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The Effect of Global Shareholder Activism on the Japanese Financial System and the Japanese Corporation

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1. Introduction

In the United States and the United Kingdom, large shareholders, such as pension funds, have come to use shareholder voting rights to change the corporations in which they invest. They tend to aggregate their power and participate in corporate governance actively. Management must now listen to their voices because there is a possibility that institutional investors will reject the management's slate of board nominees. More recently, management has been likely to agree to meet informally with institutional investors.

Institutional activism seems to be an attempt to accomplish an effective relationship between the corporation, shareholders, and other stakeholders without sacrificing the historical advantage of the market's liquidity and efficiency. Institutional investors in the United States have increased international investment since the 1990s. They have become more active in the corporate governance of foreign corporations. These kinds of movement have had a significant effect on the Japanese financial system and corporate governance.

2. Significance of Exercising Shareholder Voting Rights by Institutional Investors

The movement to promote in a positive manner the exercising of voting rights by institutional investors has flourished recently in Japan. This movement has been strongly influenced by British and American institutional investors and relevant authorities.

In 1988 the U.S. Department of Labor expressed its view in the so-called Avon Letter that "exercising voting rights is also recognized as one part of a fiduciary's responsibility," and officially published its opinion that institutional investors and even fund managers must bear the obligation of exercising voting rights. This is an official view released on the occasion of the U.S. public employees' pension starting to exercise its rights to submit shareholder proposals in 1987.[1]

In England, the FMA (Institutional Fund Managers' Association) advised its whole range of member fund managers, "You should enter into serious considerations to systematically exercise voting rights for your trust guarantors." In the same year, the ABI (Association of British Insurers) stated in its discussion paper, "Institutional investors should support the board of directors by exercising voting rights in a positive manner.[2]"

In 1991, the PIRC expressed its opinion to the Cadbury committee, "Voting rights are an asset, and must be administered with careful obligation (care and independence required of the person in the position of fiduciary). Shareholder voting rights must be exercised methodically and exceptionally for the long-term benefit of the beneficiary." In the following year, the Cadbury committee responded to the views of the ISC and the PIRC, "We must recognize voting rights as an asset. Exercising voting rights by institutional investors, or the non-exercise thereof, is an issue of proper benefit which inures to the person for whom we invest. We believe institutional investors should disclose their policies regarding their use of those voting rights."[3]

In November 2002 the SEC carried out a proposal requiring mutual funds to disclose in their Statements of Additional Information (SAIs) their policies and processes leading to exercising voting rights of stocks that they hold. The SEC related the following as background to this.

> As of November 2001, mutual funds hold $3.4 trillion in stock. This is 19% of total U.S. stock issue. Compared with the 6.4% ten years before, the rate of expansion is high. Millions of American investors hold shares of mutual funds, and they rely on these funds, i.e. the stock of the companies in which they have invested, and hold these funds to meet their financial needs for retirement, children's education, etc. Despite the huge influence of mutual funds on capital markets and their huge influence on financial assets of American investors, the funds have not made clear how they exercise voting rights of the securities they hold. We believe that now is the time to consider increasing transparency on the state of voting rights in mutual funds. Raising transparency in this way, fund shareholders will be able to check how the fund is participating in governance activities of the securities they hold. This will have a dramatic influence on shareholder value.[4]

In this way, in Great Britain and the United States, exercising voting rights by institutional investors is viewed as one part of the responsibility of the fiduciary and as an obligation in the capital markets.

In Japan also, there are indications that the role of institutional investors in corporate governance is viewed seriously.

[1] Avon Letter (1998).
[2] ISC (1991).
[3] NAPF (1995).
[4] SEC (2002).

Corporate managers are indeed subject to the control of capital markets, but it can be said that it is necessary to manage the business with a deep respect for the long-term returns of the company through nurturing shareholders. . . . As can be seen from recent developments in the U.S.A., shouldn't institutional investors of pension funds and investment trusts themselves proceed with corporate governance as mid- and long-term shareholders?[5]

Before anything else, the obligation of the shareholder in the stock-held corporation system is to supply capital. But as stated above, institutional investors as fiduciaries bear the obligation of exercising voting rights. The fact that exercising voting rights is part of asset investment by institutional investors means that they bear the "responsibility to themselves create important factors for the stock price to rise (important factors for it not to fall)."

