Principles and Agents: CalPERS and Corporate Governance Change in Japan

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Abstract:

This paper considers how foreign institutional investors can promote change in corporate governance and whether there are limits to foreign influence. Despite a vast literature on the international adoption of U.S. governance practices, there has been little empirical research on the mechanisms that facilitate institutional diffusion. My window on this process is case study of CalPERS (California Public Employees’ Retirement System) in Japan. CalPERS was among the first foreign pension funds to make major investments in Japanese equities and remains one of the largest foreign equity investors in Japan. In the 1990s, CalPERS was an unusually active investor: conscientiously voting its proxies, meeting with executives of Japanese firms, and using the media and other tactics to promulgate its shareholder-value principles, which originally were developed in the United States. The principles included independent boards, low takeover barriers, equity-based executive compensation, and corporate transparency.

In the end, CalPERS had but a modest effect on Japanese corporate governance due to opposition from Japanese business and CalPERS’s reluctance to push for change as aggressively as it did at home. Instead it urged domestic groups--pension funds and others--to play a more active role. Hence it indirect influence on Japanese corporate governance was at least if not more significant than its direct effect. Also, by 2002 CalPERS began to lose interest in leading governance reform in Japan due to free-rider costs and diminishing returns. CalPERS discovered that it could achieve better results by taking a relational investing approach than pursuing the same activities on a market-wide basis. Last but not least, the economic environment changed. Flaws in the U.S. model became evident in the myriad scandals that followed the 2001 stock market crash. In 2002 Japan finally began to pull out of its prolonged stagnation and, consequently, was less motivated to appease foreign investors. The paper concludes by drawing lessons about the international diffusion of corporate governance and about the theory of institutional investing.

Keywords: Social values, Firm behavior, Factor income distribution, International financial markets, Pension funds, Corporate governance, Corporation Law, Asia

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Japan’s corporate governance system has been the center of debate since the 1990s. The features of that system—insider boards, cross-holding, and main banks—were based on two assumptions: first, that incumbent executives could be trusted to do their best and need only be removed in emergency situations; and second, that the responsibility of senior executives was to maximize the long-term value of the enterprise by balancing the interests of corporate stakeholders. These stakeholders included shareowners, both current and future, debt holders, employees, suppliers, and business group members, if applicable. When CEOs failed—that is, when there was a marked decline in earnings, sales, share price or some combination of indicators — they would be ousted, and sometimes an independent director would be placed on the board.  

Today the traditional system is moving towards the American model that developed in the 1980s. Here the criterion for judging management performance is share price. Adherence to that standard is insured through boards comprised of independent directors, through stock-based executive compensation, and through acquisitions (the market for corporate control) when performance is poor. Even Japanese companies that have made few fundamental changes to their governance system have nevertheless responded to pressure for change by shrinking their boards, beefing up investor relations departments, and paying closer attention to the impact of management decisions on the company’s share price.  

Where is the pressure for change coming from? Some of it stems from the prolonged stagnation that slowed economic growth between the early 1990s and 2002. During that period, Japanese banks were forced to modify long-standing ties to their customers and to sell off equity held to cement those relationships. The weak economy also frayed ties between members of the *keiretsu*, again leading to a restructuring of relationships and sales of cross-held equity.  

Another source of change is the Japanese government, which has repeatedly revised Japan’s commercial law in ways that encourage the U.S. governance model. The government’s motives were, and are, murky. Some agencies believe that a shareowner-oriented approach will spur growth by raising share prices and thereby
bolstering corporate balance sheets. Others, like JETRO, are mandated to encourage foreign investment in Japan and are enthusiasts for governance reforms that will attract overseas investors. In the Health, Labor, and Welfare (HLW) Ministry and elsewhere—there is concern over Japan’s aging population and unfunded pension liabilities. Boosting stock markets will, it is believed, reduce the size of liabilities and lessen the need for politically risky changes in benefits and contributions. The government also faces pressure from the business community, which has sought enabling legislation for stock options, limits on director liability, and permissive rather than mandatory governance reforms. Finally, foreign governments, in particular the United States, have consistently pressured Japan to make it easier for overseas investors to acquire Japanese companies. 4

Foreign investors, especially those from the United States, are a key vector for change in Japanese corporate governance. Having revolutionized U.S. corporate governance in the 1980s and 1990s, activist investors turned to other markets—Europe, Japan, and emerging economies—in hopes of repeating their success. Some were speculators engaged in greenmail, others were mutual funds held by individuals seeking to diversify their holdings. Most often, however, they were overseas pension funds. In Japan, pensions funds are the dominant category of foreign investor, the largest of which is the California Public Employees’ Retirement System or CalPERS. CalPERS provides pensions for nearly 1.5 million active and retired state, school, and public-agency employees (many of them union members) in California. 5

Whereas foreign investors owned only 1 percent of Tokyo Stock Exchange (TSE) shares in 1960 and 6 percent in 1992, the figure rose to 18 percent in 2000 and to 22 percent in 2004. Foreign owners are more likely to trade their shares than domestic owners. One-third of all TSE transactions in 2004 were conducted by foreign owners, thereby magnifying the impact of foreign ownership on share prices. The ability to influence share price through “exit” -- or the threat of it -- gives foreign investors a tool to effect changes inside Japanese corporations. Foreign investors can also use “voice”, including proxy votes, meetings with executives, and other pressure tactics. But there are limits to foreign influence. Foreign investors own more than 30 percent of shares (a control threshold) at only 103 of roughly 1600 first-tier TSE companies. Foreign ownership is concentrated among the largest and best-known companies, such as Orix, Canon, and Rohm; the proportion of foreign ownership declines with firm size. Generally it is the largest companies that are most actively traded. The fifty most
actively traded companies on the TSE accounted for 43 percent of all transactions in 2004.6

Research shows that there is a statistically significant relationship between foreign ownership and adoption of corporate governance reforms related to disclosure and transparency, such as communication with shareholders. Foreign ownership also is associated with a propensity to downsize, to restructure via asset divestments, and to use equity-based measures of performance. We don’t know if the relationships here are causal -- did foreign investors actually induce these changes? -- or if they were the result of foreigners buying shares in companies that were likely to take these steps or had already begun to do so. It’s possible that restructuring was in progress before the actual changes were recorded. Given the high turnover of foreign holdings, it seems plausible that foreign capital would seek investments where the probability of shareholder-friendly change was high. We know that foreign investors tend to purchase shares in large export-oriented companies, whose size and complexity offer the greatest opportunity for job cuts and restructurings. Also, export-oriented Japanese companies with a high proportion of foreign investors are more likely to list their shares on U.S. exchanges. The listing requirements of the NYSE and NASDAQ are another way that foreign companies can be induced to adopt American features of corporate governance. That is, it may be the listing requirements, rather than foreign ownership per se, that induces change.7

Indeed, if foreign investors are agents of governance reform, the effect should exist in other countries, not only in Japan. Hence one would expect to see a positive association between a nation’s share of equity held by foreign investors and legal protections for minority shareowners. Yet neither for the developed countries nor for developing countries is there any such association; the correlation is actually slightly negative. The Netherlands, for example, has a foreign penetration ratio nearly three times as high as Japan’s yet its protections for minority shareowners are at the same level as Japan’s.8

Of course, this is a cross-sectional correlation. It’s possible that at the country level and over time, rising foreign ownership is positively associated with minority shareholder protections. And it’s also possible for foreign investors to affect corporate governance at major companies--the “micro” level--while leaving the overall legal climate unchanged. There is anecdotal evidence of this occurring in Japan after Renault’s purchase of Nissan and after acquisitions by private investors such as Carlyle and Ripplewood. However, acquisitions represent but a tiny fraction of foreign
ownership. While CalPERS is often cited as the paradigmatic activist foreign investor, in fact little is known about its corporate governance activities in Japan. It was among the first foreign pension funds to make major investments in Japanese equities. It was—and remains—one of the largest, if not the largest, foreign equity investors in Japan. As early as 1992, when foreigners were just beginning to ramp up their Japan investments, CalPERS owned $3.7 billion in Japanese equities. This stake constituted approximately 2.6 percent of the total value of TSE shares owned by foreign investors. In 2000, when the value of CalPERS’s Japan holdings was $4.8 billion, many more foreign investors had flocked to Japan, so that CalPERS now constituted 0.8 percent (about one percent) of the total value of shares owned by foreign investors in Japan. These figures are impressive but even with its large aggregate holdings, CalPERS is still a flea on the elephant. Its 1992 holdings were only .16 percent (1.6 thousandths percent, roughly a sixth of one percent) of the TSE and it rarely owned more than one percent of any single company. So how could it have had an effect on Japanese corporate governance?

One answer is that CalPERS was an unusually active investor: conscientiously voting its proxies, regularly meeting with executives of Japanese firms, and using the media and other public relations tactics to promulgate its principles. To leverage its stake, CalPERS teamed with other foreign institutional investors and with domestic groups seeking to reform Japanese corporate governance. CalPERS had prominence (some would say notoriety) in the Japanese business community and media because of its aggressive activities in the United States. And it was a first mover in Japan, pushing for change before it became fashionable to do so.

In the end, however, the fruits of CalPERS’s activities were modest. It had more of an effect on reforms related to transparency and the conduct of shareholder meetings than on those related to board structure, executive compensation, and control (takeover rules). Perhaps this is because disclosure and meeting rules are add-ons that can be adapted to the existing Japanese corporate system with minimal disruption to decision-making and incentive systems. Reconfiguring boards or permitting hostile acquisitions requires radical internal change of the sort that many Japanese companies are unwilling to initiate. CalPERS blamed this resistance on self-serving, entrenched management. But many Japanese corporate executives felt that the existing system performed reasonably well, and that the solution to economic stagnation lay outside the corporate sector—in monetary and banking policy—and would not be improved much, if at all, by CalPERS-style reforms. There was, and is, strong opposition to the CalPERS’s principles, especially from the Keidanren, the main Japanese business organization.
The limited effect of CalPERS on Japanese corporate governance also stems from CalPERS’s reticence. It did not want to be seen as an outsider meddling in Japanese public affairs and therefore pressed its agenda less aggressively than in the United States. It urged domestic groups--pension funds and others--to play a more active role. Through its encouragement of these groups, CalPERS’s indirect influence on Japanese governance was at least as significant as its direct efforts.

By 2002 CalPERS began to lose interest in leading the push for shareholder-oriented corporate governance in Japan. There were free-rider costs that it was less willing to bear as more foreign investors entered the Japanese market. Also, CalPERS discovered that it could achieve better results by pressing for change behind the scenes in companies where it held large stakes--the relational investing approach--than in pursuing the same activities on a market-wide basis. In strictly financial terms, Japan was less important to CalPERS by 2002 than it had been in 1992 because of greater diversification of CalPERS’s international portfolio. For all these reasons, the organization as a whole became less committed to being the champion of the shareholder-value philosophy in Japan. The man who had pioneered the CalPERS approach to Japan and who had a deep connection to the country -- Dr. William Crist, the president of CalPERS’s board--stepped down in 2002 after ten years at the helm. Since then, the board has been more interested in domestic issues.

Last but not least, the economic environment changed. Flaws in the U.S. approach became evident in the myriad scandals that followed the 2001 stock market crash. And in 2002 Japan finally began to pull out of its prolonged stagnation and, consequently, was less motivated to appease foreign investors.

The following article examines the history of CalPERS in Japan. It analyzes how institutional investors can promote change in overseas corporate governance as well as the limits of foreign influence. In so doing, it points out flaws in the theory that, because institutional investors are “universal owners” they will act to promote the long-run performance of an entire economy as opposed to narrower, short-term objectives. Finally, despite a vast literature on the spread of American governance practices around the world, there has been little empirical research on the processes that transmit institutional diffusion. The research that exists tends to focus on legal mechanisms--listing requirements or the training of Japanese lawyers in U.S. law schools--rather than on the investor-driven activities discussed here. This case study is one step in the ongoing effort to learn more about the varieties of global capitalism: their convergence and persistence.
I. CalPERS in the United States

To analyze CalPERS in Japan, one must understand how it evolved in the United States. CalPERS’s transformation from a sleepy state pension fund to active institutional investor began in 1984, when the state of California lifted a requirement that previously had limited CalPERS’s stock investments to 25 percent of its portfolio. The change occurred as equity markets were being transformed by an upsurge in hostile acquisitions, leveraged buyouts, and other aggressive investing tactics. At the time, state and local pension funds owned around 5 percent of U.S. equities, a significant stake that rose over the next ten years as the funds put more money into the stock market. Yet the pension funds, like other shareowners, rarely participated in corporate governance; many did not even vote their proxies. Despite their huge holdings they were routinely ignored by management and by arbitrageurs.

It was also in 1984 that the billionaire Bass brothers of Texas made a hostile bid for oil giant Texaco. To stave off the takeover, Texaco paid the brothers a premium of $138 million for their shares—a glaring example of “greenmail.” Infuriated by the deal was California State Treasurer Jesse (“Big Daddy”) Unruh, who was a trustee of the CalPERS board as well as its sister fund, the California State Teachers’ Retirement System (CalSTRS). What irked Unruh was that one major shareholder (the Bass brothers) received a better price for their shares than other major shareholders (the pension funds). Although he tried to block the deal, Unruh was unsuccessful. But he drew from the episode three lessons: that raiders did not consider the interests of other major shareowners, that incumbent managements cared more about their own jobs than shareholder value, and that large public pension funds needed better ways of coordinating their shared interests.

In 1985, Unruh helped to found the Council of Institutional Investors, an association of twenty-nine public employee pension funds and one corporate pension funds. (Additional union and corporate pension funds joined CII later on.) With $132 billion in combined assets, CII was a force to be reckoned with. Among its first acts was to adopt a “shareholder bill of rights” calling for equal treatment of shareholders, shareholder approval of key corporate decisions, and independent approval of executive compensation and auditors. One Wall Street executive said of the CII, “If the institutions start speaking with one voice, they could become a financial OPEC.”

The CII was put to the test later that year by another Texan, oilman and investor T. Boone Pickens, who was trying to take over Phillips Petroleum. Although the bid failed,
CII -- because of its collective clout -- was able to participate in meetings with company representatives, with Pickens, and with the infamous arbitrageur Ivan Boesky. CalPERS in principle supported the efforts of raiders like Pickens, even if it did not align itself with the raiders in every bid. CalPERS professed to be interested in long-term value, and used the term “shareowner” instead of “shareholder” to transmit this message. But according to disgruntled corporate executives, CalPERS was willing to abandon its long-term philosophy whenever a corporate raider offered a sufficiently juicy premium for its shares. When Pickens tried to take over Union Oil of California (Unocal), CalPERS supported the incumbent management, but in other deals CalPERS backed the raiders, as in the 1990 takeover attempt at Lockheed.

Prior to the 1980s, hostile takeovers were relatively uncommon and had a somewhat unsavory reputation. They were disdained as speculative efforts to make a quick buck. To change that perception, Pickens founded a nonprofit group called United Shareholders Association (USA), which tried to highlight abuses by corporate management that could be rectified by takeovers. Economists, too, defended Pickens and others like him for having created a “market for corporate control” which, they claimed, was a necessary goad to managements to maximize shareholder value.

