Principles and Agents: CalPERS and corporate governance in Japan

Sanford M. Jacoby*

A growing literature discusses the convergence of national systems of corporate governance. Fostering convergence are activist institutional investors, especially from the United States. The following is a case study of one institutional investor – the giant pension fund, CalPERS – and its efforts to change governance in Japan over the past 15 years. CalPERS' involvement in Japan went through three stages: solo activism; cultivation of local partners; and, most recently, a shift from marketwide activism to company-level relational investing. Although CalPERS has had some success in changing Japanese corporate governance, economic and political factors have limited its influence and permitted the persistence of Japan's distinctive governance system.

Keywords: Japan, corporate governance, pension funds, convergence, CalPERS

Introduction

Japan's corporate governance system differentiates it from other "varieties of capitalism". Key features of that system – insider boards, cross-holding and main banks – are based on two assumptions: first, that incumbent executives can be trusted to do their best and need only be removed in emergency situations; and second, that the responsibility of senior executives is to maximise the long-term value of the enterprise by balancing stakeholder interests. Stakeholders include shareowners, creditors, employees, suppliers and business group members (Dore, 2000). When CEOs fail – that is, when there is a marked decline in earnings, sales or share price – they are ousted and sometimes the main bank places an independent director on the board (Kaplan, 1994; Kaplan and Minton, 1994).

The traditional system is under pressure to move towards the model that developed in the United States in the 1980s, in which the sole criterion for judging management performance is share price. Adherence to that standard is ensured through boards comprised of independent directors, through stock-based executive compensation and through acquisitions when performance is poor.

Where is the pressure for change in Japan coming from? Some arises from the prolonged stagnation that occurred between the early 1990s and 2002. Another source of change is the Japanese government, which has repeatedly revised Japan's commercial law to encourage adoption of the US model. A third vector for change is foreign investors, especially pension funds from the United States. Having revolutionised US corporate governance in the 1980s and 1990s, these funds turned to other markets in hopes of repeating their success. In Japan, overseas pension funds are the dominant category of foreign investor, 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 employees in California. Many of the beneficiaries are current or former public-sector union members, but the law does not permit fund managers to pursue any agenda other than their fiduciary duty to secure the pensions of retirees.

There is a huge literature on CalPERS in the United States, where, together with other institutional investors and corporate raiders, it revamped corporate governance around the concept of shareholder primacy. However,

*Address for correspondence: Anderson School at UCLA, 110 Westwood Plaza, Los Angeles, CA 90095-1481, USA. E-mail: sjacoby@anderson.ucla.edu

little has been written about its activities in Japan, although it was among the first foreign pension funds to make major investments there and remains one of the largest, if not the largest, foreign shareowner. As early as 1992, when foreigners were just beginning to ramp up their Japan investments, CalPERS owned US$3.7 billion in Japanese equities. This stake constituted approximately 2.6 per cent of the total value of TSE shares owned by foreign investors. In 2000, when the value of CalPERS' Japan holdings was US$4.8 billion, many more foreign investors had flocked to Japan, so that CalPERS now constituted 0.8 per cent of the equity owned by foreign investors (TSE, 2005; Kane, 2005).

Unlike many institutional investors, CalPERS was unusually active in Japan, where it promoted changes similar to those it had sought in the United States. CalPERS had prominence (some would say notoriety) in the Japanese business community because of its aggressive posture in the United States. Its involvement in Japan went through three phases. The first comprised activities that CalPERS pursued on its own: conscientiously voting its proxies, regularly meeting with company officials, and using the media and other public relations methods to promulgate its principles. In the second stage, CalPERS teamed with other institutional investors and with domestic groups seeking to change Japanese corporate governance. The third phase saw a gradual withdrawal of CalPERS from market-wide activism in favour of more focused, firm-specific efforts based on relational investing.

Data on Japanese companies show a statistically significant relationship between foreign ownership and adoption of governance changes related to disclosure and transparency (Miyajima, 2006). Foreign ownership also is associated with a propensity to restructure via asset divestments and to use equity-based measures of performance. When it comes to downsizing, however, the effect of foreign ownership is ambiguous (Ahmadjian and Robbins, 2005; Abe and Shimizutani, 2005). Unfortunately, we don't know if the relationships here are causal – did foreign investors actually induce these changes? – or if they were the result of foreigners such as CalPERS buying shares in companies that were likely to take these steps or had already begun to do so.

