

Convergence by Design:
The Case of CalPERS in Japan*

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ABSTRACT

U.S. institutional investors are a key actor helping to diffuse shareholder-primacy precepts overseas, including to Japan. This study focuses on CalPERS, the public pension fund that is one of Japan's largest foreign equity investors. Using original sources, the article shows how CalPERS transferred to Japan the activist tactics and governance principles it developed in the United States. CalPERS had modest success in changing corporate governance law and practice in Japan. It faced opposition from big business and other groups skeptical that the CalPERS principles would improve corporate performance. Given this resistance as well as barriers to institutional and legal change, CalPERS turned to relational investing as a way of extracting greater value from its Japan investments. Although CalPERS seeks to create long-term value, it is also concerned with the distribution of value among corporate stakeholders. The article considers the distributional effects of governance change and urges continuing attention to this issue.

Japan's distinctive corporate governance system developed during and after the Second World War. The features of that system -- insider boards, cross-holding, enterprise unions, and main banks -- rested on two assumptions. One was that the company comprised a community of stakeholders rather than being the shareholders' property. The responsibility of senior executives was to maximize the enterprise's long-term value by balancing the interests of shareholders as well as creditors, employees, suppliers, and business group (*keiretsu*) members. The second assumption had to do with trust in the selection and incentive systems for corporate executives. Those who rose to the top were assumed to be competent, honest, and hard-working. They were closely monitored only when there was a marked decline in earnings, sales, or share price. In these instances, the CEO might be ousted and sometimes an independent director was placed on the board.¹

Today the traditional system is under pressure to become more like the U.S. governance model that took hold in the 1980s and 1990s. The U.S. model treats share price as the chief criterion for judging management performance. 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.²

The pressure for change stems Japan's slow economic growth between the early 1990s and 2002. The weak economy frayed ties between banks and corporate borrowers and between members of the *keiretsu*, causing sales of cross-held equity.³ A second vector for change is the Japanese government, which repeatedly has revised Japan's commercial law to facilitate implementation of the U.S. model. The government's motives were, and are, murky. Some government economists believe that a shareholder-

¹ Steven N. Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States* 102 JOURNAL OF POLITICAL ECONOMY 510-46 (1994); Steven Kaplan and Bernadette Minton, *Appointments of Outsiders to Japanese Boards*, 36 JOURNAL OF FINANCIAL ECONOMICS 225-258 (1994). On the varieties of capitalism, see PETER A. HALL AND DAVID SOSKICE (EDS.), *VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE* (2001); RICHARD WHITLEY, *DIVERGENT CAPITALISMS: THE SOCIAL STRUCTURING AND CHANGE OF BUSINESS SYSTEMS* (1999).

² RONALD DORE, *STOCK MARKET CAPITALISM, WELFARE CAPITALISM: JAPAN AND GERMANY VERSUS THE ANGLO-SAXONS* (2000); SANFORD M. JACOBY, *THE EMBEDDED CORPORATION: CORPORATE GOVERNANCE AND EMPLOYMENT RELATIONS IN JAPAN AND THE UNITED STATES* (2005).

³ JAMES R. LINCOLN AND MARK GERLACH, *JAPAN'S NETWORK ECONOMY: STRUCTURE, PERSISTENCE, AND CHANGE* (2004).

oriented approach will spur growth by raising share prices and bolstering corporate balance sheets. JETRO (the Japan External Trade Organization) is enthusiastic about governance reforms that might entice overseas investors. JETRO is a branch of METI (Ministry of Economy, Trade, and Industry), which has been a quiet force pushing the Japanese economy in an Anglo-American direction. The Health, Labour, and Welfare (HLW) Ministry is concerned about Japan's aging population and unfunded pension liabilities. Boosting share prices will, it is hoped, reduce liabilities and stave off contentious changes in benefits and contributions.⁴

Foreign investment, especially from the United States, is a third source of change. 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 24 percent in 2005. Foreign owners are more likely to trade their shares than domestic owners, thereby magnifying their impact on share prices. Foreign ownership is concentrated among large companies, such as Canon, Orix, and Sony; the proportion of foreign ownership declines with firm size. Generally it is the largest companies that are most actively traded.⁵

Some foreign investors in Japan merely buy and sell shares. Others are activists seeking to repeat the governance transformations they wrought in Europe and the United States during the 1980s and 1990s. The activists include individuals, private equity funds, and institutional investors. In Japan, the dominant institutional investors are pension funds, the largest of which is the California Public Employees' Retirement System or CalPERS. CalPERS provides pensions to nearly 1.5 million active and retired state, school, and public-agency employee in California. Many beneficiaries are current or retired union members.⁶

⁴ RICHARD KATZ, JAPANESE PHOENIX: THE LONG ROAD TO ECONOMIC REVIVAL (2003), 100-102; Christina L. Ahmadjian, *Changing Japanese Corporate Governance*, 28 THE JAPANESE ECONOMY 59 (2000); Derek Hall, *Japanese Spirit, Western Economics: The Continuing Salience of Economic Nationalism in Japan* in ECONOMIC NATIONALISM IN A GLOBALIZING WORLD (Eric Helleiner & Andreas Pickel, eds., 2005); Ronald J. Gilson and Curtis J. Milhaupt, "Choice as Regulatory Change: The Case of Japanese Corporate Governance," 53 AM. J. COMP. L. 343 (2005); RICHARD C. KOO, BALANCE SHEET RECESSION: JAPAN'S STRUGGLE WITH UNCHARTED ECONOMICS AND ITS GLOBAL IMPLICATIONS (2003).

⁵ The fifty most actively traded companies on the TSE accounted for 43 percent of all transactions in 2005. TOKYO STOCK EXCHANGE FACT BOOK (2005), 7-8, 60; *Foreign Ownership Tops 30 Percent at 103 Firms Listed on TSE*, NIKKEI WEEKLY, Nov. 21, 2005, at 3.

⁶ 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

CalPERS is often cited as the paradigmatic activist foreign investor in Japan. It was among the first overseas pension funds to make major investments in Japanese equities and remains one of Japan's largest foreign investors. As early as 1992, when foreigners were beginning to ramp up their Japan investments, CalPERS owned \$3.7 billion in Japanese equities, a stake that constituted approximately 3 percent of the total value of TSE shares owned by foreign investors. By 2000, many more foreign investors had flocked to Japan so that CalPERS now constituted slightly less than 1 percent of the total value of shares owned by foreign investors. These figures are impressive but even with its vast holdings, CalPERS remains a flea on the elephant. Its 1992 holdings were only .16 percent (roughly a sixth of one percent) of the TSE and it rarely owned more than one percent of any single company.⁷ So how could it have had an effect on Japanese corporate governance?

One answer is that CalPERS was an aggressive advocate of change. During its first phase of activism, it acted on its own: conscientiously voting its proxies, regularly meeting with executives of Japanese firms, and using the media and other public relations tactics to promulgate its principles. The second phase came when CalPERS leveraged its stake by teaming with other foreign investors and with domestic groups seeking to change Japanese corporate governance. CalPERS had prominence, even notoriety, in the Japanese business community because of its 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' activities were modest. It had more of an effect on changes related to transparency than on those related to board structure, executive compensation, and control (takeover barriers). Perhaps this is because disclosure is an add-on 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 internal change of the sort that many Japanese companies are still unwilling to initiate. CalPERS blamed this resistance on self-serving, entrenched management. But many Japanese corporate executives felt that the existing

1018 (1998). On the other hand, California's public sector is heavily unionized, with a coverage rate of 58 percent in 2005 versus 40 percent nationally. See data at <http://www.trinity.edu/bhirsch/unionstats/>

⁷ Calculations based on TOKYO STOCK EXCHANGE FACT BOOK: 2005, 60, 74 and CalPERS data supplied by Susan Kane in letter to author (March 10, 2005).

system performed reasonably well and that the solution to Japan's economic problems lay outside the corporate sector—in monetary and banking policies. There was strong opposition to the CalPERS' principles, especially from the Keidanren, the main Japanese business organization.

The limited effect of CalPERS on Japanese corporate governance also stemmed from CalPERS' reticence. It did not want to be seen as an outsider meddling in Japanese affairs and therefore pressed its agenda less forcefully 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' 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 governance in Japan. There were free-rider costs that it was less willing to bear as more foreigners 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 by pursuing the same activities on a market-wide basis. The combination of relational investing and lower levels of activism marks the third phase of CalPERS' involvement in Japan.

Last but not least, the economic environment changed. Flaws in the U.S. model became evident in the myriad scandals that followed the Enron implosion in 2001. 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 presents the history of CalPERS in Japan. It shows how institutional investors promote change in overseas corporate governance as well as the limits of foreign influence. Previous studies of Japan have statistically confirmed an association between foreign ownership and outcomes such as asset restructuring and downsizing. But the studies are unable to determine whether causal links exist between foreign ownership and observed outcomes. The present case study unpacks those causal ambiguities by examining the actual processes by which CalPERS and other institutional investors tried to change corporate governance and strategy in Japan.

A major topic in corporate law during the past decade has been speculation on the convergence of distinct national systems for corporate governance. Yet there has been

relatively little empirical research on this topic, especially on the circuits that transmit institutional diffusion. What research there is focuses 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.⁸ These investor activities are not only economic; they are political, with consequences for income distribution and social values. This case study is one step in the ongoing effort to learn more about the varieties of global capitalism: reasons for their convergence as well as endurance.

I. CalPERS in the United States

To appreciate CalPERS in Japan, one must understand how the fund evolved in the United States, not just for reasons of perspective but because many of the policies CalPERS pursued in Japan had their origins in its home country. CalPERS' transformation from a sleepy public pension fund to active institutional investor began in 1984, when California lifted a requirement limiting CalPERS' stock investments to 25 percent of its portfolio. The change occurred as equity markets were being transformed by an upsurge in hostile acquisitions, buyouts, and other investing tactics. In 1980, state and local pension funds owned 3 percent of U.S. equities, a share that nearly tripled by 1990 as the funds put more money into stocks.⁹ Yet pension funds rarely participated in corporate governance; many did not even vote their proxies.

1984 also was the year that the Bass brothers of Texas made a hostile bid for oil giant Texaco. To stave them off, Texaco paid a premium of \$138 million for their shares—an instance of “greenmail.” Infuriated by the deal was California State Treasurer Jesse Unruh, who was a trustee of the CalPERS board. Unruh tried but could not block the payoff. But he drew from the episode two lessons: that executives cared more about their jobs than about shareholder value, and that public pension funds needed better ways to coordinate their common interests.¹⁰

⁸ The literature is exemplified by CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (Jeffrey N. Gordon and Mark J. Roe, eds., (2004).

⁹ MARGARET BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE 21ST CENTURY 46 (1995).

¹⁰ Christopher Castaneda, *To Retire in Dignity and Comfort: A Decade-by-Decade History of CalPERS, 1920s-1990* (2004), *passim* (unpublished manuscript on file with the CalPERS Library, Sacramento, California); Richard Stevenson, *California Battle Over State Fund*, N.Y. TIMES, June 18, 1991, at D1. For a legal overview of the “shareholder value” concept, see Simon Deakin, *The Coming Transformation of Shareholder Value*, 13 CORPORATE GOVERNANCE 11 (2005).

In 1985 Unruh founded the Council of Institutional Investors, an association of public pension funds. Representing \$132 billion in assets, CII was a force to be reckoned with. Among its first acts was adoption of a “shareholder bill of rights” calling for equal treatment of shareholders, shareholder approval of key corporate decisions, and independent vetting of executive compensation and corporate auditors. One Wall Street executive said of the CII, “If the institutions start speaking with one voice, they could become a financial OPEC.”¹¹

The CII was put to the test later that year by another Texan, T. Boone Pickens, who was trying to take over Phillips Petroleum. Although the bid failed, CII -- because of its collective clout -- participated in meetings with company representatives. CalPERS supported raiders like Pickens, even if it did not align itself with them in every bid, because it believed that takeovers could raise shareholder value. CalPERS professed to be interested in long-term value and used the term “shareholder” instead of “shareholder” to transmit this message. But according to disgruntled corporate executives, CalPERS was quick to abandon its philosophy if a raider offered a sufficiently juicy premium for its shares.¹²

At the time around 80 percent of CalPERS’ U.S. equities were in index funds, a cheap way to track the market. Also, any above-average losses incurred by CalPERS were sure to attract public criticism, so indexing kept it free from blame. Dale Hanson, CEO of CalPERS from 1987 to 1994, adroitly managed the political environment while carrying on Unruh’s commitment to shareholder value. 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, and six representatives elected by retirees and employees. Because CalPERS could not sell its indexed shares when a company performed poorly, Hanson thought that the best way to raise returns was to propose marketwide changes in corporate governance. The board identified three problems it sought to rectify: the inability of shareholders to select the best directors; the inability of

¹¹ Castaneda, *To Retire in Dignity*, chaps. 1, 7.

¹² Castaneda, *To Retire in Dignity*, chap. 7; Stevenson, *California Battle*. CalPERS approved of efforts by the raiders, Wall Street, and academic economists to develop an efficiency rationale for hostile takeovers, which, previous to the 1980s, were uncommon and held in disdain. *Economists Urge SEC to Resist Pleas for Curbs on Hostile Takeovers*, SECURITIES REGULATIONS & LAW REPORT, Feb. 22, 1985, at 329-32.

directors to monitor executives; and the clash between shareholder interests and those of the company's executives and board.¹³

The thesis that corporate governance was responsible for poor performance was advanced with increasing regularity in the 1980s. The investing community asserted that U.S. companies had failed to respond effectively to globalization. One reason, allegedly, was that boards subscribed to a managerialist governance philosophy in which executives and boards sought to balance the interests of corporate stakeholders. This caused them to defer excessively to incumbent employees (including executives) through takeover barriers, overly high wage and staffing levels, and wasteful spending on unrelated acquisitions.¹⁴

During the late 1980s CalPERS began to openly criticize companies with what it considered to be shareholder-unfriendly policies. It introduced shareholder resolutions opposing poison pills at companies such as Alcoa, American Airlines, and K-Mart. It sought to make boards more independent, again through shareholder resolutions. At some companies the resolutions called for majority-independent boards; at others, they demanded that the board's compensation committee be comprised entirely of independents. CalPERS felt that the deck was stacked against shareholder activism. So it sought broader shareholder rights: greater disclosure, fewer barriers to dissident proposals, and advisory committees for large shareholders. To many executives, the rise of shareholder activism was unsettling. As one Wall Street expert said, "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."¹⁵

Around this time, CalPERS adopted a new approach. Instead of going after companies with faulty corporate governance, regardless of performance, it took aim at

¹³ Castaneda, *To Retire in Dignity*, chap. 7.