At this time around 80 percent of CalPERS’s U.S. equities were passively managed in index funds. The indexing strategy was a cheap way to track the market. Also, as a large public entity, any above-average losses incurred by CalPERS would be sure to attract public criticism, so indexing kept it free from blame. The CEO of CalPERS from 1987 to 1994 was Dale Hanson, who adroitly managed the political environment while carrying on Unruh’s commitment to shareholder value. (Unruh died suddenly in 1987.) Hanson ran the fund under the supervision of a 13-member board that includes ex-officio members like the state treasurer, appointees of the governor of California, and six representatives elected by retirees and employees. The board and Hanson realized that CalPERS could not sell the shares it held in index funds when a company performed poorly (the “exit” option or what is called the “Wall Street walk.”). Instead, its best option for raising the return on indexed holdings was to propose changes that would boost stock performance at large numbers of companies, such as reforming corporate governance to favor shareholders. The board identified three corporate governance problems it sought to rectify: the inability of shareowners to select the best directors; the inability of directors to supervise management; and the periodic clash between shareholders’ interests and those of the company’s incumbent management and board.
The thesis that corporate governance was responsible for poor corporate performance was advanced with increasing regularity in the 1980s. Politicians, economists, and the investing community asserted that U.S. companies had failed to respond effectively to the upsurge in competition associated with globalization. One reason, allegedly, was that boards subscribed to a managerialist governance philosophy in which management and the board were supposed to balance the interests of corporate stakeholders. This caused them to prioritize the interests of incumbent executives over shareowners through anti-takeover devices such as poison pills and staggered board terms. Managerialism also was blamed for excessively high wages and staffing levels and for wasteful spending on acquisitions, as epitomized by conglomerates. 16

Wall Street, the raiders, financial economists, and institutional investors were united by the belief that corporate performance would improve if managers and boards did one thing and one thing only: maximize shareholder value. For Hanson and for his right-hand man, general counsel Richard Koppes, the key to this objective was the board of directors. As Koppes put it, “Our role is to goad the boards into doing their job. Boards cannot run companies. They cannot micromanage. But they can ask critical questions, about strategic direction, about executive compensation, about evaluation of performance.” 17

During the late 1980s CalPERS focused its activities on firms who had what it considered to be shareowner-unfriendly policies, such as anti-takeover provisions. It introduced shareholder resolutions opposing poison pills at major companies such as Alcoa, American Airlines, and K-Mart. CalPERS also sought to make boards more independent, again through shareholder resolutions. At some companies, the resolutions called for boards to be comprised of a majority of outsiders (e.g., General Motors); at others, CalPERS demanded that the board’s compensation committee, which set executive salaries, be comprised entirely of outside directors (e.g., at conglomerate ITT).

CalPERS felt that the deck was stacked against shareholders seeking a more active role. Proxy challenges were difficult to mount because of arcane corporate rules and because the SEC tolerated corporate efforts to keep shareowners at bay. So CalPERS expanded its activism to include shareholder proposals for broadening shareholder rights. It asked Boise-Cascade to revise its rules so as to give dissident proposals a better chance of passing; it asked Hercules Chemical, Inland Steel, and Whirlpool to keep shareowner voting confidential. Many companies preferred quiet resolution of these disputes to public battles that damaged their reputations. This gave CalPERS leverage to demand private meetings with corporate executives, although some
companies were unwilling to meet with CalPERS, such as Avon and Sears Roebuck. Only after CalPERS mounted campaigns for shareholder advisory committees did Avon and Sears agree to meet twice a year with large shareholders. For many business executives, the rise of active investors like CalPERS was unsettling. As one Wall Street expert said at the time, “There are still some hard-core boards and C.E.O.’s who have that old Victorian feeling that shareholders should be seen and not heard.” 18

At the time of these battles, CalPERS’s ability to communicate with other institutional investors was hampered by an SEC rule requiring shareholders not to communicate with more than ten other shareholders until they had filed a request with the SEC and the SEC had reviewed and approved it. Given the high cost and low success rate of solo proxy battles, CalPERS decided to propose a change in the rules. It was a propitious time to seek a change since in 1988 the Department of Labor had issued its “Avon letter” ruling, which said that private U.S. pension funds had a fiduciary duty to research and vote their proxies. While ERISA did not apply to CalPERS, the latter saw the ruling as a vindication of its active proxy policies. In 1989 CalPERS formally asked the SEC to revamp its proxy limitations. After three years of hearings and despite strong opposition from the business community, the SEC adopted a change permitting an unlimited number of shareholders to communicate with each other, which substantially reduced the cost of a mailing to a company’s largest owners. Now CalPERS could more easily form coalitions with other major investors. Yet the cost of shareholder action relative to the benefit remained high. Most shareholder resolutions did not receive majority support. As Dale Hanson explained, “we may only own a million shares of a company, and I’m not about to spend a million dollars of PERS funds to do a proxy fight where I might try to run my own slate of directors, because I cannot justify, in a cost benefit analysis, that kind of activism.” 19

CalPERS made important changes to its approach in 1989. Instead of going after companies with egregious corporate governance, regardless of performance, it took aim at companies with governance defects and that had poor performance based on five year stock returns. Only companies in the bottom performance quartile were targeted, because these companies could not argue, as better performers sometimes did, that their profitability exempted them from criticism. From the bottom quartile a group of fifty companies was selected (the “Failing Fifty”) based on three additional screens: low levels of inside ownership; high levels of institutional ownership; and low scores on a corporate governance index that measured factors such as board independence, separation of the CEO and chairman positions, executive compensation in line with
performance, and independence of the compensation committee. CalPERS then filed shareholder resolutions pointing to each target firm’s most serious governance “sin.” For CalPERS, the most common charges were a lack of confidential voting, the presence of poison pill provisions, and the absence of shareholder advisory committees. Note that the methodology had the effect of creating the impression that the “sins” were the cause of the company’s poor performance, although, as we will see, evidence to prove this assertion was weak. 20

In the first year of targeting, CalPERS reached a compromise with ten of twelve targeted companies before resolutions were ever voted on. This was a much higher “win” rate than under its previous strategy. The names of the targeted companies were shared with the media, which put an unwelcome spotlight on their internal affairs. CalPERS’s success had much to do with its targeting of poor performers (firms that could not say “if it ain’t broke, don’t fix it) and with its ability to find allies in the institutional investing world. Some members of the business community, however, were furious about its tactics. In June 1991, California governor Pete Wilson, a Republican, proposed a two-prong plan to tap CalPERS’s holdings to help fund a state budget deficit, while also abolishing the CalPERS board and replacing it with a smaller board, a majority of whose members would be appointed by the governor. Said Dale Hanson, “We learned this weekend that the governor had a made a promise to business that he will put a more compliant board in there so we will not be so active in corporate governance.” 21

Although California voters rejected Wilson’s plan, it temporarily chilled CalPERS’s aggressive tactics. In the 1992 proxy season, CalPERS took a more cooperative approach. Rather than publicly identifying a targeted company, it first sent a confidential letter seeking a meeting to discuss poor performance and reform of corporate governance flaws. At the same time it quietly put into motion the machinery for a shareholder proposal. If management agreed to go along with CalPERS, even part way, CalPERS promised to withdraw its resolution. But this gentler approach failed to achieve results. Ten firms refused to cooperate with CalPERS and, in response, CalPERS released their names to the media and threatened to vote against their incumbent directors, a strong negative signal to other investors. Among the ten companies were IBM (its sin was paying its CEO, John Akers, what CalPERS regarded as excessive compensation); Salomon Brothers and Time Warner (they lacked independent boards); and Chrysler, U.S. Air, and Polaroid (they lacked shareholder advisory committees for major owners). 22
After 1992, CalPERS reverted to its previous policy of announcing to the media each proxy season around a dozen underperforming companies based on the selection criteria it had developed in 1990. Not forgetting the episode at IBM, it fought to have Akers ousted as CEO, while also seeking to get rid of the incumbent CEOs at Westinghouse, American Express, Kodak, and General Motors. The eventual dismissal of GM’s CEO, Robert Stempel, along with other GM managers, was a signal event, the result of coordinated efforts by CalPERS and other institutional investors. In these situations, CalPERS would identify particular directors who might be sympathetic to its cause and send letters urging their support. Often it acted in concert with the CII, which coordinated the actions of institutional investors. Under the new SEC proxy rules, CII was permitted to solicit proxy votes on shareholder resolutions and director elections. While the change may not have made CII a “financial OPEC,” it gave CII considerable clout in the corporate governance struggles of the 1990s. CII began to publish its own list of the worst-performing U.S. companies and worked closely with CalPERS in ousting several other CEOs, including the head of K-Mart. 23

CalPERS’s aggressive and publicity-oriented tactics reflected the idiosyncrasies of Hanson and Koppes. Other giant pension funds, such as CalSTRS and TIAA-CREF, were not nearly so media-oriented nor forceful. Robert Monks, a well-known shareholder activist, said that “what gave CalPERS power was the personality of Dale Hanson,” who was not afraid to take on the Governor of California or the CEOs of America’s most powerful corporations. Richard Koppes, Hanson’s deputy and general counsel, was similarly aggressive. According to Koppes, “Nothing rivets the attention of the corporate mind like a proposal.” Koppes was frequently in the news and a participant in the National Association of Pension Attorneys and the Working Group on Corporate Governance, a committee of corporate and pension lawyers (including the omnipresent Ira Millstein) that promoted governance reform. 24

CalPERS changed its approach yet again in 1994. The state elections that year brought several conservative public officials to the CalPERS board. Dale Hanson left for the private sector and Richard Koppes followed him there in 1996. After their departures, CalPERS adopted a lower public profile, preferring to work behind the scenes as much as possible. This disappointed people like Robert Monks, who said that “I’m sorry they’re not around to push the envelope with me.” Replacing Hanson was James E. Burton, who, although he got his start as an assistant to Jesse Unruh, wanted to concentrate more on internal affairs like technology and business processes than on corporate governance activities. 25
Another reason for CalPERS’s less aggressive approach was cost concerns. CalPERS spent considerable time and money on corporate lobbying and shareholder resolutions, the benefits of which did not return in equal measure to CalPERS. Part of this was simply due to the fact that CalPERS did not have large holdings in any single company, yet its procedure was to target individual companies. Part of it was a free rider problem: even with the existence of CII, CalPERS was picking up research and legal costs for activities that benefited less aggressive investors. The research problem was partially solved by the creation of two entities to provide proxy research and services to institutional investors: Institutional Shareholder Services (founded by Robert Monks and Nell Minnow in 1985) and the Investor Responsibility Research Center (founded in 1992). ISS and IRRC merged last year. 26

Research on Activism: In the 1990s, a stream of economic research examined whether shareholder activism had an effect on corporate performance. CalPERS touted a study by Wilshire Associates showing an improvement in stock price at companies targeted by CalPERS, a phenomenon dubbed “the CalPERS effect.” Wilshire Associates first conducted the study in 1992 at CalPERS’s request and repeated it in 1995, 1999, and 2004. The study, however, was marked by various methodological problems. Wilshire Associates was also an investment advisor to CalPERS and may have felt compelled to tell CalPERS what it wanted to hear. 27

Other studies found more ambiguous results. Roberta Romano distinguishes between activism based on shareholder votes and proposals, and that based on nonproxy activity such as targeting and negotiations. The effect of shareholder proposals on corporate performance was insignificant in all studies she reviewed, including a study by Smith of proxy submissions by CalPERS. A subsequent study by Gillan and Starks finds a negative effect of institutional proposals on share price. The evidence on nonproxy activity is inconclusive. Of nine studies reviewed by Romano, five showed positive performance effects and four found insignificant or mixed effects. Of these studies, two were based on CalPERS: one found significant performance effects; the other did not. A more recent study examines the stock-price effect of CalPERS’s targeting and finds that it occurs immediately after targeting and dissipates within six months. Another recent study finds that public disclosure of poor-performing companies by CalPERS leads to a greater likelihood of CEO dismissal and a stronger relation between performance and CEO dismissal, although the effect of disclosure on performance is not analyzed. However, the latest study in this area--by Nelson--finds previous studies deficient because they fail to control for contaminating events (e.g.,
positive news stories released shortly before public announcement of the CalPERS focus list) and because they are biased by estimation during periods of known underperformance. Controlling for these biases, Nelson finds that, while there are positive price effects of CalPERS targeting during the 1990-1993 period, there is no evidence of a CalPERS effect since then. 28

These findings suggest another reason for CalPERS’s less visible approach in the mid-to-late 1990s: nonproxy activities had a higher probability of success. After the mid-1990s, CalPERS shied away from criticizing individual CEOs and mounting shareholder resolutions. Its lower profile meant that CalPERS did not appear in the news as frequently. This bothered Koppes, who, two years after leaving CalPERS said, “Five years of going to the press and now they don’t go. You don’t hear about CalPERS. If you don’t keep the constructive tension, that’s unfortunate.” 29

The people running CalPERS after 1996--CEO Hanson, board president Bill Crist, and general counsel Kayla Gillan--disputed Koppes’s claim that CalPERS had lost its bite. The fund joined a lawsuit against Disney in 1997 charging that the firm paid excessive severance compensation to former president Michael Ovitz. It sponsored four shareholder proposals in 1998, more than two years earlier. Poor performers, like Stride Rite, a shoe retailer, appeared repeatedly on the annual focus list of “Top 10 underperformers.” Stride Rite received regular, albeit unwelcome, communications from Gillan and other CalPERS officials. The same occurred with other companies on the list as well as companies that were underperforming but had not yet made the list. Says Crist, “What we do now at CalPERS and have done for the last five or six years is we’ll talk a lot .. [so] there are many companies that never make the focus list and never make the press, because between the time we start talking to them and the time we do that, they change.” As before, CalPERS selected companies based on a screen that combined governance criteria, stock performance, and EVA/MVA (economic- and market- value-added, proprietary measures of shareholder value creation). Then it would start to communicate with company management. 30

An advantage of CalPERS’s behind-the-scenes approach was that it allowed the fund and its agents to raise politically sensitive issues such as divestitures and layoffs. The evidence shows that CalPERS’s targeting was associated with a higher rate of asset divestitures and employee layoffs than in a sample of control firms. Also, firms targeted by CalPERS had higher restructuring levels than firms targeted by other activist pension funds. CalPERS officially was on record that it preferred companies to improve shareholder returns without layoffs. But it was not averse to downsizing. Patricia Macht,
a CalPERS official, told the *New York Times* in 1996, “There are companies that are fat, that have not taken a good look at the number of employees they need.”

Still, targeting and lobbying were expensive and, according to the academic studies, had an uncertain performance payoff. So one new approach that CalPERS took was to follow a recommendation originally made by the Gordon Group in 1993: to accumulate large stakes (five to ten percent or more) in a few underperforming companies and use these concentrated holdings as leverage to effect strategic changes such as spin-offs, divestitures, and higher payouts to shareholders via dividends and/or share repurchases.

