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Public Pension Funds as Shareholder Activists: A Comment on Choi and Fisch

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I. THE COLLAGE OF SHAREHOLDER ACTIVISM

The world of shareholder activism has expanded dramatically over the past twenty years so that it now contains a broad set of actors carrying on a wide range of activities. At one end of the spectrum,

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hedge fund activist shareholders have taken large investment positions in targeted companies and spent significant amounts of money lobbying aggressively for a host of structural changes at these corporations. At a more intermediate level of activism are the labor union pension funds. The union funds have been active, making innovative uses of the federal securities laws to get shareholder proposals on corporate ballots and trying out a host of other techniques aimed at improving corporate governance systems at public companies. Union funds are willing to spend some money on corporate governance initiatives, but, unlike hedge funds, do not generally accumulate large percentage stock positions in targeted firms. At the low end on the activist scale are the public pension funds. Once touted as the potential champion for investors, public pension funds today are largely just supporting players, frequently falling in behind the activist hedge funds and labor union pension funds. Public pension funds rarely step forward with their own initiatives except for low cost activism efforts, such as “withhold the vote” campaigns. Only in securities fraud class actions have public pension funds taken the lead, apparently responding to a Congressional invitation to act as lead plaintiffs in these cases.

In an important paper recently appearing in the *Vanderbilt Law Review*, Professors Stephen Choi and Jill Fisch generate survey evidence from public pension fund respondents that documents the low cost activism practiced by public pension funds.¹ The results of their survey show, among other things, that public pension funds do a limited amount of non-litigation oriented activism mostly centered on supporting other types of activist investors. For example, these funds follow advice from their proxy voting advisors in withhold the vote campaigns or similar low cost voting initiatives. Furthermore, larger public funds demonstrate higher levels of non-litigation forms of activism than smaller sized public funds. However, the survey responses show that many public funds act as lead plaintiffs in securities fraud class actions and that the level of participation in litigation-oriented activism does not appear to vary by fund size.

These are important and very interesting results that shed light on a number of key issues but also raise a number of important questions about shareholder activism and the SEC’s regulatory approach to it. For that reason, it is important to examine critically the survey evidence provided as well as the authors’ interpretation of their results.

1. Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008).

II. THE SURVEY AND ITS RESULTS

A. Design

First, it is important to note the data limitations of the study. Choi and Fisch sent surveys to 124 funds out of the universe of 2656 public pension funds. Only forty pension funds responded to the non-litigation activism portion of the survey, while twenty-four funds responded to the litigation portion.² The project design raises a number of questions: Are the 124 funds that were sent the survey representative of the universe of public pension funds? Is it fair to draw strong conclusions from a sample containing one and one-half percent of the total population? Should we be worried about the fact that only one-third (or in the case of the litigation portion of the survey one-fifth) of those institutions surveyed responded? Are these representative funds, or is there likely to be a response bias? While the authors do discuss some of these questions briefly,³ it is important to be cautious in the interpretation of their results because of these issues.

B. Voting Results

One of the important findings from the survey is that public pension funds delegate voting authority for much of their portfolios either to outside managers or to third party proxy advisors, such as RiskMetrics.⁴ While the authors appear concerned that this delegation will lead to increased agency costs, two points bear noting. First, when the delegation is to outside managers, those managers are evaluated on the returns generated by their investments and will therefore have the correct incentives to vote these shares to maximize each corporation's value, even if they may be otherwise loath to spend money on initiating other activism. Second, delegating voting decisions to RiskMetrics may lead to more successful activist efforts

2. *Id.* at 325 tbl.1(b).

3. The authors note that the size of assets under management are not significantly different between the respondents and non-respondents in the survey, *id.* at 322, but this does not tell us anything about their representativeness with respect to the remainder of the public pension fund universe.

4. RiskMetrics acquired Institutional Shareholder Services ("ISS") in 2007. RiskMetrics Group, RiskMetrics Group History, <http://www.riskmetrics.com/about/history.html>. It is important to note that voting delegations will also be reviewed by the fund managers and can be withdrawn at any time, especially if there is an extraordinary corporate transaction being put to a vote.

because RiskMetrics can help to solve the collective action problem that institutions face when trying to mount effective voting campaigns.

A second interesting piece of evidence from the survey is that a significant percentage of public pension funds appear to let a proxy advisor develop their voting policies. The authors are again worried that this delegation may create agency costs. I view this as a specialization story.⁵ There is little reason to reinvent the wheel on voting on most routine corporate and shareholder proposals, so why not just fine tune an existing policy to meet a public fund's needs? In the event of an extraordinary transaction—which is certainly the most important class of voting decisions for funds—the pension funds' trustees, or other internal personnel, will need to make a determination if the transaction is in the fund's best interests, no matter what the fund's policy says.