¹⁴ One reason firms sought unrelated diversification was anti-trust policy. After the Reagan administration relaxed anti-trust rules, the logic behind conglomerates was vitiated, which led to "bustups" as well as takeovers to boost market power. Concentration ratios—which measure market power—rose during the 1980s and in the late 1990s. Frederic L. Pryor, *New Trends in U.S. Industrial Concentration*, 18 REVIEW OF INDUSTRIAL ORGANIZATION 301 (2001); Lawrence J. White, *Trends in Aggregate Concentration in the United States*, 16 JOURNAL OF ECONOMIC PERSPECTIVES 137 (2001).

¹⁵ Leslie Wayne, *Seeking to Stay Out of Proxy Battles*, N.Y. TIMES, Aug. 8, 1991, at D1; Richard Stevenson, "Large Foot in Board-Room Door," *New York Times* (6 June 1991), D1; Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 JOURNAL OF FINANCE 227 (1996).

companies with governance defects *and* that had poor performance. Only companies in the bottom performance quartile (measured over five years) were targeted, because these companies could not argue, as better performers sometimes did, that “if it ain’t broke, don’t fix it.” 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. The index measured board independence, separation of the CEO and chairman positions, executive compensation relative to performance, and independence of the compensation committee. CalPERS then filed shareholder resolutions that targeted the worst of the Fifty for anti-shareholder “sins” such as excessive salaries or poison pills. Note that the CalPERS methodology created the impression that poor governance caused poor performance, although, as we will see, evidence to prove this assertion was weak.¹⁶

In the first year of targeting, CalPERS had a much higher “win” rate than under its previous strategy. The names of targeted companies were shared with the media, putting an unwelcome spotlight on their internal affairs. Some members of the corporate community were furious about these tactics. In June 1991, California Governor Pete Wilson, a Republican, responded with a plan to tap CalPERS’ holdings to help fund a state budget deficit and to replace its board entirely with his appointees. Said Dale Hanson, “[Wilson] 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.”¹⁷

Although California voters rejected Wilson’s plan, it temporarily chilled CalPERS’ aggressive tactics. Now, rather than publicly identifying a targeted company, it first sent a confidential letter asking to meet with the CEO to discuss governance. At the same time it discreetly put into motion the machinery for a shareholder proposal. If management agreed to go along with CalPERS, even part way, CalPERS promised to halt

¹⁶ James Sailer, *California PERS (A)*, Harvard Business School case, (Aug. 17, 2000), Diane Del Guercio and Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 JOURNAL OF FINANCIAL ECONOMICS 293, 298 (1999). High institutional, and low private, ownership are criteria associated with successful win rates in shareholder proxy contests. Lilli Gordon and John Pound, *Information, Ownership Structure, and Shareholder Voting*, 48 JOURNAL OF FINANCE 697-718 (1993). CalPERS’ methodology selected on the dependent variable, a potential source of inferential bias.

¹⁷ Stevenson, “California Battle;” Kayla J. Gillan, “California ‘RAID’ History,” (unpublished speech, February 1997) at <http://www.CalPERS-governance.org/viewpoint/speeches/gillan.asp>.

the machinery. However, none of the targeted firms cooperated with CalPERS. In response, CalPERS released their names to the media and threatened to vote against their incumbent directors.¹⁸ The following season CalPERS reverted to its policy of announcing to the media around a dozen underperforming companies drawn from the Failing Fifty. Upping the ante, it sought to have CEOs removed at major firms such as IBM, Kodak, and General Motors. The dismissal of GM's CEO was a signal event, the result of efforts by CalPERS and other institutional investors.¹⁹

CalPERS' aggressive tactics reflected the idiosyncrasies of Hanson and his general counsel, Richard Koppes. Other giant funds, such as CalSTRS and TIAA-CREF, were not nearly so media-oriented nor forceful.²⁰ But Hanson left the fund in 1994, followed by Koppes in 1996. After their departures, CalPERS adopted a lower profile, preferring to work behind the scenes. This disappointed shareholder activists like Robert Monks, who said "I'm sorry they're not around to push the envelope with me."²¹

Another reason for its less aggressive approach was that the cost of research, meetings, and shareholder activities was disproportionately borne by CalPERS, which was subsidizing less aggressive free riders. The problem only was partially ameliorated by the creation of CII and of entities to provide proxy services to institutional investors: Institutional Shareholder Services (ISS, founded by Robert Monks and Nell Minow) and the Investor Responsibility Research Center (IRRC).²²

¹⁸ Claire E. Crutchley, Carl D. Hudson, and Marlin Jensen, *Shareholder Wealth Effects of CalPERS' Activism*, 7 FINANCIAL SERVICES REVIEW 1 (1998); Richard Stevenson, *Huge Fund Turns Up Proxy Heat*, N.Y. TIMES, March 21, 1992, at 37; Mark Trumbull, *Who's Running the Company?* CHRISTIAN SCIENCE MONITOR, Aug. 3, 1992, at 6.

¹⁹ MICHAEL J. CLOWES, THE MONEY FLOOD: HOW PENSION FUNDS REVOLUTIONIZED INVESTING 249 (2000).

²⁰ Barry Rehfeld, *Low-cal CalPERS*, 31 INSTITUTIONAL INVESTOR 42 (1997); Del Guercio and Hawkins, *Motivation and Impact*, 303; Working Group on Corporate Governance, *A New Compact for Owners and Directors*, 69 HARVARD BUSINESS REVIEW 141, 144 (1991).

²¹ Rehfeld, *Low-cal CalPERS*, 43.

²² 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' partner in the U.K. IRRC was created in response to a 1972 protest at Harvard University demanding that the university sell its stock in Gulf Oil for doing 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. ISS and IRRC merged last year. DAVID VOGEL, LOBBYING THE CORPORATION: CITIZEN CHALLENGES TO BUSINESS AUTHORITY (1978).

Research on Activism: As shareholders flexed their muscles, researchers began studying whether 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’ request and repeated it in 1995, 1999, and 2004. The study, however, was marred 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.²³

Other studies were more ambiguous. 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 is 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 show positive performance effects and four find insignificant or mixed effects. Of these studies, two were based on CalPERS: one finds significant performance effects; the other does not. A subsequent study examines the stock-price effect of CalPERS’ targeting and finds that it occurs immediately after targeting and dissipates within six months. Another recent study finds that public disclosure by CalPERS of poor-performing companies leads to a greater likelihood of CEO dismissal. The latest study--by Nelson--claims that all previous studies were deficient because they failed to control for contaminating events (e.g., positive news stories released shortly before announcement of the CalPERS list) and for biases caused by estimation during periods of known underperformance. Controlling for

²³ CALPERS, FACTS AT A GLANCE (Sept. 2005); CALPERS, WHY CORPORATE GOVERNANCE TODAY? A POLICY STATEMENT (Aug., 1995) at 6; Stephen L. Nesbitt, *Long-Term Rewards from Shareholder Activism: A Study of the ‘CalPERS Effect’*, 6 JOURNAL OF APPLIED CORPORATE FINANCE 75 (1994). For a critique of Wilshire Associates’ methodology, see Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174 (2001) at note 47. Also see Jonathan M. Karpoff, The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings, unpublished ms., University of Washington, School of Business (1998).

these effects, Nelson finds that, while there are positive effects of CalPERS targeting during the 1990-1993 period, there is no evidence of a “CalPERS effect” since then.²⁴

These results suggest another reason for CalPERS’ 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 shareholder resolutions and 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.”²⁵

The people then running CalPERS, such as board president Bill Crist and general counsel Kayla Gillan, disputed Koppes’s claim that CalPERS had lost its bite. Said Crist, “What we do now at CalPERS and have done for the last number of 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.”²⁶ CalPERS’ behind-the-scenes approach allowed it to raise politically sensitive issues such as divestitures and layoffs. The evidence shows that CalPERS’ targeting is associated with a higher rate of asset divestitures and employee layoffs than in a sample of control firms. Firms targeted by CalPERS also had more asset divestitures than firms targeted by other activist 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.”²⁷

²⁴ Crutchley et al., *Shareholder Wealth Effects*; Philip C. English, Thomas Smythe, and Chris McNeil, *The ‘CalPERS Effect’ Revisited*, 10 JOURNAL OF CORPORATE FINANCE 157 (2004); YiLin Wu, *The Impact of Public Opinion on Board Structure Changes, Director Career Progression, and CEO Turnover: Evidence from CalPERS’ Corporate Governance Program*, 10 JOURNAL OF CORPORATE FINANCE 199 (2004); Romano, *Less is More*; Smith, *Shareholder Activism*; Stuart Gillan and Laura Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 JOURNAL OF FINANCIAL ECONOMICS 275 (2000); James N. Nelson, *The ‘CalPERS Effect’ Revisited Again*, 12 JOURNAL OF CORPORATE FINANCE 187 (2006).

²⁵ Rehfeld, *Low-cal CalPERS*, 43.

²⁶ Smith, *Shareholder Activism*; Romano, *Less is More*, 185.; Del Guercio and Hawkins, *Motivation and Impact*, 310; Kayla Gillan: *CalPERS’ Grand Inquisitor*, BUSINESS WEEK, Feb. 24, 1997 at 120; Interview with Dr. William D. Crist (February 21, 2005).

²⁷ Rehfeld, *Low-cal CalPERS*, 44; Del Guercio and Hawkins, *Motivation and Impact*, 312; Floyd Norris, *On Wall Street: For Richer, For Poorer?* N.Y. TIMES, March 9, 1996 at 13. Asset divestitures and layoffs are a form of value extraction. The evidence shows that downsizing in U.S. manufacturing in the 1990s did

Still, targeting was expensive and, according to the academic studies, had an uncertain payoff. So a new approach by CalPERS was to accumulate large stakes (five to ten percent or more) in a few underperforming companies and use those holdings as leverage to effect changes such as divestitures and higher payouts. This was relational investing. Like other types of bloc holding, it allows investors to focus directly on business decisions rather than, as with governance reform, the methods used to reach those decisions. In 1995 CalPERS made an initial investment of \$250 million in Relational Investors. By 2004, it had invested over \$2 billion with Relational, which uses threats and persuasion (including board seats) to persuade management to be shareholder-friendly. CalPERS invests with other relational funds, including the Hermes Focus Fund in Europe.²⁸

Another change at CalPERS was an effort to 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 issued its preliminary governance code, which distinguished between “fundamental” and “ideal” principles. CalPERS planned to grade companies on these principles, publicize the results, and prod recalcitrants to change. But the code was met with a barrage of criticism. A *New York Times* analysis of Fortune 1000 companies found only one, Texas Instruments, meeting the full range of CalPERS’ fundamental tests. In a statistical analysis *The Times* did not detect any pattern linking governance to performance.²⁹ The following year CalPERS

not contribute to better productivity--value creation--notwithstanding claims about getting “lean and mean.” WILLIAM J. BAUMOL, ALAN S. BLINDER, AND EDWARD N. WOLFF, DOWNSIZING IN AMERICA: REALITY, CAUSES, AND CONSEQUENCES 194-233 (2003).

²⁸ Lilli Gordon and Jon Pound, *Information, Ownership Structure, and Shareholder Voting*, 48 JOURNAL OF FINANCE 697 (1993); *Meet the Friendly Corporate Raiders*, BUSINESS WEEK, September 20, 2004, at 102; CalPERS, *Hybrid Investments Monitoring Report. Relational Investors, Fourth Quarter, 2004* at <http://www.CalPERS.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200503/item05-02.pdf>; Kate Berry, *Battle for Better Corporate Governance Earns Cheers for Fund*, LOS ANGELES BUSINESS JOURNAL May 10, 2004, at 1. Relational Investors is run by former associates of T. Boone Pickens. See text at note 88, infra.

²⁹ A Conversation with Richard Koppes (1995) at www.corpgov.net/forums/conversation/koppes.html; Adam Bryant, *The Search for the Perfect Corporate Board*, N.Y. TIMES, August 3, 1997 at 1.

issued a revised document that dropped several controversial ideas (such as a limit on the number of directors older than 70).³⁰

Research on Corporate Governance: The CalPERS principles were a bold statement of the shareholder-primacy ethos. But did the principles make economic sense? The evidence on the performance effects of corporate governance 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 staggered board terms and supermajority requirements for mergers. The others concern shareholder rights in proxy voting, shareholder meetings, and bylaw amendment. While Gompers et al. did not identify the rules most strongly associated with higher share prices, a subsequent study finds that the critical rules are those facilitating takeovers. Other studies, however, do not find a causal relationship between takeover rules (or takeovers) and performance³¹

³⁰ CalPERS, *Corporate Governance: Core Principles & Guidelines, United States* (April 13, 1998); CalPERS, *Domestic Proxy Voting Guidelines* (February 16, 1999). Also see CalPERS, *Why Corporate Governance Today? A Policy Statement*, (August 14, 1995).

³¹ Paul Gompers, Joy Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, 118 QUARTERLY JOURNAL OF ECONOMICS 107 (2003); Lucian Arye Bebchuk, Alma Cohen, and Allen Ferrell, *What Matters in Corporate Governance*, Harvard Law School John M. Olin Center Discussion Paper no. 491 (2004). Not only do studies fail to find causality between governance features and performance, some actually find *positive* share-price effects associated with takeover defenses such as golden parachutes. The inference is that entrenchment has not only costs but benefits: It prevents boards from being overly sensitive to uninformed shareholders and permits boards to negotiate a better price with bidders. Also, the existence of a stock premium associated with takeover-friendly governance does not mean that takeovers or the threat of them improve efficiency. We know that takeovers are not associated with pre-existing governance or performance defects and that they do not 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 stock prices immediately after the bid is announced. The spike reflects the tendency of bidders to overpay for acquisitions (the hubris effect). It also reflects the expectation that the takeover will lead to asset sales (asset sales command price premia because bidders are seeking market power) and to tax benefits associated with the deal. Hence it is possible for takeovers to boost share price but not efficiency or value creation. Takeovers cause a flow of resources to shareholders—from customers, creditors, employees, and taxpayers—and lead to underspending on R&D and human capital. This is what currently worries some investors, who think that U.S. public companies are endangering their long-term health by paying out too much cash. However, we do not know precisely the extent to which stockholder gains are offset by losses of acquirers and of stakeholders.