Relational investing, like any other kind of block holding, allowed investors to focus directly on business decisions rather than, as with corporate governance reform, the methods used to reach those decisions. In 1995 CalPERS made an initial investment of $250 million in Relational Investors, a private fund, as well as in several other relational funds that took large positions in underperforming companies. By the end of 2004, CalPERS had invested over $2 billion with Relational Investors, which uses threats and persuasion (and board seats at a half dozen companies, including ConAgra and Apria) to persuade management to be more shareholder-friendly. CalPERS also invests in other relational funds, including Active Value Fund and the Hermes Focus Fund in Europe.

Principles: In addition to relational investing, another change at CalPERS in the mid-1990s was an effort to clarify and codify its principles of corporate governance. The first step came in 1994, when CalPERS wrote to the companies that comprised the 200 largest holdings in its domestic portfolio and asked them to perform an analysis of their governance practices. In 1997 CalPERS, as well as the Business Roundtable and TIAA-CREF, issued codes of corporate governance, although it was CalPERS whose principles received the most attention. The 1997 CalPERS code comprised preliminary guidelines intended to “provide a benchmark of what is ‘good’ corporate governance.” It included 23 items that were “fundamental” and 14 that were “ideal.” CalPERS planned to grade companies on these principles, publicize the results, and prod recalcitrants to change. But the idea was met with a barrage of criticism from the business community. The president of the National Association of Corporate Directors said, “The pendulum has swung too far, and CalPERS is starting to overreach.” A *New York Times* analysis of the 861 public companies on the Fortune 1000 list found only one, Texas Instruments, meeting the full range of CalPERS’s core tests. In a statistical analysis of its own, *The Times* did not detect any pattern linking governance to performance.
Stung by these criticisms, CalPERS issued a final set of governance principles in 1998 that dropped several of the more controversial ideas (such as a limit on the number of directors older than 70). Again it separated between “core” principles and “guidelines.” The core principles focused on the board of directors and executive compensation in such areas as: a) board independence (majority for the entire board, entirely for key committees. separation of chairman and CEO positions); b) board processes (a statement of governance principles for the board); c) executive pay (transparent executive pay packages aligned to shareholder interests via equity-based compensation) and d) limits on the outside commitments of board members. Another set of recommendations concerned “shareowner rights,” everything from the right to amend bylaws to proxy access to shareowner approval of executive stock options. CalPERS asserted the importance of transparency, equitable treatment for all shareholders, and easy and efficient voting methods. 34

Research on Corporate Governance: The CalPERS principles were a bold statement of the shareholder-value ethos. But did the principles make economic sense? The evidence on the performance effects of governance reform is ambiguous. One widely-cited study by Gompers et al. finds a strong, positive relation between an index of 24 governance rules and stock returns during the 1990s. Well more than half the rules pertain to the absence of anti-takeover defenses such as supermajority requirements for mergers and staggered board terms. The others concern shareowner rights in proxy voting, shareholder meetings, and bylaw amendment. While Gompers et al. did not identify the factors most likely to boost share price, a subsequent study finds that the critical variables are those related to facilitating takeovers and preventing executive entrenchment. 35

Elimination of takeover defenses was mentioned in the CalPERS principles. However, the core of its principles had to do with other issues, such as oversight (board structure) and incentives (executive compensation). Here the performance effects are harder to find. In fact, the preponderance of evidence shows that board independence and small board size are not associated with improved corporate performance. There is also no evidence that a split between the chairman and CEO positions is associated with better performance. However, board independence does make it easier to get rid of a CEO during periods of poor performance. 36

That CEOs were the key to a company’s performance became a credo of the investing community in the 1990s. Targeting by CalPERS is statistically associated with
CEO turnover at targeted firms. Companies targeted by CalPERS were more likely to be recipients of subsequent hostile takeover bids, perhaps because targeting sent a message to would-be raiders that at least one major shareholder was likely to support a hostile acquisition. However hostile takeovers declined in the 1990s, which could be why CalPERS turned to CEO removal as a tactic for improving performance. The success of institutional investors in ousting CEOs at underperforming companies--either by voice or exit--was responsible for changes in the CEO role in the 1990s: a decline in tenure and a shift in preference from insider CEOs to outsiders hired by independent boards and incentivized with stock options. These outside CEOs were touted as charismatic “saviors” who would turn around companies and boost their share prices. In 1980, less than 5 percent of all CEO successors in the largest 850 U.S. companies were outsiders; in 1995 the number was about 30 percent. Yet there was, and is, no evidence to support the claim that poor performance can be rectified by replacing an incumbent CEO with an outsider. If anything, the evidence suggests the opposite: that improved performance is associated with relay successes in which the incumbent plays a role in selecting his or her replacement, which remains standard practice in Japan’s insider system. 37

As for executive pay, CalPERS sought reductions in total pay levels as well as greater use of stock-based compensation for executives and boards. There is evidence that, when CalPERS succeeded in reducing executive pay levels, it had the unanticipated result of making pay less sensitive to performance. As for requiring board members to hold stock, there is no consensus regarding its effect on performance; studies find both positive and null effects. Finally, whether stock options improve performance is a vexed issue. Although some studies find a positive relationship between corporate performance and the portion of total compensation paid in stock, more recent studies reveal a slew of problems associated with stock options. They create incentives to manipulate earnings and to extract gains that benefit executives at the expense of shareowners through repricing and through rewards for sectoral or marketwide stock gains. A recent Boston Consulting Group study finds that the strongest predictor of corporate fraud is the value of outstanding stock options rather than the quality, or lack thereof, of corporate governance. To its credit, in the 1990s CalPERS did begin to criticize some of the more egregious practices related to options, such as reloading in the face of a firm-specific decline, but it nevertheless remained an enthusiastic proponent of equity-based pay. 38

In short, the evidence regarding the performance effects of the CalPERS principles is mixed: strong on efforts to eliminate takeover defenses; weak on guidelines
prescribing an optimal approach to internal organization, such as the role of boards and CEOs. This fits with a point made twenty years ago by Harold Demsetz and Kenneth Lehn: that there is no single optimal ownership structure that maximizes honesty and efficiency; rather, optimality is endogenous to idiosyncratic factors at particular firms in particular markets. This is not to say that CalPERS failed to affect the companies it targeted. In fact, those companies had more hostile takeover attempts, greater CEO turnover, larger asset sales, and more layoffs than similar companies. But these changes were not related to improved performance except immediately after the announcement that a firm had been targeted. 39

These findings had little impact on CalPERS, whose leaders held deep convictions that their approach improved performance even if the effect could not be demonstrated statistically. Said board president Bill Crist in 1997, “There’s so much contradictory evidence. I don’t believe in any of the studies. I believe [corporate governance reform] is working. Maybe it’s an act of faith, but we’re changing corporate culture. More competition. More efficiency. Not boards sleeping or playing golf and drinking fine wines.” Yet when studies showed positive results from CalPERS’s actions, as with the Wilshire Associates’ reports, CalPERS was quick to publicize them. Eight years later, Crist, now retired from the board, maintains his faith in governance reform: “I believe in something like this intuitively. You’ve got to say, ‘It makes a difference.’ . . Can you take me to a piece of scholarship which absolutely proves this? No. But can you convince me that it doesn’t make a difference on the good side? No, it has. And it does and it will continue to do so. But only so long as the pressure stays on.” 40

Sometimes the state legislature and ex-officio Democrats on the board forced CalPERS to take socially responsible positions within the confines of its fiduciary responsibilities. In the late 1980s, CalPERS, under pressure from the legislature, divested $11 billion from companies doing business in South Africa. And in 1994, CalPERS invested in affordable housing projects and adopted an investment screen that favored companies with employee teams and training. These were so-called “high performance” work practices, which were then being advocated by U.S. labor secretary Robert Reich and which were positively associated with firm performance. 41

Ironically, this kind of activism--and the 1991 fight against Governor Wilson, a Republican--gave CalPERS a progressive image even though its reputation in the investing community and overseas was that of a hard-nosed proponent of shareholder value. Until the late 1990s, the board was controlled by an “old guard,” including Crist, Robert Carlson, and Charles Valdes, who were willing to invest in almost anything that
made money. For example, in 1993, CalPERS entered into its largest-ever private equity deal: an investment of $250 million in a Joint Energy Development (JEDI) limited partnership managed by Enron. After selling the investment back to Enron (actually to Chewco) for a huge profit, CalPERS in 1997 made a second investment of $156 million in another JEDI limited partnership. The partnerships and Chewco were the off-book entities that eventually would bring down Enron. After the inauguration of Democratic governor Gray Davis in 2000, new board members, such as state treasurer Phil Angelides, began to push an energetic social agenda, including screens against tobacco companies and against investments in countries that did not respect human rights. Members of CalPERS’s staff--professionals hired to manage the portfolio--were, like the old guard, opposed to any politicization of investment decisions or departure from shareholder-value principles. Ted White, in charge of CalPERS’s corporate governance programs, said, “We lose effectiveness when we get away from arguments that carry weight with the financial community.”

II. Early Days in Japan

CalPERS gradually became more active in overseas markets, although it maintained a lower profile than at home. Seeking to avoid the image of a foreigner meddling in local affairs, it formed strategic alliances with local groups to foster its reform agenda and to change the normative climate. In the words of board member Robert Carlson, CalPERS was an international “missionary for good corporate governance.” Like other missionaries in earlier times, one of the first places CalPERS selected for governance reform was Japan.

Corporate pension funds entered the Japanese market in the early 1980s, after the bond market failure. Public pension funds, which had stricter investment rules, were slower to invest overseas, but they picked up the pace after the 1987 stock market crash in the United States. Joining the pension funds were international mutual funds and a few raiders, like T. Boone Pickens. Pickens bought a 20 percent stake in Koito, an auto parts firm. In 1989 he shocked the Japanese business community by appearing at a Koito shareholders’ meeting and demanding a seat on the board. Pressure on Japanese companies was also coming from the U.S. government, whose Structural Impediments Initiative (SII) talks started in 1989 and continued for several years. The SII sought, among other objectives, deregulation of Japanese financial markets and increased access for U.S. investors.
CalPERS’s initial purchase of foreign equities occurred in 1988 and quickly ramped up after that. By 1991 foreign holdings accounted for 12 percent of its total equity portfolio and this doubled to 24 percent in 2000. All of CalPERS’s international investments were handled by external investment banks. The initial Japan investment in 1988 consisted of $250 million placed in an index fund managed by State Street Global Advisors. At that time, CalPERS was one of the first public pension funds to invest in Japan. 45

In fiscal year 1991-1992, CalPERS made a huge investment, worth about $1 billion, in an actively managed portfolio of Japanese stocks. Different firms invested these funds, with Nomura Capital Management handling the largest chunk. By the end of 1992, 28 percent of CalPERS’s Japan portfolio was actively managed. The active share rose to 40 percent in June 1994, its peak, when the total Japan portfolio had a book value of $3.7 billion, nearly a fifteen-fold increase from the initial investment. The active percentage gradually drifted down to 32 percent in 1995, 27 percent in 2000, and 22 percent currently. Even at these reduced levels, the percentages were higher than the actively-managed share of the U.S. portfolio, which ran around 17-18 percent in the 1990s. This is an important point. The fact that CalPERS had a relatively large active stake in Japan in theory should have reduced its incentive to engage in shareholder activism; “exit” was more of an option than in the United States. But it’s also possible that its active stake created a threat effect that gave CalPERS greater leverage over Japanese companies. In a thinly traded market, exit could damage a company’s image and its share price. Also, the large actively-traded stake may have shaped CalPERS’s time horizons in Japan, making it anxious to see quick changes that could be turned into profits. 46

CalPERS’s early days in Japan were rocky. It relied heavily on services provided by Nomura and other local agents but was shocked when, in 1991, Nomura was swept up in a trading scandal. (Allegedly it gave sweet deals to preferred investors with ties to organized crime.) In response, CalPERS sent a letter to the Minister of Finance, then Ryutaro Hashimoto, calling for an investigation of security trading practices. CalPERS temporarily suspended relationships with Nomura Securities in Japan. This was a symbolic action because CalPERS kept its ties to U.S.-based Nomura Capital Management, which was delivering great returns on the active portfolio. In 1993, CalPERS demanded that Nomura as well as Daiwa appoint outside directors to their boards and warned that it might seek the same from other Japanese companies. 47
Proxies: Between 1988 and 1990, CalPERS did not vote proxies for its Japan holdings, like most other foreign institutional investors. But in 1990, the fund decided to replicate in Japan the systematic proxy voting it pursued in the United States. Proxy voting was—and is—rather complicated in Japan, especially for foreign investors. (One of the issues in the SII talks was to reduce the impediments to foreign voting.) In early June, about two weeks before a shareholder meeting, proxy material is sent to a transfer agent, such as a trust bank, which holds the shares. The bank sends the material to the appropriate custodian, such as State Street, who, in turn, passes the information to CalPERS or its proxy agent. After the proxies are voted, they are sent through the system in reverse direction. In theory this means that a Japanese company does not know the identity of the beneficial owner.

In the 1990s, all shareholder meetings were synchronized to take place in late June. So a flood of proxies would come pouring in at the same time. CalPERS hired Global Proxy Services (now ADP) as its proxy agent. Because it did not have any Japan experts on its staff, CalPERS relied on the advice of various consultants to help make its voting decisions, including Joe Luskin and Aron Viner, who were with Global Proxy, and an acquaintance of Luskin’s named Raita Sakai, who ran a Tokyo consultancy called Multilateral Investment Development Corporation. CalPERS also relied on research done by IRRC to guide its decisions. 48

Proxy issues in Japan typically include approval of the income allocation proposal (which includes dividends, directors’ bonuses, and allocations to reserve accounts and retained earnings); director elections and statutory auditor elections; directors’ retirement bonuses; and amendments to the articles of incorporation (which can include everything from entering a new business line to adoption of a holding company structure). Two key issues that concerned CalPERS were the absence of independent directors and the large size of Japanese boards. To show its displeasure, CalPERS would vote its proxy against re-election of incumbent directors and against proposals for expanding board size. Another concern, as in the United States, was management entrenchment. CalPERS opposed the raising of new equity if it felt that this was being done to erect a takeover defense. After the 1993 commercial code revisions requiring companies to add an independent auditor, CalPERS made it a policy of voting against auditors who were judged to lack independence, such as former company executives. CalPERS would also oppose the re-appointment of directors at companies whose corporate governance or performance it deemed unsatisfactory. 49
An issue of particular concern was dividend levels. In Japan, companies often held more of their assets in cash than their U.S. counterparts, partly to accommodate larger bank loans. Despite these cash holdings, dividends were meager and based on par value rather than earnings. In the United States, too, companies followed rules of thumb to guide their dividend payments; early in the twentieth century they also tied dividends to par value. But later in the century, as shareholder value norms took hold, dividends were linked to earnings in the United States. When stock repurchases became common in the 1970s, the relevant indicator became annual growth in dividend per share. CalPERS was eager to see Japanese firms return more cash to shareowners, either through dividends or stock repurchases. But it was aware that this was a touchy issue that could make CalPERS appear greedy or insensitive to Japanese norms regarding retained earnings. Exxon and Mobil, which each held 25 percent stakes in Tonen, a Japanese refiner, had received considerable negative publicity in 1993 when they forced out Tonen’s president and pressured the company to double its dividends. In contrast, CalPERS was careful to appear even-handed. It publicized the fact that, although it was voting against inadequate dividends at some Japanese companies, and that it was concerned about the low level of dividends in Japan, it was also voting against excessive dividends being paid by other, unprofitable companies such as Nissan. As Richard Koppes said, “We’re not trying to change Japanese culture.”