One area that could be explored in future research on public pension funds' voting practices is how they compare with mutual fund practices. We would benefit from public disclosure of how public pension funds vote their shares. With the recent public availability of data about mutual fund voting, there has been a flurry of research on their voting behavior and support for corporate governance changes. For example, larger mutual funds tend to vote all of their shares as a block in favor of management except on antitakeover and executive compensation issues.⁶ It would be interesting to know if public pension funds show similar tendencies.

Finally, Choi & Fisch note that their survey results show that public pension funds are not major sponsors of shareholder proposals today.⁷ This absence of activism has been true for many years, as individuals and labor unions have been the main sponsors of these proposals since the early 1990s if not before. However, public pension

5. Similarly, the benefits of specialization may explain why funds outsource their claims management practice in securities class actions and other litigation. It seems possible that a properly incentivized bank will be more efficient than a public pension fund in filing claims in these cases, making delegation to this outsider efficient.

6. Burton G. Rothberg & Steven B. Lilien, *Mutual Fund Proxy Votes*, (Working Paper Series, 2005), available at <http://ssrn.com/abstract=669161>.

7. Recent research suggests that shareholder proposals have positive stock price impacts on targeted firms. See Luc Renneboog & Peter G. Szilagyi, *The Success and Relevance of Shareholder Activism Through Proxy Proposals* (European Corporate Governance Inst. Working Paper Series, 2008), available at http://www.ecgi.org/competitions/rof/files/Renneboog,%20Szilagyi%20-%20Shareholder%20activism_ECGL_bestpapercompetition.pdf. Shareholder proposals may also lead to significant reductions in targeted firms' antitakeover defenses. Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response and Market Reaction*, 13 J. CORP. FIN. 368 (2007).

funds do support the efforts of more active investors in a variety of ways. For example, hedge funds are more likely to target firms with higher levels of institutional stock ownership.⁸

C. Legal and Cost Barriers

Two of the major barriers to public pension fund non-litigation activism are high costs and legal rules. With respect to the latter, Professor Bernard Black noted several years ago that the federal securities laws penalize any institution that successfully nominates a candidate to a corporate board of directors by restricting their ability to trade in the company's stock.⁹ Not surprisingly, the survey evidence compiled by Choi and Fisch shows that public pension funds do not nominate director candidates. What is perhaps surprising is that Congress and the SEC have done nothing to alter these rules almost twenty years after Black first pointed this problem out.

Black also predicted that public pension funds would largely engage in low cost forms of activism. Costs undoubtedly explain why public pension funds do not generally solicit proxies from other shareholders. Doing a solicitation remains an expensive proposition, as is active participation in a proxy fight. While these costs are dropping, public pension funds are undoubtedly happy to leave this task to the labor union pension funds and hedge funds. This is again consistent with the results of the survey.

Choi and Fisch argue that bigger institutions may also be more active because they can afford to bear higher costs in their larger administrative budgets.¹⁰ However, there is another equally plausible interpretation of these results: bigger funds will generally hold larger positions in the firms they target for activism, will have more influence with corporate management at those firms, and therefore will be more likely to succeed in their activism. Since they are more likely to succeed, bigger firms should be more likely to be active in the

8. Alon Brav et al., *Hedge Fund Activism, Corporate Performance, and Firm Performance*, 58 J. FIN. 1729 (2008).

9. Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

10. Choi and Fisch also analyze the effect on non-litigation activism of the presence of an appointed or elected public official as the decisionmaker discussion at the fund. Choi & Fisch, *supra* note 1, at 345-46. Using a sample of four observations, they find at a ten percent significance level that this is correlated with higher levels of non-litigation activism. *Id.* at 344 n.45 (only ten percent of forty observations have public decisionmakers). While potentially interesting, the very small number of observations would seem to merit a more detailed discussion of the characteristics of these four funds before drawing strong conclusions.

non-litigation areas.¹¹ Under either theory though, institutional activism seems to respond appropriately to cost-benefit calculations.

D. Litigation

Securities fraud class action settlements generate money for public pension funds, about \$6.75 million a year on average per fund according to the survey respondents. Choi and Fisch claim that this is a trivial fraction of these funds' total assets. But is that really the appropriate metric? For example, it would be interesting to know what percentage of these funds' annual operating budgets is covered by their recoveries. For many funds, \$6.75 million would undoubtedly cover most of their overhead, making it well worth their while to continue pursuing these cases, especially if their participation as lead plaintiffs results in higher recoveries.¹² Moreover, these payments recur on an annual basis. If we think of these payments as continuing into the indefinite future—that is, as annuities—then their present value is equal to \$135 million on average for each public pension fund.¹³ Given the low costs of filing claims, this seems like a significant gain to the funds.