The following case study of CalPERS unpacks some of the causal ambiguities in the statistical studies by examining the processes by which institutional investors have tried to change corporate governance in Japan. We find that CalPERS did have an effect on practices related to transparency. But its efforts to change board structure, takeover norms and executive compensation met with less success.

While the focus here is on Japan, there are elements of the story that apply to institutional investors in other countries, too. Hence this case study adds to our general understanding of how financial institutions diffuse the US model of corporate governance. It is one piece of the ongoing effort to learn more about the varieties of global capitalism: their convergence and persistence.

Early days: solo activism

US corporate pension funds entered the Japanese market in the early 1980s. Public-employee pension funds were slower to invest in Japan, but they picked up the pace after the 1987 stock market crash. Joining the pension funds were international mutual funds and some raiders, such as T. Boone Pickens. CalPERS' initial purchase of foreign equities occurred in 1988; the following year it invested US$1 billion in Japanese equities. By 1991, foreign holdings accounted for 12 per cent of its total equity assets and this doubled to 24 per cent in 2000. CalPERS divided its Japan equity purchases into active and passive (indexed) portfolios. The actively managed portion rose to 40 per cent of Japan equity holdings in June 1994, with a book value of US$3.7 billion, and then gradually drifted down to 32 per cent in 1995 and 22 per cent currently. Even at these reduced levels, the percentages were higher than the actively-managed share of the US portfolio, which ran around 17–18 per cent in the 1990s (Kane, 2005; Cottrill, 2005).

Proxies

CalPERS' first foray into Japanese corporate governance came in the area of proxy voting, followed by more direct efforts to change Japanese companies. Between 1988 and 1990, CalPERS did not vote proxies for its Japan holdings, like most other foreign institutional investors. But in 1990, the fund decided to replicate in Japan the systematic proxy voting it had begun to pursue in the United States. 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 and auditor elections; directors' retirement bonuses; and amendments to the articles of incorporation (which can include everything from entering a new business line to adoption of a holding company structure). Two key areas that concerned CalPERS were takeover barriers and

the absence of independent directors, both issues that CalPERS had grappled with in the United States. To show its displeasure, CalPERS opposed the raising of new equity if it felt that this was being done to erect a takeover defence. It also voted its proxy against re-election of incumbent directors (almost always insiders). After Japan adopted commercial code revisions in 1993 requiring companies to have independent auditors, CalPERS adopted a policy of voting against auditors who it judged to lack independence (Sterngold, 1993; IRRC, 2001b).

Another concern was dividend levels. In Japan, companies held more of their assets in cash than their US counterparts, partly to accommodate larger bank loans. Despite these cash holdings, dividends were meagre and based on par value rather than earnings (Kester, 1991; Milhaupt and West, 2004). CalPERS was eager to see Japanese firms return more cash to shareowners, either through dividends or stock repurchases. But it was aware that this was a touchy issue that could make CalPERS appear greedy or insensitive to Japanese norms regarding retained earnings. Exxon and Mobil, which each held 25 per cent stakes in Tonen, a Japanese oil refiner, received negative publicity in 1992 when they forced out Tonen's president and pressured the company to double its dividends (*Financial Times*, 1992; Sterngold, 1994). In contrast, CalPERS was careful to appear even-handed. It publicised the fact that, although it was voting against inadequate dividends at some Japanese companies, and that it was concerned about the low average level of dividends in Japan, it was also voting against *excessive* dividends being paid by other, unprofitable companies such as Nissan. As Richard Koppes, general counsel at CalPERS, said, "We're not trying to change Japanese culture" (Sterngold, 1993).