In 1992, CalPERS announced that it had selected Britain and Japan as foreign targets for its campaign to improve corporate governance, this at the same time the Japanese government was working on commercial code revisions. The following year CalPERS issued global proxy voting guidelines. They emphasized director accountability to shareowners; transparency of corporate information; shareholder-friendly distribution of proxy materials; and publication of final proxy tallies. The concern about distribution reflected a problem that occurred during the 1993 proxy season, when CalPERS’s “no” votes against more than 200 Japanese companies went unrecorded. Sumitomo Trust said that CalPERS’s proxies were received after the deadline, although the same glitch seems to have affected other U.S. institutional investors, a fact that Koppes termed “very disturbing.”

Proxy voting is a noisy signal. A negative vote on an income allocation proposal is subject to multiple interpretations that are based partly on knowing the identity of voters and their specific concerns. CalPERS did not publicize its proxy votes in Japan. Nor did it publish a “target list” or mount its own shareholder resolutions, as it did in the United States. Instead, CalPERS would quietly send letters to company management before or
after a vote to explain why it had acted as it did. Even when CalPERS did not send a letter, companies usually were able to identify the beneficial owner casting a large negative vote, although there were no legal provisions for disclosure. One expert estimates that firms are able to identify at least 80 percent of the beneficial owners and usually know when a bloc is owned by CalPERS. 52

Proxy voting was a cumbersome and not entirely effectual way of inducing governance reform. Rarely did anti-management votes exceed 30 percent of the total and, even then, companies almost never announced the outcome, despite CalPERS’s request that they do so. (Vote totals were educated guesses.) Although CalPERS sought higher dividend payouts, dividends remained flat until the late 1990s. CalPERS voted against all former executives who were nominated to be independent auditors, but the percentage of firms listing auditors whose outsider status was questionable actually rose between 1994 and 1996, from 11 to 20 percent. A particular hindrance to CalPERS was the fact that in its early years in Japan, its staff and board rarely visited Asia. There was talk in 1993 of opening a CalPERS office in Tokyo with a Japanese national as its head, this at the same time as there was talk of starting a Japanese “poor performers” list. But both ideas were nixed in 1994 and never pursued. According to the press, CalPERS was concerned that if appeared too assertive, it “might cause a controversy in Japan.” Indeed, CalPERS was extremely sensitive to the possibility that its reform proposals could be cast as some form of cultural imperialism. As it explained, “CalPERS is not yet ready to export its domestic corporate governance program. While the philosophy has global application, we do not yet fully understand all the foreign laws, customs, and culture that affect the corporate culture and the rights and responsibilities of shareholders.” 53

Black Ships: During the 1980s, Keidanren, the peak association for large Japanese companies, monitored U.S. economic, legal, and social issues through its Council for Better Investment in the United States. The Council advised Japanese companies how to handle their overseas direct investments. In 1989 it changed its name to the Council for Better Corporate Citizenship (CBCC) and expanded its ambit to monitoring of corporate governance issues in the United States, including “the influence of public pension funds and other institutional investors.” CBCC wanted to know how the funds made their investment decisions, how they viewed the role of outside directors, and what were their expectations for Japanese companies, especially with regard to conflicts between shareowners and other stakeholders. It led a study mission to the United States in 1993 seeking answers to these questions. 54
That year, CBCC extended an invitation to Bill Crist to visit Tokyo and address the Keidanren. This was an historic event, widely reported in the Japanese media. Some likened Crist’s visit to Admiral Perry’s “black ships,” while one reporter dubbed him “the feared and respected Dr. Crist.” In the ensuing years, Keidanren would prove to be an agile and ardent opponent of reforms promoted by CalPERS. Nevertheless, the group was interested in hearing what Crist had to say, although, says Crist, “they were interested in a very defensive way.”

Crist began his speech by reminding the audience that CalPERS was not a speculative investor but instead was interested in long-term returns. He also stressed “we are not crusaders -- we do not want to make over countries’ corporate structure.” Having said that, he laid out a detailed criticism of Japanese corporate governance based in large part on the CalPERS program in the United States. He justified the parallels by arguing that “foreign governance issues are broadly similar to those in the U.S.” Crist’s “wish list” for Japan covered five areas:

1. Boards: More independent directors and smaller boards of 10-15 people at most.
2. Dividends: Companies with limited growth prospects should return excess reserves to shareholders.
3. Financial disclosure: Adoption of a consolidated accounting system and adherence to the new independent auditor rule.
4. Investor relations: Companies should create investor relations (IR) departments with high-caliber personnel reporting to the president and relaying detailed financial information to investors.
5. Proxy voting: Spread shareholder meetings over a longer time period and give investors more time to read and vote on proxies.

Although Crist cited no evidence that any of these changes would improve shareholder value, he did mention the Wilshire Associates study showing a relationship between share price and CalPERS activism. With respect to Japan, he criticized the fact that stable domestic shareholders had inordinate influence on corporate management while foreigners and other minority shareholders were given “only cursory consideration.”

Sunshine: After his speech, Crist and other CalPERS officials visited large companies in the Tokyo and Osaka regions. The visits were arranged by Luskin and Viner. In later
years, meetings would be arranged by Raita Sakai, who Crist describes as “a zealot for trying to change things in Japan.” Because CalPERS officials could only meet with a few companies during their trips to Japan, the fund relied on its local law firms--particularly Jones, Day--to represent its interests in corporate meetings. Sometimes CalPERS asked one of its Japan investment managers to visit a company on its behalf.

In the early days, circa 1993 to 1995, a typical company visit would be preceded by letters and phone calls asking to see the company’s president (shacho). But except in a few rare instances, the requests were declined. At best, the CalPERS officials met with a managing director for overseas issues; at worst, companies refused to get together with CalPERS officials at all. CalPERS would be told that the company only met with registered shareowners and that it had no record of CalPERS’s shareholder status. The cold shoulder stemmed from a perception that CalPERS was, as Crist put it, “meddling” in places where it did not belong. Occasionally a company suspected CalPERS of being some kind of foreign sokaiya out to blackmail them. Over time, however, companies became more receptive to these visits. By the late 1990s, IR departments were ubiquitous. Companies even began to send their own delegations to Sacramento to meet with CalPERS officials, some on an annual basis.

The meetings organized by Lufkin and Viner were uncomfortable. The issues discussed included touchy topics such as board structure and return of excess cash to shareowners. As Viner said at the time, “In the Japanese style, the response at those meetings is always the same: dead silence. But the nature of that silence has been changing. It’s now an interested silence.” Starting in the mid-1990s, CalPERS intentionally shifted meeting topics to general principles of corporate governance rather than a company’s performance, what Sakai describes as “policy-oriented” as opposed to “financial-oriented” issues. Crist would explain that CalPERS was a long-term shareholder and that companies which produced long-term returns for their shareholders would end up rewarding other stakeholders. Layoffs, says Crist, were never on the table: “I hate to see that sort of Wall Street psychology that layoffs are a good thing. And especially in Japan, where the labor market is not liquid and it is hard for people to find new jobs.” However, Crist and others did continue to advocate changes in corporate governance that favored shareholders. At meetings he would reassure Japanese executives by saying, “I’m not selling anything that’s going to make me rich . . . . I just want you to think about this. I know you don’t want to change, but give me a test.”
According to Sakai, the shift from financial to governance topics was “having more of a lovely sunshine strategy rather than North Wind.” CalPERS was trying to build a different image—less adversarial and more discreet—than it had in the United States or Europe. (A French newspaper captioned a cartoon, “the ugly CalPERS comes here to take away jobs.”). Company visits were never publicized, nor did CalPERS publish target lists or sponsor shareholder proposals. Change was slow, but Crist cites Sony as an example of a company that listened to CalPERS and made necessary reforms. “Now does changing the [corporate governance] recipe mean their company is going to succeed? No, Sony’s gotten in some deep stuff. So it’s not a guarantee….But without having made that change, they would have been in deeper stuff.”

As in the United States, CalPERS selected companies to visit based on stock performance and on its calculations of EVA and MVA. Developed by Stern Stewart, an investment adviser, EVA is supposed to give a better indication of shareholder-value creation than traditional accounting measures. Essentially, EVA looks at returns received by investors (dividends and capital gains) relative to what investors could receive for an equally risky investment. EVA measures performance strictly in terms of shareholder returns. Its adoption in the United States was associated with efforts by large institutional investors to get more value out of companies that focused on other goals such as market share or ROA. CalPERS directed its investment managers to screen the actively-managed Japan portfolio based on EVA.

Despite the hype from Stern Stewart about EVA, the data (on actual market value) do not support the claim that EVA is a superior measure of value creation. A recent study finds that EVA can rise merely as a result of deferring profitable investments or shedding assets. Not surprisingly, U.S. companies that use EVA to determine executive compensation are more likely to sell assets, delay investments, and buy back shares. That is, executives at firms using EVA are basing strategic decisions not on what is in the best long-term interests of the enterprise but, instead, on actions that will serve to boost a particular performance metric: current EVA. To the extent that Japanese companies conform to the EVA standard, it may be an important albeit subtle nudge to base decisions based on “shareholder value.” That is, it will cause enterprises to favor the interests of current shareholders over other corporate stakeholders. This may be one reason for the association of foreign ownership with asset sales in Japan.

CalPERS continued to pour money into Japan during the mid-1990s. The value of its Japan equity investments swelled from $3.7 billion in 1992 to $5.6 billion in 1996. This was part of an aggressive internationalization of its holdings. Companies that had
never heard of CalPERS in 1992 now knew who it was. Publicity from the Japanese media certainly helped. One observer claims that, whenever CalPERS put out a press release on corporate governance, Nikkei’s New York office would pick it up and publish an article about it. Crist admits that “a lot of the pressure we brought was, you could say almost sort of political, but not obviously politics. You know, using the media. … It was always a good story. It was the black ships all over again.” While the effect of media is difficult to assess, a study by Dyck and Zingales empirically confirms that the media can make company policy more responsive to the concerns of minority shareholders. 63

CalPERS also made public relations efforts of its own. Sakai published a magazine in Japanese and English called M&A Review (later called Directors & Boards: Multilateral Briefing) that was distributed to major companies throughout Japan. The magazine promoted the virtues of foreign pension investors. For example, in 1996 there was an article by an executive from Daiwa House, a company whose managing director was an associate of Sakai’s, on “What We Learn from the Activities of Foreign Pension Plans as Investors.” In 1997 the former CEO of the Tokyo Stock Exchange published “Foreign Investors Give a High Impact to Tokyo Stock Exchange.” The magazine also ran articles authored by people affiliated with CalPERS, such as Joe Lufkin, “The U.S. Institutional Investors Have-Launched Corporate Governance in Earnest” (1994); William Crist, “The U.S. and Japan Have Created a New Communication Tool in Investment” and Robert Carlson, “An Award Like the Deming for the Best Corporate Governance Practice” (1996). 64

III. Local Partners

A publicity boost for CalPERS came with the 1998 publication of its Japan corporate governance principles. The process started in 1995, around the time that CalPERS boosted its allocation for international equities from 12 to 20 percent of its portfolio. In June of that year, James Burton, CalPERS’s CEO, told the International Monetary Conference that CalPERS planned an overseas governance campaign in either Germany, Japan, or the U.K. Just as Crist and other officials made a “sunshine” trip to Japan in 1995, so too did they visit Germany and the U.K. to reassure investors and executives that “there will be no straight export of what we do in the U.S. to Europe,” as Crist told a London audience in October. “We have to be let into the club and that means talking and learning from the people here how you do things.” One of the clubs
that CalPERS wanted to join was the Hampel Committee, which was then being formed to revise and implement the governance principles laid out in the 1992 Cadbury Report. CalPERS was not invited to participate on the committee, however. 65

CalPERS conducted an in-house study of how it could best bring the shareholder-value approach to overseas markets. The study saw substantial benefits to adopting shareholder activism overseas (this based again on the Wilshire Associates study), but that an uphill battle was likely, especially in Japan. Japan, said the study, “has a structure that is least like the United States. There, shareholder returns are subordinated to the growth of the company and the interest of the keiretsu and affiliated shareholders.” In March 1996 the CalPERS board voted to develop a formal governance program focusing on Britain, France, Germany, and Japan. The program had four parts: development of principles for each market; participation in local corporate governance debates; outreach to foreign companies, governments, and academics; and strategy development with potential allies. 66

Finding local partners who shared the CalPERS vision was a key element in what board member Charles Valdes called “a culturally sensitive international program.” Local partners would give CalPERS legitimacy in markets hostile to foreign interference while helping to adapt its message to particular cultures. Appearing at a London conference in March 1996, Valdes said that CalPERS was “eager to work with and through local players -- such as shareholders, regulators, associations, and/or other institutional investors from within a given country.” In Japan, institutional investors reacted favorably to announcement of the CalPERS program, with one insurance executive saying it “gives us a great deal of motivation. They are way ahead of us.” But who could serve as CalPERS’s partner in Japan? The insurance companies were not a likely prospect and the public pension funds still operated under strict government control. Having a local partner in Japan was considered essential because the CalPERS program was radically different from Japanese practice. To export its program, said Bob Boldt, the CFO of CalPERS, “We try to get a local entity to do it. In Japan, for instance, the image of CalPERS is totally blown out of proportion, so we get a better effect with a local entity doing it.” 67

The “local entity” that CalPERS initially partnered with was a small organization called the Corporate Governance Forum of Japan (CGFJ). The CGFJ was created in October 1994, one year after Crist’s speech to the Keidanren. A key figure behind the CGFJ was Ariyoshi Okumura from the Industrial Bank of Japan. Okumura credits the CGFJ’s creation to his mentor at the Bank, Kaneo Nakamura, who was active in the
Keizai Doyukai and also had served on the board of General Electric, during which time he became impressed by the need for governance reform in Japan. Okumura, too, was a regular visitor to the United States, including visits to CalPERS. Okumura ran IBJ’s asset management division and made several trips to Sacramento to solicit CalPERS’s business. In 1993, CalPERS made an initial investment with Okumura’s unit worth $300 million. Another key figure in the CGFJ was Takaaki Wakasugi, then a finance professor at the University of Tokyo. He was also a business consultant and a fan of American-style corporate governance.

Of the 17 members of the CGFJ’s governance committee, seven were academics and seven came from industry. (In addition to Nakamura and Okumura, they included Tadao Suzuki, president of Mercian Wine, and Yoshihiko Miyauchi, president of ORIX.) The other members were an attorney, Hideaki Kubori, and editorial writers from Nikkei Shinbun and Asahi Shinbun. From early on, CGFJ was a publicity-savvy organization. As Okumura observed, “Mass-media should be more alert to persuade the public opinion that corporate governance is important to rejuvenate Japanese corporations, not to blindly import an American-made concept.”