N.K. Chidambaran et al., Does Better Corporate Governance “Cause” Better Firm Performance?, SSRN working paper (March 2006); John Core, Wayne Guay, and Tjomme Rusticus, *Does Weak Governance Cause Weak Stock Returns?* 61 JOURNAL OF FINANCE 655 (2006); Sanjai Bhagat and Roberta Romano, Empirical Studies of Corporate Law, International Center for Finance, Yale University (May 2005), 63-64; Ray Fisman, Rakesh Khurana, and Matthew Rhodes-Kopf, Governance and CEO Turnover: Do Something or Do the Right Thing?, SSRN working paper (January 2005); David Ravenscraft and F.M. Scherer, *Life After Takeover*, 36 JOURNAL OF INDUSTRIAL ECONOMICS 147 (1987); Ravenscraft and Scherer,

Although elimination of takeover defenses is mentioned in the CalPERS principles, the core is concerned with other issues such as monitoring (board structure) and incentives (executive compensation). For these issues the performance effects are difficult to find. In fact, the preponderance of evidence shows that board independence and small board size, which CalPERS repeatedly emphasized, are not associated with performance. There is also no conclusive evidence that splitting the chairman and CEO positions is associated with performance. However, board independence is associated with higher CEO dismissal rates during periods of poor performance.³²

That CEOs are key to performance was a credo of CalPERS and the investing community in the 1990s. The success of institutional investors in ousting CEOs at underperforming companies caused major changes in the CEO role, including a decline in tenure and a shift from insider CEOs to outsiders incentivized with stock options. 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 850 largest U.S. companies were outsiders; by 1995 the number was over 30 percent. In cases where the CEO was dismissed, 61 percent of replacements were outsiders. Yet these trends were based on faulty assumptions. Research shows that firing a CEO does not usually improve performance and that any benefit in hiring an outsider is vitiated by the

MERGERS, SELLOFFS, AND ECONOMIC EFFICIENCY (1987); Andrei Shleifer and Lawrence Summers, *Breach of Trust in Hostile Takeovers* in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (Alan J. Auerbach, ed., 1988); Sanjai Bhagat, Andrei Shleifer, and Robert Vishny, *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 1 (1990); Andrei Shleifer and Robert Vishny, *Stock Market Driven Acquisitions*, 70 JOURNAL OF FINANCIAL ECONOMICS 295 (2003); Robert Comment and G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 JOURNAL OF FINANCIAL ECONOMICS 3 (1995); *Looking for Trouble*, THE ECONOMIST, April 23, 2005 at 71. For similar findings from the U.K., see Julian Franks and Colin Mayer, *Hostile Takeover and the Correction of Managerial Failure*, 40 JOURNAL OF FINANCIAL ECONOMICS 163 (1996) and Rajeeva Sinha, *The Role of Hostile Takeovers in Corporate Governance*, 14 APPLIED FINANCIAL ECONOMICS 1291 (2004).

³² Sanjai Bhagat and Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 JOURNAL OF CORPORATION LAW 231 (2002); Dan R. Dalton, Catherine Daily, J.L. Johnson, and A.E. Ellstrand, *Number of Directors and Financial Performance*, 42 ACADEMY OF MANAGEMENT JOURNAL 674 (1999); Dan R. Dalton et al., *Meta-Analytic Review of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MANAGEMENT JOURNAL 269 (1998); Romano, *Less is More*, *passim*.

high probability that other members of the senior management team will depart when an outsider is brought in.³³

As for executive pay, CalPERS sought salary reductions and greater use of stock-based compensation for boards and executives. There is no consensus regarding the effect of board stockholding on performance; studies find positive and null effects. Whether executive stock compensation improves performance is a vexed issue. Although some studies find a positive relationship between performance and the portion of executive compensation based on equity, other studies reveal a slew of problems. Options create incentives to manipulate earnings and to extract gains that benefit executives at the expense of shareholders. 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, CalPERS criticized some of the more egregious practices related to options, such as reloading in the face of a firm-specific decline, but it remained an enthusiastic proponent of equity-based pay.³⁴

Thus there is at best only weak evidence for a relationship between the CalPERS principles and performance. Efforts to eliminate takeover defenses may improve

³³ Del Guercio and Hawkins, *Motivation and Impact*, 310, 318; RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs (2002), chap. 3; Crutchley et al., *Shareholder Wealth Effects*, *passim*; Leslie Wayne, *Shareholders Exercise New Power with Nation's Biggest Companies*, N.Y. TIMES, Feb. 1, 1993, at D1; Robert Parrino, Richard Sias, and Laura Starks, *Voting with Their Feet: Institutional Ownership Changes Around Forced CEO Turnover*, 68 JOURNAL OF FINANCIAL ECONOMICS 3 (2003); Margarethe Wiersema, *Holes at the Top: Why CEO Firings Backfire*, 80 HARVARD BUSINESS REVIEW 70 (2002); Wei Shen and Albert Cannella, Jr., *Revisiting the Performance Consequences of CEO Succession*, 45 ACADEMY OF MANAGEMENT JOURNAL 717 (2002). Data on CEOs were provided by Prof. Rakesh Khurana, Harvard Business School. Wiersema notes that a serious backfire event occurred at K-Mart, whose performance worsened after the CEO was fired in 1995. CalPERS was one of the loudest voices calling for his dismissal.

³⁴ Dan R. Dalton and Catherine M. Daily, *Director Stock Compensation: An Invitation to a Conspicuous Conflict of Interests?* 11 BUSINESS ETHICS QUARTERLY 89 (2001); Hamid Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 JOURNAL OF FINANCIAL ECONOMICS 163 (1995); Romano, *Less is More*, 201-202; LUCIAN A. BEBCHUK AND JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); *Fat Cats Turn to Low Fat*, THE ECONOMIST, March 5, 2005, 14; CalPERS, *Domestic Voting Principles* (1999). Regarding option backdating, a potential source of fraud, see Randall Heron and Erik Lie, *What Fraction of Stock Option Grants to Executives Have Been Backdated or Manipulated?* working paper, July 2006 at <http://www.biz.uiowa.edu/faculty/elie/Grants%207-14-2006.pdf>. Englander and Kaufman note that CEOs opposed the shareholder-primacy model in the late 1980s but that opposition died down by the mid-1990s. One reason was the widespread adoption of stock-based compensation combined with the bull market, which had the effect of making executives enthusiastic advocates of shareholder primacy. Ernie Englander and Allen Kaufman, *The End of Managerial Ideology: From Corporate Social Responsibility to Corporate Social Indifference*, 5 ENTERPRISE & SOCIETY 404 (2004).

performance, although the point is far from settled. There is little evidence that performance is enhanced by guidelines prescribing an optimal approach to internal organization, including the role of boards and CEOs. These findings are consistent with research done twenty years ago by economists Demsetz and Lehn, who showed that there is no single ownership structure that maximizes executive effort 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, *ceteris paribus*. But the changes were not related to improved performance except in the period immediately after the announcement that a firm had been targeted.³⁵

The absence of a strong relationship between the CalPERS principles and corporate performance had little impact on CalPERS, whose leaders held deep convictions that their approach worked even if it lacked statistical confirmation. Said board president Crist in 1997, “There’s so much contradictory evidence. I don’t believe in any of the studies. I believe [corporate governance change] 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 while professing disdain for empirical research, CalPERS was quick to tout studies showing positive results from its actions, as with the Wilshire Associates’ reports. Part of the problem here is defining performance. If one discards the efficient markets hypothesis, there can be a wedge between share price and a company’s long-term prospects, so share-price may not be the best performance metric. Alternate measures of performance, such as EVA, present problems of their own.³⁶

³⁵ Harold Demsetz and Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 JOURNAL OF POLITICAL ECONOMY 1155 (1985); Del Guercio and Hawkins, *Motivation and Impact*, *passim*. Factors analyzed by Demsetz and Lehn include firm size, stability, and regulation. Although they had in mind industry-specific regulation, the same argument applies to cross-national differences in regulatory and political structures.

³⁶ Rehfeld, *Low-cal CalPERS*, 6; ALLAN A. KENNEDY, THE END OF SHAREHOLDER VALUE (2001). Eight years later, Crist, now retired from the board, maintains his skepticism about governance research: “I believe in something like this [governance reform] 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.” Crist

CalPERS' reputation overseas is that of a hard-nosed proponent of shareholder primacy but it has a progressive image in the United States. The latter is due to pressure from the legislature (which forced CalPERS to divest from South Africa in the late 1980s) and to developments after 2000, when a new Democratic governor and state treasurer used the fund to push an energetic social agenda. Until recently, however, the board was controlled by an old guard--including Crist, Robert Carlson, and Charles Valdes--who eschewed social activism. Members of the CalPERS staff--professionals hired to manage the portfolio--similarly were opposed to politicization of investment decisions. Their concerns were not entirely related to performance, however. Ted White, in charge of CalPERS' corporate governance programs, tellingly said, "We lose effectiveness when we get away from arguments that carry weight with the financial community."³⁷

CalPERS cast its nets widely for new investments to bolster the fund's performance. In 1993 it entered into its largest-ever private equity deal: an investment of \$250 million in Joint Energy Development (JEDI), a 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. Other CalPERS investments considered innovative for a pension plan included hedge funds and overseas stock, to which we now turn.³⁸

is now chairman of the advisory committee for the new FTSE/ISS corporate governance index, which is co-owned by the Financial Times and by ISS. Crist interview.

³⁷ Castaneda, To Retire in Dignity, chap. 7; *CalPERS Looks at Social Issues in Emerging Markets, PENSIONS & INVESTMENTS*, January 10, 2000, 25; *Poor Performance Fuels Anti-Tobacco Arguments, PENSIONS & INVESTMENTS*, March 6, 2000, 3; White quoted in Marc Gunther, *CalPERS Rides Again, FORTUNE*, December 9, 2003, 149.

³⁸ Christopher Palmeri, *Can CalPERS Afford to Throw Stones? The Pension Fund is Rife with Potential Conflicts of Interest*, BUSINESS WEEK, June 24, 2002, 132; Berry, "Battle for Better Corporate Governance." CalPERS is a proponent of corporate transparency. But the Enron investments, along with CalPERS' repeated refusal to publicly release 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 it practices what it preaches. Tessa Hebb, "The Economic Inefficiency of Secrecy," working paper, School of Geography and the Environment, University of Oxford (2004); Tom Petruno, *Suit Seeks Details of CalPERS Payments*, LOS ANGELES TIMES, September 8, 2004 at D1; *CalPERS to Reveal Venture Capital Fees*, SACRAMENTO BEE, Dec. 8, 2004, at D1.

II. Early Days in Japan

Starting in the late 1980s, CalPERS gradually became more active in international markets. Seeking to avoid the image of a foreigner meddling in local affairs, it formed strategic alliances with local groups to foster its agenda. In the words of board member Robert Carlson, CalPERS overseas was a “missionary for good corporate governance.” Like other missionaries in earlier times, one of the first places CalPERS selected for governance change was Japan.³⁹

The collapse of U.S. bond prices that started in 1979 led corporate pension funds to seek overseas investment opportunities, including the Japanese stock market. Public-employee pension funds had stricter investment rules that limited their equity and overseas investments. But they, too, entered the overseas market, especially after the stock market crash of 1987. CalPERS was one of the first: It made an initial purchase of foreign equities in 1988 and quickly ramped up after that. By 1991, 12 percent of CalPERS’ total equity portfolio was in foreign stock and this doubled to 24 percent in 2000. At the time, all of CalPERS’ international investments were handled by external investment banks. The initial Japan investment consisted of \$250 million placed in an index fund managed by State Street Global Advisors. In 1991-1992, CalPERS made a huge investment, worth about \$1 billion, in an actively managed portfolio of Japanese stocks. Different entities invested these funds, with Nomura Capital Management handling the biggest chunk.⁴⁰

By the end of 1992, 28 percent of CalPERS’ Japan equity portfolio was actively managed. The active share rose to 40 percent in June 1994, its peak. Then it drifted down to 32 percent in 1995, 27 percent in 2000, and 22 percent currently. Even at these reduced levels, the percentages are greater than the actively-managed share of CalPERS’ domestic portfolio, which runs around 17-18 percent. This is an important point: The fact that

³⁹ Robert F. Carlson, “CalPERS: A Missionary for Good Corporate Governance: Corporate Governance in a Global Economy,” October 2, 1998 at <http://www.CalPERS-governance.org/viewpoint/speeches/carlson4.asp>.

⁴⁰ Joining pension funds in Japan were mutual funds and a few raiders, including T. Boone Pickens. Pickens bought a 20 percent stake in Koito, a Japanese 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. CLOWES, THE MONEY FLOOD, 145; E. PHILIP DAVIS & BENN STEIL, INSTITUTIONAL INVESTORS 299 (2001), 299; Peter Sinton, *CalPERS Brings Shareholder Advocacy to Japan*, SAN FRANCISCO CHRONICLE, June 25, 1994, at D1; CALPERS, ANNUAL INVESTMENT REPORT, various years.

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 possible that its sizeable active stake gave CalPERS greater leverage over Japanese companies. In a thinly traded market like Japan’s, exit could damage a company’s image and its share price. Also, the relatively large actively-traded stake may have shaped CalPERS’ time horizons in Japan, making it anxious to see changes that could be turned into profits.⁴¹

CalPERS’ 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. In response, CalPERS suspended relationships with Nomura Securities in Japan and wrote to the Minister of Finance, the late Ryutaro Hashimoto, asking for an investigation of trading practices. In 1993, CalPERS demanded that Nomura and Daiwa Securities appoint outside directors to their boards and warned that it might seek the same from other Japanese companies.⁴²

Proxies: Initially CalPERS did not vote proxies for its Japan holdings; trust banks who held its proxies also did not vote them. This was not unusual for foreign investors in Japan, where proxy voting was--and is--rather complicated. Most shareholder meetings in Japan are synchronized to take place in late June. In early June, a flood of proxy material for foreign owners are sent to a local subcustodial trust bank, such as Sumitomo, which holds the shares. The bank sends the material to the appropriate custodian in the United States, such as State Street Bank, who, in turn, passes it to the foreign owner. After the foreign owner votes, the proxies 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, a point we will return to.

In 1990, CalPERS decided to replicate in Japan the systematic proxy voting it pursued in the United States. It hired Global Proxy Services (now ADP) as its local proxy agent. Because there were no Japan experts on its staff, CalPERS relied on consultants to offer advice on how to vote and streamline the process. They included

⁴¹ Susan Kane to author, March 10, 2005; Mary Cottrill to author, Dec. 15, 20005); Crist interview; CALPERS, ANNUAL INVESTMENT REPORT, various years.