Proxy voting is a noisy signal. A negative vote on an income allocation proposal is subject to multiple interpretations. CalPERS did not publicise its proxy votes in Japan. Nor did it publish a "target list" or mount its own shareholder resolutions, as it did in the United States (Jacoby, 2006). Sometimes it sent letters to company executives before or after a vote to explain why it had acted as it did (Goldstein, 2005; Crist, 2005). Proxy voting proved an ineffectual way of inducing governance change in Japan. Rarely did anti-management votes exceed 30 per cent of the total, a key threshold, and, even then, companies almost never announced the outcome, despite CalPERS' request that they do so. Although CalPERS sought higher dividends and share repurchases, payouts at profitable companies declined from 1993 to 2000 (Ryder, 2005). CalPERS voted against all former executives who were nominated to be independent auditors, but the percentage of firms listing auditors whose outsider status was questionable actually rose in the mid-1990s, from 11 to 20 per cent (IRRC, 2001b).

Black ships

During the 1980s, Keidanren, the peak association for large Japanese companies, monitored US economic, legal and social issues through its Council for Better Corporate Citizenship (CBCC). In 1993, CBCC extended an invitation to CalPERS board president William D. Crist to visit Tokyo and address the Keidanren. (CBCC, 1993) 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" (Crist, 2005).

Crist began his speech by reminding the audience that CalPERS was not a speculative investor but instead was interested in long-term returns. He also stressed "we are not crusaders – we do not want to make over countries' corporate structure". But then he laid out a detailed criticism of Japanese corporate governance based in large part on the CalPERS programme in the United States. Crist's "wish list" for Japan covered five areas: smaller and more independent boards; higher dividends; better financial disclosure; improved investor relations; and investor-friendly shareholder meetings. He criticised the fact that domestic cross-shareholders had inordinate influence on corporate management, while foreign and minority shareholders were given "only cursory consideration" (Crist, 1993).

Sunshine

After the speech, Crist and other CalPERS officials visited companies in the Tokyo and Osaka regions. A typical company visit would be preceded by letters and phone calls asking to see the company's president. But except in rare instances, the requests were declined. At best, the CalPERS officials met with a director for overseas issues; at worst, companies refused to meet with them. This stemmed from a Japanese perception that CalPERS was, as Crist put it, "meddling" in places where it did not belong (Crist, 2005). Occasionally a company suspected CalPERS of being some kind of foreign blackmailer (Learmount, 2002). Over time, however, companies grew

receptive to these visits as investor relations (IR) departments became ubiquitous in Japan. Companies even began to send their own delegations to Sacramento to meet with CalPERS officials, some on an annual basis.

Issues discussed included touchy topics such as board structure and return of excess cash to shareowners. One of Crist's advisors said, "In the Japanese style, the response at those meetings is always the same: dead silence" (Sterngold, 1993). Starting in the mid-1990s, CalPERS intentionally shifted the agenda to general principles of corporate governance rather than financial topics, a shift that another advisor called, "having more of a lovely sunshine strategy rather than North Wind" (Sakai, 2005). Crist would explain that CalPERS was a long-term shareholder and that companies which produced long-term returns for their shareholders would end up rewarding other stakeholders. Layoffs, says Crist, were never on the table: "I hate to see that sort of Wall Street psychology that layoffs are a good thing. And especially in Japan, where the labor market is not liquid and it is hard for people to find new jobs" (Crist, 2005).

CalPERS continued to pour money into Japan. The value of its Japan equity investments swelled to US$5.6 billion in 1996. Companies that had never heard of CalPERS in 1992 now knew who it was. Crist admits that "a lot of the pressure we brought was, you could say almost sort of political, but not obviously politics. You know, using the media. . . . It was always a good story. It was the black ships all over again" (Crist, 2005). While the effect of media is difficult to assess, a recent study empirically confirms that the media can make company policy more responsive to the concerns of minority shareholders (Dyck and Zingales, 2002).

CalPERS also made public relations efforts of it own. One of its consultants published a magazine in Japanese and English called *M&A Review* (later *Directors & Boards*) that was distributed to major companies throughout Japan. The magazine promoted the virtues of foreign investors. For example, in 1997 the former CEO of the Tokyo Stock Exchange wrote an article called, "Foreign Investors Give a High Impact to Tokyo Stock Exchange". Crist wrote for the magazine, as did CalPERS board member Robert Carlson, whose piece was titled, "An Award Like the Deming for the Best Corporate Governance Practice".