Wakasugi drafted the CGFJ’s corporate governance statement, a process that started in 1996 and ended in October 1997 with the publication of an interim set of principles. The 1997 document is a marvel of diplomacy. It consists of three parts: a philosophical introduction, principles to be implemented in the short term (next five years) and principles for the medium term (next ten years). The introduction acknowledges a stakeholder approach but puts shareholders in a special category above other stakeholders. It says that the board of directors’ job is to maximize shareholder value and to represent the immediate interests of shareholders. On the other hand, the board is also supposed to coordinate stakeholder interests and be accountable for its actions to all stakeholders, but particularly to shareholders.

After that, the principles say nothing else about stakeholders other than that they should receive information from the board. The main focus is on disclosure to shareholders and on management monitoring. Regarding disclosure, the report urges that information be provided to shareholders in a timely fashion and on a quarterly basis, adjusted to global accounting rules, and facilitated by an upgrading of the investor relations function. It also calls for more dialogue at shareholders’ meetings and separate information meetings for major shareholders. Regarding monitoring, it urges the inclusion of independent directors on boards (short term) until boards are comprised of a majority of independent directors (medium term). The principles call for a reduction
in board size and separation of the CEO and board chairman positions. The board should include an auditing committee comprised entirely of independent directors (medium term) and more than one independent auditor (short term). These principles strongly resemble the ideas being promulgated by CalPERS in Japan, and, as one scholar said, are “close in tone to that of an assertive-type classical model” of corporate governance. 69

There is some disagreement as to how the principles were formulated. According to Okumura, the basic ideas came from the IBJ’s Nakamura and from Doyukai (which issued its own, more pluralist, principles in 1998). Raita Sakai, however, says that the inspiration for the statement came mainly from CalPERS, which was invited to participate in the drafting process. Crist says that he helped edit the initial set of principles: “I wish I could just capture for you the sitting around the table with the Forum, and they have this process, they’re taking pieces from here and there and from the CalPERS’ principles and writings…And I’m sitting there saying, ‘You know, this is the wrong emphasis. Let’s scratch this out and put this. Let’s add this here and let’s take this out altogether.’” What makes Crist’s account plausible is the provision in the CGFJ principles calling for meetings with major shareholders, a particular concern of CalPERS rather than any domestic investors. 70

Four months after the CGFJ published its principles, CalPERS issued its own governance principles for Japan. The advantage of following on the CGFJ’s heels are obvious. Instead of being seen as an insensitive foreign interloper, CalPERS could--and did--give the impression that it was merely endorsing indigenous ideas promulgated by Japan’s own leaders. As the CalPERS principles stated, “The Corporate Governance Forum of Japan, a body consisting of representatives from Japanese corporations, institutional investors, and academia, has developed an interim report that promotes a sensible two-step approach to reforming Japanese corporate governance.” The CalPERS principles listed all of the short- and medium-term proposals contained in the CGFJ report and noted, “CalPERS believes that Japanese corporations that adopt the CGFJ’s proposals sooner rather than later will best be able to attract investor capital and contend with global competitors.” However, the CalPERS principles did not include any of the CGFJ language to do with stakeholders. Also, its principles included three provisions not mentioned by the CGFJ: reform of proxy voting, endorsement of stock option plans for directors and executives, and reduction of “unproductive” cross-shareholding. CalPERS sent Japanese translations of its principles to all major interest groups in Japan, from the LDP to Keidanren and Nikkeiren. Coming at a time when Japan was being
rocked by bankruptcies of major banks (Hokkaido Takushoku) and brokerage houses (Yamaichi Securities), the principles received wide press coverage and gave weight to Crist’s warning that “Japan needs to demonstrate that corporate assets are being managed in the best interests of the company and its owners.”

Crist brought CGFJ to the attention of the institutional investing world through the International Corporate Governance Network (ICGN). The origins of the ICGN go back to the early 1990s, when Crist, Robert Monks, and other governance activists discussed the need to create an international analogue to the CII, one that would coordinate and legitimate the activities of activist investors around the world. In 1994, Crist and Koppes from CalPERS and other heavyweights from elsewhere in the institutional investing world met at the CII to discuss forming an international association. The ICGN officially was established in 1995 at a conference attended by delegates from the AFL-CIO, the Association of British Insurers, the CII, the National Association of Pension Funds (U.K.), and various state and local pension funds. Koppes envisioned the ICGN as a “clearinghouse for local market standards of conduct and governance procedures. It could also be a conduit for cross-border shareholder initiatives.”

Concerned about the ICGN’s lack of Asian involvement, Crist recommended that the CGFJ be permitted to affiliate, which occurred around 1996. Later Ariyoshi Okumura of the CGFJ was elected to the ICGN’s board, the first governor from Asia. Tadao Suzuki of the CGFJ was a keynote speaker at ICGN’s 1998 conference in San Francisco.

The ICGN’s membership was broad, including not only pension funds but also union representatives and major financial companies. When it issued its own set of governance principles in 1999, they endorsed shareholder value as the corporation’s “overriding objective,” but followed the OECD (which issued principles in 1999) in calling for cooperation between corporations and stakeholders. ICGN recommended employee participation to “align shareholder and stakeholder interests.” This was more pluralistic than anything previously published by CalPERS. While CalPERS incorporated the ICGN language into its own Global Principles, it omitted any mention of stakeholders in its country-specific principles for Germany, Japan, the United States and the United Kingdom. If CalPERS ever were accused of insensitivity to stakeholders, it could point to its Global Principles and its membership in the ICGN, a helpful fig leaf in markets like Japan where stakeholder concepts were still prevalent.

The CGFJ, the Tokyo Stock Exchange, and the Pension Fund Association of Japan hosted the annual ICGN conference in Tokyo in July 2001. It was a major media event and, according to Okumura, was a “timely kick to deliver a positive message to the
Japanese corporate executives who were still somewhat suspicious of corporate governance concepts imported from abroad.” Over 400 attendees listened to Orix’s Yoshihiko Miyauchi speak on the need for a ratings system to improve corporate governance. Awards were handed out to Sir Adrian Cadbury and Ira Millstein.

In charge of the ICGN Tokyo conference was Nobuo Tateishi, CEO of Omron. Although Tateishi had become a board member of the CGFJ, he was also active in Nikkeiren and Keidanren. His views on corporate governance were more pluralist than those of the CGFJ or CalPERS, as reflected in the 1998 report issued by a Nikkeiren special committee that he chaired. The report presented the mainstream managerial view in Japan that, while transparency in reporting to shareholders was desirable, “it would be rather imprudent to think that British or American style corporate governance is the global standard, which other countries in the world must follow.” The goal of governance reform in Japan should be “not to negate everything Japanese but to preserve those basic features of Japanese management which are laudable,” presumably including insider boards and a stakeholder orientation that respected employee interests.  

Perhaps Tateishi was the person responsible for inviting Hiroshi Okuda to give the keynote address at the ICGN conference. Okuda was then chairman of Toyota and of Nikkeiren. His speech was a polite rebuke of the assertive shareholder-value model that CalPERS was promoting in Japan. Okuda stressed the social dimension of corporate activity in Japan. Any approach to corporate governance that fails to take this into account, he said, “could cause major problems.” Japanese management’s commitment to stakeholders, he said, “is in our DNA.” While acknowledging the importance of holding managers to account, Okuda said this had to come from “different perspectives,” including banks and enterprise unions, and not only from shareholders. As for shareholders, who were then urging Toyota to return more of its cash hoard to them, Okuda said, “We prefer to aggressively promote R&D. We aren’t ignoring ROE but we must balance it with R&D.”

Bill Crist was dumbfounded to hear Okuda express “almost identical” words to those Crist heard from Keidanren in 1993. The speech marked the beginning of the end of CalPERS’s hopes that the CGFJ would be a vehicle for governance reform in Japan. Crist believes that the Keidanren had decided to use the Tokyo conference to publicize its views, perhaps through Tateishi, who Crist calls “Mr. Inside/Mr. Outside” and a likely “mole [who] keeps an eye on things” for the Keidanren. An article in the Asian Wall Street Journal expressed a similar view, saying that the Keidanren wanted to
signal to other top executives that they should not “make public comments that are ‘too out of line.’” At the time of the conference, the Keidanren was backing a Diet bill to limit liability of directors and to quash rules facilitating appointment of independent directors, measures that were adopted in the 2001 reform of the Commercial Code. 76

Another theory of Crist’s is that Keidanren backed the CGFJ in its early years as a foil against foreign pressure but that the CGFJ became less useful in later years because it had failed to stop “this new bunch of crazy Japanese guys at the Pension Fund Association.” Whatever the explanation, the fact is that CalPERS’s alliance with the CGFJ was yielding little fruit. Crist says that at one time he “rather naively” thought that CGFJ would “make a real difference” but in the end it had not: “My disappointment was that after the [CGFJ statement] was printed and published and sent all over the world, they never did much. But they knew even while they were doing it that getting these guys up there to change wasn’t going to be that easy.” CGFJ was “very big on having meetings and putting out publications” but its position “inside the business sector” made it “useless” as an instrument of transformation. Who, then, would help CalPERS bring reform to Japan? Perhaps those “crazy guys” at the Pension Fund Association. 77

Pension Fund Association: The Japanese pension fund system is complex and includes first-tier old-age insurance and employer-provided pension plans (DB and some DC plans since 2001). There is tight coordination of old-age insurance and employer-provided plans. At one time there were strict government rules regarding the investment of pension assets. Most assets are managed by trust banks or by insurance companies. The largest fund in Japan is the Pension Fund Association for Local Government Officials (Chikoren), with over $100 billion in assets. Another very large fund is the Japan Pension Fund Association, which was established by the Ministry of Health and Welfare in 1967 to pay benefits to employees who had left corporate plans prior to vesting or whose corporate plans had been terminated. PFA is an umbrella for over a thousand of these corporate plans.

For most of its history, the PFA was lost in obscurity, with its equity investments strictly limited to 30 percent of assets. But the PFA began to change in 1999, when it published a white paper addressing proxy voting. It opposed the taboo of voting against management proposals at shareholder meetings. At the time, it was unheard of for Japanese public (or private) pension funds to directly manage assets, to vote proxies, or to exercise other shareholder rights. So the 1999 white paper marked a significant departure from previous passivity. Near the end of 2000, a Health and Welfare advisory
commission headed by Takaaki Wakasugi, who had drafted the CGFJ’s principles back in the mid-1990s, recommended that public employee pension funds hold their fund managers to fiduciary standards that would include active proxy voting and attention to shareholder-value corporate governance at companies where the funds invested. 78

On the heels of Wakasugi’s report, the man in charge of pensions at the Health and Welfare ministry, Tomomi Yano, was assigned to become managing director of the Pension Fund Association. Yano was familiar with the dire situation faced by Japan’s pension funds. Due to slow population growth, pension funds were projected to show widening deficits as the ratio of retired to active employees crept steadily up. The PFA itself was not in good shape at the time Yano took over, having shown a -10 percent return in 2001, its first loss ever. In 2002 and 2003, its returns were -4 percent and -12 percent respectively. The fund had assets of over $60 billion in 2004. 79

Knowing that he would be running the PFA for only a few years, Yano wasted no time in establishing an aggressive program to raise returns through activist governance. Yano’s model for transforming PFA was--and remains--CalPERS. The two funds have cooperated in various ways since the early 1990s. PFA representatives have visited Sacramento repeatedly over the past ten years and there have also been meetings in Japan. When asked in 2003 if PFA would become like CalPERS, Yano responded, “We may turn out to be a Don Quixote, but as a representative of pension funds in Japan we have no choice but to be an active shareholder.” 80

Recapitulating CalPERS’s approach, Yano’s first step in 2001 was to introduce proxy voting guidelines for the PFA’s asset managers. In keeping with Wakasugi’s recommendation, the guidelines asked PFA’s asset managers to designate staff responsible for proxy voting, to vote according to guidelines--favoring shareholders over management if need be--and to report details back to the PFA. In 2002, Yano took another step by having PFA assume management of some of its domestic investments and initiate proxy voting on its passively invested stocks, thereby breaking taboos. 81

The most dramatic change came in 2003, when PFA published proxy voting principles for itself and its asset managers. What received the most attention was its stated intention to vote against renomination of and retirement payments for directors at companies that had not paid dividends for three years or had losses for the previous five years. PFA developed its principles after culling ideas from Anglo-American pension funds such as CalPERS, TIAA-CREF, and Hermes (CalPERS’s partner in the U.K.) PFA said that it would vote proxies against companies whose boards had more than
twenty people; who failed to separate the CEO and chairman positions; and who failed to hire independent statutory auditors and nominate independents for at least one-third of the board seats. Also, PFA launched a campaign to publicize its principles to other Japanese pension funds and insurance companies. It met with 12 asset management companies that invested equities for PFA and told them to follow its guidelines. (PFA is not permitted to attend meetings of companies whose stock it owns through asset managers like trust banks.)

In light of proxy voting’s ambiguous effects in the United States, PFA’s emphasis seems a bit surprising. But proxy voting is partly a means to the larger end of helping to publicize PFA’s shareholder-value ethos. Yano envisions the future creation of a broad coalition of pension funds and shareholders in Japan. In 2003, PFA voted against management proposals at 43 percent of the companies in which it held stock (and 42 percent in 2004), including votes against non-independent directors and bonuses for them. Yet while this was a high rate of anti-management voting as compared to private Japanese pension funds, it was relatively modest as compared to U.S. pension funds like CalPERS and TIAA-CREF. In 2004, for example, U.S. pension funds in Japan voted against director appointments at a 93 percent rate versus only 49 percent for PFA, leading one to suspect that PFA’s bite is weaker than its bark.

A recent study of Japanese companies assesses the effect of governance reforms on corporate performance. It divides governance reforms into three categories: shareholder rights, board structure, and disclosure. Of the three, only disclosure—which includes dissemination of reports and active IR departments—is significantly related to performance. This is consistent with evidence from U.S. studies.