One of the most interesting findings from the survey is that public pension funds, irrespective of their size, actively participate as lead plaintiffs in securities fraud class actions. Choi and Fisch offer

11. As I discuss below, fund size may not be correlated with success in litigation activism.

12. Although a number of studies have found correlations between higher settlements and the presence of a public pension fund as a lead plaintiff in a securities class action, Choi and Fisch argue that there may be no causal linkage because institutions may just be “cherry picking” the best cases. *Choi & Fisch, surpa* note 1, at 341. They cite to one of their previous articles in which they found that institutional participation raised settlement values, but argued that their analysis had omitted two important explanatory variables, the presence of an accounting restatement, and an SEC investigation. *Id.* (citing Stephen J. Choi, Jill E. Fisch & Adam C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869, 892 (2005)). More recent papers by Michael Perino and by Cornerstone Research that include these variables (and a host of other additional control variables) in their analysis of settlement size, however, find that the presence of a public pension fund leads to increased settlement size. See Michael Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* 23 (St. John's Legal Studies Research Paper No. 06-0055, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=938722 (finding results consistent with the hypothesis that “public pension fund monitoring is effective in enhancing class recoveries”); LAURA E. SIMMONS & ELLEN M. RYAN, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2007 REVIEW AND ANALYSIS 10, 16 (2007), available at http://securities.stanford.edu/Settlements/REVIEW_1995-2007/Settlements_Through_12_2007.pdf (finding that “public pension fund monitoring is effective in enhancing class recoveries,” and listing the control variables used to arrive at that conclusion). This would seem to resolve the issue in favor of finding a causal relationship.

13. This assumes a discount rate of five percent and an indefinite stream of payments.

several explanations why they believe that fund size is not a determinant of participation, but I want to add another one: unlike with non-litigation activism, where the larger size of the fund's holdings in the targeted firm may make it more likely to succeed, in litigation, the size of the fund's holdings may not have any effect on its success. In other words, it may make little difference to the size of a recovery in litigation how much stock an institutional lead plaintiff holds.¹⁴ If this is true, then we should expect all funds to be willing to serve in this capacity in order to increase their recoveries, especially because the PSLRA limits the number of cases in which any lead plaintiff can appear.

Finally, the survey data show that public pension funds are largely inactive in pursuing some other types of litigation, such as appraisal or derivative actions. This is hardly surprising for several reasons. First, appraisal is widely viewed as an expensive, ineffective remedy for shareholders. Few appraisal cases are filed and even fewer are actively pursued by any shareholders. Second, derivative litigation suffers from high procedural barriers, such as the demand requirement and the use of special litigation committees, plus relatively low recoveries in comparison to securities fraud class actions. Furthermore, there is no lead plaintiff provision for derivative suits that would help ensure that public pension funds would be more likely to be selected as class representatives. Moreover, as Choi and Fisch note, it may be important to public pension funds to have the legislative stamp of approval before they choose to appear as lead plaintiffs in derivative cases, something that the States have yet to do.

III. CONCLUSION

Choi and Fisch's survey evidence gives us some tantalizing glimpses inside the black box of public pension fund activism. At the end of the day though, we are still left with lots of big questions. Do we need more activism? Are public pension funds doing the optimal amount already given the level of hedge fund and labor union pension fund activism? If those investors are already generating plenty of pressure for corporate boards to take investor interests seriously, maybe it is a good thing that public pension funds are not firebrands. Certainly from the perspective of their beneficiaries, it is cheaper for public pension funds to free ride on the efforts of the other activists.

14. It is undoubtedly true that, as between two potential lead plaintiffs, a court is more likely to choose the one with the larger holdings. But to date there is no evidence that having a bigger public pension fund as a plaintiff results in a bigger recovery for investors.

The SEC's deregulatory initiatives of the early 1990s that freed up the shareholder voting process opened the door for hedge funds and labor union pension funds to become more effective shareholder activists. As Choi and Fisch note, they also opened the door for public pension funds to do the same thing, but unlike their brethren, American public pension funds chose not to do so. This leaves us to wonder whether it would have been more efficient if American public funds had taken a different road and instead followed the path of the Ontario Teachers' Pension Plan ("OTPP") in imitating hedge fund shareholder activism.¹⁵ The OTPP has shown that public pension funds can be highly activist institutions when they choose to do so. We should be reluctant therefore to jump to the conclusion that public pension funds in the United States will always select low cost activist strategies regardless of legal barriers and financial constraints.

15. For example, the OTPP financed the largest corporate takeover in Canadian history when it acquired BCE Inc. *Ontario Teachers' Pension Plan Wins Battle for BCE*, CBCNEWS.CA, June 30, 2007, available at <http://www.cbc.ca/canada/story/2007/06/30/bce-teachers.html?ref=rss>.