The mission of investors who make a business in investing assets is to provide investment returns by gauging the future based on current information, and to invest in companies whose stock price, it seems, will go up. As the "separation between ownership and management" expands, corporate managers have been placed in the position of administrators of society, and they have come to bear the duty of making sure their companies continue to exist, that is, responsibility for their companies' profitability and their products. However, there are instances when managers of modern big businesses use their position as administrator and take actions to pursue their own benefit, not that of the corporation. Or in the position of administrator, there are also corporate managers who have no ability to accomplish their responsibilities. Staving off actions of these kinds of managers is a new role sought in institutional investors. That is to say, in modern large corporations, institutional investors bear a part of the responsibility in ensuring the continuing existence of the company, its profitability, and its goods and services.

3. Japan's Financial System Reform and Pension Fund Asset Management

Financial system reforms that were promoted after November 1996 aimed at reinvigorating Japan's financial markets to align them with the international financial markets of New York and London by 2001, and the reforms were based on the three principles of "free" (free market where market mechanisms work), "fair" (market that is transparent and reliable), and "global" (market that is international and ahead of its time). Incorporated in these financial system reforms were stock trading system reforms such as liberalizing commissions on stock transactions and liberalizing the system of trades outside the market, and encouraging participation by the banking, brokerage, and insurance industries. That is, a goal was set to devise efficient management of the Japanese people's assets

[5] Morita (2002).

under conditions in which a great variety of brokers utilizing cheap and efficient stock trading systems would compete with one another on a global scale for a wide variety of high-quality asset investment and management services. Thus, in order to invest ¥1.4 quadrillion in individuals' assets under risk management, positive utilization of investment trusts (funds) was promoted, and participation in the stock market by institutional investors of pension and other funds was promoted as well.

Growth in investment trusts and pension funds signifies an increase in indirect stock ownership through financial brokerage institutions rather than direct stock ownership by households. After the Second World War, financial brokerage institutions continued to grow in Britain and the United States and to become powerful stock investment entities, i.e., institutional investors. Their influence gradually increased, and it became significant to study the reasons for the growth of these institutional investors, their role, investment activities and strategies, and their characteristics. The enormous capital of pension funds in Japan also exposed the need for increasing the rate of investment in stocks, and the activities of institutional investors began to draw attention.

3.1 Relaxing Investment Regulations and Managing Pension Assets

3.1.1 Managing Assets of Public Pensions

In the pension system reform draft of 1999, it was discussed how best to take a new look at public pension payments and burdens in light of the lower birth rate and aging of society. The new Government Pension Investment Fund was established to independently invest public pension reserves as of April 2001.

The target investment return for the new pension assets was set at 4.5%, and in order to assure this target return, the decision was made to invest 68% of the total assets in domestic bonds, 12% in domestic stocks, 7% in foreign bonds, 8% in foreign stocks, and 5% in short-term assets. A certain leeway was built into the asset distribution structure. Domestic stocks, for example, could be increased or decreased by 6 points from the 12% mark. Reserves are estimated to be ¥150 trillion around year 2010, and of that, if 12% is attributed to stocks, the stock portfolio will be worth ¥18 trillion. Of the approximately ¥82 trillion managed assets in fiscal year (FY) 2002, ¥12.4 trillion was the amount of managed assets invested in stocks. It is rare throughout the world for public pension funds that have adopted a taxation method to invest in stocks, but Japan's public pensions already have capital of more than ¥12 trillion invested in stock, and alone they are the largest holder of stocks. With the Government Pension Investment Fund, concerning about management of the nation's private industry, the need to rely on fiduciary institutions having shareholder voting rights has been exposed.[6]

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[6] See http://www.gpif.go.jp/unyou/unyou16/gaiyou16.pdf, pp. 3–5.

