 5, 14 (Jan. 2007) (concluding that CalPERS own efforts in Japan to improve corporate governance met with mixed results, but “it planted a seed that is sprouting in the form of pension fund activism by domestic groups like the PFA”). For a discussion of CalPERS withdrawal from its early direct activism in Japan since around 2002, see Jacoby supra note 8, at 275-80.
16 As noted above, the limited literature to date has focused largely on legal and market constraints which discourage institutional investors from assuming activist roles. Although relevant, these factors are not considered in this Article because they do not appear to be of vital importance for activist shareholders in the U.S. and Japan in devising and implementing their activist strategies.
diversified, passive index investing, a reliance on proxy voting and standard good
corporate governance issues, and a relatively low level of resources devoted to activist
activities. However, the constituency constraints for the PFA and CalPERS are
significantly different and largely account for the two different “styles” of activism.
CalPERS is encouraged by its members and, to a lesser extent, its other constituencies to
be a highly public and somewhat adversarial activist, while the PFA’s activism is
supported only to the extent it focuses on its core mission of managing assets to make
future payments to beneficiaries and largely eschews high profile, adversarial activism.

This Article is divided into six parts. Part II discusses the theoretical and practical
roles of institutional investors in corporate governance and discusses this Article’s
criteria for comparing the strategies of activist institutional investors in different
corporate government systems and operating environments. Part III examines the
CalPERS model of investor activism in the United States, focusing on its activist strategy
in light of the resource and expertise constraints and the constituency constraints in its
operating environment. Part IV takes a similar approach with the PFA in Japan,
concluding that although the resource and expertise constraints are similar, the
constituency constraints are more restrictive. This has a significant effect on its activist
strategy. Part V considers the effectiveness of the PFA’s strategy and the broader
implications of the relationship between the differing activist strategies and operating
environment of the PFA and CalPERS.
II. ROLE OF ACTIVIST INSTITUTIONAL INVESTORS IN DIFFERENT CORPORATE GOVERNANCE SYSTEMS

A. Role of Activist Institutional Investors as External Monitors of Management

There is probably little overall change in academic evaluation of the role of activist institutional investors in the decade since Bernard Black concluded that their modest efforts at activism had not made “much of a difference.”\textsuperscript{17} Criticisms of the shortcomings of activist institutional investors as external monitors have been widespread. They have been accused by some commentators of doing too much, and by many others of doing too little. Both sets of criticisms stem, to a significant degree, from activists’ frequent referrals to an appealing, but unproven, correlation between standard good governance practices and firm economic performance.

If institutional investors believe in the validity of this correlation, they should devote much greater effort to becoming effective external monitors of management by addressing the following longstanding and oft-cited problems:\textsuperscript{18} the limited number and types of institutional investors willing to undertake activist strategies, institutional investors’ inability to coordinate effectively to overcome shareholders’ collective action problem,\textsuperscript{19} limited resources devoted to activism due to a free rider problem, a lack of competence and expertise, and a preference for liquidity over control and for exit over voice\textsuperscript{20} (particularly for private institutional investors, such as mutual funds). If, on the

\textsuperscript{17} See Black, supra note 1, at 464.
\textsuperscript{18} For a summary and discussion of the limits on institutional investor activism in a comparative context, see Black and Coffee, supra note 4, at 2055-2077.
\textsuperscript{19} See, e.g., Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. REV. 811 (1992) (noting the potential for institutional investors to overcome their collective action problem through increased coordination)
other hand, this correlation is to be discounted or ignored, institutional investors should stick to strategies which are clearly related to maximizing their beneficiaries’ wealth and should not engage in governance-related activism, particularly social or political activities that appear to be unrelated to investment performance.  

In this latter view, institutional investors (particularly public pension funds) face conflicts of interests and agency cost problems which make them poor monitors.

However, a substantial part of the disappointment in the performance of institutional investors as monitors of management may result from corporate law commentators assigning to institutional investors a role in our corporate governance system which is beyond both their capabilities and intentions. In the United States there has arguably been a long-standing preference, at least among academic commentators, for a market solution to monitoring management (in the form of an effective market for corporate control) over governance-related shareholder activism. The role of institutional investors may have come to prominence in the 1990s in large measure as a matter of fortuitous timing—the period in the late 1980s and early 1990s saw an end of the M&A boom accompanied by the rising importance of institutional investors—and a lack of alternatives. At that time there was no other obvious choice to succeed the market for corporate control as the primary external monitor of management under our system of corporate governance.

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23 See, e.g., Black supra note 1.
Persistent questions about the effectiveness of institutional investors’ monitoring of management have already led to the identification of a new, possible monitor--activist hedge funds.\(^{25}\) Although hedge funds and other private funds may have a potentially significant role to play in corporate governance, they face their own serious problems as monitors of management. Like the M&A boom in the 1980s, private fund activities wax and wane with the availability of cheap debt and favorable market conditions, and such funds are also subject to their own severe conflicts of interests between their private benefits and benefits for the corporation and shareholders generally.\(^{26}\)

In reality, even the most activist institutional investors, such as CalPERS, have generally purported to fulfill a more modest role than ascribed to them by corporate law commentators. CalPERS has characterized its corporate governance role in terms of education and acting as a “catalyst” rather than acting as the main external monitor of corporate management.\(^{27}\) The primary “activist” investment strategy of public pension  


\(^{26}\) See, e.g., Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1283-1292 (2007-2008). In addition to economic incentives and conflict of interests, there is also an issue of disclosure and transparency in hedge fund investments. See, e.g., Philippe Jorion, *How to Resolve Hedge fund Transparency*, P&I, June 9, 2008, at 12. There is also the question of public acceptance of an important corporate governance role for aggressive private funds, particularly outside the United States. For example, in Japan, the activities of a well-known, aggressive, private fund headed by a former government bureaucrat, were highly controversial and ultimately led to an indictment of the fund manager for insider trading. See infra note 117.

\(^{27}\) See, e.g., *CALIFORNIA PUBLIC EMPLOYEES’ RETIREMENT SYSTEM, WHY CORPORATE GOVERNANCE TODAY?* (1995) (formerly on CalPERS website; on file with the author) (“CalPERS has neither the resources, nor the expertise, to run the companies in which it holds publicly-traded stock. Moreover, the legal duties of care and loyalty rest with the corporate board of directors, not with the shareholders. For these reasons, CalPERS views its role as that of a catalyst for improved management and accountability,(emphasis in original)”). However, CalPERS may, at times, have created or contributed to an impression that it has a larger role. See infra notes 86-88 and accompanying text.
funds--passive investing in diversified portfolios and utilizing proxy voting to encourage corporations to adopt standard “good governance” measures--is not designed to play the role assigned to activist institutional investors by commentators.

Nevertheless, as noted in the Introduction, activist institutional investors can play a more modest, but potentially significant role as one component of a web of legal and market forces which monitor management and act as a partial constraint on management discretion. Despite the criticisms of activist institutional investors in the United States, their potential role remains of great interest to commentators from other corporate governance systems. Part of the appeal of institutional investor activism may well be that “the limited success with limited investment” approach appears to be a practical, measured improvement in systems with a lack of complementary institutions able to act as effective external monitors of management.

B. Criteria for Comparison of Institutional Investor Activism

This Article does not attempt to develop a comprehensive theory of how different activist strategies might be employed in various operating environments. It mentions, but does not focus on, factors such as the share of the market owned by institutional investors, the number, type, and location of such investors, and legal rules. It does not seek

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29 For a classification of institutional investors with regard to their potential to pursue activist strategies, see K.A.D. Camara, Classifying Institutional Investors, 30 J. CORP. L. 219 (2004-2005).

30 Legal rules, although perhaps overemphasized in the literature, are nevertheless potentially significant. Black and Coffee cite the requirement of Schedule 13D filings under U.S. securities laws and the lack of widespread litigation in the United Kingdom as one factor in explaining why British institutional investors act in a more collaborative and somewhat more activist manner than their U.S. counterparts. See supra note 4, at 2078. Santella et al. speculate over whether fewer voting rights in the United States as compared to the European Union help explain the greater activism of American institutional investors than their EU counterparts. See supra note 6, at 47-48. In my research on the PFA in Japan specific legal rules were not usually cited as major obstacles to pursuing activist strategies, although there was a strong, general concern about the level of information disclosure and a specific complaint about time constraints in the proxy
either to examine general barriers to activism or to measure the effectiveness of activism. This Article explains specifically, and as simply as possible, the similarities and differences between the activist strategies of two public pension funds in the United States and Japan. It seeks to provide a third point of reference beyond the United States and the United Kingdom that may suggest significant factors and approaches which are useful in our understanding of the potential of institutional investor activism throughout the world. It accomplishes this task by limiting its focus to the two most important sets of constraints on activist strategy within an operating environment.

1. Portfolio Investment Strategy and Resource and Expertise Constraints

The portfolio investment strategy of activist institutional investors heavily influences the form and level of activist efforts. The typical investment strategy of public pension funds for the stock portion of their portfolio could be summarized as emphasizing diversification in the form of passive, index investing supplemented by outsourcing to active managers. This investment strategy is accompanied by advocating, and exercising proxy voting rights on behalf of, standard good corporate governance measures (e.g., an emphasis on independent directors) for portfolio companies that can be easily applied to a large number of companies. Such an approach requires minimal effort and expense, but is often viewed as being relatively ineffective in realizing change in corporate governance practices. It also gives rise to the criticism that activists, who controversially claim a correlation between good corporate governance and firm performance, do not act accordingly either in terms of concentrating their portfolios to

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32 Researchers have generally found no correlation between good corporate governance and firm performance, although there are difficult methodological issues and this remains a controversial topic. A
maximize their influence over portfolio companies or in their overall level of activist efforts.

Institutional investors throughout the OECD countries generally rely on passive equity investing; they have not constructed concentrated, actively-managed portfolios premised on the existence of a correlation between good corporate governance and enhanced portfolio returns. This phenomenon can best be explained by the major portfolio-related constraints discussed in this Article: expertise constraints and resource constraints. Pension fund managers are bureaucrats, not money managers. This fact leaves open two obvious choices for equity investments: entrust investment funds to outside managers for active investment or retain funds in-house for passive, index investment which requires no expertise. This choice leads to the typical pension fund pattern of emphasizing in-house passive investment supplemented by outside, active investing which seeks a higher return. In theory there could also be a “hybrid” approach under which a public pension fund hires some number of professional investment managers to join the organization and manage investments internally. This is a fair description of the approach taken by Harvard University’s endowment office. But such an approach raises its own difficult issues concerning compensation, institutional “fit,” and expectations about investment performance.


34 Jack R. Meyer, the manager of Harvard University’s endowment from 1990 to 2005 resigned amidst criticism of the compensation for him and his top six managers—a total of $107.5 million in 2003 and $78.4 million in 2004. See Marcia Vickers, The Money Game—For Years the Ivy League Rivals had Dueling Geniuses Running Their Endowments. Now Yale’s Man is Seeking the Spotlight While Harvard’s Heads for the Exit. FORTUNE, Oct. 3, 2005, at 155, 164. By contrast, Yale was successful with a more traditional strategy of outsourcing its investment funds to well-compensated money managers with more
A related issue is resource constraints. The overriding goal of a public pension fund is to provide a return sufficient for the retirement of its beneficiaries, and it is intended (and, in theory, required) for pension funds to act prudently and not take unreasonable risks. A passive investment strategy is the simplest method to achieve this goal by keeping investment costs to a minimum and lowering risk through portfolio diversification. A more active strategy would be riskier by incurring higher costs to place bets on achieving above-market performance. And devoting additional resources to corporate governance activities, as opposed to more investment management staff, would place an even greater speculative bet on the investment return produced by those activities.35

Expertise and resource constraints are significant partly due to the relentless pressure on pensions’ portfolio performance generated by the global pension crisis. The aging of industrialized societies means that unfunded, “pay-as-you-go” social security (or “public pension”36) systems will not have a sufficient working age population to sustain payments to the growing ranks of the elderly in the future.37 This has focused new

modest compensation for David Swensen, the head of Yale’s endowment ($1 million in 2004 versus $7 million for Meyer). Id., at 156.

35 CALPERS, WHY CORPORATE GOVERNANCE TODAY? (formerly on CalPERS website; on file with the author) (stating that “As an aspect of fiduciary duty, CalPERS has always balanced the cost of corporate governance, against the practical possibilities of improved performance at targeted companies.”).