⁴² *California Pension Fund Urges Inquiry by Japan*, WALL STREET JOURNAL, August 12, 1991, at C9; *California Pension Fund Suspends Nomura Trading*, JIJI PRESS, Aug. 21, 1991; W. Stern, *Do As I Say*, FORBES, Dec. 23, 1991, 16; *International Outlook: Japan*, BUSINESS WEEK, Jan. 18, 1993 at 48.

Joseph C.F. Lufkin and Aron Viner, who were with Global Proxy Services, and an acquaintance of Lufkin's named Raita Sakai, who ran a Tokyo consultancy called Multilateral Investment Development Corporation. CalPERS also relied on local law firms and on research done by IRRC to guide its decisions.⁴³

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 to adoption of a holding company structure). As in the United States, an issue of concern to CalPERS in Japan had to do with corporate boards: the paucity of independent directors and the large number of directors, such that a Japanese board with thirty or more members was not unusual. CalPERS routinely would vote its proxies against internal directors and against proposals for expanding board size. Another concern was executive entrenchment. CalPERS opposed the issuance of new equity if it thought this was being done to defend against takeovers. In 1993, Japan amended the commercial code to require companies to have at least one independent statutory auditor. After this, CalPERS made it a policy of voting against auditors who were judged to lack independence, such as former company executives. CalPERS also opposed the re-appointment of directors at companies whose corporate governance it deemed unsatisfactory.⁴⁴

Dividend levels were another matter of concern. Japanese companies held more of their assets in cash than their U.S. counterparts partly to accommodate relatively large bank loans. In spite of these cash hoards, dividends were meager and based on par value rather than earnings. CalPERS wanted Japanese companies to return more cash to shareholders either through dividends or stock repurchases. But it knew that this was a sensitive issue that could make CalPERS look greedy or indifferent to Japanese financial norms. Exxon and Mobil, which each held 25 percent stakes in Tonen, a Japanese refiner,

⁴³ Interview with Raita Sakai, March 18, 2005; Crist interview. Global Proxy simplified the voting process by physically retrieving CalPERS' proxies from the Japanese subcustodians. Joseph Lufkin to author, August 3, 2006.

⁴⁴ James Sterngold, *Japanese Companies Rebuff Mighty U.S. Pension Funds*, N.Y. TIMES, June 30, 1993, at D1; *CalPERS Announces Votes Regarding Japanese Companies*, BUSINESS WIRE, June 24, 1994; *Less Japanese Companies Use Governance Loophole*, IRRC CORPORATE GOVERNANCE BULLETIN (October 2001), 1.

were criticized when they forced out Tonen's president and pressured the company to double its dividends. Therefore, CalPERS was careful to appear even-handed. It publicized the fact that, although it had voted proxies against inadequate dividends and was concerned about their generally low levels, it had also voted against *excessive* dividends being paid by some unprofitable companies such as Nissan. Said Richard Koppes, "We're not trying to change Japanese culture."⁴⁵

CalPERS announced in 1993 that it had selected Britain and Japan as targets for a campaign to improve overseas corporate governance. The following year it issued global proxy voting guidelines that emphasized director accountability to shareholders; transparency of corporate information; shareholder-friendly distribution of proxy materials; and publication of final proxy tallies. The concern about proxy distribution reflected a problem that occurred in Japan during the previous proxy season, when CalPERS' "no" votes against more than 200 Japanese companies went unrecorded. Sumitomo Trust said that CalPERS' completed 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."⁴⁶

Proxy voting is a noisy signal. A vote against the income allocation proposal is subject to multiple interpretations that are based on knowing the identities of voters and their specific concerns. Yet CalPERS did not publicize its individual proxy votes nor did it publish a "target list" and mount its own shareholder resolutions, as in the United States. Moreover, because Japan has no legal provisions for ownership disclosure, companies could not always identify the beneficial owners casting negative votes. (One expert estimates that Japanese firms do not know about 20 percent of their owners.) However,

⁴⁵ W. Carl Kester, *Japanese Takeovers: The Global Contest for Corporate Control* 224-27 (1991); Curtis J. Milhaupt and Mark D. West, *Economic Organizations and Corporate Governance in Japan* chap. 7 (2004); *Japanese Oil Refiner Surprises with Large Increases in Dividends*, Financial Times, Feb. 2, 1992, at 22; James Sterngold, *Lessons in Shareholder Power for Japanese Refiner*, N.Y. Times, Jan. 17, 1994, at D2; Koppes in Sterngold, *Japanese Companies Rebuff*. In the United States, too, companies followed rules of thumb to guide their dividend payments: Early in the twentieth century they tied dividends to par value but later in the century dividends were tied to earnings. When stock repurchases became common in the 1970s, the relevant norm for dividend payments was annual growth in dividend per share. Mary O'Sullivan, *Living with the U.S. Financial System: The Experiences of General Electric and Westinghouse in the Last Century*, working paper, University of Pennsylvania (January 2005).

⁴⁶ *Japanese Corporate Governance: Dawning*, THE ECONOMIST, May 22, 1993, at 87; Sterngold, *Japanese Companies Rebuff; California Pension System Misses Deadline to Vote No*, NIKKEI WEEKLY, July 5, 1993, at 17; CALPERS, *GLOBAL PROXY VOTING PRINCIPLES* (Revised, March, 2001).

CalPERS sometimes sent letters to company management before or after a vote to explain its actions.⁴⁷

Proxy voting was not an effectual way of inducing change. Rarely did anti-management votes exceed 30 percent of the total and, even then, companies rarely announced the outcome, despite CalPERS' request that they do so. (Vote totals were educated guesses.) Although CalPERS sought larger payouts to shareholders, payouts actually declined during the 1990s. And, although CalPERS voted against insiders who were nominated to be independent auditors, the percentage of firms listing auditors whose outsider status was questionable rose between 1994 and 1996, from 11 to 20 percent.⁴⁸

A particular hindrance to CalPERS in its early years was that 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 CalPERS considered the initiation of a Japanese target 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." CalPERS wanted to avoid controversy and the possibility that its 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."⁴⁹

Black Ships: The main association of large Japanese corporations is Keidanren. During the 1980s it monitored U.S. economic, legal, and social issues through its Council for Better Corporate Citizenship (CBCC). In 1989 the CBCC expanded its ambit to include monitoring of corporate governance issues in the United States, such as "the influence of public pension funds and other institutional investors." CBCC wanted to know how the funds made investment decisions, how they viewed the role of directors,

⁴⁷ Interview with Marc Goldstein, March 19, 2005; Interview with Ariyoshi Okumura, March 15, 2005; Interview with Kuny Kobayaschi, March 17, 2005; Sakai interview; Crist interview.

⁴⁸ Chris, *The Japan Turnaround is Real*, Capital Guardian Trust Company, 2005; *Less Japanese Companies Use Governance Loophole*, op. cit.

⁴⁹ *CalPERS Puts Off Tokyo Office Opening*, JIJI PRESS TICKER SERVICE, April 13, 1994; CALPERS, WHY CORPORATE GOVERNANCE TODAY? A POLICY STATEMENT, Aug. 14, 1995, pt. 3 at 4.

and what were their expectations for Japanese companies, especially with regard to conflict between shareholders and other stakeholders. It led a study mission to the United States in 1993 seeking answers to these questions.⁵⁰

That same year, CBCC invited 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." In the ensuing years, Keidanren would prove to be an agile and ardent opponent of changes 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."⁵¹

Crist reminded his audience that CalPERS was not a speculative investor but instead was interested in long-term returns. He reassured the Keidanren that CalPERS' leaders "are not crusaders -- we do not want to make over countries' corporate structure." Then, however, Crist laid out a detailed proposal for changing Japanese corporate governance that was based on the CalPERS program in the United States. He justified the parallels by claiming 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 cash to shareholders.
3. Financial disclosure: Adoption of a consolidated accounting system and adherence to the new independent auditor rule.
4. Investor relations: Create investor relations (IR) departments with high-caliber personnel reporting to the president and relaying detailed financial information to investors.
5. Proxy voting: Spread out shareholder meetings and give investors more time to read and vote proxies.

Crist cited no evidence that any of these changes would improve shareholder value, although he did mention the Wilshire Associates study showing a relationship between share price and CalPERS activism. With respect to Japan, he criticized the fact

⁵⁰ Council for Better Corporate Citizenship, Purpose of the CBCC Study Mission, Sept. 22, 1993; Crist interview.

⁵¹ Ibid.

that stable domestic shareholders received deference from senior management while foreigners and other minority shareholders were given “only cursory consideration.”⁵²

After his speech, Crist and others visited companies in the Tokyo and Osaka regions. The visits were arranged by Lufkin and Viner, and, in later years, 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 local law firms to represent its interests at corporate meetings. Sometimes CalPERS asked one of its Japan investment managers to visit a company on its behalf.⁵³

In the early days, circa 1993 to 1995, a typical company visit would be preceded by letters and phone calls requesting to see the company’s president (*shacho*). But except in a few rare instances, the requests were declined. CalPERS would be told that the company only recognized registered shareholders and that it had no record of CalPERS’ 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. At best, the CalPERS officials met with a relatively insignificant managing director for overseas issues. Over time, however, Japanese corporations grew more receptive to these visits. By the late 1990s, IR departments were becoming ubiquitous. Companies even began to send their own delegations to Sacramento to meet with CalPERS officials, some on a regular basis.⁵⁴

The meetings were uncomfortable. The discussion included touchy topics such as board structure and return of cash to shareholders. 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 its discussions 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

⁵² William D. Crist, CalPERS Experiences in Corporate Governance and Suggestions for Improvement in Japanese Corporate Governance and Investor Relations, Tokyo, May 10, 1993. typescript.

⁵³ Crist interview; Lufkin to author, Aug. 3, 2006.

⁵⁴ SIMON LEARMOUNT, CORPORATE GOVERNANCE: WHAT CAN BE LEARNED FROM JAPAN? 64 (2002); Sakai, Crist, and Kobayashi interviews.

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 continued to advocate governance changes 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.”⁵⁵

According to Sakai, the shift from financial to governance topics meant “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.”). Its company visits in Japan were never publicized nor did CalPERS publish target lists or sponsor shareholder proposals. Crist cites Sony as an example of a company that listened to CalPERS and made necessary changes. “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.”⁵⁶

As in the United States, CalPERS selected companies to visit based on stock performance and its calculations of EVA. Developed by Stern Stewart, an investment advisor, EVA is supposed to give a better indication of shareholder value creation than traditional accounting measures. EVA looks at returns received by investors relative to what investors could receive for an equally risky investment.⁵⁷ Despite the hype from Stern Stewart about EVA, the data on actual market values do not support the claim that EVA is a superior measure of value creation. 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,

⁵⁵ Viner in Sterngold, *Japanese Companies Rebuff*; Crist and Sakai interviews.

⁵⁶ John Tagliabue, *Compliments of U.S. Investors: New Activism Shakes Europe’s Markets*, N.Y. TIMES April 25, 1998, at D1; Kayla J. Gillan, Voting for Value: What Are American Shareholders Looking For?”, Speech to Pension Investment Research Consultants, London, March 26, 1997 at <http://www.CalPERS-governance.org/viewpoint/speeches/gillan3.asp>; Crist and Sakai interviews.

⁵⁷ Kenneth Lehn and Anil Makhija, *EVA and MVA as Performance Measures and Signals for Strategic Change*, 24 STRATEGY & LEADERSHIP 34 (1996); Crist and Sakai interviews; *Xerox Included in CalPERS’ Hit List for Bad Governance*, FINANCIAL TIMES, March 28, 2003 at 17.

and buy back shares. That is, firms using EVA are basing strategic decisions not on what is in the best long-term interests of the enterprise but on actions that will serve to boost the EVA performance metric. To the extent that Japanese companies conformed to the EVA standard, it may have provided a subtle nudge to favor “shareholder value.” This could be an explanation for the association of foreign ownership with asset sales.⁵⁸

CalPERS continued to pour money into Japan during the mid-1990s. The value of its equity investments expanded from \$3.7 billion in 1992 to \$5.6 billion in 1996. 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.” 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.⁵⁹

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 overseas pension funds. 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 head of the Tokyo Stock Exchange wrote “Foreign Investors Give a High Impact to Tokyo Stock Exchange.” The magazine also ran articles authored by people directly affiliated with CalPERS, such as Joseph Lufkin, “The U.S. Institutional Investors Have Launched Corporate Governance in Earnest,” William Crist, “The U.S. and Japan Have Created a New Communication Tool in

⁵⁸ Pablo Fernandez, EVA, Economic Profit, and Cash Value Added Do NOT Measure Shareholder Value Creation,” Research Paper 453, IESE, Barcelona (January 2002); Christina L. Ahmadjian and Gregory Robbins, *A Clash of Capitalisms: Foreign Shareholders and Corporate Restructuring in 1990s Japan*, 70 AMERICAN SOCIOLOGICAL REVIEW 451 (2005).

⁵⁹ Crist interview; Alexander Dyck and Luigi Zingales, The Corporate Governance Role of the Media, NBER working paper 9309 (2002).

Investment,” and Robert Carlson, “An Award Like the Deming for the Best Corporate Governance Practice.”⁶⁰

III. Local Partners

As CalPERS boosted its allocation for overseas equities, it redoubled efforts to internationalize its governance programs. In June 1995, James Burton, the CEO of CalPERS, told the International Monetary Conference that CalPERS was planning to launch overseas governance campaigns in Europe and Japan. Just as Crist and other officials made “sunshine” trips to Japan, so too did they visit Europe 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 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, however.⁶¹

CalPERS conducted an in-house study of how it could best bring the shareholder-primacy 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.” Nevertheless, in March 1996 the CalPERS board voted to develop a governance program focusing on Britain, France, Germany, and Japan. The program had four parts: specifying principles for each market; participation in local governance debates; outreach to local media, governments, and academics; and sharing strategy with potential allies.⁶²

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

⁶⁰ Back issues of *M&A Review* courtesy of Raita Sakai.

⁶¹ *CalPERS to Track Foreign Groups*, FINANCIAL TIMES, June 8, 1995, at 27; *CalPERS Reassures City Over Tactics*, FINANCIAL TIMES, Oct. 12, 1995, at 22; *U.S. Investors May Target Poor Performers*, FINANCIAL TIMES, March 29, 1997; Holly Gregory, International Comparison of Selected Corporate Governance Guidelines and Codes of Best Practice, Weil, Gotshal, and Manges, New York (Feb. 2005).