3.1.2 Relaxing Investment Regulations of Corporate Pensions

At the end of 2003, corporate pensions held assets of ¥71.2684 trillion yen. Of this, ¥51.2805 trillion, or 72% were assets of the Pension Fund Association. If one looks at this distribution by fiduciary institution share of corporate pensions, at the Pension Fund Association, 28.9% were life insurance companies, 50.3% were trust banks, and 20.8% were investment consulting firms. For tax-qualified pension plans, 51.8% were life insurance companies, 42% were trust banks, 5.3% were investment consulting firms which became able to be fiduciaries after October 1997, and 1% was the National Mutual Insurance Federation of Agricultural Cooperatives (Zenkyoren). In recent years, there has been a tendency for the share in investment consulting firms to grow for both the Pension Fund Association and tax-qualified pension plans.

Asset management in the fund was restricted by the so-called 5-3-3-2 Regulation of the uniform Legal List Rules. Before the revision in Pension Fund Association regulations in 1997, investment was carried out for all funds uniformly under an assumed rate of return of 5.5%. But since the 1990s, they were not able to achieve the assumed rate of return, and the inefficiency of investing under legacy asset distribution regulations and the dissipation of fiduciary responsibility became a problem. So the 5-3-3-2 regulations went through a gradual revision and in 1997 they were completely eliminated. Investment consulting firms were allowed in 1990 to participate as fiduciary institutions only as a part of expanded investment. In 1999 the distinction between expanded investment and legacy investment was eliminated. This is how relaxing regulations on investing was advanced, and currently the system has widened even more to encompass competition from investing institutions, including those of foreign capital lineage who act as fiduciaries for pension fund assets.[7]

While relaxing regulations on pension fund asset investments was progressing, relaxing regulations on the markets for asset investment was also in progress. In the "financial system reforms" (called Financial Big Bang in Japanese) proclaimed in 1996, reforms such as liberalization of stock transaction commissions, abolition of obligation to centralize transactions at the stock exchange, and introduction of privately subscribed investment trusts and corporate-style investment trusts came into effect, all of which had a great influence on institutional investors' management of assets. With the relaxing of pension fund investment regulations, a gigantic amount of capital flowed into the securities markets, and legacy regulations in the securities markets were abolished so institutional investors could more easily utilize these markets. From this point on, it was expected that investment fiduciary institutions like trust banks, life insurance companies, investment consulting firms and others would become positively involved in investing risk assets like stocks.

Until this time, investment had just been left up to groups like life insurance companies and trust banks, but now each investment institution, including

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[7] Life design kenkyusho (1999), p. 33.

investment consulting firms, would have to carry out investments in accordance with the Prudent-Man-Rule.

3.1.3 Increases in Passive Investment

Investment efficiency is required of Japanese pension fund investment trustees and fiduciaries, and asset distribution is an important problem. A characteristic of recent years is that the ratio of investment in stocks is rising, and as a part of that the move to increase the rate of passive investment that dovetails an index (stock index) continues to expand. If one examines the rate of passive stock investment of U.S. and Japanese large pension funds, the U.S. rate stands at 76% while Japan does not exceed 15%. Active investment that carries out investment in individual corporate issues incurs research costs, and the more there is diversity in investment institutions, the higher the commissions that are paid. In spite of this the investment performance may from time to time be below that of a stock index. However, in passive investment research costs are unnecessary, and in general investment commissions seem to be about one third those of active investments. In recent years, pension funds are clearly cognizant of investment costs and are increasing their rate of passive investments.[8]