36 “Public pensions” are the name given to social security systems throughout much of the world outside the United States. By contrast, “public pension funds” referred to in this Article are, in fact, private, defined benefit pension plans which are established and sponsored by governmental units and in which governmental employees are often the participants. Such public pension plans are financed, in the first instance, by means of payroll contributions by employees and employers like corporate or other private pension plans. However, the employer is usually a governmental entity, and it may need to raise taxes if it is unable to meet its obligation to make employer contributions.

37 Aging population is a combination of a large cohort of those who are becoming elderly and a low birth rate so that in the future payroll deductions for social security taken from the working-age population will be insufficient to fund payments to the elderly. There are numerous OECD and IMF publications that discuss this trend and the resulting debate on how pension reform might address it. See, e.g., Nicholas Barr, The Truth About Pension Reform, 38 FINANCE AND DEVELOPMENT (Sept. 2001), available at http://imf.org/external/pubs/ft/fandd/2001/09/barr.htm (noting that “Aging populations in industrial and transition countries have provoked heated debate about pension reform—in particular, about the desirability
attention on private, funded pensions as a necessary supplement to public pensions. In theory it might be best for private pensions to invest solely in individual long-term bonds which match their future payments and thereby avoid market risk. Such “liability-driven” funds do exist, but the pressure both to minimize contributions (from employers and employees) and to maximize assets for future payments to beneficiaries has resulted in a general trend throughout developed countries in which legal restrictions on investment choices have been relaxed over time and pension funds have moved heavily into equity and other risk assets.38

The “public” nature of public pension funds further reinforces these expertise and resource constraints. Unlike mutual fund investors, pension fund beneficiaries have no exit option, and are not reluctant to exercise their voice. As a result, even during times when investment strategies were highly successful, Harvard University has faced difficulty justifying the compensation given to its investment professionals (particularly when compared to the university’s top academic officers).39 And for both the organization and individuals involved in portfolio investment, making concentrated portfolio investments in an attempt to achieve above-market returns is a high-risk strategy of abandoning pay-as-you-go schemes in favor of private, funded pensions.”); OECD, PENSIONS AT A GLANCE: RETIREMENT-INCOME SYSTEMS IN OECD COUNTRIES (Summary, at 1) (2005), available at http://www.oecd.org/dataoecd/44/55/34816545.pdf (stating that “...a wave of pension reforms across OECD countries...were motivated primarily by concerns about the financial sustainability of pension systems in the context of ageing populations.”) (emphasis in original).

38 It is now typical for pension funds to allocate 50-60% or more of their assets to stock investments. A more conservative approach would be to match future liabilities exactly with future payouts from long-term bond investments. Some pension funds do follow a “liability-based” conservative approach, but it is no longer typical. Above and beyond the obvious benefits of higher returns, reasons for the more aggressive asset allocation model pursued by most pension funds would include the following: lower investment cost to the pension sponsor, the ability to benefit from paper profits or surpluses, a possible moral hazard for corporate pension funds from the Pension Benefit Guaranty Corporation, and support from money managers who profit from such asset allocation. For a concise discussion of the issue, see Mary Williams Walsh, Undone by Market Risk: A Premature Sunset for Pension Plans?, N.Y. TIMES, Nov. 28, 2004, at WK5.

39 See supra note 32.
in which the severe potential consequences for failure may substantially outweigh the benefits from success.

2. Activist Strategy and Constituency Constraint

The other criterion utilized in this Article to compare the activism of CalPERS in the United States and the PFA in Japan is constituency constraints. This Article attempts to go beyond a general distinction between “market-driven” private funds and “politically-driven” public funds⁴⁰ to examine how specific activist strategies pursued respectively by CalPERS and the PFA (e.g., selection of issues, proxy voting guidelines, degree of coordination with other institutional investors) and their “style” of activism (e.g., adversarial or cooperative, formal or informal) relate to their respective operating environments.

The constituency constraint can be divided into three parts: (1) pension fund members, (2) political interaction with government, and (3) media/public opinion. Each of these segments may wish to see its preferences reflected in the operations of public pension funds. Every activist pension fund will utilize a strategy which it believes will appeal to, or at least be permitted by, its constituencies, and will therefore be a good “fit” within its operating environment.

The attitudes of pension fund members is the most immediate, and perhaps most significant, constituency constraint. Even in the United States, a relatively limited number of institutional investors are enthusiastic about shareholder activism. Many of these are union-related pension funds or state employee funds. In addition to the initial question of becoming an activist, the more relevant question to the inquiry in this Article

⁴⁰ See, e.g., K.A.D. Camara, supra note 27.
is how member attitudes influence the form of activism. Activist funds can be rewarded—or punished—for high profile activism.

Politics can also affect activist strategies. In general, state employee funds like CalPERS are thought to benefit from political distance from national controversy, and this political “breathing space” is sometimes pointed out as an important factor enabling shareholder activism. Nevertheless, politics can readily intrude in many ways, including pressure to make certain investments (for example, to benefit local industry), pressure to politically support elected pension officials, and others. Political considerations may also be reflected internally in the form of differences between investment staff and either the “political” board (whether elected by members or appointed by government officials) or possibly the chief investment officer. Public pensions outside the United States are often closely related to national governments, with more direct political influence on their policies and operations. In such case political pressure can take the form of government pressure to support not only particular investment policies (pork barrel projects) for political gain, but more generally to support the stock market in times of market volatility.

Media and public support may also be significant to an activist’s efforts and can influence activist strategy. In many countries outside the United States there is the additional complication of dealing with the tendency for the media and public to be sympathetic to domestic companies that are pressured by foreign activists.

As there is also significant interaction among the three components of the constituency constraint, an activist’s strategy must consider their combined effect. This

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41 The latest controversy in this area is an investigation by a California state agency concerning accusations that a CalPERS board member, Charles Valdes, accepted campaign contributions from an investment placement agent that does business with CalPERS. See, e.g., Arleen Jacobius, CalPERS Trustee Target of Pay-to-Play Probe, PENSION & INVESTMENTS, Sept. 7, 2009, at 1.
is complicated by the fact that each constituency may have different interests. They are
united, however, in their common concerns about the adequacy of pension assets and
investment returns to fund future retirement in volatile investment markets. Thus, activist
pension funds will enjoy greater success to the extent that they can portray their
governance-related activities as being part of a watchdog role (i.e., as an “active” investor
looking out for its constituencies’ interests in difficult times) which will contribute to
easing of the pension crisis. Accordingly, the correlation between good corporate
governance and good financial performance, insisted upon by activist pension funds such
as CalPERS and the PFA, has important implications for an activist fund’s constituencies
and their willingness to support activist strategies.

III. THE CALPERS MODEL

CalPERS, originally created in 1932 by the State of California to manage
retirement benefits for state employees, has grown to become the largest pension fund in
the United States and fourth largest in the world with over $200 billion in assets (see
Appendix 2)\(^{42}\) managed on behalf of over 1.6 million state employees, retirees, and their
families.\(^{43}\) Like many public pension funds today, it depends on investment portfolio
returns to provide the bulk of its income to meet present and future pension obligations
and, accordingly, invests in a diversified portfolio of risk assets. It is perhaps best known
as a high profile, adversarial activist investor that advocates publicly for good corporate

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\(^{42}\) Appendix 2 is based on the most recent 2009 global comparison of pension funds and lists CalPERS
assets at $215 billion. Due to the stock market collapse in 2008-2009 and recent partial recovery, CalPERS
assets have been quite volatile. Total assets sank from $255 billion in the 2008 comparative survey (see
PENSION AND INVESTMENTS, Sept. 1, 2008, at 13) to $160 billion in March 2009, and stood at $180.9
billion at the end of CalPERS’ fiscal year on June 30, 2009. See Press Release, CalPERS, CalPERS
Reports Preliminary 2008-2009 Fiscal Year Performance (July 21, 2009), available at

\(^{43}\) See, e.g., CalPERS, FACTS AT A GLANCE: GENERAL (Sept. 2009), available at
governance and lobbies portfolio companies to improve governance practices in an effort to increase long-term returns.

A. Resource and Expertise Constraints

1. Diversification and Passive Investment

CalPERS was originally established as a “liability-driven” fund, which could only invest in long-term bonds to match future payment obligations to beneficiaries.\(^{44}\) It now has a diversified portfolio which emphasizes risk assets in order to maximize portfolio returns.\(^{45}\) Its asset allocation policy is determined by its investment committee and approved by its Board of Administration.

Although generally willing to embrace new asset classes for investment more quickly and extensively than most pension funds, CalPERS has basically pursued a mainstream investment strategy bounded by resource and expertise constraints. Traditional equity investments are largely managed passively through the use of index funds by in-house investment staff, and supplemented by investments with outside money managers for active management. Investments outside of traditional equity investments, which include domestic and global bonds, real estate, and, more recently, alternative

\(^{44}\)Like nearly all public pension funds, over time CalPERS sought to minimize contributions and maximize investment returns to meet its obligations, which led to a gradual expansion of permissible asset classes for investment to include real estate (1953), limited investments in common stocks (1967, limited to 25% of its portfolio), unlimited investment in common stocks (1984, proposition 21) which led to an early embrace of international investing, and, more recently, various alternative investments. For a concise summary of this history, see, Raquel Pichardo, *CalPERS a Model of Innovation at 75*, PENSION & INVESTMENTS, May 14, 2007, available at http://www.pionsline.com/apps/pbcs.dll/article?AID=/20070514/PRINTSUB/70511017&crit=calpers%20model%20of%20innovation.

investments (hedge funds and private equity) and inflation-linked investments, are all managed actively by outside money managers.\textsuperscript{46}

2. Relational Investing and Alternative Investments

One investment strategy which departs from pension funds’ general reliance on a passive indexing strategy for equity investment is CalPERS’ relational investing. This refers to investments with outside money managers in private funds that make concentrated investments in a limited number of underperforming companies and seek to influence the business strategies of portfolio companies to produce outsized returns. The first of these investments, in 1995, was with Relational Investors L.L.C., a private activist investment fund managed by Ralph Whitworth, a former lieutenant of the corporate raider T. Boone Pickens.\textsuperscript{47} This strategy was also pursued internationally, as CalPERS made substantial investments in activist funds in the United Kingdom and Japan.\textsuperscript{48}

During the past decade, CalPERS has also embraced alternative assets/private equity (including hedge funds) as a substantial asset class for investment, and in its three-year asset allocation plan adopted in December 2007 added a new inflation linked asset

\textsuperscript{46} For a summary, \textit{see id.} For complete data, \textit{see generally CALIFORNIA PUBLIC EMPLOYEES’ RETIREMENT SYSTEM, COMPREHENSIVE ANNUAL FINANCIAL REPORT} (for fiscal year ended June 30, 2008), \textit{available} at https://www.calpers.ca.gov/mss-publication/pdf/xGIPCN0RsQoyQ_2008%20CAFR(r3).pdf.

\textsuperscript{47} With CalPERS support, Whitworth, who had been regarded as something of a corporate gadfly, went mainstream and in 1999 became interim chairman of Waste Management Inc. Although CalPERS’ initial investment in Relational Investors L.L.C. was $200 million, by 1999 it had increased its investment to encompass $500 million of the $750 million of investor funds held by Relational Investors. \textit{See Andrew Pollack, Investing; Raider? Gadfly? Chairman,} N.Y. TIMES, Aug. 8, 1999. The article quotes well-known corporate governance expert Nell Minow as saying "You’ve heard of extreme sports…This is extreme shareholder activism." \textit{Id.}

\textsuperscript{48} This program was formalized in 1999 as the Corporate Governance Investment program. In addition to the United Kingdom and Japan, the program has also invested elsewhere in Europe and, in May 2008 made its first investment in an emerging market, a corporate governance fund in Korea. \textit{See CALPERS, FACTS AT A GLANCE: CORPORATE GOVERNANCE} (Aug. 2009), \textit{available} at http://www.calpers.ca.gov/eip-docs/about/facts/corpgov.pdf. For the program’s investment policy, \textit{see CALPERS, CALIFORNIA PUBLIC EMPLOYEES’ RETIREMENT SYSTEM STATEMENT OF INVESTMENT POLICY FOR CORPORATE GOVERNANCE PROGRAM} (April 21, 2008), \textit{available} at http://www.calpers.ca.gov/eip-docs/investments/policies/inv-asset-classes/equity/corp-gov/corp-gov-investments.pdf. For a discussion of its relational investments in two Japanese funds, \textit{see, e.g.,} Jacoby, \textit{supra} note 8, at 277-79.
class which includes “commodities, infrastructure, forestland, and inflation-linked bonds.”