Finding local partners

In 1995 CalPERS conducted a study of how to bring its shareholder-value approach to overseas markets. The study saw substantial benefits to the endeavour, but predicted an uphill battle in Japan, which "has a structure that is least like the United States. There, shareholder returns are subordinated to the growth of the company and the interest of the keiretsu and affiliated shareholders." In 1996 the CalPERS board voted to develop formal governance programmes for Britain, France, Germany and Japan. Each programme had four parts: developing governance principles; participating in local debates; outreach to companies and governments; and strategy development with potential allies (CalPERS, 1996).

Finding allies who shared the CalPERS vision was a key element in its second phase of activism. Local partners would give CalPERS legitimacy in markets hostile to foreign interference, while helping to adapt its message to local audiences. CalPERS director Charles 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". To export its programme, said Bob Boldt, CFO of CalPERS, "We try to get a local entity to do it. In Japan, for instance, the image of CalPERS is totally blown out of proportion, so we get a better effect with a local entity doing it" (CalPERS, 1996; Sailer and Pick, 2001).

The "local entity" that CalPERS initially partnered with in Japan was a small group of businessmen and academics called the Corporate Governance Forum of Japan (CGFJ). A key figure behind the CGFJ was Ariyoshi Okumura from the Industrial Bank of Japan. Okumura credits the CGFJ's creation in 1994 to his mentor at the Bank, Kaneo Nakamura, whose term on the board of General Electric had led him to appreciate the need for governance change in Japan. Okumura, too, was a regular visitor to the United States. He ran IBJ's asset management division and his US trips included visits to Sacramento to solicit CalPERS' business (Okumura, 2005).

University of Tokyo finance professor Takaaki Wakasugi drafted the CGFJ's corporate governance principles, published in 1997. The document is a marvel of diplomacy. The introduction acknowledges the Japanese stakeholder philosophy, but puts shareholders in a special category above other stakeholders. It says that the board of directors' job is to maximise shareholder value and to represent the immediate interests of shareholders. On the other hand, the board is also supposed to coordinate stakeholder interests and be accountable for its actions to all stakeholders (CGFJ, 1997).

After that, the principles say nothing else about stakeholders. As one Japanese scholar notes, the overall theme is "close in tone to that of an assertive-type classical model" of corporate governance (Inagami, 2001). Regarding disclosure, the report urges that information be provided to shareholders in a timely fashion, adjusted to global accounting rules, and facilitated by an upgrading of the IR function. As for monitoring, it recommends the inclusion of independent directors on boards (short term) until boards are comprised of a majority of independent directors (medium term). The report urged a reduction in board size and separation of the CEO and board chairman positions. Boards should include more than one independent auditor (short term) and an auditing committee comprised entirely of independent directors (medium term).

Four months after publication of the CGFJ report, CalPERS issued its own principles. 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 state, "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 list all of the short- and medium-term proposals contained in the CGFJ report. However, the principles do not include any of the CGFJ language related to stakeholders. Also, the principles have two recommendations not mentioned by the CGFJ: stock option plans for directors and executives and reduction of "unproductive" cross-shareholding. CalPERS sent translations of its principles to major interest groups in Japan, from the LDP to Keidanren and Nikkeiren (CalPERS, 1998a).

Crist brought CGFJ to the attention of the institutional investing world through the International Corporate Governance Network (ICGN), which was established in 1995. The origins of the ICGN go back to the early 1990s, when Crist, Robert Monks and other governance activists discussed the need to form an international analogue to the Council of Institutional Investors, the US group that CalPERS had created in the 1980s. Concerned about the ICGN's lack of Asian involvement, Crist recommended that the CGFJ be made an affiliate. Later Ariyoshi Okumura of the CGFJ was elected to the ICGN's board, the first governor from Asia (Crist, 2005).

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. Over 400 attendees listened to Yoshihiko Miyauchi, a CGFJ founder and CEO of Orix, speak on the need for a ratings system to improve Japanese corporate governance (IRRC, 2001a). In charge of the ICGN Tokyo conference was Nobuo Tateishi, CEO of Omron. Although Tateishi had become a board member of the CGFJ, he was also active in Nikkeiren and Keidanren. His views on corporate governance were more traditional than those of the CGFJ or CalPERS, as reflected in the 1998 report issued by a Nikkeiren committee that he chaired. The report presented the mainstream 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, insider boards and a stakeholder orientation (Inagami, 2001, p. 229).