3.1.4 Competition Among Active Investment Fiduciary Institutions

There seems to be a move among large investment banks and others to create passive investment teams as fiduciaries for pension assets; and for active investments, investment consulting firms, for whom the investment trustee ban was lifted in April 1990, have increased competition to acquire fiduciary relationships. The fiduciary balance for domestic pension funds at the end of FY2003 was ¥32.4364 trillion yen, an increase of 27.4% over the previous fiscal year. A breakdown of this fiduciary capital shows public pensions at ¥14.886 trillion yen, an increase of 15.3%, and corporate pensions at ¥17.5504 trillion yen, an increase of 39.8%. Corporate pension funds that had been eyeing an improved rate of return showed a tendency to utilize investment consulting firms. In recent years the fiduciary roles of foreign capital lineage investment consulting firms in pension assets have been increasing. The vigor of JP Morgan, Merrill Lynch Mercury Asset Management, Fidelity, and other American investment companies has been striking. Japanese life insurance companies and trust banks have joined forces with foreign capital lineage investment firms with a strategy to expand their asset investment business. Take, for example, the ties between Dresdner Kleinwort Benson and Meiji Life, Putnam and Nihon Life, Allianz and Sumitomo Trust Bank, etc.[9]

In this way, domestic and foreign investment consulting firms, as well as trust banks and life insurance companies that had been entrusted with legacy investing, are competing in investment performance to gain pension asset fiduciary

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[8] See *Nikkei kinyu shinbun*, "pension money increases passive investment," Nov. 30, 2000.
[9] McDonald (1998).

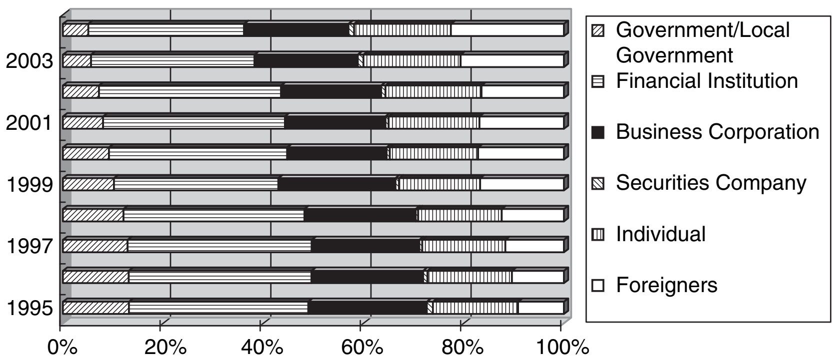
trusts. Moreover, the competition for fiduciary trust in pension assets by foreign capital lineage investment consultants is expanding into alternative investments like hedge funds and unlisted stock investment (investments in assets outside traditional stocks and bonds).

4. Changes of Stock Ownership in Japan

A characteristic of the Japanese stock market used to be mutual stock ownership. However in the 1990s, stock prices dropped quickly and stagnation continued for quite a while afterwards. This expansive drop in stock prices and stagnation eliminated unrealized gains in stock held by financial institutions and companies and forced them to account for unrealized losses on their books. Because of this, financial institutions and companies that mutually held each other's stock were forced to dig in their heels during the stagnation in corporate earnings, and corporate earning strength deteriorated even more because of the unrealized losses. As a result, the structure of mutual stock ownership in Japan collapsed and stock ownership by institutional investors such as pension funds and foreigners expanded.

Table 1 shows the shift in investment sector-specific equity stakes over the most recent 10 years. A characteristic of this period is a continuing flow in which financial institutions sell stock and foreign investors buy stock. Equity stakes by foreign investors stood at 23.7%, the highest since such studies began in 1970. Equity stakes of corporations stood at 21.9% because they acquired high levels of their own company's stock despite selling due to the liquidation of mutual holdings in those years. Long-term credit banks, municipal banks, and regional banks reduced their equity stakes for 10 years in a row, and life insurance companies and non-life insurance companies reduced their equity stakes for 4 years in a row, reaching new lows for each of the three sectors since such studies began.

Table 1. Shift in Equity Investment by Sector (10 years)



National Securities Exchange "Distribution of Stock holdings 2004" p. 5

Throughout these 10 years, pension trusts were actively engaged in stock investment and increased their equity stakes, but from FY2003 they tended to sell stock along with the Pension Fund Association's Agency Return (returning their obligation back to the government to act as its agent in making partial pension payments), and their equity stakes stood at 4.0%.