The recent economic crisis and poor investment portfolio performance created both serious strains on CalPERS’ resources available for payments to beneficiaries and administrative expenses, and new controversy over its recent emphasis on alternative investments. CalPERS lost over 23% in portfolio value during 2008-2009, the worst year in its history, and at that point was only 66% funded, the lowest level in twenty years. At the same time, it is difficult for a public pension fund like CalPERS to increase the contributions of state employees and their public employers in an attempt to reduce the funding gap. Alternative investments performed poorly during the recent stock market crash, and outside critics have raised questions about the appropriateness of such high-risk assets for pension fund investments. Nevertheless, CalPERS’ chief investment

49 See CalPERS’ ANNUAL REPORT supra note 46, at 84, 88. This plan provides for a 10% allocation to alternative investment/private equity and a 5% allocation to inflation-linked assets. Id. at 88.

50 See Leslie Wayne, California Pension Fund Hopes Riskier Bets Will Restore its Health, N.Y. TIMES, July 24, 2009. In its defense, CalPERS notes that during that year, however, global equity prices declined 29.3%, and CalPERS long-term (20 year) annual investment return is 7.75%. See Press Release, supra note 42.

51 Although a corporate pension fund could decide to increase its contribution to its pension plan in order to make up the shortfall, it is extremely difficult, both financially and politically, for a public pension fund to do so. See, e.g., Arleen Jacobius, CalPERS Eyes Risk, Liquidity in Asset Review, PENSION & INVESTMENTS, March 23, 2009, at 1. In fact, CalPERS drew the ire of California governor Arnold Schwarzenegger by limiting increases in employer contributions by California municipalities due to the state’s fiscal crisis. See, Wayne, supra note 50 (quoting Governor Schwarzenegger as denouncing that action as a “pass the buck to our kids idea”).

52 During 2008-2009 private equity investments declined by 31.4%, compared to 28.55 for public stocks in the portfolio. Real estate investments, which included SIVs with mortgage-backed securities, did even worse, with a 35.8% loss. See Press Release, supra note 42. CalPERS filed a lawsuit against the three major credit rating agencies with respect to its losses on a total $1.3 billion investment in three triple-A rated SIVs which defaulted on their payments. See Rick Brooks, Raters Sued by CalPERS Over Losses, WALL. ST. J., July 15, 2009.

53 For criticism of CalPERS’ investment in risky assets, see, e.g., Wayne, supra note 50. Alternative investments tend to be illiquid, private investments. Liquidity risk was not included in traditional asset allocation models of pension funds. As a result of the recent market crash CalPERS’ pension consultant, Wilshire Associates, is now considering incorporating liquidity considerations into its asset allocation model for CalPERS. See Jacobius, supra note 51.
officer has recently emphasized his continuing commitment to private investments, and, to date, CalPERS’ board has accommodated such an approach.  

3. Emphasis on Proxy voting and Standard Good Corporate Governance Measures

CalPERS began its corporate governance activities in the mid-1980s in reaction to poison pills and other defensive measures taken by individual companies. It gradually developed a broader set of corporate governance principles and practices. Its proxy voting policy basically states that it will vote its proxies so as to implement these corporate governance principles. Although CalPERS frequently votes against company proposals, its corporate governance principles contain a long list of recommendations without any specific indication of what corporate practices would trigger a “no” vote by CalPERS when exercising its proxy voting rights.

54 See, Mark Veverka, Interview with Joe Dear, Chief Investment Officer, California Public Employees’ Retirement System, Keeping His Eyes Trained on the Long Term, BARRON’S, June 29, 2009, at 34. CalPERS’ CIO has clearly not lost the faith, as he stated that he expects CalPERS’ investment in private equity to outperform its investments in public equity by 300 basis points (3%) on a risk-adjusted basis. Id., at 35.


57 CalPERS formerly had separate domestic and international corporate governance principles. They remain separate, although they are now combined under one policy which contains a brief statement of core principles which are applicable to both. See GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE, supra note 55. Domestic principles cover six areas (board independence & leadership; board, director, and CEO evaluation; executive & director compensation; integrity of financial reporting; corporate responsibility; and shareowner rights) and make a variety of recommendations ranging from those already legally required for public companies under Sarbanes-Oxley (e.g., a majority of independent directors; see id. at 10) to more ambitious practices which are still relatively uncommon (e.g., environmental disclosure including utilizing the Ceres Climate Change Governance checklist as a tool in applying the Global Framework for Climate Risk Disclosure; see id. at 17). For international proxy voting, CalPERS utilizes the International Corporate Governance Network Corporate Governance Principles, which are general principles and do not contain specific recommendations. Id. at 19-24.
CalPERS came to emphasize a broader set of standard good governance measures relating to areas such as shareholder voting rights, board composition, and executive compensation which could be easily applied to a broad set of companies. It also adopted a now familiar set of tactics: public advocacy for overall corporate governance reform (which it currently refers to as “market initiatives”) and pressuring portfolio corporations to adopt its recommended good corporate governance practices by utilization of proxy voting, shareholder proposals, public “jawboning”, and informal communications with corporations. Significantly, these standard good corporate governance measures were not applied to companies in its concentrated relational investing portfolio; those managers, such as Relational Investors L.L.C. focused solely on aggressively pressuring portfolio companies on business strategy to maximize investment returns.

CalPERS has long premised its activism on the straightforward notion that shareholders must act like owners and be actively involved in the activities and performance of companies they own. CalPERS ties the idea of activism generally, and utilizing proxy voting in particular, to its fiduciary duties as a trustee, i.e. viewing corporate governance measures as being related to its duties of loyalty and care to enhance long-term results on behalf of its beneficiaries. It also recognizes a duty to monitor investment performance and vote proxies as “inherent within the concept of prudence.” In keeping with this view of acting as a fiduciary on behalf of the owners of corporations, it consistently refers to shareholders as “shareowners.”

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59 See, e.g., Jacoby, supra note 8, at 280.
60 See STATEMENT OF INVESTMENT POLICY FOR GLOBAL PROXY VOTING, supra note 56.
61 Id. For a discussion of a duty of monitoring, see Richard H. Koppes & Maureen L. Reilly, An Ounce of
4. The “CalPERS Effect:” Insistence on a Correlation between Corporate Governance and Firm Performance

Together with its emphasis on acting on behalf of shareowners and fulfilling its duties to its beneficiaries, CalPERS has consistently and loudly defended its corporate governance activism by insisting that such activities enhance long-term portfolio performance. This is a controversial proposition which can be subjected to attempts at empirical testing, and has given rise to a cottage industry of researchers trying to determine if there truly is a “CalPERS effect” as claimed by CalPERS and its pension consultant, Wilshire Associates.

The general view is that there is no correlation between the number of independent directors (a typical, standard good governance measure advocated by CalPERS) and increased firm performance. Wilshire Associates’ studies, which focus on a small group of targeted focus list companies, consistently find a positive effect but tend to be discounted due both to an obvious conflict of interest and to difficult methodological issues. The results may best be described as ambiguous, with perhaps a short-term rise in stock price when CalPERS first announces it is targeting a firm but less...
evidence of long-term impact. However, since CalPERS’ main claim is that its corporate governance activities result in a long-term gain in its portfolio performance, perhaps the most accurate judgment at present might be the Scottish criminal result of “not proven.”

This ambiguous result on a critical issue is further complicated by CalPERS’ citing its success in relational investing as “proving” the existence of a general positive relationship between good corporate governance and firm performance. Although relational investing might well fit within a typically broad definition of “activism,” CalPERS’ argument conflates two essentially different strategies: (1) CalPERS’ typical governance strategy of advocating that all portfolio companies generally adopt standard good corporate governance measures and (2) the investment strategy of relational investment funds that utilize highly concentrated portfolios to pressure individual companies and their business strategies without regard to standard good corporate governance measures. It would therefore seem highly questionable to utilize a relational

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66 For a non-CalPERS’-sponsored event study which found a positive short-term effect from being added to CalPERS’ focus list, see Brad Barber, Monitoring the Monitor: Evaluating CalPERS’ Activism, available at SSRN: http://ssrn.com/abstract=890321. But see James N. Nelson, The ‘CalPERS Effect’ Revisited Again, 12 J. CORP. FIN. 187 (2006) (criticizing the methodology of the Wilshire Associates’ studies and finding no shareholder wealth effect from CalPERS’ activism). There is greater agreement that there is no demonstrated wealth effect over the long term. See, e.g., Aaron Elstein, Pension funds Try to Play A Key role as Activists, WALL ST. J., Nov. 6, 2007 (quoting Stuart Gillan as summarizing his research and the literature by stating “In general, the research shows no wealth effect over the long term.”). For a review of the literature on the “CalPERS’ effect” see Jacoby, supra note 8, at 247-48.

67 CalPERS’ relational investments (formally its “Corporate Governance Investment program”) now includes 22 external managers, both domestic and international, with $3.7 billion in investments. See FACTS AT A GLANCE: CORPORATE GOVERNANCE, supra note 45. Up until last year the program’s results significantly outperformed its benchmark. However, last year this higher risk segment of CalPERS’ portfolio produced extremely poor returns. CalPERS’ program lost 24.69% compared to 14.63% for the benchmark. See CalPERS’ website at http://www.calpers-governance.org/docs-sof/investments/charts/performance.pdf. Longer-term returns are still favorable, with performance of 500 basis points (55) above the benchmark. See FACTS AT A GLANCE: CORPORATE GOVERNANCE, supra note 48.

68 The author witnessed this directly at a conference held by CalPERS and Sparx, its first relational investment partner in Japan, where both CalPERS’ vice president of corporate governance and Sparx’s fund manager made that claim.

69 See Black supra note 1.
investment strategy as evidence proving a broader correlation between good corporate governance and firm performance simply because the relational investment funds are provided by CalPERS.

B. Constituency Constraint

CalPERS’ passive indexing investment strategy, which is typical of public pension funds, may strongly encourage proxy voting as the most realistic mechanism for pursuing shareholder activism. However, we must look at CalPERS’ constituency constraints to help explain the specifics and “style” of its activist strategy.

CalPERS’ members, who are state and local government employees, consistently elect representatives to CalPERS’ board of administration that are sympathetic to labor issues. Although their primary concern may be protecting their benefits under CalPERS’ defined benefit pension plan, they also tend to support enthusiastically both corporate governance initiatives and labor-related political and social issues. To the extent that members believe in enhanced investment returns due to a “CalPERS effect,” they should also support corporate governance initiatives for economic reasons (i.e., to increase the resources available to pay member benefits) in addition to any ideological reasons.

State public pension funds like CalPERS may generally be in a favorable political position to pursue activist strategies, but CalPERS is nevertheless regularly embroiled in state politics. CalPERS’ board of administration is composed of 13 individuals with staggered term: six elected by CalPERS’ members, three appointed by the governor and

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70 For a flavor of the views of, and pressure from, members who are sympathetic to labor interests see, e.g., the website http://www.perswatch.net/, which was founded and is moderated by James McRitchie, a labor activist.
71 In fact, the perswatch website advocates less use of passive, index investing for domestic equities and greater use of corporate governance tests to create enhanced indexes and take full advantage of the greater returns due to the “CalPERS effect.” See http://www.perswatch.net/iss/iss.html.
legislature, and four state government officials that are statutory designated board members, including the state’s treasurer and controller.\textsuperscript{72} The seven appointed and statutory designated board members can potentially outnumber the six elected members, and despite its reputation as a liberal, “blue” state, California has experienced several changes of administration over the past two decades. It currently has a Republican governor who wishes to radically alter CalPERS structure and activities by converting it from a traditional defined benefits plan to a 401k defined contribution plan. At other times Democratic state officials have pressured CalPERS to aggressively pursue labor-related issues.