It is likely that Tateishi was the person responsible for inviting Hiroshi Okuda to give the keynote address at the ICGN conference. Okuda was then chairman of Toyota and of Nikkeiren. His speech was a polite rebuke of the shareholder-value model that CalPERS and the CGFJ were promoting in Japan. Okuda stressed the social dimension of corporate activity in Japan. Any approach to corporate governance that fails to take this into account, he said, "could cause major problems". Japanese management's commitment to stakeholders, he said, "is in our DNA". While acknowledging the importance of holding managers to account, Okuda said this had to come from "different perspectives", including banks and enterprise unions, and not only from shareholders. As for shareholders, who were then urging Toyota to return more of its cash hoard to them, Okuda said, "We prefer to aggressively promote R&D. We aren't ignoring ROE but we must balance it with R&D" (Bingham, 2001; Benes, 2001a).

Bill Crist was dumbfounded to hear Okuda express "almost identical" words to those Crist heard from Keidanren in 1993. The speech marked the beginning of the end of Crist's hope that the CGFJ would be a vehicle for governance change in Japan. Crist says that at one time he "rather naively" thought that the CGFJ would "make a real difference", but in the end it had not (Crist, 2005). Who, then, would help CalPERS bring change to Japan?

Pension fund association

The Japanese pension fund system is complex and includes old-age insurance and employer-provided pensions. There is tight coordination of these tiers. Pension assets are managed by trust banks or by insurance companies. The largest fund in Japan is the Pension Fund Association for Local Government Officials (Chikoren), with over US$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 1000 of these plans.

For most of its history, the PFA was lost in obscurity, with administration of its equity investments left to asset managers who never challenged companies. But the PFA began to change in 1999, as its funding situation grew more dire and new leaders came on board. It published a white paper calling for an end to the taboo of voting against management proposals at shareholder meetings. Subsequently, a Health and Welfare ministry commission headed by Takaaki Wakasugi recommended that pension funds like the PFA hold their asset managers to fiduciary standards that would include active proxy voting and attention to shareholder value (IRRC, 2002; Wakasugi, 2003).

On the heels of Wakasugi's report, the official in charge of pensions at Health and Welfare, Tomomi Yano, was assigned to become managing director of the PFA. Yano was familiar with the problems facing Japan's pension funds. Due to slow population growth, pension funds were projected to show widening deficits as the ratio of retired to active employees crept steadily up. The PFA itself was not in good shape when Yano took over, having shown a –10 per cent return in 2001, its first loss ever. In 2002 and 2003, its returns were –4 per cent and –12 per cent (McClellan, 2004; Yano, 2005).

Knowing that he would run the PFA for a limited term, Yano wasted no time in establishing an aggressive programme to raise returns through investor activism. Yano's model for transforming PFA was – and remains – CalPERS. PFA representatives have visited Sacramento repeatedly in recent years and there have also been meetings in Japan. When asked in 2003 if PFA would become like CalPERS, Yano responded, "We may turn out to be a Don Quixote, but as a representative of pension funds in Japan we have no choice but to be an active shareholder" (*Nikkei Weekly*, 2003).

Recapitulating CalPERS' approach, Yano's first step was to introduce proxy voting guidelines for the PFA's asset managers. In line with Wakasugi's recommendation, the guidelines instructed the managers to designate staff responsible for proxy voting, to vote according to guidelines – favouring shareholders over management if need be – and to report details back to the PFA. In 2002, the PFA assumed direct management of some of its equity holdings and initiated proxy voting on its passively invested stocks, thereby breaking old taboos (Benes, 2001b; IRRC, 2002; Yano, 2004).