Yet like Bill Crist, Yano is skeptical of statistical evidence on the relationship between board independence and performance. He argues that the experience of companies like Seibu Railway, Daiei, and Misawa Homes has taught him the importance of board independence. How, then, does Yano explain firms like Toyota and Canon, which have traditional governance systems but strong performance? He says that they are simply lucky to have outstanding CEOs but lack systems to guarantee good leadership and performance in the future. Yano is a true believer in the shareholder-value ethos. He rejects the notion that Enron and related scandals were evidence of defects in the U.S. governance system. In his view, that system is more reliable than Japan’s for producing good results and effecting improvements when results are poor. Somewhat dogmatically he says, “Those Japanese who criticize the U.S. are incompetent directors who are afraid of changing to the U.S. system that may threaten...
their position. They just want to protect their positions.” Yano is opposed to giving enterprise unions a say in selecting board members or statutory auditors, blaming the pre-Ghosn problems at Nissan on management’s close relationship with its enterprise union. Unions, he says, worsen company performance. 85

Since 2003, Yano has ramped up his activities beyond proxy voting. In 2004, PFA invested $100 million in a “good” corporate governance fund managed by Nomura Asset Management. The fund invests in TSE companies according to various criteria, with board size and independence being the main screens, along with disclosure, executive compensation, and legal compliance. Although Yano initially planned to put close to $300 million into the fund, this has not occurred. On another front, the PFA in 2004 sent letters to around twenty problem-ridden companies, urging them to change their governance practices by reducing board size, adding independent directors, or firing incompetent directors. Subsequently, it held private discussions with a subgroup of these firms. Yano says that this kind of pressure gets better results than proxies: “In proxy voting, PFA’s opinion is one of the minority opinions that are rarely accepted in the shareholders’ meeting. Stockholders should express their opinion, and proxies are important, but having meetings is more effective.” PFA’s modus operandi in this area is based on lessons learned from CalPERS. On the other hand, he laments the fact that CalPERS has better access to CEOs of Japanese companies than the PFA. 86

Like CalPERS in its early days, Yano seems to relish confrontation with complacent managers and the ensuing publicity. When the proxy battle between corporate raider Yoshiaki Murakami and Tokyo Style heated up, Yano supported Murakami’s unsuccessful effort to get Tokyo Style to distribute to shareholders its hoard of nearly $1 billion in cash and securities. Yano excoriated an asset management company that handled investments for PFA and that planned to support Tokyo Style’s incumbent management. To a company official he said, “Why are you following the actions of your parent bank? You should make a decision after listening to the views of both sides.” In disgust Yano said, “Institutional investors [in Japan] claim they are ready to act, but in fact many of them are bound by conventional thinking.” In Yano’s view, hostile takeovers are a good thing and Japan needs more of them. Yet while PFA has invested a small amount in foreign takeover funds, it has not yet done so in Japan. Yano was back in the limelight in 2005 when the PFA filed a lawsuit against Seibu Railway seeking damages for losses suffered when Seibu’s stock was delisted by the Tokyo Stock Exchange. (Seibu allegedly had falsified financial statements.) This is one of the first cases in which a Japanese institutional investor has gone to court in search of
damages. However, there are several interesting facts about the PFA’s claim. First, Seibu Railway was part of PFA’s indexed portfolio; PFA sold its shares as delisting was being discussed but before it occurred, hardly a case of passive investing. Second, if PFA wins the suit, it will come at the expense of other shareholders who continue to hold the company’s stock. One thing is certain, as the *Nikkei Weekly* observed, “the court’s decision is certain to garner attention,” which would suit Yano’s purposes. 

In light of all this, it makes sense that the PFA has become CalPERS’s favorite partner in Japan. Both are public pension funds; both were headed by people who had a flair for publicity. Crist calls Yano “a good friend” and says that Yano is willing to shake things up in a way that the JCGF never could because it is “not inside” the business system. Since leaving CalPERS, Crist has put most of his energy into an organization called the Pacific Pension Institute, which holds conferences for institutional investors from Asia and the United States. Yano is a regularly featured speaker at these conferences. At a 2003 Pacific Pension Institute conference, Ted White, then the official in charge of CalPERS’s corporate governance programs, explained the fund’s relationship with PFA. CalPERS was best suited to a “macro” approach to governance reform in Japan, one that involved “exerting pressure on regulatory or legislative bodies. This includes guidelines for best practice.” But the “micro” approach, which is company by company, is better carried out by local entities like PFA. In the micro area, CalPERS prefers to be “a facilitator where it can assist and mobilize Japanese investors to take the lead role in enacting change.” Whereas CalPERS had a focus list in the United States, it was difficult for CalPERS to be publicly critical of individual companies in Japan. But, said White, “this type of tool can readily be mimicked by foreign players such as the PFA.” Similarly, while CalPERS does not publicize its proxy votes for Japanese companies, PFA is not shy to do so. Even the kind of “macro” change that CalPERS promoted, such as urging more dispersed shareholder meetings, might better come from a group like the PFA in the form of a domestic-led initiative, said White.

CalPERS also has a relationship with Chikoren, the giant pension fund for local government officials. It has sponsored several visits by Chikoren officials to Sacramento, where Crist and others urged cooperation in bolstering governance reform in Japan. In 2001, a delegation of Chikoren officials attended a CalPERS board meeting, learned about CalPERS’s governance programs, and met with U.S. asset managers. (Chikoren started to invest in U.S. equities in 2001.) In 2002, the relationship began to bear fruit when Chikoren directly exercised its voting rights rather than going through
its asset managers, something that CalPERS encouraged and which PFA started doing the same year. In 2003, Chikoren excoriated Matsushita for its plan to have directors play a double role as executive officers because this went “against mainstream thinking,” Chikoren also said that it “looks to CalPERS as its role model because of the latter’s activism as a shareholder.” The following year Chikoren introduced its own proxy voting rules. Chikoren is part of the Council of Public Institutional Investors, which was started in 2002 as a way for Japanese public pension fund executives to discuss issues of mutual interest, including governance reform, much like the CII in the United States. Members include the PFA, the giant Government Pension Investment Fund, and several other public pension funds. Thus far, however, the Council has resisted requests that they coordinate their proxy votes, as CalPERS has done with CII. Says Yano, “In Japan, other pension funds are very conservative and too careful.”

CalPERS occasionally reaches out to Japan’s corporate pension funds. In 2002, Raita Sakai organized a conference for 27 large private funds under the auspices of Mitsubishi Trust. A couple of CalPERS officials, including Robert Carlson, vice president of the board, explained CalPERS’s investing philosophy and its methods of portfolio management. Heretofore, most corporate pension plans have let their trust banks and insurance companies manage their assets and proxies with little direct involvement. The asset managers historically were complacent because of their dual role of managing pension fund assets and selling products to the companies they invested in. But even in the early 1990s, some private plans, like Toshiba’s, pressured asset managers to more aggressively pursue performance. And recently, some asset managers have become more assertive. Nippon Life publicly opposed Seiyu’s acquisition by Wal-Mart in 2002. Later it demanded that Hitachi move ahead with its plan to buy back shares and threatened to oppose the company at the general meeting if it did not raise its payout rate.

Thus it may turn out that the most effective proponents of governance reform in Japan will be, as in the United States, domestic pension funds. How present trends unfold depends on how many funds will imitate Yano’s aggressive stance, and whether the next head of the PFA will be cut from the same cloth as Yano. One must be careful, however, not to exaggerate Yano’s current influence. For example, the TSE had a corporate governance advisory committee that included Yano, academics, consultants, and Keidanren representatives. Yano wanted the TSE to create a code of best governance practice that would be attached to listing requirements. But due to resistance from the corporate community, particularly Keidanren, the idea went nowhere. At the
micro level, PFA has not had many notable successes, perhaps because the balance of power at many Japanese companies remains in the hands of management-friendly investors. Also, PFA is hamstrung by social norms regarding appropriate behavior. Noting that CalPERS has on numerous occasions proposed a CEO dismissal, Yano said, “PFA cannot do such a thing yet, though we want to. If we do, we will be criticized in the Japanese society. We cannot be such an activist as CalPERS.” Another factor is the gradual reduction of CalPERS’s involvement with governance issues in Japan, meaning that any future education and coordination will have to come from within the Japanese institutional investing community.

IV. Withdrawal Symptoms

Since 2002 there has been a noticeable decline in CalPERS’s activities in Japan: no new governance initiatives, few visits by CalPERS officials, and near-invisibility in the Japanese media and business forums. The reasons for the withdrawal are complex, having to do with internal changes at CalPERS, diminishing returns on activism, and new investment strategies.

One internal factor is the diversification of CalPERS’s international portfolio. Japan holdings fell from 45 percent of the portfolio in 1993 to 25 percent in 2001 to 20 percent in 2005. CalPERS staff even have proposed getting rid of the distinction between Japan and ex-Japan investment managers, although for tangential reasons this did not occur. Bill Crist’s retirement from the board was also significant in that Crist had a deep commitment to governance reform in Japan that his successor, Sean Harrigan, a former official of the retail workers’ union, did not share. Harrigan was more interested in domestic policy issues, especially those in which shareholder and labor-movement interests coincided. Under Harrigan, CalPERS became a vocal critic of U.S. executive pay levels, including the pay of Richard Grasso, former head of the New York Stock Exchange. After a bitter supermarket strike against the Safeway Company in 2004, CalPERS voted its shares against the re-election of the company’s CEO, claiming that the strike had hurt the company’s share price. The action made the business community livid, and, apparently at the behest of Governor Schwarzenegger, Harrigan lost his job. Yet he had the support of several CalPERS board members, including state treasurer Phil Angelides. On the other hand, several senior board members who had supported Crist’s international campaigns and more conciliatory approach were gone. Few CalPERS officials other than Ted White have visited Japan in
the past three years and White resigned from CalPERS in 2005. There has been no effort by CalPERS to develop formal structures-- such as a Japan advisory committee-- to replace Crist’s network of contacts. 92

In 2003, ten years after Crist made his speech to the Keidanren, the governance principles that he espoused had become widely known in Japan. Several had been adopted into the Commercial Code, such as rules facilitating share buybacks (1994, 1997, 1998), issuance of stock options (2001), and the “company with committees” system (2003). The latter gives companies the option of doing away with statutory auditors if they appoint a majority of outside directors on three key board committees and if the board eschews operational responsibilities. Hence by 2003 CalPERS faced diminishing returns to the “macro” approach of publicizing the shareholder-value model. At the “micro” level of firm-by-firm monitoring, CalPERS confronted some of the same problems that had cropped up in the United States. It rarely held more than one percent of a company’s stock and, even when it did, there was the free-rider problem, that is, that other investors were happy to have CalPERS incur the cost of active shareholding, while they reaped the benefit. As the head of international corporate governance for TIAA-CREF said, “Why bother to expend any effort on behalf of monitoring portfolio companies, when someone else will do it for you without cost to yourself?” 93

In fact, Robert Monks and Michael Porter had foreseen this problem years earlier. Monks understood that public pension funds were political entities whose boards could not or would not maintain pressure on individual companies for the long term. Both Monks and Porter proposed as a solution that institutional investors increase the size of their stakes and pool their enlarged holdings in “relational” or “turnaround” funds that target underperforming companies. It was the logic behind Monks’s LENS fund, established in 1992, and the Hermes Lens Fund, established in 1998. It was the same logic that led CalPERS to invest ever-increasing amounts with Relational Investors and similar entities in the United States and Europe. One advantage of relational investing is that it mitigates the free-rider problem associated with activism. Also, when the funds are successful, their substantial returns allow big pension funds like CalPERS to “beat the index.” In turn, this reduces the incentive to pursue macro governance reform, which may explain why CalPERS’s public activism is negatively associated with its stake in these funds over time. 94

In 2001, the CalPERS board approved a plan to invest an additional $1.7 billion in relational or “corporate governance” funds so as to bring total relational investments to $3 billion. A substantial portion of these funds was intended for overseas markets,
chiefly continental Europe and Japan. The first foray into the Japanese market came in September 2002, when CalPERS invested $200 million (a 20 percent stake) in Sparx Value Creation Fund; by the end of 2004 it had invested another $165 million.

The Sparx fund was started by Shuhei Abe, former Nomura analyst and admirer of Warren Buffett. Abe launched his own asset management company in 1989. The fund that Abe manages for CalPERS invests in undervalued companies with a market capitalization of between $300 million and $3 billion. Abe and his analysts select the companies and then engage actively with management to improve performance. They “seek to influence” managements to restructure inefficient operations so as to raise shareholder value, with stock repurchases and dividend payouts being a key measure of value. According to Abe, “Many Japanese CEOs don’t know why they have to improve their return on equity because they have no sense of ownership and no sense of being part of the market.” His leverage with management comes from the fact that his fund is concentrated in but five companies. One of these companies is (or possibly was) Nissan, whose CEO, Carlos Ghosn, is admired by Abe. However, Abe’s opinion of other CEOs in Japan is almost contemptuous: “In the past, meeting the CEO was harder than meeting the prime minister. But these days, they come to my office and even bow to me.”

Before CalPERS invested with Abe it vetted his background to make sure that he wasn’t “a raider like Murakami.” As compared to Murakami, who is insensitive to social norms and willing to make outrageous public statements, Abe is relatively low-key. Yet while the Sparx fund has not pursued hostile takeovers, its approach of pressuring companies to return cash to shareholders is not very different from what Murakami tried at Tokyo Style. Because the fund will exist for ten years, Abe and CalPERS at some point will have to “start cutting all of the fruits.” The process is underway. Of $365 million invested, $200 million has been distributed to the partners in the first two years. In at least one case, Sparx bought shares in a small company, Miyairi Valve, and sold all of them six months later. One observer says that Sparx is “using the corporate governance idea but not following it . . .. they are not as rushed as the greenmail investors but I should say it’s rather hard to call them long-term investors.” Crist defends the Sparx approach, saying that “nothing is pure” and that the bulk of CalPERS’s investments in Japan remain long-term, passive holdings.

Another Japan relational fund in which CalPERS has invested is Taiyo Pacific Partners, which is managed by two gaijin. One is Wilbur L. Ross, a New York-based billionaire who helped reorganize Continental Airlines in the 1980s and more recently
has been dabbling in mature U.S. industries such as coal, steel, textiles, and auto parts. The other is Brian Heywood, a one-time Mormon missionary who later worked for Citibank in Japan. CalPERS signed a deal with Taiyo in April 2003 and invested $200 million, a twenty percent stake. Taiyo’s approach is similar to Sparx’s. It wants to avoid Murakami-like controversy, while using the threat of foreign takeovers to induce managers to work with Taiyo in raising share price. The fear of hostile takeovers is genuine. In April 2005, on the heels of the Livedoor incident, a survey found that senior executives at 70 percent of Japanese companies were concerned about the takeover threat. Taiyo tries to persuade the companies it approaches that it can help them avoid the clutches of raiders like Steel Partners while taking a long-term, cooperative approach to boosting shareholder value. Agreeing to work with Taiyo doesn’t mean that a company has accepted shareholder-value principles, however. Says Heywood, “In general the mindset is not so much, ‘I’ve been converted to governance,’ but ‘I’m afraid of being taken over so I’ve got religion’.”

Once Taiyo begins working a company, it trims “bloated” balance sheets by selling unrelated assets and returning cash to shareholders. The fund’s major success story is an auto-parts firm called Nifco. Over time, Nifco had diversified into a variety of unrelated businesses including ballpoint pens, Australian real estate, and media (including *The Japan Times*). Taiyo is helping Nifco get ride of non-core assets that do not meet a hurdle rate of return. At Maezawa Kasei, maker of plumbing fixtures, Taiyo zeroed in on the firm’s cash hoard. Said Heywood, “They had a lot cash sitting there doing nothing. We said, ‘Lots of cash makes you a target.’” The firm has since raised its dividends. To improve corporate governance, Taiyo urges firms to focus on disclosure, such things as establishing IR departments and communicating with investors. At Nifco, Taiyo recommended that the company send out press releases in Japanese and English to explain that its divestments were driven by a focus strategy. Taiyo told Maezawa Kasei to establish ties to investment analysts and make sure that they covered the relatively obscure company. Many of these moves are intended to boost interest in share purchases by foreign investors, the one group that has consistently been buying Japanese equities in recent years. While Taiyo says it is not interested in a quick buck, its time horizon is far from the long-term promised by CalPERS. Ross’s biggest deal in Japan came in 2003, right before Taiyo was formed. Ross sold his shares in Kansai Sawayaka Bank for double his initial investment, having held the shares for a little over two years. Yet Ross bristles at the “vulture fund” label and prefers to describe it as a “phoenix.”
One way that Ross has made money in the U.S. is by relying on government to minimize his investment risks. He purchases mature firms and helps them terminate their retiree health plans and shift underfunded pension plans to the government’s Pension Benefit Guarantee Corporation. He also has joined with unions in demanding that the government erect stronger tariff barriers against manufactured imports. It’s a curious mixture that may explain why Ross is a major donor to the Democratic Party.  