These political considerations can be reflected in CalPERS’ internal structure and personnel. For example, it may be more useful for a chief investment officer at a public pension fund like CalPERS to have a political background rather than an investment background.\textsuperscript{73} Although CalPERS has been pushed and pulled to some degree by political forces, its high profile and adversarial style of governance-oriented activism has been reasonably consistent. Here again, the touted “CalPERS effect” has played a role. One of the goals of state government is to minimize employer contributions to pension funds (and thereby keep taxes low and economic growth and employment high), and corporate governance activism is more politically acceptable and sustainable if it is thought to contribute to this important economic goal.\textsuperscript{74}

\begin{footnotesize}
\footnotetext{72}{For a summary of the board positions, see FACTS AT A GLANCE: GENERAL 3, supra note 43. For information on current board members, see http://www.calpers.ca.gov/index.jsp?bc=/about/organization/board/members/home.xml. }
\footnotetext{73}{This is true of the current chief investment officer, Joseph Dear. See, e.g., Craig Karmin & Joann S Lublin, \textit{Dear Wins Job of CIO at CalPERS} (referring to Mr. Dear as an “unusual choice’ who will use his “political skills” to protect CalPERS from the possibility of adverse state legislation).}
\footnotetext{74}{See \textit{STATEMENT OF INVESTMENT POLICY FOR GLOBAL PROXY VOTING}, supra note 56 (including, within the section on CalPERS’ fiduciary duties, a statement that “The Board also has a duty to maximize the value of its investments, in order to avoid the increases in state and local government taxes}}
\end{footnotesize}
A relatively liberal political setting, and a media which sells into that market, is an additional factor which provides support for CalPERS’ activist policies. Corporate scandals, both Exxon/Worldcom and the financial crisis of 2008, which have occurred during down stock market cycles, have helped to develop a positive image for CalPERS’ corporate governance activism. There appears to be some popular belief in the “CalPERS’ effect” despite continuing skepticism in the Academy over both its validity and the effectiveness of pursuing standard good corporate governance measures.

1. Proxy Voting and Shareholder Proposals

From the beginning of its activism, CalPERS has emphasized the importance, and obligation, of institutional shareholders to exercise their voting rights in portfolio companies through the proxy process. Beyond its general exercise of proxy voting rights, CalPERS’ reputation as a corporate governance activist derives from its combination of strategies—shareholder proposals, public “jawboning,” and informal communications—utilized to implement CalPERS’ principles and policies on governance issues with respect to portfolio companies.

CalPERS’ shareholder proposals have tended to focus on a limited number of companies and on certain bread-and-butter corporate governance issues, such as shareholder voting rights (particularly removal of staggered boards, certain poison pill defenses, and supermajority voting requirements) and shareholder advisory votes on executive compensation. A pattern has developed in which CalPERS first files proposals, then negotiates with the target company, and then “settles”—i.e., reaches agreement with the company on corporate governance measures to be taken and subsequently withdraws

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75 See, e.g., supra note 69.
76 See supra notes 60-61.
its shareholder proposal. CalPERS pursues proxy votes on its shareholder proposals with recalcitrant companies that will not settle, and generally wins a majority of shareholder votes for such proposals. For example, in fiscal year 2007-2008 CalPERS voted 7,471 individual global proxies.\textsuperscript{77} It initiated 32 shareholder proposals, subsequently withdrew 25 of these proposals, voted on seven, and received a majority shareholder vote on five of the seven proposals.\textsuperscript{78}

2. Focus List

Perhaps CalPERS’ most high profile strategy over the years has been to compile a relatively small focus list of targeted companies. It is a comparison of companies on the focus list with broader market indices which forms the basis of the claimed “CalPERS’ effect” of excess returns. The focus list methodology has changed over time, beginning with company-specific anti-takeover measures in the late 1980s and gradually evolving into a combination of poor market performance (underperforming both a broad index, such as the Russell 1000, and an industry peer index) and poor corporate governance practices involving shareholder voting rights.\textsuperscript{79} Focus list companies include both those companies that have settled with CalPERS on corporate governance measures and those which have not.\textsuperscript{80}

\textsuperscript{77} ANNUAL REPORT, supra note 46, at 84.
\textsuperscript{80} For the four companies on the current focus list (2009), two companies agreed to corporate governance reforms which were acceptable to CalPERS (and, accordingly, there is no pending CalPERS’ shareholder proposal), one company reached a partial settlement (and CalPERS has a pending shareholder proposal on an unsettled issue), and one did not reach any agreement (a CalPERS’ shareholder proposal is pending).
3. Lack of Coordination

Although CalPERS’ board members were instrumental in founding the Council of Institutional Investors (“CII”), and CalPERS’ chief investment officer is the current president of CII, CalPERS has generally pursued its individual corporate governance policies and actions with a relatively low level of coordination with other institutional investors. Pension funds’ passive indexing investment strategies would suggest substantial benefits to coordination among like-minded institutional investors, with the potential to have a significantly larger voice in the affairs of portfolio companies than could be achieved singly. However, this has generally not happened, despite some coordination on broad regulatory issues, such as the current focus on financial system reform, and in specific proxy voting campaigns against certain corporations on particular issues.

Several factors may contribute to this result. The academic literature often cites the costs of coordination as weighed against the benefits and legal barriers to coordination. An even larger issue may result from CalPERS’ constituency constraint—CII is a broad-based organization and most of its members are unwilling to “go public” with complaints against specific corporations. Although CII compiles its own focus list, based on criteria similar to CalPERS’ list, it does not publicly disclose the

See CALIFORNIA PUBLIC EMPLOYEES’ RETIREMENT SYSTEM, REFORM FOCUS LIST COMPANIES, available at http://www.calpers-governance.org/focuslist/reform-companies. This mixed bag of results is also applicable to the five companies on the list for 2008 and the 11 companies on the list for 2007. Id.


82 See, e.g., Coffee, supra note 29.

83 See, e.g., Black and Coffee, supra note 4.
corporations it has targeted. To the extent that CalPERS’ constituencies expect or reward it for being at least somewhat high-profile and adversarial, as best exemplified by its focus list, any subordination of CalPERS’ activities to the broader constituency and milder methods of CII might have negative implications for CalPERS.

4. Social Issues

Perhaps the most vocal criticism of CalPERS’ activism is its foray into social and political issues which are dear to labor activists but which may be unrelated to CalPERS’ portfolio performance and its core mission of providing retirement benefits to members. CalPERS has been somewhat inconsistent on this point. In the 1990s the leaders of CalPERS specifically disavowed the legitimacy of its becoming involved in social issues. However, by 2002 the CalPERS’ Board of Administration was composed entirely of labor representatives and Democrats, and there were allegations that CalPERS would alter its investment standards to favor social change and political correctness, and use its proxy voting to support labor union activities. With a change to a Republican administration, CalPERS’ labor activist president (and board member) Sean Harrigan failed to win reappointment from the State Personnel Board in 2004. This “firing” stoked its own controversy, however at least some of the more aggressive labor-related policies

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84 The stated purpose of this secrecy is to make it easier for focus list companies to discuss problematic governance issues with CII members. See http://www.cii.org/resourcesFocusList.
85 See WHY CORPORATE GOVERNANCE TODAY? supra note 35 (stating that “By longstanding policy, CalPERS does not incorporate this issue [shareholder activism for rights to sponsor social causes and human rights] into its corporate governance program. CalPERS believes its policy is necessary to avoid an inherent conflict both for its own fiduciaries, and those on a corporate board, that would arise if trust funds were invested imprudently or corporate policies were diverted into non-shareholder purposes.”) [emphasis in original]. See speech of Robert F. Carlson, supra note ___ (“The duty of loyalty is the “sole purpose” doctrine. This means that the board and other CalPERS fiduciaries must act solely in the interest of members and beneficiaries. For this reason, CalPERS cannot base its corporate governance activities on social or political causes. Instead, we must focus on the “bottom line” of enhanced shareowner returns.”).
87 See, e.g., CalPERS: An Activist Ousted, ECONOMIST, Dec. 4, 2004, at 77. Among Mr. Harrigan’s better-known examples of alleged overreaching were voting against the reappointment of Warren Buffett as
implemented between 2002 and 2004 were modified.\textsuperscript{88} CalPERS continues, however, to advocate for corporate social responsibility.\textsuperscript{89}

IV. THE PFA MODEL

A. Japan’s Pension System and the Role of PFA

Japan shares the same problems with all developed countries of financing social security and health care costs, only worse. Japan has the most rapidly aging population and the longest life expectancy among OECD countries.\textsuperscript{90} As a result, even though it devotes above-average financial resources to public pensions, Japan has one of the lowest compensation rates (pension levels compared to earnings when working) within the OECD.\textsuperscript{91} Due to its long economic malaise beginning in the 1990s and various economic stimulus packages, its gross national debt is the highest percentage of GDP among OECD

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\textsuperscript{88} One example is CalPERS’ investment policy with respect to emerging markets. In 2002 CalPERS, led by State Treasurer Phil Angeledes (a CalPERS board member) had Wilshire Associates grade 27 emerging markets based half on typical investment criteria and half on civil-governance categories, including labor practices. The result was that 14 of these markets were put off-limits. See Gary LaMoshi, \textit{CalPERS Plays With Investment Fire}, ASIA TIMES ONLINE, March 5, 2003, available at http://www.atimes.com/atimes/Global_Economy/EC05Dj01.html. In 2007 CalPERS eased up on these investment criteria and adopted a more holistic approach, opening the way for investment in China and Russia. See, e.g., Steve Brull, \textit{Emerging Targets: CalPERS May Soon Drop the Rule That Kept it Out of Many Developing Nations}, INST. INV’T, July 13, 2007.

\textsuperscript{89} See \textit{GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE}, supra note 55, at 17-18 (containing recommendations on eliminating human rights violations, environmental disclosure, sustainable corporate development, and reincorporation).

\textsuperscript{90} Japan is the “oldest” country in the OECD, with 2.6 people of working age for each person over 65, compared to the OECD average of 4.0. See \textit{Japan: Highlights from OECD Pensions at a Glance 2009}, excerpted from ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PENSIONS AT A GLANCE: RETIREMENT-INCOME SYSTEMS IN OECD COUNTRIES (2009), available at http://www.oecd.org/document/49/0,3343,en_2649_34757_42992113_1_1_1_1,00.html.

\textsuperscript{91} Japan’s public pension spending as a percentage of GDP is 8.7%, compared to the OECD average of 7.2%. \textit{Id}. The percentage of income provided by public pensions (the “pension replacement rate”) for an average worker is 33.9%, compared to the OECD average of 59.0%. This places Japan second lowest (ahead of Germany) among all OECD countries. \textit{Id}. 

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countries. Finally, special social factors in Japan which aided financial support and care of older citizens—a relatively old retirement age plus a traditional family structure in which the elderly often live with, and are supported by, adult children—are fading.

In any system where public pensions are relatively low, individuals bear greater responsibility for providing for their retirement income and private pensions assume great importance. Although, like the United States, there are no mandatory private pensions in Japan, some 45% of the Japanese workforce is covered by private pensions, chiefly those sponsored by employers. The PFA was established in 1967 and its present role encompasses two main purposes: (1) to act as the umbrella organization for corporate pension funds in Japan (its members), and (2) to manage retirement assets for individuals (beneficiaries/participants) who have left corporate employment in mid-career or whose company pension plans have dissolved. Its role has continued to gain in importance, as labor has gradually become more mobile and as corporations have felt the financial crunch of maintaining pension plans. As a result, the PFA is now the 11th largest pension

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92 Japan’s gross national debt was 170% of GDP in 2008, which was second worst in the world after Zimbabwe. See U.S. Central Intelligence Agency, The World Factbook 2008, “Country Comparisons – Public Debt,” https://www.cia.gov/library/publications/the-world-factbook/rankorder/2186rank.html. This figure does not, however, include public reserves set aside for future social welfare payments, so the ranking of the net public debt of Japan would be lower.


94 See Japan Highlights, supra note 90.

95 For an overview and history of corporate pensions in Japan, see, e.g., David Rajnes, The Evolution of Japanese Employer-Sponsored Retirement Plans, 67 SOC. SEC. BULL. 89 (No. 3, 2007), available at SSRN: http://ssrn.com/abstract=1154007. Although a type of defined contribution plan was introduced in 2001 as part of a series of reforms, most corporate pension plans are defined benefit plans. Id.

fund in the world ($130 billion assets) and is over six times larger than the largest Japanese corporate pension fund (see Appendix 2).

B. Resource and Expertise Constraints

1. Diversification and Passive Investment

The PFA’s portfolio strategy is not fundamentally different from CalPERS’ approach, and presumably for similar reasons. Ever since major investment limitations on Japanese asset managers were lifted in 1996, the PFA has kept a relatively steady asset allocation among four major classes of investments: domestic bonds, domestic stocks, foreign bonds, and foreign stocks. It formulates a Basic Plan for Pension Asset Management (every three years) which includes a targeted asset mix of these four classes of investment. Its stated goal is to set an appropriate risk level and maximize returns, utilizing portfolio diversification as a means of limiting risk.

Overall, the PFA’s portfolio is somewhat more conservative than CalPER’s asset allocation, with the PFA allocating 45% of its target portfolio to domestic and international stocks compared to well over 60% at CalPERS. However, this difference is typical as between U.S. and Japanese asset managers. In addition, the PFA has been

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97 Data on the current target allocation, past target allocations and changes in asset allocation over time are all found at the portion of the PFA website entitled “Basic Approach to Pension Asset Management and Overview of Investment,” available in English at http://pfa.or.jp/english/english05/05_01.html. The target allocation and current allocation (in parentheses) for each of the four major asset classes are as follows: domestic bonds 35% (34.2%), domestic stocks 23% (23.2%), foreign bonds 20% (19.0%), and foreign stocks 22% (20.9%). Id.