The most dramatic change came in 2003, when PFA issued its own proxy guidelines. What received the most attention was its intention to vote against renomination of, and retirement payments for directors at, companies that had not paid dividends for three years or had losses for the previous five years. PFA developed these guidelines after culling ideas from other pension funds such as CalPERS, TIAA-CREF and Hermes (CalPERS' partner in the UK). PFA also promised to vote against companies whose boards had more than 20 people; who failed to separate the CEO and chairman positions; and who failed to nominate independents for at least one-third of the board. It launched a campaign to publicise its principles to other Japanese institutional investors (*Pensions & Investments*, 2003; *Nikkei Weekly*, 2003).

Yano is a true believer in shareholder primacy. He rejects the notion that Enron and related scandals indicate defects in the US governance system. In his view, that system is more reliable than Japan's for producing good results: "Those Japanese who criticise the US are incompetent directors who are afraid of changing to the US system that may threaten their positions" (Yano, 2005).

In 2004, PFA placed US$100 million in a "good" corporate governance fund managed by Nomura Asset Management. The fund invests in TSE companies according to various criteria, with board size and independence being the main screens, along with disclosure, executive compensation and legal compliance. On another front, the PFA sent letters in 2004 to around 20 problem-ridden companies, urging them to change their governance practices by reducing board size, adding independent directors and firing incompetent directors. The PFA also tries to meet with company executives. Like Crist, Yano says that this kind of direct pressure gets better results than proxy voting. However, he laments the fact that CalPERS has better access to CEOs of Japanese companies than does PFA (Yano, 2005).

In light of all this, it's unsurprising that the PFA has become CalPERS' favourite partner in

Japan. 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, unlike the JCGF, the PFA is not "inside the business system" (Crist, 2005). At a 2003 conference, Ted White, then the official in charge of CalPERS' governance programmes, explained the relationship between the funds. CalPERS, he said, 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-based, 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" because it is difficult for CalPERS to be publicly critical of individual companies in Japan. But, said White, a tool like the focus list, which CalPERS never used in Japan, "can readily be mimicked by foreign players such as the PFA". Similarly, while CalPERS does not publicise its proxy votes for Japanese companies, PFA can do so (White, 2003).

Withdrawal symptoms

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

One internal factor is the diversification of CalPERS' international portfolio. Japan holdings fell from 45 per cent of the portfolio in 1993 to 25 per cent in 2001 to 20 per cent in 2005 (Cottrill, 2005). Bill Crist's retirement from the board at the end of 2002 was also significant in that Crist had a deep commitment to governance change in Japan, while his successor, Sean Harrigan, a former official of the retail workers' union, did not. Harrigan was more interested in domestic policy issues, especially those in which shareholder and labour-movement interests coincided. Few CalPERS officials other than Ted White have visited Japan in the past three years and White resigned from CalPERS in 2005. There has been no effort by CalPERS to develop formal structures – such as a Japan advisory committee – to replace Crist's network of contacts (Gunther, 2003; Crist, 2005; Sakai, 2005).

By 2003, ten years after Crist made his speech to the Keidanren, the governance principles that he espoused had become widely known in Japan. Several had been adopted into the Commercial Code, such as rules facilitating share buybacks (1994, 1997, 1998), issuance of stock options (2001), and the "company with committees" system (2003). The latter gives companies the option of doing away with statutory auditors if they appoint a majority of outside directors on three key board committees and if the board eschews operational responsibilities (Hashimoto, 2002). Hence by 2003 CalPERS faced diminishing returns to "macro" activities in support of the shareholder-value model. At the "micro" level, CalPERS rarely held more than 1 per cent of a company's stock, which limited its influence, as did its own reluctance to publicly criticise individual firms. There also was the free-rider problem: other investors were happy to have CalPERS incur the cost of active shareholding while they reaped the benefit. As an official at TIAA-CREF said, "Why bother to expend any effort on behalf of monitoring portfolio companies, when someone else will do it for you without cost to yourself?" (Clearfield, 2005, p. 117).

In fact, Michael Porter (1992) and Robert Monks (1993) 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" funds targeting underperforming companies. Relational investing, like any other kind of bloc holding, allows investors to focus directly on business decisions rather than, as with governance reform, the methods used to reach those decisions. Another advantage of relational investing is that it mitigates the free-rider problem associated with activism. Finally, when the funds are successful, their substantial returns allow institutional investors to "beat the index". In turn, this reduces the need to pursue governance change at the macro level.