In addition to Sparx and Taiyo, CalPERS has invested in other “alternative” vehicles such as Japanese real estate trusts. It also holds substantial chunks in private equity funds, including Carlyle Partners ($300 million), KKR ($85 million), and Ripplewood ($12 million), of which around $50 million is invested in Japan. While the majority of CalPERS’s Japan holdings remain passive, its interest in securing good returns on its alternative investments inevitably has skewed CalPERS’s focus more to the short-term. Over 10 percent of its Japan investments are in relational and private equity funds. Ironically, these funds do not hold the firms in which they invest to CalPERS-style governance principles, with the exception of disclosure efforts. Neither are they having much impact on other Japanese companies. This is of little concern to Heywood, who says, “We don’t need to change the whole market.”

V. Appraising the CalPERS Effect

Over the past fifteen years, one way that CALPERS has changed Japanese corporate governance has been through law and social norms. Not only was CalPERS regularly in the Japanese media, it mounted public relations efforts of its own. It worked closely with domestic norm entrepreneurs such as the JCGF and, more recently, the PFA. It’s significant that several commercial code revisions adopted in recent years are consistent with positions and principles originally espoused by CalPERS, including those related to online proxy voting, stock options, share repurchases, and independent board subcommittees (the “company with committees” system). However, it’s difficult to assess the extent to which CalPERS’s ideas were an inspiration for these revisions or whether government bureaucrats used “foreign pressure” (gaiatsu) as an excuse to adopt them. Some bureaucrats viewed shareholder-value governance as a cheap way of jump-starting the Japanese economy by raising asset prices and improving corporate balance sheets; others hoped that these reforms would keep the U.S. government at bay. U.S. officials repeatedly have pressured the Japanese to Americanize their governance system, from the SII of the early 1990s to the 2001 Bush-Koizumi
“Investment Initiative,” whose objective is to facilitate foreign acquisitions of Japanese companies. However, CalPERS’s effectiveness at the macro level was limited by its reluctance to be seen as “the ugly American” meddling in Japanese affairs. Also, ever since its entry into the Japanese market CalPERS has faced opposition from the Keidanren, which has worked behind the scenes to slow the adoption of a shareholder-value model. Keidanren has tried to preserve internal boards and cross-holdings, to deter hostile acquisitions, and to keep TSE listing standards free of mandatory criteria. One result is that many commercial code revisions have been permissive rather than mandatory and without enforcement mechanisms, leaving companies free to stick with the status quo or to adopt changes that meet the letter but not the spirit of the law (e.g., claiming quasi-insiders as independent directors and statutory auditors). “The Japanese resistance,” says Bill Crist, “is from the old guys in Keidanren who have made it.” But Keidanren hasn’t been opposed to all reforms. In recent years, it has urged Japanese companies to improve auditing, control, and disclosure practices. These reforms are relatively easy to graft onto existing governance structures.

It’s likely that CalPERS has more leverage in countries that depend heavily on foreign capital, such as emerging economies. CalPERS carefully rates emerging nations on factors such as corporate governance, political stability, and openness. It consistently reminds those nations—and their business leaders—that adherence to international governance standards (i.e., the shareholder-value model) will make them more attractive to international investors. CalPERS’s officials made the same argument on several occasions in Japan. The difference, however, is that while Japan welcomes foreign investment, the nation hardly suffers from a scarcity of capital.

At the micro level of individual corporations, CalPERS had greater leeway to exert pressure, although its concerns here had more to do with boosting shareholder returns than with specific governance practices. It relied on proxies and meetings with executives, and, to boost its leverage, sought alliances with other institutional investors in the ICGN, the CII, and in Japan. According to Crist, these efforts bore fruit in numerous instances, although he refuses to discuss specifics. The claim fits with research showing an association between foreign ownership and restructuring in Japanese companies. It also fits with evidence from the United States showing the same relationship for companies targeted by CalPERS. The problem is that it’s extremely difficult to prove causality here and, as previously discussed, there are alternative explanations for these associations. Also, the U.S. evidence suggests that the most
powerful effect of shareholder activism on performance comes via public targeting (or the threat of it), a tactic CalPERS eschewed in Japan. Since 2001, CalPERS has put less emphasis on proxies and meetings because of their high cost, its low ownership ratios, and the free-rider problem. Instead it has come to rely more on relational investing handled by third parties like Abe and Ross.

To what extent have Japanese companies adopted the CalPERS model of governance? To answer this, it’s useful to break the model down into four parts: disclosure and transparency; boards and directors; shareholder rights and minority protection; and control (absence of takeover barriers). Of the four, by far the most prevalent is disclosure, which includes publishing reports and disseminating information, meeting with analysts, creating IR departments, and so forth. This is also the area where legal changes, such as consolidated accounting and fair-value accounting, have been mandatory rather than permissive. Consolidated accounting, which Crist urged during his 1993 Tokyo speech, makes it more difficult for companies to hide losses (and to transfer redundant employees to affiliated companies). 105

Less prevalent have been changes in boards and directors. In 2003, the average number of outside board members on the Nikkei 225 was 1; it was less than 1 for the 1,500 companies on the TSE’s first section. These low numbers reflect the fact that, as of 2004, two-thirds of publicly-traded companies had no independent directors, while a minority of companies have several such directors. Board size has declined since 1990, from 17 to 15, although some of this reflects a cosmetic change associated with adoption of the executive officer system, which formalizes the pre-existing division of the board between a core group that makes strategic decisions and a larger group that rubber stamps them. The company-with-committees system is not catching on, with successively fewer companies adopting it each year -- only 9 in 2005 -- and some, like Hitachi, doing so in ways that are completely at variance with “American governance. However, since 2000 stock options have become more popular, with 35 percent of large Japanese companies reporting their use, especially in large firms with high foreign ownership. As a proportion of CEO pay, however, options and other performance-based compensation are about a third of U.S. levels. 106

Shareholder rights have strengthened since the late 1980s. The change here has been modest partly because Japanese law regarding shareholder rights was always relatively good and in conformance with global standards. On the plus side, votes against management at shareholder meetings are at higher levels than in the past. Executives now are peppered with difficult and sometimes embarrassing questions.
There are far more shareholder derivative suits than before 1990, when there were hardly any. The number of companies holding shareholder meetings on the same day has declined, as has sokaiya activity. In other respects, however, the pace has been glacial. Minority shareholders filing derivative lawsuits still find it difficult to obtain information and usually can win only if there are criminal charges involved. Shareholder meetings remain concentrated in the same period during June, if not the same day. Few companies use electronic mail for meeting notifications or voting, although both are permissible. There are more foreign shareholders in attendance at meetings, but less than one percent of large companies provide simultaneous English translation. In one area, law and practice even seem to be moving backwards: In the past, companies had to present share buyback proposals for shareholder approval. But under a recent commercial code revision, firms are permitted to transfer that authority to their board if they amend their articles of incorporation; many companies have been grabbing the prerogative. 107

The fourth element in the CalPERS model was removing barriers to managerial entrenchment so that a market for corporate control could flourish. Without doubt, a few dramatic and unprecedented hostile takeover attempts have occurred recently. Some have involved foreign investors, as in the 2004 bids by Steel Partners for Sotoh and for Yushiro Chemical; others have been led by domestic “bad boys” like Murakami and Takafumi Horie of Livedoor, who tried to take over Fuji Television. As noted, Japanese managers are afraid of what may lie ahead. Shares held by financial institutions and corporations have fallen from 72 percent in 1992 to 56 percent in 2004, while foreign ownership has steadily crept upwards. One can argue about how rapidly cross-shareholding is unwinding but the trend is clear. 108

Yet just as cross-shareholding accelerated in the 1950s to stave off foreign takeover threats, so today a new set of takeover barriers is being erected. Concerned that Japanese companies are undervalued and lack adequate takeover defenses, the Ministry of Economy, Trade, and Industry (METI) has proposed “poison pill” strategies and adoption of the British “City Code” that restricts partial acquisitions. METI is considering whether to facilitate employee stock ownership plans as a way of increasing the number of stable shareholders. Meanwhile Japanese companies are erecting their own defenses. In 2005, more than 30 percent of major companies proposed charter revisions to permit takeover defenses such as sale of authorized stock and issuing of equity warrants. With the Nikkei on the upswing, some of management’s takeover fears may subside. But the threat of takeovers--and the defenses against them--will not go
away. It remains to be seen who will blink first: the irresistible force or the immovable object.\textsuperscript{109}

In short, the greatest changes that have occurred in Japanese corporations involve disclosure and transparency. Change has occurred elsewhere--boards, shareholder rights, and control--but in those areas it has been less broad and less deep. What are the implications for corporate performance? Miyajima recently examined the relationship between performance and different types of governance reform in Japan. He found that disclosure was the only type significantly associated with stock-market returns (Tobin’s q) and with accounting measures of performance (ROA). Neither board structure nor shareholder rights showed an association with performance, which corresponds with other studies from Japan and the United States.\textsuperscript{110}

Miyajima did not examine the effect of anti-takeover measures. In the United States, as noted, companies that have such measures tend to have poor stock market performance. But the reason for this is not entirely clear because studies from the U.S. and the U.K. show that hostile takeovers are not tied to pre-existing defects in corporate governance or to subsequent long-term improvements in performance. Takeovers are, however, associated with tax advantages, layoffs, and increased market power of acquiring firms. This can cause a share-price premium at firms that are takeover friendly but it does not mean that takeovers create new wealth.\textsuperscript{111}

The most widely adopted governance reforms in Japan--to do with information and disclosure--are those which have shown to be positively related to performance. Reforms whose link to performance is weak or unproven--board structure and shareholder rights--are less extensive. Although takeover defenses are just now being beefed up in Japan, it remains to be seen what effect this will have on performance. For now it appears that corporate governance in Japan has changed in ways that correspond to the Demsetz-Lehn thesis that corporate governance--defined as a system for maximizing manager efficiency and honesty--is endogenous and that there is no one-best way of structuring it. If this is true, then why have investors so doggedly pursued the CalPERS principles in Japan? The answer is simple: they hope to implement governance practices that will privilege current shareholders and redistribute resources to them from bondholders, employees, customers, taxpayers, and even from future shareholders.\textsuperscript{112}

Evidence of resource redistribution is not hard to find. In the United States, the advent of a shareholder-value model in the 1980s and 1990s caused dividends and share
buybacks to swell. In Japan, the dividend yield has nearly doubled over the last ten years, although it still remains about one-half of U.S. levels. Share repurchases are on the rise, with over 800 Japanese companies announcing repurchases in 2003 (actual repurchases are often less than announced, however). Downsizing, which became pervasive in the 1990s, has a positive effect on the stock price of Japanese companies, in contrast to the United States.

Yet these changes have not thus far affected the labor share of net corporate value-added in Japan or the share of income going to the top one-percent (and more rarified income brackets), unlike the United States. Perhaps for this reason foreign investors remain critical of Japanese companies for “hoarding” cash or using it unwisely. Undoubtedly there are cases where these criticisms are warranted. But what would have happened if dividends and repurchases had risen to levels demanded by foreign investors? When Okuda defended Toyota in 2001 for not returning cash to shareholders, it was precisely the moment when the firm was spending heavily on R&D for hybrids and other innovations that have boosted its overseas sales. The phenomenon is not unique to Toyota. For the last twelve years, Japan has spent more on R&D as a percentage of the economy than any other OECD nation, and this is one important reason for the current recovery. Meanwhile G.M. and Ford, who pay hefty dividends, are on the road to ruin.

The fact that CalPERS and its allies in Japan have not made more headway can be explained in two ways: One is to argue that resistance from entrenched managers, in particular those represented by Keidanren, has kept Japan from adopting the global governance optimum, ostensibly the shareholder-value model. This is the argument made by both Crist and Yano. The other is to claim that Japan has adopted only those changes that are a good fit with its existing incentives and institutions. Frankly, the entrenchment argument is difficult to believe in light of the relatively modest salary and perquisites associated with executive status in Japan, where CEO compensation is only one-fourth of U.S. levels. If anything, Japanese executives would, based on U.S. experience, make out much better under a shareholder-value approach to compensation. Entrenchment might be more plausible if it were extended to include all the other groups that have a stake in Japanese governance. On the other hand, even if entrenchment exists, it is not inherently “bad” and may be a good fit to the Japanese situation. The good-fit argument is supported by data showing that many proposed governance reforms are, at best, orthogonal to performance in Japan.
Why, then, do CalPERS and allies like the PFA keep asserting their claims with such tenacity? One reason is the tendency of investors to assume that the strength of the U.S. economy in the 1990s was due to adoption of the shareholder-value model and that other countries will benefit from imitation. Another explanation derives from institutional theory. Decision-makers--whether from pension funds, government, or business--often don’t know what is the best governance structure to suit their own interests, let alone to maximize value-added. So they formulate prescriptions based on early successes at a few well-known companies or based on theoretical predictions; these then become received wisdom. Companies in turn will comply with the received wisdom or give the appearance of doing so because it fits with investors’ sense of what is appropriate or legitimate, not because it makes economic sense. For a while, jumping on this bandwagon can create self-fulfilling results. For example, historical shifts in the returns to shareholder activism (e.g., weak in the 1980s, strong in the early 1990s) may reflect this effect. Related to this is the effect of social conformity. The CalPERS professional staff come from the private investing community, where the shareholder-value model holds sway. Elected board members take their cues from the professional staff or directly from the elite of the investing community, with whom they regularly interact during conferences and asset manager negotiations. This is a closed world in which ideas gain currency because, it seems, everyone believes them. 118

It has also been argued, by Kevin J. Murphy and by Roberta Romano, that public pension funds face different constraints and incentives than their private-sector counterparts. They are subject to political pressure, relatively transparent, and more likely to be criticized for a single year of below-average returns. Hence they invest and vote proxies differently than do corporate pension funds. Public pension boards usually have elected directors (six out of thirteen at CalPERS), who want their constituents to think they are working hard on their behalf so that they can be re-elected. Frequent publicity around issues like corporate governance helps create that impression. 119

Despite repeated claims that the CalPERS governance principles are intended to raise the long-term performance of its indexed holdings, the fund’s board has relatively short time horizons. CalPERS and PFA are evaluated on their annual returns, not on ten- or twenty-year performance criteria. (Few at CalPERS can even remember what happened ten years ago.) High-minded governance principles provide a legitimate cover for short-term squeezing through targeting and relational investing, which results in larger cash flow to investors. A few such successes are all that is required for the performance of a largely-indexed portfolio to rise above average. This may be
overstating the case in a way that impugns the motives of pension-fund leaders. But it is a fair representation of the incentives they face. In the final analysis, many of the CalPERS principles have less to do with long-term performance than with putting in place people and institutions that will direct corporate resources to the shareholders’ pockets. 120

This point is at variance with the notion that pension funds have ushered in a new, more socially responsible era of “fiduciary capitalism.” The claim is that because pension funds are universal owners and hold the entire market in indexed form, they are concerned with long-term performance issues that affect all companies. As universal owners, they internalize externalities and will induce particular firms to maximize positive externalities (e.g., employee training) and minimize negative externalities (e.g., environmental harms). Also, because they represent the interests of a large and diverse segment of the population, their objectives blend those of shareholders as well as other stakeholders. Hence in theory institutional investors will pursue corporate governance practices that promote long-term performance and social welfare (in the sense of resolving externalities). But there are problems with the theory. 121

First, correctly identifying the factors that will boost economy-wide performance is extremely difficult. There is always the chance of converging on an inappropriate solution and elevating it to the status of conventional wisdom. Also, because pension funds are well diversified, they favor riskier corporate strategies than employees, suppliers, or bondholders, groups whose preferences are not represented under the shareholder-value model but whose concerns are relevant to long-term performance. Third, at the margin, pension fund leaders must decide whether to focus their limited energy and resources on improving the performance of all their holdings or settling for average returns on most of them and high returns on a few. Because it is easier to boost returns at individual companies than for the market as a whole, there is a tendency for activist funds to focus narrowly. This does not make macro concerns moot. In their dealings with individual companies, institutional investors are less likely to appear greedy if they portray themselves as being driven by long-term shareholder value, unlike, say, Murakami or Horie. Sunshine wins more friends than the North Wind.
VI. Conclusions

Institutional investors are one important mechanism by which American governance principles are being transmitted to overseas markets like Japan’s. Huge pension funds have the experience and funds to promote practices that privilege shareholders in overseas corporate boardrooms. In Japan, CalPERS worked with other institutional investors and with norm entrepreneurs to change prevailing governance standards. It was most successful in affecting aspects of corporate governance that had a clear relationship to efficiency and performance, such as disclosure, and less successful in other areas.