99 See supra note [62].

100 Id.
slower to adopt alternative investments, making very modest investments in private equity and its first hedge fund investment in October 2007.\textsuperscript{101}

Like CalPERS, the PFA relies on outside asset managers for active fund management (and for all management of international stocks and bonds). The PFA began its own in-house investing in April 2002 through passive indexing of domestic stocks. The small PFA in-house investment staff does not engage in active fund management, but administers the investment operations, including selection and monitoring of outside money managers.\textsuperscript{102} The PFA is also under considerable budgetary pressure, due to declining corporate pension membership.\textsuperscript{103}

2. Standard Good Corporate Governance Measures and Their Justification

Having embraced passive index investing for much of its domestic stock portfolio, the PFA utilizes proxy voting based on standard good governance measures. It also uses justifications for its activism which are broadly similar to those of CalPERS. The PFA emphasizes its duty to act on behalf of its beneficiaries and also sees proxy voting as part


\textsuperscript{102} The PFA has a very small staff with only six professionals in charge of equity investing within its Pension Investment Department. In total, the PFA entrusts 71.9\% of its assets to outside managers and manages 28.1\% in-house. \textit{See id.}, at 8 (calculated from numbers appearing in Section 5, Sanko Deeta [Reference Data], Table 1 Itaku Unyo–Jika Unyo (Inhaasu Unyo) Zandaka no Suii [Change in Balances of Entrusted Management and Self-Management (In-house Management)]. Unlike CalPERS, it now also engages in “semi-active” (i.e., enhanced index investing) in-house management for a portion of its domestic bond portfolio. \textit{Id.}

\textsuperscript{103} See Pension Fund Association Faces Restructuring on Lower Income, NIHON KEIZAI SHIMBUN, Sept. 17, 2003, available in English at http://www.nii.nikkei.co.jp (noting a PFA staff reduction in response to “…expected sharp reduction in [the PFA’s] membership fee income as many employee pension funds are being dissolved.”). Traditional pension plans were required to be PFA members, but new defined benefit plans, following reform in 2001, have the option of joining the PFA. There has been a trend of traditional plans either dissolving or converting to new defined benefit plans which results in a net loss of PFA membership.
of a fiduciary duty. It emphasizes the corporate purpose as the maximization of shareholder value. In a stakeholder system like that of Japan, it goes on to clearly state its view that there is no conflict, at least in the long term, between the maximization of shareholder value and stakeholder considerations.

The PFA has also consistently stated that it views improved corporate governance as leading to enhanced portfolio returns. However, the claim is less controversial partly because there is no equivalent to Wilshire Associates producing controversial empirical studies in support of that claim and partly because, as discussed infra, the PFA’s proxy voting guidelines incorporate specific performance standards which are of greater importance than the standard good corporate governance measures related to areas such as board composition and shareholder voting rights.

C. Constituency Constraint

The PFA emerged unexpectedly as an active voice for shareholders in 2002. From around 1998 there was an increase in general interest in corporate governance issues, including various educational efforts, activities by foreign activist investors such as CalPERS, and the formation of groups in Japan interested in corporate governance. However, there were two immediate catalysts for the PFA’s embracing activism: the entry into the PFA of Tomomi Yano from the central government’s Ministry of Health and Welfare in 2001, and three consecutive years of negative portfolio performance.

104 See PENSION FUND ASSOCIATION, PRINCIPLES OF CORPORATE GOVERNANCE 2, available at http://www.pfa.or.jp/jigyo/shisan/gava_giketsuken/files/gensoku_e.pdf (“...the PFA is called upon to exercise shareholder voting rights properly in order to fulfill the fiduciary responsibilities it has been assigned.”).

105 Id. (“The objective of a corporate entity is to seek to maximize shareholder value on a long-term basis.”).

106 Id. (“Maximization of shareholder value does not conflict with the interests of stakeholders...but can be achieved through the establishment of good cooperative relationships with such stakeholders.”).

107 See generally, Jacoby supra note 8.
during the crash of the tech bubble (2000-2002) which severely strained pension assets and planning.

Although Mr. Yano, perhaps comparable with Robert Monks in the United States due to his regulatory background, has been called an unlikely activist,\(^{108}\) he seized the opportunity to institute activist PFA policies which center on proxy voting and corporate governance guidelines.

The PFA’s activism is surprising, in part, because its membership is composed of corporate pension plans. Although the PFA provides information, technical support, and policy advocacy on behalf of its members, and they have a shared interest in the vitality of the corporate pension system, it is not obvious that such shared interests would extend to corporate governance activism.

The governance of the PFA is structured as follows:\(^{109}\) Member corporate pension plans elect 37 trustees to a Board of Trustees (34 elected by region and three elected by type of pension plan). Trustees select an 18 member board of directors, 14 of which are part time and four of which are full time and act as executive officers (President, Executive Director, Managing Director, and director). The part-time directors are generally selected from among the trustees, but the full-time directors/officers generally include a number of outsiders, particularly government officials.\(^{110}\)

So why would the member corporate pension funds acquiesce to an activist strategy? There has been both public and private criticism of the PFA’s activism by

\(^{108}\) See Fackler, supra note 13.

\(^{109}\) For an organization chart and explanation, see PENSION FUND ASSOCIATION, WE SUPPORT THE CORPORATE PENSION PLANS, at 7, available in English at http://www.pfa.or.jp/gaiyo/kanyu/files/pamphlet_2004_e.pdf.

\(^{110}\) Of the current full-time directors, two come from corporations and two are ex-government officials (a fifth executive who is not a director also comes from a corporate background. See section of the PFA website entitled Jokin Yakuin no Jokyo [Overview of Full-time Directors], http://www.pfa.or.jp/gaiyo/description/description02.html.
corporate managers,\textsuperscript{111} although the separately incorporated corporate pension plans do not generally engage in public criticism. Both corporations and their pension plans have been on the defensive due to poor financial results, and, as discussed below, the PFA’s proxy voting focuses strongly on financial performance. The PFA seems to enjoy substantial media, and public support. Another possible factor is that many corporate pension funds also have former government officials from Japan’s Ministry of Health Labor and Welfare, where Mr. Yano was formerly in charge of pensions, and so this bureaucratic old boys’ network may help to mute criticism or at least prevent it from becoming public.\textsuperscript{112}

There is no real PFA equivalent to the state politics which affects CalPERS. In Japan, the world’s largest pension fund, the (GPIF) which invests public pension (social security) funds is part of the national government and is subjected to heavy political pressure. However, the PFA was created and is regulated by the Ministry of Health Labor and Welfare, and like the Department of Labor and ERISA in the United States, it is concerned primarily with policy issues such as the appropriate standards and regulation of pension funds. In the past there were strong allegations of politically-motivated pork barrel investments by the predecessor of the GPIF.\textsuperscript{113} There have also been periodic newspaper reports that the government has pressured public pension funds to purchase equity shares to support the stock market in times of market volatility,\textsuperscript{114} however there is no evidence that the PFA has engaged in such practice.

\textsuperscript{111} See Fackler, supra note 13.  
\textsuperscript{112} Confidential interview, Tokyo, July 2007.  
\textsuperscript{113} In fact the GPIF was created as part of a pension reform enacted in 2001 primarily to change the investment of public pensions from a trust fund associated with the Ministry of finance to new, independent, professional management in the form of the GPIF.  
\textsuperscript{114} The financial crisis of 2008 and continuing pressures on the stock market have prompted government officials to speculate about the more drastic step of having the government purchase stocks. See, e.g., Kenji
The media and public in Japan form an important, but uncertain, constituency for the PFA. The pension crisis, poor corporate performance, and a series of corporate scandals form the background in which a champion on behalf of shareholders might thrive. However, as noted in the Introduction, there is no history of activism in Japan. In fact, shareholder activism can have negative connotations as the group which traditionally challenged authority at general shareholder meetings were sokaiya racketeers.115 More recent domestic shareholder “activists,” such as the iconoclastic Takafumi Horie of Livedoor,116 and Yoshiaki Murakami of M&A Consulting117 were both highly controversial and ultimately found guilty of criminal securities law violations, while foreign activist hedge funds, such as Steel Partners, have been seen as too self-interested and aggressive by the Japanese media and public.118 As a public pension fund, however, the PFA was in a better position to try and demonstrate that its actions were for the “public interest” rather than for private gain.

115 See West, supra note 9.
116 Livedoor, an internet service provider led by a brash young internet entrepreneur, Takafumi Horie, acquired overnight 29.6 of Nippon Broadcasting System, Inc., a radio broadcaster and corporate member of Japan’s largest media group. The main defensive measure was to issue warrants to friendly shareholders, thus diluting Livedoor’s holdings. This defensive tactic was struck down in court, although the two sides ultimately settled amicably. See generally Curtis J. Milhaupt, In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan, 105 COLUM. L. REV. 2171 (2005). Mr. Horie, although initially popular, was later brought to criminal trial on charges of securities fraud for inflating Livedoor profits. See, e.g., Norimitsu Onishi, Livedoor Tycoon Gets Jail Term for Fraud, N.Y. TIMES, March 16, 2007.
117 Yoshiaki Murakami, a former government official, became the most controversial fund manager in Japan. His fund, MAC Asset Management, targeted complacent companies and utilized aggressive tactics in an attempt to raise dividends or otherwise create value for shareholders. Although he was both admired and vilified as the symbol of a new, aggressive form of activist investor, he ultimately was charged and convicted of a criminal violation of insider trading laws in connection with the Livedoor case (see id.). See, e.g., Murakami Gets Two Years in Jail in Livedoor Scandal, N.Y. TIMES, July 19, 2007.
118 Hostile takeover attempts may even have a negative and perverse effect, as they may permit domestic management of a Japanese company to appeal to nationalism and act against the financial interests of shareholders. One example is the attempt in 2007 by an activist American hedge fund, Steel Partners, to effect a hostile takeover of Bulldog Sauce Co., Ltd., a well-known Japanese condiment maker. In that case the Tokyo high court labeled Steel Partners an “abusive acquirer.” The Japanese Supreme Court ultimate validated Bulldog Sauce’s shareholder rights plan. Its decision also had important implications for the future, as it discussed factors, such as shareholder approval, which would make such defenses reasonable. See, e.g., Kenichi Osugi, What is Converging? Rules on Hostile Takeovers in Japan and the Convergence Debate, 9 ASIAN-PAC. L. & POL’Y J. 143, 158-59 (2007).
Accordingly, the PFA has portrayed itself as a “reluctant activist” that has been forced by poor corporate performance, lax regulation,\textsuperscript{119} and its duty to its participants and beneficiaries to play a more active role as a voice for shareholders. It utilizes performance-linked objective standards for proxy voting, does not generally publicly “jawbone” corporations, and, in fact, typically emphasizes examples of good corporate governance rather than criticizing companies for poor corporate governance. It does not make shareholder proposals and generally does not support proposals by other (often foreign) shareholders, and does not engage in litigation, but does look for specific opportunities where it can safely utilize more aggressive tactics.

1. Objective Standards for Proxy Voting

One of the major differences with CalPERS is the PFA’s proxy voting guidelines.\textsuperscript{120} The PFA, like CalPERS, includes standard good governance measures in its proxy guidelines, such as Japan’s optional board committee system (“American-style” governance introduced as an option in 2002)\textsuperscript{121}, small boards and independent directors.

\textsuperscript{119} Mr. Yano has repeatedly criticized Japan’s Financial Services Agency, Tokyo Stock Exchange, and others for their lack of sufficiently strong regulations requiring information disclosure and other corporate governance measures, thus “forcing” the PFA to assume an active role. Interview with Tomomi Yano, Executive Managing Director, Pension Fund Association, Tokyo, Japan.

\textsuperscript{120} These guidelines were first formulated in 2003 in connection with the PFA’s initiating passive in-house investing. Prior to 2002 the PFA entrusted all of its investing to outside money managers. In 1999 it began to require such managers to exercise proxy voting rights and formulated a more specific guideline in 2001. Although this Article focuses on the proxy voting policies and results of PFA’s own in-house investing, similar policies apply to outside money managers and the also PFA publishes the proxy voting results for such outside managers. For the proxy voting results of outside money managers, see http://www.pfa.or.jp/jigyo/shisan/gava_giketsuken/koshikekka/koshikekka02.html.