In FY2004 foreigners invested a huge amount of capital in the Japanese stock market with purchases exceeded ¥6.3563 trillion yen. Looking at industry sectors in which foreigners bought stock, they bought a wide spectrum of all industry sectors, and there was a tendency to greatly increase equity stakes in industries where industry-specific stock price indicators were increasing at a greater rate, particularly food, electricity and gas, and machinery.[10]

What countries had investors holding Japanese stocks? According to documents of the Bank of Japan, as of the end of December 2003 foreign investors held a total of ¥60.1 trillion in Japanese stocks, and a breakdown of this by country shows that ¥25.1 trillion or 41.8% of the total was investment of American capital, and ¥18.6 trillion or 30.9% was British capital.

If one looks at percentage of stock ownership, British and American investors stand out at the head of the list with more than 70%, and the tendency is the same for the number of investors. Currently, among institutional investors (excluding hedge funds) that actively manage their Japanese stocks and hold more than ¥10 billion in Japanese stock assets, there are about 100 companies in the United States and 80 companies in Britain. In comparison, there are about 50 such companies on the European continent. The British and American institutional investors are more active in exercising shareholder voting rights than investors from other areas, and because of this, the British and American institutional investors are very influential in Japanese companies.

As of the end of FY2004, there were 104 companies in which foreigners had equity stakes of 30% or more, 29 more companies than 1 year before. Canon was among those newly added to the companies in which foreigners' equity stakes exceeded 50%, doubling the number to six companies. Table 2 shows major companies that have high foreign equity stakes, and companies that have large market share and continue to demonstrate high rates of profit are adding their names to the top of this list. The company that has the highest foreign equity stake, 57.2%, is Orix Corporation. Through the last quarter, Orix's net profit hit new highs for two straight quarters, and the management team annually makes several investor relations trips to Europe and the United States to strengthen their development of overseas investors. Hoya, Canon, Nitto Denko, Fuji Photo Film, etc., have a lot of products which rank #1 or #2 in the global market share, the overseas percentage of their sales which adds to their stabilized earnings power is high, and they are very popular among foreign investors. Powerful companies involved in domestic demand such as those in the service or retail industries are also adding their names to this list. Yamada Denki, leveraging its

[10] See http://www.tse.or.jp/data/examination/distribute/h16/distribute_h16a.pdf, pp. 1–6.

TABLE 2. Major Japanese companies that have high foreign equity stakes (2004)

	%	Rate of change (1 year)
1. Orix	57.2	6.5
2. Hoya	55.6	5.1
3. Yamada Denki	55.6	5.5
4. Credi Saison	52	9.8
5. Canon	51.7	1.8
6. Don Quijote	50.9	9.9
7. Nitto Denko	49.5	4
8. Matec	49.5	9.7
9. Fuji Photo Film	48.7	4.5
10. Rome	48.7	1.7

Source: *Nihon Keizai Shinbun*, June 28, 2005

aggressiveness in adding outlets, became the first specialty store to break through ¥1 trillion in sales in the March 2005 period. Don Quijote, Meitec, Aderans, etc., command a high share in their niche markets, and are highly rated as companies showing steady gains.

With the increase in foreign investors, even in companies with high earnings power, management supervision in areas of use of capital, the way corporate governance should be, information disclosure and accountability tend to be strengthened. Tokyo Electron has a foreign equity stake of 41.5%, and in the FY2004 shareholder meeting expansion of the limits on stock issuance was voted down. It seems that one reason for this was that some of the foreign stockholders opposed it.[11]

5. Recent Pension Fund Activism and the Response of the Corporations

5.1 Japanese CalPERS, Pension Fund Association

The Pension Fund Association is called Japanese CalPERS, because it is influenced by the CalPERS to exercise voting rights actively. I will summarize here the June 2005 shareholder meeting results of PFA's in-house exercise of shareholder voting rights.

When it came to exercising shareholder voting rights in the June 2005 shareholder meetings, voting rights were exercised for all proposals (a total of 5773 proposals over 1347 companies) on the agendas after examining each item based on the Pension Fund Association Criteria for Exercising Shareholder Voting Rights.[12]

[11] *Nihon keizai shinbun*, "Foreigners shareholding is increasing," June 28, 2005.
[12] See http://www.pfa.or.jp/jigyou/pdf/gov_inhouse17_6.pdf.