⁶² *CalPERS Adopts International Governance Program*, DAILY YOMIURI, March 20, 1996, at 9; CalPERS, CalPERS Adopts International Corporate Governance Program, press release, March 18, 1996.

partners would give CalPERS legitimacy in markets hostile to foreign interference while helping to adapt its message to diverse national 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.” But who could serve as CalPERS’ partner in Japan? Institutional investors such as insurance companies were not a likely prospect; one Japanese insurance executive said of CalPERS, “They are way ahead of us.” As for public pension funds, they still operated under strict government control. Having a local partner in Japan was considered more important than in Europe because the CalPERS program was radically at variance with Japanese practice. As Bob Boldt, CalPERS’ CFO at the time, explained, “In Japan . . . the image of CalPERS is totally blown out of proportion, so we get a better effect with a local entity doing it.”⁶³

Corporate Governance Forum: 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, whose service on the board of General Electric impressed him with the need for governance change in Japan. Okumura, too, was a regular visitor to the United States, including trips to CalPERS. Okumura ran IBJ’s asset management division and went to Sacramento to solicit CalPERS’ 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.

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, a corporate upstart. The other members were an attorney, Hideaki Kubori, and editorial writers from two large newspapers, Nikkei Shinbun and Asahi Shinbun. From early on, CGFJ was a publicity-savvy organization. As Okumura observed, “Mass-media should be

⁶³ Ibid.; James Sailer and Katharina Pick, *California PERS (B)*, Harvard Business School case (Feb. 5, 2001), 11.

more alert to persuade the public opinion that corporate governance is important to rejuvenate Japanese corporations, not to blindly import an American-made concept.”⁶⁴

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, provide information to stakeholders, and be accountable for its actions to all stakeholders but particularly to shareholders.

Beyond that, the principles say nothing more about stakeholders. The focus is on disclosure to shareholders and on 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 meetings for major shareholders. Regarding monitoring, it urges the inclusion of independent directors (short term) until boards are comprised of a majority of independents (medium term). The principles call for a reduction in board size and separation of the CEO and chairman positions. Boards should include an auditing committee comprised entirely of independent directors (medium term) and more than one independent auditor (short term). The 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.⁶⁵

⁶⁴ Okumura interview; Corporate Governance Forum of Japan, Corporate Governance Principles: A Japanese View, Interim Report, Oct. 30, 1997; Ariyoshi Okumura, Japan’s Corporate Governance Overview: ‘Perception Gaps?’, presentation to the Japan Financial Services Agency, Nov. 18, 2003, 5.

⁶⁵ Takeshi Inagami, *From Industrial Relations to Investor Relations? Persistence and Change in Japanese Corporate Governance, Employment Practices, and Industrial Relations* 4 SOCIAL SCIENCE JAPAN JOURNAL 225, 229 (2001).

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 the progressive business group Keizai 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 for meetings with major shareholders, a particular concern of CalPERS rather than Japanese investors.⁶⁶

Four months after publication of the CGFJ document, 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 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 changing 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. Included, however, were two provisions not mentioned by the CGFJ: an 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, including the Liberal Democratic Party (LDP), Keidanren, and Nikkeiren, the employers' federation. Coming at a time when Japan was being rocked by bankruptcies of major banks (Hokkaido Takushoku) and

⁶⁶ Okumura, Sakai, and Crist interviews.

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."⁶⁷

Crist introduced CGFJ to the institutional investing world through the International Corporate Governance Network (ICGN). The ICGN's origins go back to the early 1990s, when Crist, Robert Monks, and other activists discussed the creation of an international analogue to the CII, one that would coordinate and legitimate activities of institutional investors around the world. Crist and Koppes from CalPERS and other heavyweights from elsewhere in the institutional investing world met at the CII in 1994 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 public 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.⁶⁸

The ICGN's membership was broad, including not only pension funds but also union representatives and financial companies. When it issued its own 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

⁶⁷ CalPERS, Japan Market Principles (March 1998); CalPERS, CalPERS Adopts Corporate Governance Practices for Japan, press release, March 18, 1998; *CalPERS Proposes Corporate Governance Principles for Japan*, JIJI PRESS SERVICE, March 17, 1998.

⁶⁸ ICGN. Statement on Global Corporate Governance Principles, July 9, 1999; Koppes memo to CalPERS Board, August 1995, quoted in Mary E. Kissane, *Global Gadflies: Applications and Implications of U.S.-Style Corporate Governance Abroad*, 17 N.Y. LAW SCHOOL JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW 621, 637 (1997); Crist and Okumura interviews; CalPERS, Wall Street Walk Being Replaced with Wall Street Talk, press release, July 9, 1998.

ICGN language into its own Global Principles, it omitted any mention of stakeholders in its country-specific principles for Germany, Japan, the U.K. and the U.S. 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 prevalent.⁶⁹

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 call for a corporate rating system to improve governance in Japan. 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 Tateisi 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 change 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.⁷⁰

Perhaps Tateisi 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-primacy model that CalPERS was promoting in Japan. Okuda stressed the social dimension of corporate activity in Japan. Any approach to corporate governance that failed to take this into

⁶⁹ ICGN, Statement on Global Corporate Governance Principles.

⁷⁰ Okumura, Japan’s Corporate Governance Overview, 5; *ICGN Conference Highlights Growing Awareness of Need to Improve Governance in Japan*, IRRC CORPORATE GOVERNANCE BULLETIN (Oct. 2001); Nikkeiren International Special Committee report (1998) quoted in Inagami, *From Industrial Relations to Investor Relations*, 229.

account, he said, “could cause major problems.” The commitment of Japanese companies to stakeholders, he said, “is in our DNA.” While acknowledging the importance of holding managers to account, Okuda said that 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 hand over more of its cash, Okuda said, “We prefer to aggressively promote R&D. We aren’t ignoring ROE but we must balance it with R&D.”⁷¹

Bill Crist was dumbfounded to hear Okuda express “almost identical” words to those expressed by the Keidanren in 1993. The speech marked the beginning of the end of CalPERS’ hopes that the CGFJ would be a vehicle for governance change in Japan. Crist believes that the Keidanren had decided to use the Tokyo conference to publicize its views through Tateisi, 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 director liability and to quash rules facilitating appointment of independent directors. Meanwhile the Japanese trade union federation, RENGO, was lobbying to preserve the stakeholder system, including a proposal to have employee representatives on audit committees.⁷²

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 fell out of favor 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’ 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’s 1997 statement] was printed and published and sent all over the world, they

⁷¹ *The \$10 Trillion Question*, at <http://www.irmag.com/newsarticle.asp?articleID=1461>; Nicholas Benes, *The Keidanren Circles the Wagons*, ASIAN WALL STREET JOURNAL, July 20-22, 2001; PETER A. GOUREVITCH AND JAMES SHINN, POLITICAL POWER & CORPORATE CONTROL 173-74 (2005); Fujikazu Suzuki, *Corporate Governance Reform and Industrial Democracy in Japan*, 2 JAPAN LABOR REVIEW 83, 97 (2005). Tateisi also was Japan’s representative on the advisory committee helping to write the OECD’s governance guidelines.

⁷² Crist interview; Benes, *The Keidanren Circles*; Motomi Hashimoto, Commercial Code Revisions: Promoting the Evolution of Japanese Companies, Nomura Research Institute paper, no. 48, May 1, 2002.

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 it was "useless" as an instrument of transformation. Who, then, would help CalPERS bring change to Japan? Perhaps it would be those "crazy guys" at the Pension Fund Association.⁷³

Pension Fund Association: The Japanese pension fund system includes first-tier old-age insurance and a second tier of employer-provided pension plans (DB as well as some DC plans since 2001). At one time strict regulations controlled the investment of employer pension assets, most of which were (and are) managed by trust banks and insurance companies. The largest fund in Japan is the Pension Fund Association for Local Government Officials (Chikoren), with well over \$100 billion in assets. Another big 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 and has assets of close to \$100 billion.

The PFA was lost in obscurity for most of its history. Its investments were in the hands of asset managers who rarely challenged company managements. But the PFA began to change in the late 1990s as its unfunded liabilities rose and new leaders took over. It published a white paper on proxy voting in 1999 that called for an end to the taboo of voting against management at shareholder meetings. The following year a Health and Welfare advisory commission headed by Takaaki Wakasugi recommended that public pension funds like PFA hold their asset managers to fiduciary standards including active proxy voting and promotion of shareholder value.⁷⁴

The person in charge of pensions at the Health and Welfare ministry, Tomomi Yano, became managing director of the PFA around the time of Wakasugi's report. Yano

⁷³ Crist interview.

⁷⁴ Japan's Pension Fund Association Urges Funds to Vote Their Proxies, IRRC CORPORATE GOVERNANCE BULLETIN (Jan. 2002); Tak Wakasugi, *Government Pension Fund and Shareholder's Right* in 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 further recommended that the Government Pension Investment Fund be required to follow similar principles when investing its \$100 billion in equities. However, 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."

well knew the dire situation faced by Japan's pension funds. Due to slow population growth, the funds were projected to show widening deficits as the ratio of retired to active employees steadily crept up. Japan's stock-market woes also contributed to the problem. The PFA, for example, had a -10 percent return in 2001, its first loss ever. In 2002 and 2003, its returns were -4 percent and -12 percent respectively.⁷⁵

Knowing that he would be running the PFA for only a few years, Yano quickly created an aggressive program to raise PFA's portfolio returns through shareholder activism. Yano's model for transforming PFA was--and remains--CalPERS. The two funds have cooperated in various ways over the years. PFA representatives have visited Sacramento repeatedly 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 [like CalPERS]."⁷⁶

Yano's program broke new ground for Japanese pension funds. His first step was to introduce proxy voting guidelines for the PFA's asset managers in 2001. In keeping with Wakasugi's report, the guidelines required PFA's asset managers to designate staff responsible for proxy voting, vote according to principles--favoring shareholders over management if need be--and to report results back to the PFA. In 2002, Yano started to internally manage some of the PFA's domestic investments and he initiated proxy voting on its passively-invested portfolio.⁷⁷

The most dramatic change came in 2003, when PFA published its proxy principles. Receiving the most attention was PFA's plan to vote against renomination of, and retirement payments for, directors of companies that had not paid dividends for three years or that 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

⁷⁵ Sarah McClellan, Corporate Pension Change 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 (2004); Yukiko Katsumata, *The Relationship Between the Role of The Corporate Pension and the Public Pension Plan in Japan* in RETHINKING THE WELFARE STATE: THE POLITICAL ECONOMY OF PENSION CHANGE 56 (Martin Rein & Winifred Schmahl, eds., 2004).

⁷⁶ Crist interview; Interview with Tomomi Yano, March 16, 2005; *Hidden Giants: Past Bureaucrat Takes Pension Issues to Heart*, NIKKEI WEEKLY, Aug. 5, 2003.

⁷⁷ *Japan's Pension Fund Association Urges Funds*, op. cit.; Nicholas Benes, *Japan's Coming Shareholder Revolution*, ASIA WALL STREET JOURNAL, Feb. 14, 2001; Tomomi Yano, Corporate Governance Activities of Pension Fund Association, at http://www.usajapan.org/pdf/tyano_1104.ppt; Yano interview.

Hermes (CalPERS' 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 to nominate independents for at least one-third of the board seats. PFA met with 12 asset management companies that invested equities for PFA and told them to follow its principles. It also launched a campaign to publicize the principles to other Japanese institutional investors. Clearly, the Health and Welfare Ministry hopes that PFA can serve as a lightning rod for introducing more assertive and remunerative pension-fund management in Japan.⁷⁸

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-primacy ethos. Yano envisions the future creation of a broad coalition of pension funds in Japan. In the meantime, PFA is setting an example by voting against over 40 percent of all management proposals, including votes against non-independent directors and paying them bonuses. While this is a high rate of anti-management voting as compared to other Japanese pension funds, it is relatively modest as compared to U.S. funds like CalPERS and TIAA-CREF. In 2004, U.S. pension funds in Japan voted against director appointments at a 93 percent rate versus 49 percent for PFA, leading one to suspect that PFA's bite might be milder than its bark.⁷⁹

Since 2003, Yano has ramped up his activities beyond proxy voting. PFA invested \$100 million in a 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. On another front, the PFA in 2004 sent letters to around twenty underperforming companies, urging them to change their governance practices by reducing board size, adding independent directors, and firing incompetent directors. Subsequently, it held private discussions with a subgroup of these firms. Yano says that

⁷⁸ *Japan Pension Fund Puts Muscle Into Guidelines*, 31 PENSIONS & INVESTMENTS 11 (March 2003); *Hidden Giants*, op. cit.; *Can Japanese Fund Managers Emulate CalPERS?* NIKKEI WEEKLY, Sept. 18, 2003.

⁷⁹ Yano, Corporate Governance Activities, op. cit.; *Japan Pension Fund Groups Puts Muscle Into Guidelines*"; IRRC, unpublished voting data, June 2004, courtesy of Kuny Kobayaschi.

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 recapitulates lessons learned by (and from) CalPERS. Yet Yano laments the fact that CalPERS has better access to CEOs of Japanese companies than does the PFA.⁸⁰

Like Dale Hanson, Yano relishes 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 publicly excoriated one of PFA’s asset management companies for opposing Murakami. 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 that asset managers “claim they are ready to act, but in fact many of them are bound by conventional thinking.” To Yano, hostile takeovers potentially are a good thing and Japan needs more of them. However, while PFA has invested a small amount in overseas takeover funds, it has not yet done so in Japan. Yano was in the limelight in 2005 when the PFA filed a lawsuit against Seibu Railway seeking damages for losses suffered when Seibu Railway was delisted by the Tokyo Stock Exchange. (Seibu allegedly had falsified financial statements.) This is one of the first cases in which a Japanese pension fund has gone to court in search of damages. There are a couple of interesting facts about the PFA’s claim, however, which suggest that the PFA may have difficulty in creating a Japanese pension-fund alliance. First, Seibu was part of PFA’s indexed portfolio; PFA quietly 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.

⁸⁰ *Japanese Pension Fund Manager Pushes Accountability*, REUTERS ASIA, March 17, 2002; Yano interview.