CalPERS' foray into this area first came in 1995, when it took a stake in Relational Investors, a domestic fund, to which it added steadily over the years. In 2002 the board approved a plan to invest an additional US$1.7 billion in relational funds, with a substantial portion of the amount earmarked for overseas. Later that year CalPERS invested US$200 million (a 20 per cent stake) in Japan's Sparx Value Creation Fund; by the end of 2004 it had invested another US$165 million (CalPERS, 2004).

The Sparx fund was started by Shuhei Abe, former Nomura analyst and admirer of Warren Buffett. The fund invests in undervalued companies with market capitalisations of between US$300 million and US$3 billion. Abe and his analysts select the companies and then engage actively with management to improve performance. They "seek to influence" managements to restructure inefficient operations so as to raise shareholder value, with stock repurchases and dividend payouts being key measures of value. According to Abe, "Many Japanese CEOs don't know why they have to improve their return on equity because they have no sense of ownership and no sense of being part of the market." His leverage with management comes from the fact that his fund is concentrated in but five companies. One of these companies possibly was Nissan, whose CEO, Carlos Ghosn, is admired by Abe. However, Abe's opinion of other Japanese CEOs 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" (Abe, 2003; Japan Society, 2003).

Before CalPERS invested with Abe it vetted his background to make sure that he wasn't "a raider like [Yoshiaki] Murakami". As compared to Murakami, who has made several bold takeover attempts, Abe is relatively low key. Yet the Sparx approach of restructuring companies to return cash to shareholders is not very different from what Murakami does in his takeover bids. Of US$365 million invested, US$200 million has been distributed to the partners in the first two years. In at least one case, Sparx bought shares in a 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 (Crist, 2005; Kobayaschi, 2005; Sakai, 2005).

Another Japan relational fund in which CalPERS invests is Taiyo Pacific Partners, which is managed by two *gaijin* (foreigners). One is Wilbur L. Ross, a New York-based billionaire who helped reorganise Continental Airlines in the 1980s and more recently has been dabbling in mature industries such as coal, steel, textiles and auto parts. The other is Brian Heywood, a former missionary who later worked for Citibank in Japan. CalPERS signed a deal with Taiyo in April 2003 and invested US$200 million, a 20 per cent stake. Taiyo's approach is similar to Sparx's. It wants to avoid Murakami-like controversy, while using the threat of hostile takeovers to induce managers to work with Taiyo in raising share price. The fear of hostile takeovers is genuine. In April 2005, a survey found that senior executives at 70 per cent of Japanese companies were concerned about takeovers, this right after Livedoor's hostile bid for Nippon Broadcasting and one month before the law was changed to facilitate takeovers (Milhaupt, 2005). Agreeing to work with Taiyo doesn't mean that a company has accepted shareholder-value principles, however. Says Heywood, "In general the mindset is not so much, 'I've been converted to governance,' but 'I'm afraid of being taken over so I've got religion'" (*Financial Times*, 2004).

Once Taiyo begins working with a company, it trims "bloated" balance sheets by selling unrelated assets and returning cash to shareholders. The fund's 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 (including *The Japan Times*). Taiyo pushed Nifco to get rid of non-core assets that did 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'" (*Financial Times*, 2004). The firm has since reduced cash by raising its dividends. Taiyo urges firms to establish IR departments and communicate with investors. At Nifco, Taiyo recommended that the company send out press releases in English to explain that its divestments were driven by a "focus strategy". Taiyo told Maezawa Kasei to build ties with investment analysts. These moves are intended to boost interest in share purchases by foreign investors, the one group that has consistently been buying Japanese equities in recent years. Ross bristles at the "vulture fund" label and prefers to describe Taiyo as a "phoenix" (*New York Times*, 2003; *Nikkei Weekly*, 2004).

CalPERS also invests in "alternative" vehicles such as Japanese real estate trusts. It holds substantial chunks in private equity funds, including Carlyle Partners (US$300 million), KKR (US$85 million) and Ripplewood (US$12 million), of which around US$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 shortens its horizons. Currently, over 10 per cent of its Japan investments are in relational and private equity funds (Mark, 2005). These funds do not

engage in "macro" activities to promote the CalPERS governance principles. This is of little concern to Heywood, who says, "We don't need to change the whole market" (*Financial Times*, 2004).