When it came to examining proposals, shifts in corporate performance and governance structure were essential elements, and the proposals were judged comprehensively from a viewpoint of how management efforts would be put into practice to maximize shareholder profit; and for proposed items difficult to judge based on these criteria, after a detailed examination of the contents of the proposal and individual examination, discussions were undertaken by the voting rights exercise committee as necessary. Cases of significant items towards which the Pension Fund Association expressed its opposition in the June 2005 shareholder meetings follow.

- Proposals for Disposition of Profits
  In the past 5 quarters, aggregate profit or loss (consolidated) was in deficit; corporate performance was in long-term stagnation
- Proposals to Change a Portion of Articles of Incorporation
  - Without any explanation of a concrete reason, expanding the authorized limits on stock issuance, or attempting to make Stock Issuance Date more flexible
- Proposals to Elect Directors
  - Despite long-term corporate performance slump or significant effect on corporate performance due to eruption of a scandal, renominating a Director for election who should be questioned about his management responsibilities
  - Not electing even one outside Director
  - Decreasing number of outside Directors
  - In companies with committees established, when an executive originating from a company that is already a major shareholder (holds more than 1/3 of total voting right shares) becomes a candidate for outside Director
- Proposals to Grant Special Retirement Service Bonuses
  - Paying special retirement service bonuses despite questions that should be asked about management responsibilities during a continuing slump in long-term corporate performance
  - Paying special retirement service bonuses to outside Directors or Corporate Auditors who are required to maintain a high degree of independence
- Proposals to elect Corporate Auditors
  - Without any explanation of a concrete reason, decreasing number of Corporate Auditors
- Proposals to Grant Stock Options
  - Granting stock options to people who do not seem to have any strong connection to raising corporate performance

Shareholder motions were considered individually, and proposals such as individual disclosure of Directors' compensation, establishment of Directors' personal stock acquisition parameters, or increasing dividends were voted yes in cases where it was recognized that they would accrue to shareholder profits.

Response to Corporate Buy-out Defense Policies

- Yes votes in cases (4 companies) in which a Rights Plan in accordance with standards of the Association was introduced
- Yes votes to expand limits on authorized stock issuance in cases in which there were concrete explanations and the purpose of which was clearly not a defense against a corporate buy-out
- Opposition, as a rule, to relaxing Stock Issuance Dates if the possibility to impair stockholder value was incontrovertible
- However, yes votes on reducing the fixed number of Directors if there was some leeway to implement it as a defense against a buy-out and it was a fundamentally beneficial move

The Pension Fund Association established the Corporate Governance Fund in March 2004 as a part of its corporate governance activities. This fund, based on questionnaires and visits to the companies, sorts out and invests in corporate issues recognized as excelling in governance as reflected in concrete corporate governance evaluation criteria, and joined ranks with 43 companies in August 2004. In June 2005 it conducted new studies and added 10 more corporate issues to these ranks.[13]

(1) Governance Evaluation Criteria
Based on "Governance Evaluation Criteria" worked out among the Pension Fund Association, its investment trustee Nomura Asset Management, and Nomura Research Institute, they evaluated companies' governance, and companies which were judged as having a high level of governance were selected. In evaluating companies' governance, it was not enough that companies had formalized systems such as a transition towards a company with committee structures or adoption of outside directors, but placed great importance on how those mechanisms function effectively to produce material results.

(2) Research by Questionnaires
They implemented a questionnaire targeting companies listed on the 1st Section on the Tokyo Stock Exchange and gathered basic information regarding governance of these listed companies.
Second Questionnaire Results
Companies Sent Questionnaires: 1548 companies
Companies Responding to Questionnaires: 847 companies (55% answer rate)
Companies Responding to Questionnaires Aggregate Value: 85% of total value of 1st Section listed companies

(3) Research by Visits to Companies
Investment trustee Nomura Asset Management analysts and portfolio managers visited companies, scrutinized actual governance conditions, and carried out final evaluations.