One thing is certain, as the *Nikkei Weekly* observed, “the court’s decision is certain to garner attention,” which would suit Yano’s purposes.⁸¹

It makes sense that the PFA has become CalPERS’ favorite partner in Japan. Both are public pension funds; both are aggressive with 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 the PFA is “not inside” the business system. Since leaving CalPERS, Crist has put 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’ corporate governance programs, explained the fund’s relationship with PFA. CalPERS was best suited to a “macro” approach to governance change 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 Japanese companies. But, said White, “this type of tool can readily be mimicked by foreign players such as the PFA.” 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 seeks, 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.⁸²

CalPERS also has a relationship with Chikoren, the giant pension fund for local government officials. It sponsored several visits by Chikoren officials to Sacramento, where Crist and others urged cooperation in the pursuit of governance change in Japan. In 2001, a delegation of Chikoren officials attended a CalPERS board meeting, learned

⁸¹ *Institutions Threaten Corporate Governance*, NIKKEI WEEKLY, July 22, 2002); Yano interview; *Pension Association Sues Seibu Railway, and Association Shares Blame for Investment Failure*. NIKKEI WEEKLY, July 19, 2005, at 3.

⁸² Crist and Okumura interviews; Ted White, *A Foreign Perspective*, in CORPORATE GOVERNANCE IN THE NEW JAPAN, op. cit., 23.

about CalPERS' governance programs, and met with U.S.-based asset managers. (Chikoren started to invest in U.S. equities in 2001.) The following year Chikoren directly exercised its proxy voting rights rather than going through its asset managers, something CalPERS had encouraged and which PFA started doing the same year. In 2003, Chikoren publicly excoriated Matsushita for having an insider board because this was "against mainstream thinking." More recently, Chikoren has voted to oppose poison-pill plans instituted without shareholder approval. Chikoren says that it "looks to CalPERS as its role model because of the latter's activism as a shareholder." Chikoren is part of the Council of Public Institutional Investors that was launched in 2002 as a way for public pension funds to discuss issues of mutual interest, including governance change. Members include the PFA, the Government Pension Investment Fund, and several others. Thus far, however, the Council has resisted requests that they coordinate their proxy votes, as CalPERS does with CII. Says Yano, "In Japan, other pension funds are very conservative and too careful."⁸³

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, attended the conference and explained CalPERS' investing philosophy and its methods of portfolio management. Heretofore, most corporate pension plans have let trust banks and insurance companies manage their assets 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 in which they invested. Recently, however, some asset managers have become more assertive. For example, Nippon Life opposed Seiyu's acquisition by Wal-Mart in 2002. Later it demanded that Hitachi move ahead with its

⁸³ Pension Fund Association for Local Government Officials, Visit to Sacramento, May 16, 2001; Crist interview; *Disclosure: Firms Called on to Satisfy Activist Shareholders*, NIKKEI WEEKLY, June 13, 2003 at 4; *Global M&A Wave Heading for Japan*, NIKKEI WEEKLY, March 22, 2004 at 3; Jerry Borrell, How to Play Chikoren, VENTURE CAPITAL JOURNAL, June 1, 2003; *Big Players: Top Japanese Public Funds Discuss Future with Tokyo Stock Exchange*, PENSIONS & INVESTMENTS, Oct. 14, 2002 at 14; John Taylor, Japanese Investors Step Up Activism, ISS, July 6, 2006; Yano interview.

plan to buy back shares and threatened to oppose the company at the general meeting unless it raised its payout rate.⁸⁴

Thus it may turn out that the most effective proponents of governance change in Japan will be, as in the United States, domestic institutional investors. How present trends unfold will depend on the number of funds imitating 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 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, 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."⁸⁵

IV. Withdrawal

CalPERS' activities in Japan have declined markedly since 2002: no new governance initiatives, few visits by CalPERS officials, and near-invisibility in the Japanese media and business forums. 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' overseas 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 investments. Bill Crist's retirement from the board was significant in that

⁸⁴ MULTILATERAL INVESTMENT DEVELOPMENT CORPORATION, JAPAN PENSION FUND RESEARCH CONFERENCE, May 2003; KESTER, JAPANESE TAKEOVERS, 214; *Can Japanese Fund Managers Emulate CalPERS?*, op. cit.

⁸⁵ Goldstein and Kobayaschi interviews; Darrel Whitten, *Comply or Explain: Japan's Shareholders Speak Up*, 34 MONEYWATCH: WEEKLY FINANCIAL COMMENTARY FROM TOKYO 1 (2003).

Crist had a stronger commitment to governance change in Japan than his successor, Sean Harrigan, a former official of the retail workers' union. Harrigan was interested in domestic policy issues, especially those in which shareholder activism and labor-movement interests coincide. Under Harrigan, CalPERS became a vocal critic of U.S. executive compensation levels. 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, allegedly at the behest of Governor Schwarzenegger, Harrigan lost his job. His successor, Rob Fechner, has as yet shown little interest in overseas investments. Few CalPERS officials other than Ted White have visited Japan in the past three years and White moved from CalPERS to the CII 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.⁸⁶

Another factor is this: By 2003, CalPERS faced diminishing returns to its "macro" approach of promoting the shareholder-primacy model. Ten years after Crist made his speech to the Keidanren, the governance principles 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, known in Japan as the "American system," gives companies the choice 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. At the "micro" level of firm-by-firm monitoring, CalPERS experienced 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, it faced a free-rider problem in 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

⁸⁶ *Staff Slammed: CalPERS Blasts International Equity Search*, PENSIONS & INVESTMENTS, Oct. 30, 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, Dec. 2, 2004, at 1; CalPERS data as of October 31, 2005, courtesy of Mary Cottrill.

effort on behalf of monitoring portfolio companies, when someone else will do it for you without cost to yourself?”,⁸⁷

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. This was the logic behind Monks’ 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 relational funds are successful, their substantial returns allow big pension funds like CalPERS to “beat the index.” This, in turn, reduces the incentive to pursue macro governance change, which may explain why CalPERS’ public activism has declined as its stake in relational funds has grown.⁸⁸

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 portion of these funds was intended for overseas markets, chiefly 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.⁸⁹

The Sparx fund was started by Shuhei Abe, a former Nomura analyst and admirer of Warren Buffett. The fund that Abe manages for CalPERS invests in undervalued

⁸⁷ Hashimoto, *Commercial Code Revisions*; Andrew M. Clearfield, “With Friends Like These, Who Needs Enemies? The Structure of the Investment Industry and Its Reluctance to Exercise Governance Oversight

13 CORPORATE GOVERNANCE 117 (2005).

⁸⁸ MICHAEL E. PORTER, CAPITAL CHOICES: CHANGING THE WAY AMERICA INVESTS IN INDUSTRY (1992); Robert A.G. Monks, Relationship Investing (1993) at <http://www.lens-library.com/info/column.html>.

⁸⁹ CalPERS press release, CalPERS Turns Up Corporate Governance Heat, Nov. 15, 2001); *Biggest Pension Fund Spies an Opportunity in Japan’s Ailing Economy*, FINANCIAL TIMES, Sept. 24, 2002, at 27; *External Forces Take Aim at Governance*, NIKKEI WEEKLY, Nov. 25, 2002. The other investors were “related” to CalPERS: Relational Investors (10 percent) and Sparx (70 percent).

companies with a market capitalization of between \$300 million and \$3 billion. Abe and his analysts select the companies and then “influence” their managements to restructure operations and raise shareholder 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 CEOs comes from the fact that his fund is concentrated in five companies and takes large stakes in them. Again, Abe’s opinion of CEOs in Japan is 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.”⁹⁰

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 attempted at Tokyo Style. Abe’s time horizon is shaped by the fact that the fund will exist for ten years. 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’ investments in Japan remain long-term, passive holdings.⁹¹

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

⁹⁰ *Sparx to Bolster Ties with CalPERS, Offer Stock Options*, NIKKEI WEEKLY, Jan. 23, 2003; CalPERS, Hybrid Investments Monitoring Report: Sparx Asset Management, Fourth Quarter 2004, at <http://www.CalPERS.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200503/item05-02.pdf>; SPARX Founder Shuhei Abe on Why He’s Bullish On Corporate Japan, Oct. 1, 2003, Japan Society, New York at http://www.japansociety.org/corporate/event_corp_note.cfm?id_note=191080341; James DiBiasio, *Japan Fund Weighs Aggressive Governance*, FINANCEASIA.COM, Jan. 8, 2004; Shuhei Abe, *How External Investors Influence Corporate Governance*, CORPORATE GOVERNANCE IN THE NEW JAPAN, 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 the fund but has not been invited to join. Yano interview.

⁹¹ Crist, Sakai, and Kobayaschi interviews.

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 missionary who later worked for Citibank in Japan. CalPERS signed a deal with Taiyo in 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 shareholder value. The fear of hostile takeovers is genuine. In 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 that it can help them avoid the clutches of raiders like Steel Partners by working cooperatively with them to boost shareholder value. Agreeing to partner with Taiyo doesn't mean that a company has accepted shareholder-primacy 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'." ⁹²

Once Taiyo takes a stake in 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. Nifco had diversified into a variety of unrelated businesses including ballpoint pens, Australian real estate, and media properties (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 English to explain that its divestments were not willy-nilly but 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 were intended to attract foreign

⁹² Milhaupt, *In the Shadow of Delaware; Trade Ministry Mulls Giving Companies More Options for Fending Off Takeover Bids*, NIKKEI WEEKLY, Sept. 13, 2004, at 1; *Japan Fund Drives at Governance Change*, FINANCIAL TIMES, July 19, 2004, at 23.

investors, the one group that has consistently been buying Japanese equities in recent years. While Taiyo says it is not seeking a quick buck, its time horizon is far from the long-term touted 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 Taiyo as a "phoenix."⁹³

In addition to Sparx and Taiyo, CalPERS invests in "alternative" vehicles such as Japanese real estate trusts and 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' Japan holdings remain passive, its interest in securing good returns on its alternative investments inevitably has skewed CalPERS' 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 require firms in which they invest to adhere to the CalPERS governance principles. Neither are they seeking to affect economy-wide governance practice. This is of little concern to Heywood, who says, "We don't need to change the whole market."⁹⁴

V. The Consequences of CalPERS

Over the past fifteen years, CalPERS sedulously sought to change Japanese law and public opinion. It regularly appeared in the media while working closely with domestic norm entrepreneurs such as the JCGF and the PFA and indirectly with government ministries such as METI and HLW. The result of its labors are the various commercial code revisions consistent with positions originally espoused by CalPERS. They include provisions for online proxy voting, proxy access for major shareholders,

⁹³ Turnarounds are Drawing Foreign Prospectors to Japan, N.Y. TIMES, June 4, 2003, at W1; Japan Fund Drives at Governance Change, FINANCIAL TIMES, July 19, 2004, at 23; U.S. Players Get Involved, NIKKEI WEEKLY, Aug. 1, 2004, at 1; Paul Wiseman, Funds Bring American Ideas to Japanese Business, USA TODAY, Aug. 10, 2004, at D1; W.L. Ross Introduces Change Through Private Equity Investments, JETRO: INVESTING IN JAPAN, April 2002. 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 underfunded pension plans and shift costs to Medicare and the Pension Benefit Guarantee Corporation. He also has joined with unions in demanding that the government erect stronger tariff barriers against manufactured imports. Ross, UNITE Climb Aboard Anti-Textiles Coalition, HOME FURNISHING NEWS, Sept. 8, 2003; Melting Away Steel's Costs, BUSINESS WEEK, Nov. 8, 2004 at 48; The Benefits Trap, BUSINESS WEEK, July 19, 2004, at 64; Is Wilbur Ross Crazy? BUSINESS WEEK, Dec. 22, 2003, at 74.

⁹⁴ CalPERS to Invest \$200 Million in Japan Turnaround Fund, N.Y. TIMES, April 14, 2003, C7; Heywood quoted in Japan Fund Drives at 23; Joncarlo Mark to author, Dec. 27, 2005. Other public pension funds recently have followed CalPERS' lead and boosted their target allocations for alternative investments such as private equity, hedge funds, and real estate. Hopped Up on Hedge Funds, BUSINESS WEEK, Sept. 25, 2006.

stock options, share repurchases, independent board subcommittees, and acquisitions by foreign companies. However, it's difficult to assess the extent to which CalPERS was a catalyst for legal reforms or whether government officials used pressure from CalPERS as a justification to adopt them, an old tactic in Japan known as *gaiatsu*. As noted, some officials saw governance change as a fiscally neutral way to jump-start the Japanese economy; others, such as the economists working at METI, were keen to achieve the efficiency gains they attributed to shareholder primacy. The Ministry of Foreign Affairs hoped that commercial code changes would reduce economic friction between the U.S. and Japan. The United States government repeatedly has pressured Japan to Americanize its governance system, starting in 1989 with the Structural Impediments Initiative talks, which have continued since then. The SII's most recent incarnation is the Bush-Koizumi "Investment Initiative," whose objective is to facilitate FDI in Japan, including foreign acquisitions.⁹⁵

Limiting CalPERS' effectiveness at the macro level was opposition to its shareholder-primacy concepts from business groups like the Keidanren and from organized labor. Keidanren tried to preserve internal boards, to maintain cross-holdings as barriers to hostile acquisitions, and to keep TSE listing standards free of mandatory criteria. Hence many of the commercial code revisions have been permissive rather than mandatory. Also, the revisions lack 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 changes. In recent years, it has urged Japanese companies to improve auditing, control, and disclosure practices. These changes are relatively easy to graft onto existing governance structures.⁹⁶

CalPERS has more sway in the United States, where it need not worry about an "ugly American" image and so is able to use a panoply of influence tactics. It also has

⁹⁵ U.S. DEPARTMENT OF STATE, U.S.-JAPAN ECONOMIC PARTNERSHIP FOR GROWTH: U.S.-JAPAN INVESTMENT INITIATIVE REPORT 2006 at <http://www.state.gov/p/eap/rls/rpt/68428.htm>.