Over time, the cost of pursuing market-wide activities has led CalPERS to do more targeting of individual Japanese firms, with relational investing being the ultimate expression of that tendency. At this micro level, governance principles take a back seat to more pragmatic efforts to boost shareholder returns. Public pension funds like CalPERS are a unique type of institutional investor prone to taking a public stance on governance issues. But because of changes at CalPERS in recent years, the fund is likely to play a smaller role in future debates over Japan’s corporate governance while continuing to pursue investment opportunities there.
Notes and References:


5 CalPERS is not, however, a “union” pension fund. See Stewart J. Schwab and Randall S. Thomas, “Realigning Corporate Governance: Shareholder Activism by Labor Unions,” 96 Michigan Law Review (1998), 1018-94. On the other hand, California’s public sector is heavily unionized, with a density rate of about 60 percent versus 40 percent nationally.


7 Hideaki Miyajima, “The Performance Effects and Determinants of Corporate Governance Reform in Japan” in Masahiko Aoki, Gregory Jackson, and Hideaki Miyajima, eds., Corporate Governance in Japan (forthcoming); Christina L. Ahmadjian and Gregory Robbins, “A Clash of Capitalisms: Foreign Shareholders and Corporate Restructuring in 1990s Japan,” 70 American Sociological Review (June 2005), 451-471; Christina L. Ahmadjian, “Foreign Investors and Corporate Governance in Japan”, working paper, Hitotsubashi University, September 2004; John C. Coffee, Jr., “Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance,” 102 Columbia Law Review (2002), 757. A recent study finds that financial ownership is positively associated with downsizing, which is consistent with the main-bank monitoring hypothesis, but that foreign ownership has no significant effect on layoffs, hiring, or pay cuts, contrary to the aforementioned studies.
Naohito Abe and Satoshi Shimizutani, “Employment Policy and Corporate Governance: An Empirical Analysis on the Stakeholder Model in Japan,” working paper, Economic and Social Research Institute, Cabinet Office, Tokyo, April 2005. Regarding the possibility that institutional investors purchase companies that are about to make significant changes, note that a study of CalPERS in the United States finds that many companies make significant pro-shareholder changes a day or two before they are targeted by CalPERS; presumably other changes would be recorded were the observation window extended further back. James N. Nelson, “The “CalPERS effect’ Revisited Again,” 12 Journal of Corporate Finance (2006), 187-213.

8 Peter Gourevitch and James Shinn, Political Power and Corporate Control: The New Politics of Corporate Governance (Princeton University Press, 2005), 120.


10 Margaret Blair, Ownership and Control: Rethinking Corporate Governance for the 21st Century (Brookings Institution, 1995).


12 Castaneda, To Retire in Dignity, chapters 1 and 7.

13 Castaneda, To Retire in Dignity, chapter 7; Stevenson, “California Battle.”


15 Castaneda, To Retire in Dignity, chapter 7.

16 One reason firms spent heavily on unrelated diversification was their fear that acquisitions of related units would result in anti-trust charges. After the Reagan administration relaxed anti-trust enforcement, the economic logic behind conglomerates was vitiated, which led to the infamous conglomerate “bustups” and a rise in horizontal mergers that promoted market power. After falling during the 1960s and 1970s, concentration ratios--a measure of market power--rose during the 1980s and again in


26 Institutional investing can be a strange and occasionally incestuous world. Monks sold ISS to Thomson Financial and it was later sold to Proxy Monitor, which is owned by Hermes Asset Management, CalPERS’s partner in the U.K. IRRC was created in response to a protest at Harvard University demanding that the university sell its stock in Gulf Oil, which conducted business in Angola. With funding from universities, foundations, and institutional investors, IRRC positioned itself as an intermediary between these organizations and the corporations it monitored on their behalf. David Vogel, *Lobbying the Corporation: Citizen Challenges to Business Authority* (Basic Books, 1978).


29 Rehfeld, “Low-cal CalPERS”, 43.


35 Paul Gompers, Joy Ishii, and Andrew Metrick, “Corporate Governance and Equity Prices,” 118 Quarterly Journal of Economics (Feb 2003), 107-155; Lucian Arye
Bebchuk, Alma Cohen, and Allen Ferrell, “What Matters in Corporate Governance,” Harvard Law School John M. Olin Center Discussion Paper no. 491 (September 2004). Note that neither of these studies can show causality between governance features and performance; there is evidence that causality runs in the opposite direction.

Moreover, other studies find positive share price effects associated with takeover defenses, such as golden parachutes, or that the effects vary over time. These findings suggest that entrenchment has not only costs but benefits: It prevents boards from being excessively sensitive to the whims of oft-misguided shareholders and may allow them to negotiate a better price with the bidder. Also, the existence of a stock premium associated with takeover-friendly governance does not mean that takeovers, or the threat of them, improve efficiency. Nor does research show that takeovers primarily occur at firms with governance and performance defects or that they lead to improved performance in the long term. Ravenscraft and Scherer, for example, find no evidence of greater profitability nine years after a takeover; in fact profitability declined. We do know, however, that hostile bids generate a spike in acquisition stock returns immediately after the bid. These returns reflect the oft-observed tendency of bidders to overpay when bidding for an acquisition (the hubris effect). They may also be due to the expectation that the takeover will lead to layoffs, to asset sales (asset sales command price premia because bidders are seeking market power), and to tax advantages associated with the takeover. Hence being highly receptive to takeovers is not clearly justified in efficiency terms. It can cause excessive resources to flow to shareholders—from customers, employees, and taxpayers—and lead to underspending on R&D and human capital. This is precisely what worries some U.S. investors, who think that public U.S. companies currently are paying out too much cash. However, empirical efforts to measure whether the gains to acquisition stockholders come at the expense of other stakeholders has not thus far been addressed with a consistent sample. Nor do we know the extent to which gains by acquisition shareholders are offset by losses of acquirer shareholders.


Rehfeld, “Low-cal CalPERS,” 6; Crist interview.


White quoted in Marc Gunther, “CalPERS Rides Again,” 148 Fortune (8 December 2003), 149. Also see “CalPERS Looks at Social Issues in Emerging Markets,” 28 Pensions & Investments (10 January 2000), 25; “Poor Performance Fuels Anti-Tobacco Arguments,” 28 Pensions & Investments (6 March 2000), 3; Christopher Palmeri, “Can Calpers Afford to Throw Stones? The Pension Fund is Rife with Potential Conflicts of Interest,” Business Week (24 June 2002), 132; Berry, “Battle for Better Corporate Governance.” CalPERS is a firm proponent of corporate transparency. But the Enron investments, along with CalPERS’ repeated refusal to release various internal data, such as the fees it pays to venture capital firms (an issue about which it was sued and lost), makes one wonder if CalPERS practices what it preaches. Tessa Hebb, “The Economic


45 CalPERS, Annual Investment Report, various years.

46 Susan Kane to author (10 March 2005); Mary Cottrill to author (15 December 2005); Crist interview; CalPERS, Annual Investment Report, various years.


48 Interview with Raita Sakai and Tokutaro Kawai, 18 March 2005; Crist interview.


Interview with Marc Goldstein, 19 March 2005; Interview with Ariyoshi Okumura, 15 March 2005; Interview with Kuny Kobayaschi, 17 March 2005; Sakai interview; Crist interview.


Council for Better Corporate Citizenship, “Purpose of the CBCC Study Mission,” 22 September 1993; Crist interview.

Ibid.


Crist interview.

Simon Learmount, *Corporate Governance: What Can Be Learned from Japan?* (Oxford University Press, 2002), 64; Sakai, Crist, and Kobayaschi interviews.

Viner in Sterngold, “Japanese Companies Rebuff,” D2; Crist and Sakai interviews.


64 Back issues of M&A Review courtesy of Raita Sakai.


70 Okumura, Sakai, and Crist interviews.


73 ICGN Statement on Global Corporate Governance Principles, Adopted July 9, 1999 at the Annual Conference in Frankfurt.

74 Okumura, “Japan’s Corporate Governance Overview,” 5; “ICGN Conference Highlights Growing Awareness of Need to Improve Governance in Japan,” IRRC Corporate Governance Bulletin (October 2001); Nikkeiren International Special Committee report, 1998 quoted in Inagami, “From Industrial Relations to Investor Relations,” 229.


77 Crist interview.

78 “Japan’s Pension Fund Association Urges Funds to Vote Their Proxies,” IRRC Corporate Governance Bulletin (January 2002); Tak Wakasugi, “Government Pension Fund and Shareholder’s Right,” Corporate Governance in the New Japan, a conference sponsored by the Pacific Pension Institute, San Francisco State University, the Japan Society, and JETRO, San Francisco, November 2003. Wakasugi also recommended that the huge Government Pension Investment Fund be permitted to follow similar principles in investing its $100 billion in equities but, to avoid charges of political interference in business, the decision was made to leave proxy voting in the hands of the GPIF’s asset managers with the proviso that the managers were to “maximize long-term shareholder value.” In addition to his work on pensions, Wakasugi also is a key figure in the Business Accounting Deliberation Council, which sets accounting standards in Japan.

79 Sarah McClellan, “Corporate Pension Reform in Japan: Big Bang or Big Bust?” Pension Research Council, working paper, 2004, University of Pennsylvania, 13; Jennifer Amyx, Japan’s Financial Crisis: Institutional Rigidity and Reluctant Change


84 Miyajima, “The Performance Effects and Determinants of Corporate Governance Reform in Japan,” tables 4-10. The study is unable to determine whether profitable companies are more likely to disclose information or whether causality runs in the opposite direction. It assumes the latter to be the case.

85 Yano interview.

86 “Japanese Pension Fund Manager Pushes Accountability,” Reuters Asia (17 March 2002); Yano interview.


88 Crist and Okumura interviews; Ted White, “A Foreign Perspective,” in Corporate Governance in the New Japan, 23.


Goldstein and Kobayaschi interviews; Darrel Whitten, “Comply or Explain: Japan’s Shareholders Speak Up,” *Moneywatch: Weekly Financial Commentary from Tokyo*, issue 34 (1 July 1 2003).

“Staff Slammed: CalPERS Blasts International Equity Search,” *Pensions & Investments* (30 October 2000), 52; Crist and Sakai interviews; CalPERS, “Written Testimony of Sean Harrigan to the U.S. Senate Commerce Committee, May 20, 2003; Gunther, “CalPERS Rides Again,” 151; “Activist Chief at CalPERS is Voted Out,” *Los Angeles Times* (2 December 2004); CalPERS data as of October 31, 2005, courtesy of Mary Cottrill.


Why He’s Bullish On Corporate Japan, 1 October 2003,” Japan Society, New York, August 2004; James DiBiasio, “Japan Fund Weighs Aggressive Governance,” FinanceAsia.Com (8 January 2004); Shuhei Abe, “How External Investors Influence Corporate Governance,” Corporate Governance in the New Japan, p. 15. During its first two years of existence, the fund beat the Topix index by over 20 percent. PFA’s Tomomi Yano wishes that he could invest in Sparx but has not been invited to join.

97 Crist, Sakai, and Kobayaschi interviews.


2003. In his 1993 speech to the Keidanren, Crist predicted that Japanese corporations would pay more attention to shareholder value as their “need for capital and the diminishing internal liquidity forces them to woo foreign sources of capital.” A similar argument was made when CalPERS released its 1998 Japan principles. Crist, “CalPERS Experiences,” 9; CalPERS press release, “CalPERS Adopts Corporate Governance Practices for Japan,” 18 March 1998.


111 Miyajima, “Performance Effects,” table 4; see notes 16 and 35.


113 In the United States, although the dividend payout ratio among all firms that pay dividends was stable in the 1980s and 1990s, there was a swelling of total dividend payments as earnings rose. Added to this was a huge increase in share buybacks. Harry DeAngelo, Linda DeAngelo, and Douglas J. Skinner, “Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings,” 72 Journal of Financial Economics (2004), 425-56; Franklin Allen and Roni Michaely, “Dividend Policy,” Wharton School, working paper, May 1995.


115 Gregory Jackson, “Stakeholders Under Pressure: Corporate Governance and Labour Management in Germany and Japan,” 13 Corporate Governance (2005), 419-428; Chiaki Moriguchi and Emmanuel Saez, “The Evolution of Income Concentration in
Japan, 1885-2002,” paper for the 2004 Economic History Association Meeting, San Jose, August 2004. De Jong’s study of European corporations divided them between Anglo-Saxon, Germanic, and Latinic corporations. In the early 1990s, he found Anglo-Saxon corporations paying 23.5 percent of net value added to “capital” (chiefly dividends and share repurchases) versus 8.8 in Germanic firms and 14.4 percent in Latinic firms. Labor’s share of value-added was correspondingly lower in the Anglo-Saxon firms (62.2 percent versus 86.1 and 80.3 percent respectively). This is consistent with Roe’s observation that strong minority shareholder protection is associated with greater income inequality. Henk W. De Jong, “The Governance Structure and Performance of Large European Corporations,” 1 Journal of Management and Governance (1997), 5-27; Roe, Political Determinants of Corporate Governance, passim.


120 Conversely, institutional investors do not have much incentive to monitor their indexed holdings because all that counts is their performance compared to peers. As a result, they will tend to hold on to overvalued stock because selling might hurt relative