\textsuperscript{121} Traditionally Japanese boards were very large and hierarchical. As there was no separation of officers and directors, becoming a director was merely another promotion for senior managers and directors generally retained “line” responsibilities for a department or division of the corporation. An overhaul of Japan’s corporate law in 2002 provided for the optional adoption of an “American-style” board committee system with audit, nominating, and compensation committees, and a system of executive officers. Under this optional board system the two key German-inspired features of Japanese corporate governance are replaced by “American-style” institutions: representative directors are replaced by executive officers with authority to bind the corporation and internal auditors are replaced by the board’s audit committee. \textit{See generally} Ronald J. Gilson & Curtis J. Milhaupt, \textit{Choice as Regulatory Reform: The Case of Japanese Corporate Governance}, 53 AM. J. COMP. L. 343 (2005).
However, it votes against company proposals for director re-nomination based largely on objective, performance-related proxy voting standards. The two original standards covered situations where a company incurred either three straight years of losses and no dividend payout or five years of cumulative losses (the 3/5 performance rule”) or if during the directors’ term there was a violation of law or other matter of corruption which had a large impact on the company (“scandal rule”) (See Appendix 3).\(^{122}\)

However, even this specific performance standard is not applied mechanically. The PFA’s proxy voting guidelines merely state that it will support company proposals in violation of the guidelines if there is a “convincing explanation” from the company.\(^{123}\) In its annual reports on the results of proxy voting, the PFA has noted that in exercising its voting rights it considers a company’s economic performance and governance structure as factors in reaching an overall judgment about management’s efforts to achieve maximization of shareholder value.\(^{124}\) In practice, this sometimes resulted in a linkage between firm economic performance and governance structure: a company with poor economic performance, for example, might avoid PFA votes against its proposals if it increased its information disclosure or added to the number of independent directors.\(^{125}\)

Application of these proxy guidelines has resulted in the PFA voting against the re-nomination of directors and other company proposals at a significant number of

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122 These standards for opposing the election of directors are also applied to other areas. For example, the PFA will generally vote for internal corporate auditors unless the scandal rule applies, and will generally vote for compensation plans and director bonuses unless the 3/5 performance rule applies. See PRINCIPLES OF CORPORATE GOVERNANCE, supra note 104. Other performance-based standards were subsequently added. Id.
123, Id. at 5.
125 No independent directors are required under the traditional system of corporate governance utilized by most Japanese companies (which has internal corporate auditors rather than independent directors) and many Japanese companies have no outside directors.
portfolio companies (See Appendix 4), throughout the period 2002-2009. The PFA’s proxy voting record has been affected by a number of factors, including overall economic conditions which have impacted firm performance and the emergence of new issues and changes in the PFA guidelines.

During 2004-2005 hostile takeovers suddenly became a big issue in Japan for the first time, following the Livedoor case.\(^\text{126}\) Many companies rushed to put poison pills into place, but initially it was not clear what form and procedures for defensive measures would be upheld by courts. The PFA developed its own proxy voting guidelines for takeover defenses in April 2005.\(^\text{127}\) It phrased the guideline in a positive form, stating that the PFA would vote in favor of rights’ plans which met its criteria. The criteria were as follows: (1) sufficient explanation of long-term shareholder value, (2) shareholder approval, (3) approval by independent directors or clear provisions which prevent arbitrary decisions by management, and (4) limited duration.\(^\text{128}\) This required greater judgment by the PFA in a number of related areas. For example, a company proposal to amend its articles of incorporation to increase the company’s authorized shares might be opposed if it appeared to be connected to a shareholders’ rights plan which did not meet the above criteria.

In the early stages, some companies did not present their rights’ plans for shareholder approval and so the PFA had no opportunity to vote on such plans. A subsequent Japanese supreme court decision in the Bulldog Sauce case\(^\text{129}\) included

\(^\text{126}\) See supra note 116.
\(^\text{128}\) Id.
\(^\text{129}\) See supra note 118.
shareholder approval as part of the reasonableness standard for defensive measures, so that seeking shareholder approval has now become standard practice for shareholder rights’ plans.

During 2003-2007 economic recovery began to lift both corporate performance and pension funds’ portfolio returns. However, the PFA remained concerned that Japanese corporate management did not have sufficient incentive or focus on improving long-term corporate performance. Return on equity in the United States and Europe was often at twice the level of Japanese companies.\(^{130}\) In 2008 it adopted a new proxy voting guideline on return of equity which is perhaps its most aggressive guideline and may, in retrospect, prove to be the high-water mark of PFA activism. Under this guideline, the PFA will vote against the election of directors at companies where return on equity is less than 8% for three consecutive years (the “ROE 8% rule”).\(^{131}\) A substantial number of PFA portfolio companies have failed to meet the ROE guideline and, as a result, PFA votes against the election of directors have remained relatively steady despite fewer companies failing under the original economic performance standard, the 3/5 Loss Rule (See Appendix 4).\(^{132}\)

2. Informal Communications

\(^{130}\) See, e.g., Shareholder Activism in Japan; In the Locust Position, THE ECONOMIST, June 28, 2007 (stating that the ROE of Japanese companies is around 9%, while in America and Europe it is in the range of 14%-17%). [Morningstar-15%]

\(^{131}\) See PRINCIPLES OF CORPORATE GOVERNANCE, supra note 104 at 7; Appendix 3.

An informal communication system between the PFA and portfolio companies also developed in connection with the PFA’s proxy voting guidelines. Despite the objective nature of much of the PFA’s proxy guidelines, judgment was still required for certain categories and portfolio companies could always try to supply “convincing explanations.” As a result, portfolio companies began to privately explain to the PFA the background and reasoning behind company proposals. Over time this practice came to include a substantial number of portfolio companies during the proxy season run-up to general shareholder meetings (e.g., 155 out of 819 portfolio companies in 2008 and 128 out of 825 portfolio companies in 2009\(^\text{133}\)). Initially, this practice involved additional company explanations of published proposals, but over time it gradually shifted to earlier consultation and crafting of company proposals which complied with the PFA’s proxy voting guidelines. This was particularly true in the case of poison pills and other defensive measures.

Mr. Yano has stated that this informal communication was a result of initiatives by the portfolio companies and not by the PFA, and, in addition, it would be preferable for the companies to provide public disclosure of the detailed reasons for their actions and proposals rather than a private explanation to the PFA.\(^\text{134}\) Nevertheless, this practice has served to enhance both the PFA’s importance in proxy voting and greater compliance with PFA proxy voting guidelines.

In addition to implementing its proxy voting guidelines, the PFA also utilized this informal communication system to push for portfolio companies to lessen legal barriers to the exercise of proxy voting. These concerns focused on inadequate mandatory

\(^\text{133}\) See Voting Results 2008, supra note 132, at 2, and Voting Results 2009, supra note 132, at 2.

\(^\text{134}\) See Yano Interview, supra note 119.
information disclosure, and also included the minimum two week notice period for
delivery of proxy materials prior to a general shareholders meeting and the concentration
of general shareholder meeting dates in the end of June.\textsuperscript{135} Although these issues remain
as PFA concerns, over time the PFA was able to persuade a substantial number of
portfolio companies to adopt practices in these areas which went beyond the legally
mandated minimal requirements,\textsuperscript{136} and there were also some broader legal reforms.\textsuperscript{137}

3. Corporate Governance Fund

The PFA’s positive emphasis on promoting good corporate governance rather
than criticizing bad corporate governance is epitomized by its antithesis of CalPERS’
focus list: its corporate governance fund. Established in March 2004 and managed by
Nomura Asset Management, the purpose is to create a portfolio of the 50 or so companies
with the best corporate governance practices out of the 1500+ companies listed in the first
section of the Tokyo Stock Exchange in order to “send a message” to corporate

\textsuperscript{135} As an example of the lack of information disclosure, Mr. Yano cited the Japanese rule of only disclosing
the total amount of compensation for directors as a group with no information on individual compensation.
\textit{Id.} The two-week notice period under Japanese law is, in fact, longer than the minimum required under
Delaware law in the United States. See DEL. GEN. CORP. LAW §222 (providing for a notice period of
“not less than 10 nor more than 60 days”). However, American corporations have developed practices for
distributing proxy voting materials to shareholders months in advance of the meeting date. Japanese law
requires a general shareholders meeting to be held within 90 days of the end of the fiscal year (which for
most companies is March 31). As most companies wait until the last possible moment, this leads to a high
concentration of general shareholder meeting toward the end of June, and particularly on the last Thursday
of the month. In the past this was justified as a way to prevent sokaiya racketeers from attending many
meetings, but the practice continued even after the sokaiya ceased to be a major issue. Of course, these
legal barriers are even a greater hindrance to foreign institutional investors. For a discussion of these
concerns, see ASIAN CORPORATE GOVERNANCE ASSOCIATION, WHITE PAPER ON
CORPORATE GOVERNANCE IN JAPAN 32-33 (May 2008), available at http://www.acga-

\textsuperscript{136} A majority of portfolio companies (467 or 57% in 2008 and 409 or 50% in 2009) sent proxy materials to
shareholders more than 20 days in advance of the shareholders’ meeting and held their annual meetings on
days other than the highest concentration date (442 or 545 in 2008 and 446 or 54% in 2009). See VOTING

\textsuperscript{137} An overhaul of Japan’s securities laws in 2005 focused on internal controls and added a requirement of
semi-annual financial statements (as opposed to the prior rule requiring only annual financial statements).
The Tokyo Stock Exchange began to require annual corporate governance reports by listed companies and
also established a system for electronic proxy voting (although only a limited number of issuers have joined
the system). Mr. Yano did not view these efforts as sufficient. Yano Interview. \textit{supra} note 119.
manager’s concerning the PFA’s expectation as to what constitutes “good governance.”

The methodology utilized in company selection is for the PFA (and Nomura) to develop its own governance evaluation standard, distribute governance questionnaires to all first section companies, and engage in onsite visits and interviews at each company for the final evaluation. However, the PFA closed the Corporate Governance Fund in February 2009.

In addition to the corporate governance fund, the PFA has also undertaken other activities to promote good corporate governance. For example, it has actively distributed annual reports from a few portfolio companies that engage in best corporate governance practices. It should also be noted that the PFA is not the only organization that has found it beneficial to emphasize the positive, rather than the negative in corporate governance-related investing. Socially responsible investment (“SRI”) began in Japan in 1999, but has remained a relatively small market, as it was initially led by retail investors rather than large institutional investors as in the United States. More importantly, SRI funds in Japan do not engage in negative social screening (i.e., eliminating companies engaged in “anti-social” activities such as tobacco, gambling, and weapons), but only in positive social screening to emphasize investment in “eco-friendly” companies.

\[138 \text{See generally KOSEI NENKIN KIKIN RENGOKAI [PENSION FUND ASSOCIATION],}\]
\[\text{“KOOPERATO GABANANSHU FANDO” KARA MITA NIHON KIGYO NO KOOPERATO GABANANSHU NO GENJO TO KADAI [CURRENT STATE AND ISSUES OF CORPORATE GOVERNANCE OF JAPANESE COMPANIES AS SEEN FROM THE “CORPORATE GOVERNANCE FUND”] (Feb. 2005); in English see Pension Association Adopting Governance Rating as Yardstick to Select Portfolio, THE NIKKEI WEEKLY, March 22, 2004.}\]
\[139 \text{The initial results in 2004 were 1,546 questionnaires sent, 804 responses (which is only 52%, but 85% by market capitalization), and 43 companies selected for the fund. Id.}\]
\[140 \text{See the PFA website at http://www.pfa.or.jp/jigyo/shisan/gava_giketsuken/gava_giketsuken05.html. No reason is stated for closing the fund.}\]
4. No Social/Political Activism

The PFA disavows any social or political activism unrelated to its mission of enhancing portfolio returns on behalf of its participants/beneficiaries. It does not make shareholder proposals. With respect to shareholder proposals put forth by other shareholders, its proxy voting guidelines state that it will decide on a case-by-case basis.\textsuperscript{142} The guidelines further state that the standard will be whether the proposal “contributes to the maximization of shareholder value,” and goes on to specify that the PFA will oppose shareholder proposals “solely being used to address specific social or political issues.”\textsuperscript{143} Its voting record is generally hostile with regard to shareholder proposals, voting against such proposals over 90\% of the time during the last three years (see Appendix 4). The PFA makes only a general referral to corporate social responsibility within its general governance principles and makes no specific recommendations in that area under its proxy voting guidelines.\textsuperscript{144}

5. Lack of Coordination

The PFA faces a relative dearth of potential domestic partners for coordinating proxy votes and other governance measures. Foreign institutional investors have come to own a substantial share of the Japanese market and potentially could assume a significant

\textsuperscript{142} \textit{See PRINCIPLES OF CORPORATE GOVERNANCE, supra note 104, at 13.}
\textsuperscript{143} \textit{Id.} Examples of shareholder proposals which the PFA favored would include proposals on increasing corporate disclosure and proposals on spreading out the dates of general shareholders’ meetings. \textit{See, e.g., KIGYO NENKIN RENGOKAI [PENSION FUND ASSOCIATION], 2003 NEN6GATSU KABUNUSHI SOKAI INHAUSU KABUNUSHI KETSUGI KOSHI KEKKA NI TSUITE [RESULTS OF EXERCISE OF VOTING RIGHTS AT GENERAL SHAREHOLDERS MEETINGS OF PFA PORTFOLIO COMPANIES IN JUNE 2003], available at http://www.pfa.or.jp/jigyo/shisan/gava_giketsuken/koshikekka/files/gov_inhouse15_6.pdf.}
\textsuperscript{144} PRINCIPLES OF CORPORATE GOVERNANCE, supra note 104, at 5 (stating that “Companies should discharge their responsibilities as a good corporate citizen, complying with laws and ordinances and corporate ethics, forging cooperative relationships with stakeholders…and taking initiatives to deal with global environmental issues.”).
role. Many foreign pension funds and other institutional investors share many of the PFA’s concerns and interests, and coordination between the PFA and foreign investors could create a greater influence on portfolio companies.