⁹⁶ DORE, STOCK MARKET CAPITALISM, 94; Crist interview; Hugh Patrick, Evolving Corporate Governance in Japan, Center on Japanese Economy and Business, Columbia University (2004), 26; KEIDANREN, A PROPOSAL FOR BETTER CORPORATE ACCOUNTING (2001). Keidanren has accepted proposals that benefit incumbent managers, however, such as stock options.

more power in emerging nations that depend heavily on foreign capital. CalPERS carefully rates countries on factors such as corporate governance, political stability, and openness. It consistently reminds countries--and their leaders--that adherence to international governance standards (i.e., shareholder primacy) will make them more attractive to international investors. CalPERS' officials made the same argument on several occasions in Japan. The difference, however, is that while Japan welcomes foreign investors, it hardly suffers from capital scarcity.⁹⁷

At the micro level CalPERS had greater leeway to exert pressure in Japan, 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 leverage its clout, sought alliances with other institutional investors. 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. Nevertheless, according to Crist, company-based efforts by CalPERS bore financial fruit in several instances, although he refuses to discuss specifics.⁹⁸

Crist's claim fits with research showing an association between foreign ownership and restructuring via asset divestments in Japanese companies (and with evidence from showing the same relationship for U.S. companies targeted by CalPERS). Foreign ownership of Japanese companies also is associated with a propensity to downsize. The problem is, we don't know if foreign owners actually cause these changes or if they are the result of foreigners buying shares in companies that are likely to take these steps or have already begun to do so. Given the high turnover of foreign holdings, it seems plausible that foreign capital would seek investments where the probability of shareholder-friendly change is high. We know that foreign investors tend to purchase shares in large export-oriented companies, whose size and complexity offer the greatest opportunities for downsizing and restructuring. Also, export-oriented Japanese companies

⁹⁷ Tessa Hebb and Dariusz Wojcik, *Global Standards and Emerging Markets: The Institutional Investment Value Chain and CalPERS' Investment Strategy*, School of Geography and the Environment, University of Oxford (2003). In 1993 Crist predicted that Japanese corporations would pay more attention to shareholder value as their need for capital "forces them to woo foreign sources of capital." CalPERS made a similar argument when it released its 1998 Japan principles. Crist, CalPERS Experiences 9; CalPERS press release, *CalPERS Adopts Corporate Governance Practices for Japan*, March 18, 1998.

⁹⁸ See note 27, *supra*; Crist interview.

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 Japanese companies are induced to adopt U.S.-style corporate governance. Hence it is the listing requirements, rather than foreign ownership per se, that causes change. Nevertheless, if any foreign investor was able to affect strategic decisions at Japanese companies, CalPERS was the most likely candidate.⁹⁹

To what extent have Japanese companies adopted the CalPERS model of governance? To answer, 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 part is disclosure, which includes accounting standards, publishing reports and disseminating information, meeting with analysts, creating IR departments, and so forth. This is also the area where statutory reforms--such as consolidated accounting, fair-value accounting, and disclosure of takeover defenses and internal controls--have been mandatory instead of 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. Research shows that there is a statistically significant relationship between foreign ownership and adoption of governance changes related to disclosure.¹⁰⁰

⁹⁹ Hideaki Miyajima, *The Performance Effects and Determinants of Corporate Governance Change in Japan* in CORPORATE GOVERNANCE IN JAPAN (Masahiko Aoki et al., eds., forthcoming 2007)); Ahmadjian and Robbins, *A Clash of Capitalisms*, 451; 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 757 (2002). A recent study finds that domestic financial ownership is positively associated with Japanese 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, Economic and Social Research Institute, Cabinet Office, Tokyo (2005). Regarding the possibility that institutional investors purchase companies that are about to make significant changes, note that many U.S. 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. Similarly Japanese stock prices do not fluctuate promptly around the date of a downsizing announcement, which again suggests that information has been leaked ahead of the event. Nelson, *The 'CalPERS Effect'*, 187-213; Noriko Tanaka and Fumio Ohtake, *Impact of Labor Shedding on Stock Prices*, JAPAN LABOR BULLETIN, January 1, 2003, at 6.

¹⁰⁰ Miyajima, *Performance Effects*; Yoshifumi Nakata and Ryoji Takehiro, *Joint Accounting System and Human Resource Management by Company Group*, JAPAN LABOR BULLETIN, October 1, 2001.

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 numbers reflect the fact that nearly two-thirds of publicly-traded companies have no independent 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 (the *Jomukai*) and a larger group that discusses (and often 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 U.S.-style 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 related types of equity-based compensation are less important than in the United States.¹⁰¹

Shareholder rights have strengthened since the late 1980s. Change *de jure* has been modest partly because Japanese law regarding shareholder rights was always relatively good and in conformance with global standards. The big changes have come in practice. There are more votes against management at shareholder meetings 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

¹⁰¹ Miyajima, *Performance Effects*, app. 1; Seiki Takaya, Towards the Establishment of a New Shareholder-Corporate Relationship in Japan, RIETI working paper, Oct. 29, 2003; Masaru Hayakawa, "Business of Commercial Law and Change of Corporate Governance," working paper, Law School, Doshisha University (2004) and communication to author; *More Firms Tap Outside Directors*, NIKKEI WEEKLY, Sept. 13, 2004; Abe and Shimizutani, Employment Policy and Corporate Governance,; TOWERS, PERRIN, EQUITY INCENTIVES AROUND THE WORLD, 6 (2005) and TOWER PERRIN, WORLDWIDE TOTAL REMUNERATION 24 (2006), 24; Konari Uchida, *Determinants of Stock Option Use by Japanese Companies*, REVIEW OF FINANCIAL ECONOMICS (forthcoming, 2007); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options*, 69 UNIVERSITY OF CHICAGO LAW REVIEW 847 (2002). Note that the large Japanese board has a rationale: it is a way to coordinate and motivate divisional managers by permitting their participation in strategic decisions. General Motors used the same approach, successfully, until it moved to the textbook M-form (centralization and strict financial controls), after which its performance faltered. ROBERT F. FREELAND, THE STRUGGLE FOR CONTROL OF THE MODERN CORPORATION: ORGANIZATIONAL CHANGE AT GENERAL MOTORS, 1924-1970 (2000).

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 for shareholder approval their income allocation proposals governing buybacks and dividend changes. 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.¹⁰²

The fourth element in the CalPERS model was removing barriers to managerial entrenchment so that a market for corporate control could flourish. Without doubt, 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 involved domestic “bad boys” like Murakami and Takafumi Horie of Livedoor, who tried to take over Fuji Television (albeit with funding from Lehman Brothers). As noted, Japanese managers are afraid of what may lie ahead. Shares held by financial institutions and corporations have fallen steadily since 1990, while foreign ownership has crept upwards steadily.¹⁰³

However, 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. The government recently revised the commercial code to permit foreign firms to use their own stock (or a local subsidiary’s) to acquire Japanese firms, effective May 2007. Concerned that

¹⁰² KESTER, JAPANESE TAKEOVERS, 97; Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 JOURNAL OF LEGAL STUDIES 351 (2001); Kenji Utsumi, *The Business Judgment Rule and Shareholder Derivative Suits in Japan*, 14 NEW YORK INTERNATIONAL LAW REVIEW 124 (2001); Miyajima, *Performance Effects*, app. 1; Goldstein interview.

¹⁰³ So ‘Takeover’ Does Translate, BUSINESS WEEK, Feb. 9, 2004, at 51; TSE FACT BOOK, 60; JACOBY, EMBEDDED CORPORATION, 73; Hideaki Miyajima and Fumiaki Kuroki, *The Unwinding of Cross-Shareholding: Causes, Effects, and Implications in CORPORATE GOVERNANCE IN JAPAN* (Masahiko Aoki et al., eds., forthcoming 2007); Dai Higashino, *Corporate Restructuring Pick Up Steam*, 9 JETRO JAPAN ECONOMIC MONTHLY 1 (2004).

Japanese companies are undervalued and lack adequate takeover defenses, the government included provisions for firms to issue special class shares, golden shares, and related poison pills. In anticipation of 2007, most Japanese companies are erecting defenses such as expanded cross-holding, issuance of new shares, and early warning provisions.¹⁰⁴

Next, we may ask, what are the implications of the CalPERS model for corporate performance in Japan? Miyajima recently examined the relationship between performance and different types of governance change 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 show an association with performance.¹⁰⁵

Miyajima also considers anti-takeover practices in Japan, such as block holding by a parent corporation and cross-shareholding by banks and by corporations. He finds that the sole anti-takeover measure that is negatively associated with performance is shareholding by banks, which declined sharply in recent years. Similarly, in the U.S. and the U.K., anti-takeover measures do not have a consistent association with performance, contrary to the entrenchment thesis. Speaking conservatively, we can say that efficiency gains from takeovers and from low barriers to their occurrence are unproven.¹⁰⁶

In short, the most widely adopted governance reforms in Japan--to do with information and disclosure--are positively related to performance. Changes whose link to performance is weak or unproven-- in board structure, shareholder rights, and takeover barriers -- have been less extensive. Hence Keidanren was not far off the mark when it

¹⁰⁴ *Trade Ministry Mulls Giving Companies More Options for Fending off Takeover Bids*, NIKKEI WEEKLY, Sept. 13, 2004; *Shareholders' Meetings Reflect Huge Changes in Japan*, NIKKEI WEEKLY, June 27, 2005; D.H. Whittaker and M. Hayakawa, Contesting 'Corporate Value' through Takeover Bids in Japan, Doshisha University (2006); *Buyout Funds Targeting Japan to be Tested by Rate Hike*, NIKKEI WEEKLY, July 17, 2006, at 8.

¹⁰⁵ Miyajima, *Performance Effects*, table 4-10; Yoshiro Miwa and J. Mark Ramseyer, *Who Appoints Them? What Do They Do? Evidence on Outside Directors from Japan*, 14 JOURNAL OF ECONOMICS & MANAGEMENT STRATEGY 299 (2005). On another matter of concern to CalPERS -- cross shareholding -- the evidence shows a positive effect of concentrated ownership on profitability of Japanese companies. Eric Gedajlovic and Daniel M. Shapiro, *Ownership Structure and Firm Profitability in Japan*, 45 ACADEMY OF MANAGEMENT JOURNAL 565 (2002).

¹⁰⁶ Miyajima and Kuroki, *Unwinding of Cross-Shareholding*; Miyajima, *Performance Effects*, table 4; note 31, *supra*; Shleifer and Vishny, *Stock Market Driven Acquisitions*, *passim*. It is reasonable to ask: what will fill the monitoring hole left by the dissolution of the main-bank monitoring system? The fact that Japanese firms are becoming more transparent and sensitive to share price suggests that they intend to substitute market signals for inside information in judging corporate performance.

insisted that the CalPERS principles were a poor fit to Japanese business practices. Why, then, have foreign investors so doggedly pursued governance change in Japan? One explanation is *hubris*: Investors watched what happened in the United States, where efforts to change corporate governance were followed by a boom, and thought that they could repeat these events in Japan and elsewhere. Believing that governance change had *caused* share prices and economic growth to rise (and, by extension, that the absence of shareholder primacy caused depressed stock prices and economic growth in Japan) was an instance of *post hoc ergo propter hoc* reasoning.¹⁰⁷ Another answer is that investors suffered from *economic ethnocentrism*: to the extent that the CalPERS principles were valid in the United States, the assumption was made that they were equally valid in other economies. The problem, however, is that the average Japanese company is unlike its U.S. counterpart with respect to factors that determine governance effectiveness, such as incentives (executives are lifers who are motivated by duty, reputation, and trust) and business strategy (in Japan strategy is relatively resource-based and relational).¹⁰⁸ The third explanation is that investors are *myopic*. Even professional managers at the helm of institutional portfolios have myopic biases. What matters is not how to maximize the corporate pie tomorrow, an uncertain recipe at best, but how it is sliced today: more for current shareholders; less for bondholders, creditors, employees, customers, taxpayers, and future shareholders. That is, shareholder primacy is not about creating value but extracting it.¹⁰⁹

¹⁰⁷ An alternative interpretation is that U.S. economic growth was caused by fiscal policies to reduce the deficit, which stimulated markets and set off a speculative boom resulting in spiraling stock prices. Corporate governance was orthogonal to growth, although it played a role in spurring the stock bubble. For evidence refuting the notion that Japan's stagnation was related to corporate governance, see Sanford M. Jacoby, *Corporate Governance in Comparative Perspective: Prospects for Convergence* 22 COMP. LAB. L. & POL'Y J. 5 (2000) and J. Mark Ramseyer and Yoshiro Miwa, Financial Malaise and the Myth of the Misgoverned Firm, SSRN working paper (Oct. 2001).

¹⁰⁸ Ronald Dore, *Pros and Cons of Insider Governance*, Doshisha University, Kyoto (2004); JACOBY, THE EMBEDDED CORPORATION, chap 2. Norm entrepreneurs in Japan who advocate incentives based on self-interest face the problem that norms such as duty are not easily reconfigurable to utilitarian standards. But norms are relatively plastic among the young, which is why Japan is going through a debate over the cultural values taught in its schools. Until his arrest, Takefumi Horie was popular with young people, who admired his wealth, youth, and irreverent style. Elders in Japan have compared him to Gordon Gekko, the 1980s movie character whose mantra was "greed is good." Jane Mansbridge, *Starting with Nothing: On the Impossibility of Grounding Norms Solely in Self-Interest* in ECONOMICS, VALUES, AND ORGANIZATIONS 151-70 (Avner Ben-Ner and Louis Puterman, eds., 1998); *Star Entrepreneurs Inspire School Kids to Dream Big*, NIKKEI WEEKLY, Apr. 25, 2005, at 3.

¹⁰⁹ Michael C. Jensen, *The Puzzling State of Low-Integrity Relations Between Managers and Capital Markets*, SSRN (2005) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=783604; Jacoby *Corporate*

If this is true, then changes in corporate governance that foster shareholder primacy should affect labor's share of income, the distribution of that share between executives and employees, and returns to shareholders via dividends and buybacks. In the United States, labor's share of value-added has fallen since 1980, which is when corporate governance began to emphasize shareholder primacy.¹¹⁰ After 1980 there also was a steady widening of the pay gap between executives and front-line employees. Finally, dividends and payouts have risen in recent years. Increased returns to shareholders register in the upper tail of the income distribution because capital gains and dividends are concentrated among the rich. The top 1 percent income share was stable for much of the postwar period, hovering around 8 percent. However, between 1980 and 2004 it made a leap: doubling to 16-17 percent¹¹¹

Unlike the United States, however, the data from Japan show less resource redistribution favoring executives and other shareholders. It's true that income inequality in Japan has risen since the late 1990s and that the country has been unnerved by this development. But recent inequality in Japan is primarily the result of two effects, one cyclical and the other demographic. The cyclical component is the hiring of temporary workers instead of regular employees to cope with depressed demand in the late 1990s, an effect that has attenuated slightly with the resumption of regular hiring in 2005. The demographic component is related to the high levels of inequality that exist among the Japanese elderly (those over 60). Inequality automatically increases as the population

Governance and Society; Steven N. Kaplan, *Management Buyouts: Evidence on Taxes as a Source of Value*, 44 JOURNAL OF FINANCE 611 (1989); Shlomo Benartzi and Richard Thaler, *Myopic Loss Aversion and the Equity Premium Puzzle*, 110 QUARTERLY J. OF ECONOMICS 73 (1995).