[13] See http://www.pfa.or.jp/jigyou/pdf/gov050607.pdf.

Governance Evaluation Criteria

1) "Stressing Stockholder Value" is a distinct management principle and objective
   - The principle of "Stressing Stockholder Value" is distinct
   - The stockholder is afforded the position of an important stakeholder
2) Establish and disclose business numerical targets which recognize shareholder equity cost
   - Conducting business which recognizes shareholder equity cost
   - Together with setting concrete business numerical targets, evaluating and disclosing the degree to which those targets are achieved
3) Drawing up and executing a proper business strategy
   - Establishing and disclosing business numerical targets which recognize shareholder equity cost in specific business sectors
   - Setting criteria for exiting a business

1. Business Stressing Shareholder Value
   1) An attitude of giving back to the shareholder
      - Dividend pay out ratio and shareholder equity ratio at appropriate levels
      - Carrying out appropriate corporate stock buy backs
   2) Having a responsible system for Investor Relations
      - Full-time Investor Relations position with sufficient staff in place
      - Company President himself attending Investor Relations meetings and being accountable
   3) Substantial information disclosure
      - Disclosing sufficient information on the company's website homepage
      - Award-winning Investor Relations activities
   4) Timely disclosure system
      - Disclosing appropriately other information in quarterly disclosures, not just limiting the information to sales figures, etc.
      - When significant facts arise, disclose them quickly on the company's website homepage
2. Information Disclosure & Accountability
   1) Access to shareholder meetings
      - Notification of Meeting is sent with enough lead time
      - Constructive posture towards computerizing the exercise of shareholder voting rights through an intention to participate in the "Platform for Exercising Shareholder Voting Rights" recommended by the Tokyo Stock Exchange.
      - Allow public access to Notification of Meeting and related documents on the company's website homepage
   2) Distinguishing between Business Execution and Supervision
      - The same person does not have co-responsibilities of Chairman of the Board and CEO

- More than 1/3 of the Board of Directors are not Directors who also have the duties of an executive
- The number of Directors is 20 or less

3) Independence of outside Directors
   - Number of outside Directors is more than 1/3 of the Board of Directors
   - Independence of outside Directors is guaranteed
4) Effectiveness of outside Directors is guaranteed
   - Attendance ratio at Board of Directors meeting by outside Directors is above a certain level
   - Together with advance distribution of materials to outside Directors, appropriate explanation is also made
5) Method of nominating Directors (for a company that has established committees)
   - Nominating criteria for Directors are in statutory form
   - Chairman of Nominating Committee is an outside Director
     (for a company that has adopted Corporate Auditor system)
   - Nominating criteria for Directors are in statutory form
   - Systematic correspondence is made by the Nominating Committee, etc.
   - There are members of the Nominating Committee from outside the company

3. Board of Directors
   1) CEO (top executor) Leadership
      - Former chairmen & former company presidents are not in a position of strong influence like the Board of Directors
   2) Disclosure of the executive compensation decision process and compensation amounts (for a company that has established committees)
      - Chairman of Compensation Committee is an outside Director
        (for a company that has adopted Corporate Auditor system)
      - When setting compensation, there is independent organization for the compensation committees
      - There are people from outside the company included in compensation committees
   3) Presence of an Achievement-Based Compensation System and its Details
      - Introduction of an achievement-based compensation system for executive compensation
      - Introduction of a stock option system, and the conditions for granting options are appropriate
4. Executive Compensation System
      - Acquisition and Holding of Company Stock
      - Rules for acquiring stock in an executive's own company, and criteria for acquiring such company stock are expressed in numerical values
   1) Operations of the Corporate Audit Committee & Board of Corporate Auditors (for a company that has established committees)
      - Staff belonging exclusively to the Corporate Audit Committee is secure in both quality and quantity

- Meetings are held regularly among Corporate Audit Committee members and independent auditors and the internal audit office, etc. (for a company that has adopted Corporate Auditor system)
- Staff belonging exclusively to the Board of Corporate Auditors is secure in both quality and quantity
- Meetings are held regularly among the Corporate Auditors and independent auditors and the internal audit office, etc.