Despite these potential gains, and the PFA’s own history with CalPERS, the PFA has generally shunned cooperation with foreign institutional investors due to its constituency constraints. As noted earlier, the Japanese media tend to focus on the most aggressive foreign (and domestic) investors, such as hedge funds attempting hostile takeovers of Japanese companies, and to adopt a clearly negative tone. The PFA’s governance activities are already criticized in some quarters as being “anti-business” and it has no wish to depart from its role as a “reluctant” and “responsible” activist and court additional controversy by joining with aggressive foreigners.

6. Opportunities for New Activities and Future Policy

The PFA also engaged in certain “unfriendly” activities when circumstances permitted. The most notable case was its sole litigation in 2005 against the Seibu Railway Corporation and its individual family founder in connection with a notorious corporate scandal. This was the first time in Japan that an institutional investor filed a lawsuit against a portfolio company.

145 For a discussion of the activities and impact of foreign institutional investors in Japan, see Christina Ahmadjian, *Foreign Investors and Corporate Governance in Japan, in Corporate Governance in Japan: Institutional Change and Organizational Diversity* 125 (Masahiko Aoki et al. eds., 2007).
146 See WHITE PAPER, supra note 135.
147 See notes 116-18 supra and accompanying text.
148 Yoshiaki Tsutsumi, a railway and resort tycoon who was listed by Forbes magazine as the world’s richest man from 1987-1990, pleaded guilty to criminal charges of falsifying financial statements and insider trading, including a falsified list of shareholders in an effort to conceal concentrated ownership by a controlling group in violation of Tokyo stock exchange regulations and avoid a delisting of the company. The PFA filed a suit for civil damages resulting from the subsequent drop in stock price once the scandal become public. See, e.g., Associated Press, *Japanese Tycoon is convicted of Falsifying Company Records*, WALL ST. J., Oct. 27, 2005. The PFA’s complaint in the case is available (in Japanese) at http://www.pfa.or.jp/jigyo/shisan/gava_giketsuken/files/gov_20050719.pdf.
The PFA’s “reluctant activist” strategy has been consistent, although there is evidence of occasional disagreement between the outspoken Mr. Yano and others within the PFA. The clearest example is the question of a PFA focus list. Mr. Yano clearly advocated the creation of a focus list which, like that of CalPERS, would directly criticize and target companies with bad corporate governance. The PFA never adopted such a strategy prior to Mr. Yano’s retirement from the PFA in the fall of 2008. It appears that some within the PFA saw a dissonance between the PFA’s proclaimed role as a “reluctant activist” that emphasized good corporate governance and the adversarial style represented by public criticism of specific companies in a focus list. CalPERS’-style adversarial activism could not be implemented.

There has also been speculation about whether the PFA’s activities will look any different in the “post-Yano” era, and some observers claim to see a recent toning down of PFA activism. It is too early to judge such a claim. PFA personnel do not seem to blame corporate managers for poor performance during the 2008 economic and financial crisis (unlike the earlier 2000-2002 downturn). However, both the “3/5 performance rule” and the “ROE 8% rule” measure firm performance over a multi-year period. It remains to be seen whether the PFA will retreat from its objective standards in the future if poor corporate performance continues.

150 See Yano interview, supra note 119.
151 Interview with Mr. Taku Yamamoto, head of equity investing, Pension Fund Association, Tokyo, Japan
152 See, e.g., supra note 132 and Appendix 4 which show that despite an increasing number of portfolio companies which fail the ROE test negative votes by the PFA declined in 2009. The PFA’s explanation is that more portfolio companies provided additional information or added independent directors. See VOTING RESULTS 2009, supra note 132, at 1. But See notes 133 and 136 which indicate a decline in 2009 in the number of portfolio companies that visit the PFA for informal communications or voluntarily go beyond legal requirements with respect to barriers to proxy voting.
153 Telephone Interview with Mr. Taku Yamamoto, head of equity investing, Pension Fund Association, Tokyo, Japan. This partially reflects a general view of the Japanese media and public that the 2008 economic crisis was “made in America.” The impact in Japan, as measured by fall in GDP, was substantially worse than in the United States.
V. EVALUATION OF THE PFA’S ACTIVIST STRATEGY AND IMPLICATIONS FOR A GENERAL MODEL OF INSTITUTIONAL INVESTOR ACTIVISM

A. Evaluation of the PFA’s Activist Strategy

Although this Article does not attempt to utilize any quantitative or systematic measurement to compare the outcomes or effectiveness of the activist strategies of CalPERS and the PFA, a preliminary assessment of the PFA’s “success” with its activist strategy is appropriate. Viewing the PFA either as an alternative model of activism for the “rest of the world” or as a new, third data point in our theoretical understanding of the role of activist institutional investors from a comparative corporate governance perspective depends on the PFA having achieved something worth considering—i.e., some level of “success”—with its activist strategy.

The standard for measuring such “success” is problematic. The typical activist strategy of a public pension fund like CalPERS—passive index investing and proxy voting in favor of standard good corporate governance measures—is often judged to be ineffective in terms of acting as an external monitor of management or achieving widespread change in corporate governance practices.154 As noted in Part II, much of the dissatisfaction with the performance of activist institutional investors in the United States may stem partly from an exaggerated notion of the role which such activists can be expected to play in our corporate governance system. In such case, what would constitute an appropriate standard for measuring success?

One approach would be to take an activist such as CalPERS at its word with respect to its purpose for initially undertaking corporate governance activism—to act as an educational force and catalyst for improving corporate governance. This would

154 See, e.g., Black, supra note 1.
presumably mean that, despite a portfolio investment strategy and scarce utilization of resources which limit their activism, the efforts of activist institutional investors would have two effects: (1) activists exercise voice to exert an impact on portfolio companies and improve corporate governance in these companies, and (2) activists have a broader impact in promoting good corporate governance more generally through policy advocacy and encouraging broader adoption of good corporate governance practices by corporations.

Such an activist would not simply “follow the herd,” but would target selected companies and utilize them as examples to “move the herd.” The result would be that such activist institutional investors function as one complementary component of a web of forces which potentially can monitor management and act as a partial constraint on management discretion. Although even the results under this simple test are not easily measured, CalPERS has arguably achieved its modest, stated goal of being a catalyst for improving corporate governance.

How about the “success” of the PFA? The PFA has clearly had an impact on its portfolio companies. Even without the threat of shareholder proposals, the prospect of the PFA voting against company proposals has been sufficient to affect the practices of

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155 CalPERS discusses its strategy in just these terms. It singles out criticism by Coffee that the use of passive index investing might have a chilling effect on other managers which discourages them from trying to beat the index through active trading (see Coffee, supra note 20), and responds that utilizing selected companies as examples it can influence other portfolio companies and corporations generally, and thus can “move the herd” “while still retaining the risk-reward reliability of an indexed portfolio.” See CALPERS, WHY CORPORATE GOVERNANCE TODAY? supra note 35.

156 This result is the opposite of the typical assessment (see Black, supra note 1), largely because of the significantly lower standard activist institutional investors would be required to meet. As evidence of CalPERS impact on portfolio companies, one can point to the willingness of portfolio companies to generally reach agreement on good corporate governance measures rather than potentially be subject to a shareholder proposal. See supra notes 77-78 and accompanying text. This group is limited, although there is presumably some value in using these companies to make examples for portfolio companies generally. CalPERS informal communications are probably more important, but data on the number of companies involved are less clear.
portfolio companies. The PFA has gradually persuaded a majority of portfolio companies to reduce barriers to the exercise of proxy voting—by staggering general shareholder meeting dates, providing more than the legal minimum of two weeks’ notice prior to general shareholder meetings, and providing greater information disclosure (although often only informally) than legally required.157

The PFA and portfolio companies have gradually developed a system of informal communications under which advance consultations results in more company proposals which comply with PFA proxy voting standards. The PFA has focused attention both on firm performance and standard good governance measures relating to governance structure. It has also played a meaningful role both in opposing antitakeover measures which are unfriendly to shareholders and in encouraging a more acceptable form of rights plans which includes shareholder approval.

The wider impact of the PFA beyond its portfolio companies appears to be quite substantial, even if it is difficult to measure. The PFA and Mr. Yano have certainly received extensive media attention, and the PFA is generally regarded as the leading domestic institutional voice for good corporate governance in Japan. One example of its impact is the prominent mention it receives in Japan’s popular “how to” manuals for corporate managers on preparing for and conducting general shareholder meetings.158 It should also be noted that the PFA’s prominence in Japan may also partially result from the dearth of other activists and forces to monitor management; this may limit the overall

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157 See supra note 136.
158 See, e.g., KABUNUSHI SOKAI SOTEI MONDOSHU HEISEI 21 NENPAN [COLLECTION OF ANTICIPATE QUESTIONS FROM SHAREHOLDERS’ MEETINGS AND ANSWERS 2009 EDITION], 327 BESSATUS SHOJI HOMU 22-23 (2009) (including a special section on the PFA in its discussion of institutional investors, cautioning that corporate managers must “pay attention to trends” at the PFA, and summarizing the PFA proxy voting guidelines).
effectiveness of the monitoring of management under Japan’s corporate governance system.

B. Implications for a General Model of Institutional Investor Activism

This Article’s case study raises the broader question of what actors are likely to have broad comparative applicability in explaining the activist strategies of institutional investors in different operating environments. As the thesis of this Article is that resource and expertise constraints account for the basic similarities between the activist strategies of the PFA and CalPERS while constituency constraints explain their significant differences, the analysis will first focus on issues relating to these two sets of constraints and then briefly consider other factors which have been utilized in comparative studies to date on the United States and the United Kingdom.

1. Resource and Expertise Constraints: Is there an Alternative to a Diversified, Passive Portfolio Investment Strategy?

Both the PFA and CalPERS pursue a basically similar diversified, passive, portfolio investment strategy. This raises a question: if indexing makes it more difficult to influence portfolio companies compared, for example, with a concentrated portfolio, is there any real possibility that activist pension funds elsewhere will pursue a different portfolio strategy that would facilitate their exercise of voice with portfolio companies?

Given the expertise constraint, it is likely that pension funds will not engage in active, in-house investment management in any significant way, and that the Harvard University investment office will remain as an exception which proves the rule. The compensation and other issues related to in-house active investing are too difficult, and the current practice of broad diversification, with in-house indexing supplemented with
active investment management by outside money managers achieves the important goals of minimizing risk through diversification and minimizing investment expenses.

Alternative private investments may theoretically provide both further portfolio diversification into additional investment classes and the potential for higher returns. CalPERS’ relational investments and other alternative investments provide an example of how a public pension fund could partially incorporate such an approach through the use of outside managers to include some concentrated investments within a broader portfolio. However, as dramatically demonstrated by the 2008 financial crisis, alternative investments entail not only higher investment risk but also a significant, but heretofore unrecognized, liquidity risk. In addition, there may be caution in expanding aggressively into alternative investments such as commodities which may have benefitted from unusually favorable market conditions earlier this decade. Accordingly, resource and expertise constraints establish practical limits on the extent of alternative investments and make it unlikely that pension funds will fundamentally alter their basic portfolio strategy in a manner which increases their potential to exercise voice with portfolio companies.