¹¹⁰ When real wages fail to rise in line with productivity, labor's share will fall. Wages and salaries as a share of gross domestic product are presently at their lowest level since 1947. Wages plus benefits -- total employee compensation -- was briefly lower than its present level in the mid-1990s but otherwise has not been so low as it is now since 1966. *Real Wages Fail to Match a Rise in Productivity*, NEW YORK TIMES, Aug. 28, 2006, at A1; Alan B. Krueger, *Measuring Labor's Share*, 89 AMERICAN ECONOMIC REVIEW 45 (1999).

¹¹¹ In the United States, firms that pay large dividends--the top earners--raised their real dividends in the 1980s and 1990s. Harry DeAngelo, Linda DeAngelo, and Douglas J. Skinner, *Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings*, 72 JOURNAL OF FINANCIAL ECONOMICS 425 (2004); Franklin Allen and Roni Michaely, *Dividend Policy*, Wharton School (1995); KEVIN PHILLIPS, *WEALTH AND DEMOCRACY: A POLITICAL HISTORY OF THE AMERICAN RICH* (2003); Chiaki Moriguchi and Emmanuel Saez, *The Evolution of Income Concentration in Japan: 1885-2002: Evidence from Income Tax Statistics* (2005) at <http://elsa.berkeley.edu/~saez/moriguchi-saez05japan.pdf>; Thomas Piketty and Emmanuel Saez, *The Evolution of Top Incomes: A Historical and International Perspective*, 96 AMERICAN ECONOMIC REVIEW 200 (2006).

ages, and Japan has the fastest aging population in the world. The latter contributes more to the recent growth of inequality in Japan than any other factor.¹¹²

Labor's share of net value-added in Japan rose during the 1990s (unlike the U.S.); from 2002 to 2004, when real wage gains turned negative, labor's share declined. The trend reversed in 2005 when real wages were positive. Similarly, payouts to shareholders have moved cyclically: Japan's dividend yield and share repurchases declined in the 1990s but increased over the past six years. Overall payouts remain well below U.S. (and European) levels, however. Finally, Japan's top 1 percent income share (around 8 percent) has not budged from 1951 through 2002.¹¹³

These trends are consistent with the survey data showing modest governance change in Japan as compared to the United States. Indeed, foreign investors remain critical of Japanese companies for resisting takeovers and for "hoarding" cash. Undoubtedly there are cases where such criticism is 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 new models. The phenomenon is not unique to Toyota. For the past twelve years, Japan has spent more on R&D as a percentage of the economy than any other OECD nation, and it is one reason for Japan's current recovery.¹¹⁴

The fact that CalPERS and its allies in Japan have not made more headway can be explained in two ways: One is to claim that resistance from entrenched and pampered

¹¹² Norimitsu Ohnishi, *Revival in Japan Brings Widening of Economic Gap*, N.Y. TIMES, Apr. 16, 2006, at 1; Kiyoshi Ota, *Rise in Earnings Inequality in Japan: A Sign of Bipolarization?* Japan Research Institute, Tokyo (2005).

¹¹³ Gregory Jackson, *Stakeholders Under Pressure: Corporate Governance and Labour Management in Germany and Japan*, 13 CORPORATE GOVERNANCE 419 (2005); Ryder, *The Japan Turnaround*, op. cit.; *Share Buybacks Emerging as New Demand Driver*, NIKKEI WEEKLY, May 1, 2006; JAPAN INSTITUTE OF LABOUR POLICY & TRAINING, MAIN LABOR ECONOMIC INDICATORS 4, 23 (2006); Moriguchi and Saez, *Evolution of Income Concentration*, op. cit.; Ronald Dore to author, Sept. 3, 2006.

De Jong's study of European corporations divided them into Anglo-Saxon, Germanic, and Latinic types. During the early 1990s, Anglo-Saxon corporations paid 23.5 percent of net value added to "capital" (chiefly dividends and share repurchases) versus 8.8 percent 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 dispersed ownership 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 5 (1997).

¹¹⁴ Investors Demand Firms Use Capital Effectively, NIKKEI WEEKLY, Dec. 5, 2005; Martin Fackler, *New Optimism About the Japanese Economy After a Bleak Decade*, N.Y. TIMES, Dec. 7, 2005.

managers, in particular those represented by Keidanren, has kept Japan from adopting the ostensible global governance optimum, the shareholder-primacy model. This is the argument made by both Crist and Yano, as well as by American investors based in Japan. 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 one-fourth of U.S. levels.¹¹⁵ If anything, Japanese executives would, based on U.S. experience, make out better under a shareholder-primacy approach, although there would be a low-level risk that some might lose their positions after a takeover.¹¹⁶ The other explanation of modest change is the Demsetz-Lehn thesis that corporate governance is endogenous and that there is no one-best way of structuring it. Japanese corporations have adopted only those changes that are a good fit with their existing incentives and institutions, which is to say, those that have an unambiguous relationship to performance.¹¹⁷

There are special reasons why public pension funds like CalPERS and the PFA keep asserting their claims with such tenacity. Unlike their private-sector counterparts, public pension funds are relatively transparent, subject to political pressure, and more likely to be criticized for a single year of below-average returns. Public pension boards have elected directors who want constituents to think they are working hard on their behalf. Frequent publicity around issues like corporate governance helps create that

¹¹⁵ LAWRENCE MISHEL ET AL., THE STATE OF WORKING AMERICA table 2.49 (2005). At first glance, Japan looks like the liberal economies: its ownership concentration is low and its after-tax inequality is in the upper-middle range. Yet cross-holding in Japan has the same effect as ownership concentration: it facilitates insider control that balances stakeholder interests. And income inequality before taxes is quite low in Japan, even lower than some Scandinavian countries. The reason is that corporations play a relatively important role--as compared to the state--in providing security and reducing inequality. This raises the political stakes associated with governance change. MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 53 (2003); Marco Forster and Marco Mira d'Ercole, "Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s, OECD, 26 (2005).

¹¹⁶ Recall that U.S. executives opposed shareholder primacy until the early 1990s, when stock options and a bull market caused a shift in their orientation. What makes that shift less likely in Japan are two factors: first, executive pay is still not based heavily on equity, and second, Japanese shares remain concentrated in the hands of domestic investors who are either cross-holding partners or domestic institutional investors, groups who are reluctant to rock the boat. If and when the majority of institutional investors follow PFA's lead, the system might change quickly.

¹¹⁷ Dore, Pros and Cons; Fisman et al., Governance and CEO Turnover.

impression. The result is that public funds invest, vote, and approach activism differently than corporate funds.¹¹⁸

CalPERS, like other public funds, claims it is driven by long-term considerations. But this is true only of the fund's actuaries. The evaluation of officers and managers is based on annual returns, not on five- or ten-year performance criteria. (Few at CalPERS even can remember what happened ten years ago.) There is an active labor market for fund managers, whose tenures are relatively brief.¹¹⁹ In dealing with individual companies, institutional investors are less likely to appear greedy if they portray themselves as being motivated by long-term principles, unlike, say, Icahn, Pickens, Horie, or Murakami.¹²⁰ 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.

This point is at variance with the thesis that pension funds have ushered in a new, more socially responsible, era of "fiduciary capitalism." The reasoning here is that because pension funds are universal owners holding the entire market, they are concerned with long-term performance issues that affect all companies. As universal owners, they internalize externalities and therefore seek to induce 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, says the theory, institutional investors promote not only growth but social welfare.¹²¹

There are problems with the universal-owner thesis. Correctly identifying the factors that boost corporate performance market-wide is 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 highly diversified, they favor riskier corporate strategies than employees, suppliers, or bondholders, groups whose

¹¹⁸ Kevin J. Murphy and Karen Van Nuys, *Governance, Behavior, and Performance of State and Corporate Pension Funds* (1994) at <http://www-rcf.usc.edu/~kjmurphy/Pensions.pdf>; Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUMBIA LAW REVIEW 795 (1993).

¹¹⁹ Mark Anson served as CalPERS' chief investment officer for four years and left for Hermes in 2005.

¹²⁰ Both men were indicted in 2006 on different charges related to their financial dealings. Murakami pled guilty; Horie's trial is taking place in 2007.

¹²¹ JAMES P. HAWLEY AND ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC* (2000).

preferences are not represented under the shareholder-primacy model but whose concerns are relevant to long-term performance. Third, pension funds 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 portfolio as a whole, there will be a tendency for funds to focus narrowly.¹²²

VI. Conclusions

Institutional investors are an important mechanism for transmitting U.S. governance principles to overseas markets. In Japan, CalPERS worked with other institutional investors and domestic norm entrepreneurs to promote shareholder primacy in corporate governance. CalPERS was most successful in affecting aspects of corporate governance with a clear relationship to performance, such as disclosure. It was less successful, but not without influence, in other areas.

CalPERS officials well understood, as should we, that corporate governance is grounded not only in efficiency considerations but also in politics and social norms. In Japan as in the United States, CalPERS brought to bear a panoply of tactics to achieve its goals. Its manifest objective was the redesign of governance institutions to improve performance; the latent intent was to reallocate corporate resources to current shareholders. When CalPERS' own power was insufficient, it sought alliances to bring about change. CalPERS chose to ignore evidence that its principles could not be verified according to its stated objective of bolstering long-term performance. One can surmise various reasons for this, including strong support for the CalPERS principles from experts in the investment community.

The CalPERS principles were not framed in a vacuum but instead reflected the prevailing wisdom among U.S. investors and financial economists in the 1980s and 1990s. During those decades, rational choice theory fused with financial economics to produce agency theory, which views managers (agents) as prone to self-serving or irrational

¹²² Another problem: institutional funds do not have an incentive to monitor their indexed holdings because all that counts, at least for the funds' managers, is performance relative to peers. Hence the funds will hold overvalued stock because selling might damage relative performance. At its peak, sixty percent of Enron stock was held by large institutional investors who knew better but dared not risk a premature sale. John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 869; Markus Brunnenmeir and Dilip Abreu, *Bubbles and Crashes*, 71 ECONOMETRICA 173 (2003).

behavior at the expense of shareholders (principals). While any single shareholder may not be rational, dispersed ownership creates financial markets whose collective wisdom promotes efficiency when managers are incentivized to pursue shareholder interests. At the same time, there arose within the academy and the judiciary a law-and-economics movement that sought to reorient legal thinking to agency theory and other economic doctrines. The merger wave of the 1980s and the U.S. bull market of the 1990s provided vindication for practices derived from agency theory; so too did the mediocre performance of shareholder-wary economies in continental Europe and Japan.¹²³

Economic ideas come and go; agency theory today is under assault by the new behavioral approach to economics and finance. The behavioral approach is grounded in empirical anomalies: between rational-choice predictions and actual behavior, and between theoretical explanations of how institutions operate and their actual performance. For example, agency-theory rationales for hostile takeovers and for stock options are now found wanting and fraught with unintended consequences. The presumption that financial markets are efficient and that they are more rational than managers has been replaced by the hypothesis, consistent with empirical evidence, that financial markets are prone to mispricing and irrationality, perhaps more so than managers. From this hypothesis it is possible to justify institutions held suspect by agency theory, ranging from insider boards and takeover defenses to regulation of financial markets. Although a few law-and-economics doyens recognize the challenge and have responded defensively, the new ideas have been slow to penetrate legal discourse.¹²⁴

Missing from contemporary discussions of corporate governance is a recognition that the shareholder-executive relationship is not the sole interdependency that organizations must balance. Also critical are relations between headquarters and subunits, and between the corporation and its employees, creditors, customers, suppliers, and

¹²³ Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS 305 (1976); Sanford M. Jacoby, *Economic Ideas and the Labor Market: Origins of the Anglo-American Model and Prospects for Global Diffusion*, 25 COMP. LABOR LAW & POLICY J. 43 (2003).

¹²⁴ Russell Korobkin and Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051 (2000); ANDREI SHLEIFER, INEFFICIENT MARKETS : AN INTRODUCTION TO BEHAVIORAL FINANCE (2001); Malcolm Baker, Richard Ruback, and Jeffrey Wurgler, *Behavioral Corporate Finance: A Survey* in HANDBOOK OF CORPORATE FINANCE ch. 4 (B. Espen Eckbo, ed., 2006); BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, supra; Henry G. Manne, *Efficient Markets: The Welfare of American Investors*, WALL STREET JOURNAL, June 13, 2006, at A16.

regulators. The variety of relationships suggests the infeasibility of there being a single best way to structure corporate governance.¹²⁵

What legitimate claim can non-shareholders make on the corporation's resources? Agency theory, which treats shareholders as residual claimants, favors a distribution of rents that privileges shareholders; behavioral theory, while agnostic on most distributional issues, is compatible with the notion that shareholders do not always promote the firm's best interests, or even their own. Team-production theory is based on the idea that the corporation is a cooperative endeavor whose members all have made firm-specific investments. The board's role is to allocate rents; no stakeholder has primacy in receiving them.¹²⁶ Roe has a view closer to my own that emphasizes how politics--normative and distributional--drives corporate governance and law.¹²⁷

The future of national governance systems is unlikely to be the result of market forces selecting an optimal model. Instead, the CalPERS story suggests that the evolution of corporate governance will be shaped by historical actors committed to contending definitions of the corporation's legal, social, and economic responsibilities. Governance politics takes different forms in Japan and the United States, but it exists in both nations. Because of changes at CalPERS in recent years, however, the fund is likely to play a smaller role in future debates over Japan's governance system while continuing to pursue investment opportunities there.

¹²⁵ Neil Fligstein and Robert Freeland, *Theoretical and Comparative Perspectives on Corporate Organization*, 21 ANNU. REV. SOCIOl. 21 (1995).

¹²⁶ Margaret M. Blair and Lynn Stout, *A Team Production Theory of Corporation Law*, 85 VA. L. REV. 247 (1999). Team production theory is similar to the Japanese corporate model as conceived by Aoki in MASAHIKO AOKI, *INFORMATION, INCENTIVES, AND BARGAINING IN THE JAPANESE ECONOMY* (1988).

¹²⁷ ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE*. Also see NEIL FLIGSTEIN, *THE TRANSFORMATION OF CORPORATE CONTROL* (1990); WILLIAM ROY, *SOCIALIZING CAPITAL: THE RISE OF THE LARGE INDUSTRIAL CORPORATION IN AMERICA* (1999); PETER A. GOUREVITCH AND JAMES SHINN, *POLITICAL POWER & CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE* (2005); and, for Japan, TETSUJI OKAZAKI AND MASAHIRO OKUNO-FUJIWARA, *JAPAN'S PRESENT DAY ECONOMIC SYSTEM AND ITS HISTORICAL ORIGINS* (1999).