2) Compliance System
   - There are an exclusive post and internal company regulations regarding compliance, and employee training regarding compliance is conducted
   - An internal reporting system is set up with an exclusive post and an outside third party as a central resource

3) Responding to Unforeseen Circumstances
   - A manual is prepared for responding to accidents, scandals, etc.
   - After accidents, scandals, etc. occur, appropriate explanations are made

5. Compliance and Risk Management
   1) A Healthy Relationship with Independent Auditors
      - There are clear rules when requesting non-audit business of independent auditors
      - There is currently no contract for non-audit business with independent auditors

5.2 Trends in Shareholder Meetings in June 2005

Shareholder meetings were held at the end of June for about 1600 companies whose fiscal year closed in March 2005. In this hostile fiscal year, in preparation for hostile takeovers that began to be conspicuous even in Japan, there was an onslaught of motions introduced by companies as plans of resistance. However, motions by Fanuc, Tokyo Electron, and Yokogawa Electric requesting an expansion of limits on stock issuance of these three companies were voted down by opposition of domestic and foreign institutional investors. Common among these three companies were: a high percentage of foreign stockholders; abundant capital at hand; there seemed to be no obstacle for current capital investment plans; and they would more than double issuance of authorized capital. In other words, if they were to increase the issuance at the shareholder meeting, the number of shares that could be issued would increase at the judgment of the board of directors. Because of this, the issuance of stock for unaccounted purposes could dilute shareholder value. If this situation were just left alone, it would result in concerns that institutional investors could be questioned about their fiduciary responsibilities.

There were many companies where opposition votes were cast for proposals to appoint new directors. Since the authority of directors was expanded through a revision in corporate law in June 2005, a vote of confidence in management took on added strength in shareholder meetings. Also, pressure from shareholders was intense regarding systems of executive compensation. Sony and

Toyota Motor Corp. received shareholder motions for itemized disclosure of executive compensation from NPOs. "Yes" votes at Sony totaled 39% and at Toyota totaled 25%, showing an extremely high number. Sojitz Holdings submitted a motion to raise the scope of total compensation along with an increase in the number of directors and corporate auditors due to the merger with its subsidiary. This motion was approved with a majority "yes" vote, but in the annual meeting expressions of opposition were continually raised toward increasing compensation totals regardless of the rebuilding in progress. There were also shareholders who showed up expressing their opposition to the merger proposal. According to a study by the Nihon Keizai Shimbun, as many as 80% of the institutional investors of the top 100 companies ranked by invested assets responded that they "had opposed proposals" in the June 2005 shareholder meetings. This shows that institutional investors continue to have a hand in corporate governance by exercising shareholder voting rights.[14]

6. Conclusion

In this chapter, I focused on the changes of the Japanese financial system and the institutional investor's activism, which are heavily influenced by the institutional investor in the United States.

Japanese financial system reform, which is based on the three principles of "free," "fair," and "global," was identified in the globalization of the U.S. investor's actions.

The U.S. institutional investors' influence gradually increased, and it became significant to study the reasons for the growth of these institutional investors, their role, investment activities and strategies, and their characteristics.

Today, the structure of Japanese stock ownership is changed dramatically. It used to be said that a characteristic of the Japanese stock market was mutual stock holding. However, the expansive drop in stock prices and stagnation eliminated unrealized gains in the stock held by banks and companies. Because of this, banks and companies are forced to sell their stocks. Now, foreign investors are taking banks and companies' places. They have a significant impact on Japanese corporate governance.

One of the biggest institutional investors, the Pension Fund Association, have learned CalPERS investment behavior and they have begun to use their voice to change the corporations in which they invest. This shows institutional investors continue to have a hand in corporate governance by exercising shareholder voting rights and thus, Japanese companies tend to lend their ear to institutional investors.

[14] *Nihon keizai shinbun*, "Shareholder Meetings in June 2005", June 30, 2005.

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