Expertise and resource constraints are likely to be similar in many countries, as pension funds focus on their primary mission of providing beneficiaries, and the result may well be similar diversified, passive portfolio investment strategies. Even in developing countries, we are beginning to see an investment trend in which pressure to increase portfolio returns moves pension fund portfolios away from concentrating on low-risk bonds and toward diversifying into stock and other investments.\(^\text{159}\) However, due to similar resource and expertise constraints it is difficult to imagine that they will

\(^{159}\) *See generally THE TIME TO LEAD IS NOW, supra note 3.*
pursue a radically different portfolio investment strategy than the widely diversified, largely passive strategy of the PFA and CalPERS.

2. Constituency Constraint: Reconsidering the Claimed Correlation between Good Corporate Governance and Good Economic Performance

CalPERS and the PFA pursue activist strategies with some basic similarities (e.g., use of proxy voting to influence portfolio companies), but also with quite significant differences—the PFA does not engage in “adversarial” activism and eschews a focus list of companies with “bad” corporate governance, shareholder proposals and litigation in favor of an emphasis on economic performance and publicizing examples of good corporate governance. The differences can be accounted for by corresponding differences in their respective constituency constraints.

Despite the differences in both constituencies and activist strategies, both CalPERS and the PFA rely heavily on the argument that their activism is justified, and even required, to enhance shareholder value and portfolio investment return, and to fulfill its fundamental obligation to make payments to its beneficiaries. CalPERS utilizes this argument to justify its relatively more aggressive style which is encouraged, or at least permitted, by its constituencies, while the PFA does the same in order to help convince its own members and the public of the necessity and desirability of its own activism.

As noted above, due to the pension crisis in all developed countries and the overriding concern over the ability of pension funds to make future payments to beneficiaries, constituency acceptance of a correlation between good corporate governance and enhanced portfolio returns would provide the most powerful argument in favor of institutional investor activism. Thus, while this claimed correlation is a popular
subject of academic analysis and debate, its real importance to activist institutional investors is political—it helps persuade constituencies to support activism.

This political aspect helps explain the phenomenon that activist institutional investors, including both CalPERS and the PFA do not devote significant resources to their activism. Despite their claim that such activist activities enhance portfolio returns, they generally make the rational decision that keeping costs low is a surer method of enhancing portfolio returns. The claimed correlation is more of a political argument to justify activism generally than an economic argument utilized to allocate resources efficiently to enhance portfolio returns and, ultimately, payments to beneficiaries.

Both CalPERS and the PFA are subject to the same criticisms that they either do too much or do too little. In the United States, the criticism that they do too little may be more widespread due to the higher expectations concerning the corporate governance role of activist institutional investors and the discrepancy between their claim of a correlation between good corporate governance and superior economic performance and their actual allocation of resources for corporate governance activities. In Japan, the PFA is probably more subject to the opposite criticism that it does too much, although its activities generally receive favorable support. This difference is also a reflection of the differing attitude of their constituencies toward shareholder activism.

Both CalPERS and the PFA refute this accusation. CalPERS often points to Wilshire Associates’ studies on focus list companies and also to its relational investing (which until the financial crisis of 2008 had produced superior investment returns for some time) as proof of the correlation between good corporate governance and enhanced investment performance. However, the Wilshire studies remain controversial and
relational investing is quite different than CalPERS traditional investment strategy of passive indexing with advocacy of standard good corporate governance measures that can be easily and widely applied to portfolio companies. CalPERS attempt to utilize relational investing to conflate two different investment and governance strategies, and cite relational investing as “proof” of a correlation between good corporate governance and improved economic performance, is evidence of how the advocacy of such correlation is politically important to CalPERS to justify its activism.

The PFA, while advocating the same correlation, does not engage in relational investing. Instead it points to its proxy voting guidelines which incorporate concrete economic performance standards to back up its claim that its activism directly relates to enhancing portfolio performance. This is perhaps a tighter argument which is dictated by its constituency constraint, i.e., the necessary of obtaining support, or at least limit any opposition, to its activism from members and of appealing to the public.

In sum, although perhaps not as loudly as CalPERS, the PFA provides another example of an activist institutional investor which insists that its good governance activities enhance shareholder results. As noted above, a significant part of this claim may be political, i.e., it is the strongest and most widely appealing justification for activism among all constituencies. This may help explain why activist institutional investors’ arguments about the positive economic impact of governance-related activism have overshadowed other arguments about the non-economic benefits of good corporate governance, such as better decision-making processes, risk management, and balancing of interests.
As a result, we may find that would-be activists in other countries will also be attracted to the claim of a correlation between good corporate governance and superior economic performance despite the ongoing academic controversy over the validity of such correlation. However, in developing countries there also may be an additional powerful economic argument that good corporate governance is related to attracting foreign investment capital.

3. Other Factors

Factors which have loomed large in comparisons of activist institutional investors to date, which often focus on the United States and the United Kingdom, may not be as prominent in a more general comparative framework. One example is legal barriers to the exercise of proxy voting rights. Although legal rules may raise transaction costs for activist institutional investors, the PFA’s experience suggests that an activist can reduce legal barriers by influencing portfolio companies to develop voting and information disclosure practices which go beyond the legal minimum. And there is no evidence that legal rules were important either in the PFA’s decision to become an activist or in the overall activist strategy which it pursued.

Similarly, ownership structure, together with legal rules and costs, is relevant to the lack of coordination among activist investors. Commentators regularly cite activists’ failure to overcome the collective action problem and increase their influence with portfolio companies as another important reason why activism has not amounted to much.

Although coordination among activist institutional investors is often cited as a significant difference between activist strategies in the United Kingdom and the United States, we may be granting it greater emphasis than deserved. Since most large
institutional investors are situated in the United States and the United Kingdom, the “rest of the world” is quite likely to face a situation similar to the PFA in Japan—the only real counterparts for coordination are foreign institutional investors who are viewed with suspicion by the national media. Even if potential partners are available, this Article suggests that constituency constraints are likely to limit coordination generally. In this respect, the United Kingdom may turn out to be an exception rather than a realistic model.

Portfolio companies sufficiently fear and dislike votes cast against their proposals by well-known institutional investors (even when the percentage of such negative votes is small compared to the total vote) that they are willing to take substantial measures to avoid such negative vote. Although Japan may have an operating environment which is less supportive of an adversarial brand of activism, the fact that other activist strategies are possible has significant implications for our understanding of the role of activist institutional investors in a comparative context.

VI. CONCLUSION

The PFA’s activist strategy provides a practical model for the “rest of the world” by demonstrating how an activist strategy can work within corporate governance systems quite different from the United States and the United Kingdom. Japan is likely more representative of the operating environment facing would-be activist institutional investors in most developed and developing countries. This relatively unsupportive operating environment includes a stock ownership and political system which greatly limits both the potential number of domestic activists and the ability to coordinate activities among activists, a lack of any tradition of activism or independent directors, pension fund members who are generally less activist than CalPERS members, a media
and public which may frown upon aggressive activism and be leery of foreign activist investors, insufficient information disclosure, and rules which raise the costs of exercising proxy voting rights.

The PFA’s approach, as compared to that of CalPERS, also provides a useful new data point for our theoretical understanding of the relationship between activist strategies and operating environments. Similar expertise and resource constraints result in basically comparable portfolio investment strategies and a reliance on proxy voting to promote standard good governance measures with a broad range of companies. Differences in constituency constraints produce differences in particular issues and in activist “style.”

It is likely that this pattern will be repeated elsewhere, with public pension fund activists pursuing a portfolio investment strategy that is basically similar to that of CalPERS and the PFA, but encountering relatively restrictive constituency constraints that will favor the PFA’s style of “reluctant” activism over CalPERS’ style of adversarial activism. The PFA’s strategy of emphasizing economic performance in its proxy voting guidelines, emphasizing good corporate governance rather than criticizing poor governance practices, and refraining from aggressive tactics such as litigation and shareholder proposals, suggests a path for activist institutional investors to achieve “success” in terms of exerting meaningful influence on portfolio companies and public debate without alienating constituencies.

Any spreading of this pattern of PFA-style activism will serve to continue the debate over the role of activist institutional investors. We may see activists in more countries proclaim their belief in a correlation between good corporate governance and economic performance and strongly identify themselves as acting in the public interest,
but only undertake limited activism. This “activism lite” will continue to feed both sets of criticisms that activist institutional investors do too much and do too little. Is it a clever means of achieving an impact with limited resources and expertise and within political constraints or is it a recipe for, as characterized by John Coffee, being trapped in a no-man’s land between exit and voice?¹⁶⁰

The conclusion, at least from the perspective of countries seeking to improve their corporate governance systems, may well be that activist institutional investors can fulfill a useful role within corporate governance systems, even if not the expansive role of the external monitor of corporate management assigned to them by commentators. Activists can assume a more modest role of educator and catalyst on corporate governance issues and act as a component in a corporate governance system which, in concert with other institutional and market forces, acts as an external monitor of management and partially constrains management discretion. Even if not a cure-all, the emergence of such activist institutional investors in the “rest of the world” may be a positive and significant step in the development of corporate governance systems.

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APPENDIX 3

PFA CORPORATE GOVERNANCE PRINCIPLES
(effective Feb. 28, 2007) (Partial Summary)

I. Basic Policy

II. Corporate Governance Principles

III. Shareholder Proxy Voting Guidelines

1. Proposals concerning Corporate Organization
   • Support introduction of board committee system ("American-style" governance)
   • Outside directors should be completely independent
   • Support introduction of executive officer system (separation of officers and directors)
   • Board composition must be 20 or less directors
     • Board must have at least one outside director

2. Proposals concerning Director Compensation
   • Generally favor director compensation proposals, unless 3/5 Rule applies
   • Generally favor proposals for revision of director compensation unless it is large and there is no persuasive explanation
   • Generally vote in favor of director retirement bonus unless 3/5 Rule or Scandal Rule applies
   • Generally vote in favor of retirement bonus for corporate auditor unless Scandal rule applies
   • Oppose repricing of stock options’ exercise price

3. Capital Policy
   • Generally vote in favor of stock buybacks
   • Generally vote in favor of profit distribution plan if it at least achieves a balance between shareholders and other interests such as future business plans, employees and director compensation
   • Oppose profit distribution plan at companies which have a large capital cushion but continue to accumulate cash if there is no persuasive explanation

4. Amendment of Articles of Incorporation
   • Generally vote in favor of an increase in authorized shares, but will oppose if there is no persuasive explanation concerning any significant dilutive effect on existing shareholders or the necessity for the increase
• Generally oppose abolishing shareholder approval of distribution of surpluses (if currently required)
• Oppose reduction in the minimum voting requirement for special resolutions without a specific explanation

5. Election of Directors
• Oppose reelection of directors at companies with either three straight years of losses and no dividend payout or five years of cumulative losses [“3/5 Rule”]
• Oppose reelection of directors if during their term there was a violation of law or other corruption matter which had a large impact on the company [“Scandal Rule”]
• Oppose reelection of directors at companies with three straight years of return on equity (ROE) of less than 8% and no persuasive explanation concerning the cause and management’s response [“ROE Rule”]
• Oppose reelection of directors at companies which have adopted anti-takeover defenses without shareholder approval and with no persuasive explanation of long-term benefits to shareholders [“Poison Pill Rule”]
• Oppose reelection of directors at companies where the board of directors (without shareholder approval) has issued new shares to a third party (third party allocation) which exceed 20% of issued shares [“Anti-dilution rule”]
• Generally vote for internal corporate auditors unless they also serve as directors or Scandal Rule applies

6. Shareholder Proposals
“Shareholder proposals shall, in principle, be taken under advisement individually, and the basic criterion shall be whether or not the given proposal would contribute to increasing shareholder value. A proposal cannot be judged favorably, however, in cases where it is recognized that the proposal is being used primarily as a means of resolving a specific social or political issue.”

### APPENDIX 4


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<th>2008 No. of Proposals</th>
<th>Percentage Opposed</th>
<th>2009 No. of Proposals</th>
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<td>95.6%</td>
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<td>3.3%</td>
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Source: PENSION FUND ASSOCIATION, RESULTS OF EXERCISE OF VOTING RIGHTS AT GENERAL SHAREHOLDERS MEETINGS OF PFA PORTFOLIO COMPANIES (annual reports from 2002-2009), available at http://www.pfa.or.jp/jigyo/shisan/gava_giketsuken/koshikekka/koshikekka01.html (reports for 2007 and 2008 available in English)