Appraising the CalPERS effect in Japan

Over the past 15 years, CalPERS' macro activities have definitely affected Japanese corporate governance. Not only was CalPERS regularly in the Japanese media, it mounted public relations efforts of its own. It worked closely with domestic norm entrepreneurs such as the JCGF and, more recently, the PFA. Several commercial code revisions are consistent with principles originally espoused by CalPERS, such as those concerning online proxy voting, stock options, share repurchases and independent board subcommittees. However, it's difficult to assess the extent to which CalPERS was the inspiration for these revisions or whether government officials used "foreign pressure" (*gaiatsu*) as an excuse to adopt them. Some officials viewed shareholder-primacy governance as an inexpensive way of stimulating the Japanese economy by raising asset prices and improving balance sheets; others hoped that these changes would keep the US government at bay (Koo, 2003). The United States repeatedly has pressured the Japanese to Americanise their governance system, from the Structural Impediments Initiative of the late 1980s to the recent "Investment Initiative", whose objective is to facilitate foreign acquisitions of Japanese companies (US Department of State, 2005).

Limiting CalPERS' effectiveness at the macro level was its reluctance to be seen as an American bully. Also, ever since entering the Japanese market, CalPERS faced opposition from the Keidanren, which worked behind the scenes to slow the adoption of a shareholder-value model. Keidanren has tried to preserve internal boards and cross-holdings, to deter hostile acquisitions and to keep TSE listing standards free of mandatory governance criteria (Crist, 2005). One result is that many commercial code revisions have been permissive rather than mandatory and without enforcement mechanisms, leaving companies free to stick with the status quo or to adopt changes that meet the letter but not the spirit of the law (e.g. claiming quasi-insiders as independent directors and auditors). But in one area – transparency – Keidanren has urged Japanese companies to improve accounting, control and disclosure practices. Legislative changes in this area have been mandatory (Patrick, 2004; Keidanren, 2001).

It's likely that CalPERS has more leverage in countries that depend heavily on foreign capital, such as emerging economies, than in Japan. CalPERS rates emerging nations on factors such as corporate governance, political stability and openness. It reminds those nations – and their business leaders – that adherence to international governance standards will make them more attractive to foreign investors (Hebb and Wojcik, 2003). CalPERS made the same argument on several occasions in Japan (Crist, 1993; CalPERS, 1998b). The difference, however, is that while Japan welcomes foreign investment, it hardly suffers from capital scarcity. While payouts to shareholders have risen in Japan since the recovery started in 2001, the payout rate remains low by international standards (Ryder, 2005).

At the micro level CalPERS had greater leeway to exert pressure, although its concerns here had more to do with boosting shareholder returns than with specific governance practices. It relied on proxies and communications with executives, and, to boost its leverage, formed alliances with other institutional investors. According to Crist, these alliances bore fruit in numerous instances, although he refuses to disclose specifics. The claim fits with research indicating an association between foreign ownership and restructuring in Japanese companies. However, the US data show that the most powerful effect of shareholder activism on performance comes via public targeting (or the threat of it), yet this was a tactic CalPERS eschewed in Japan, thereby limiting its effectiveness (Jacoby, 2006).

The fact that a stakeholder approach to governance – as reflected in board structure, employment practices, executive pay and takeover norms – remains alive in Japan today can be explained in two ways. The first is that resistance from entrenched managers who jealously guard their perquisites has kept Japan from adopting the shareholder-value model. This is the argument made by Crist and Yano. There has been resistance, to be sure, but the entrenchment argument is difficult to accept in light of the relatively modest pay associated with executive status in Japan, where CEO compensation is one-quarter of US levels. If anything, Japanese executives would make out better under a shareholder-primacy approach, as they did in the United States, where stock-based pay aligned CEO and shareholder interests. The second explanation is that corporate governance is endogenous to a firm's incentives and its institutional environment (Demsetz and Lehn, 1985).

Companies, including those in Japan, adopt only those governance practices that are a good fit. This view is supported by a recent study of Japanese corporate performance and governance practices, such as shareholder rights, board structure and disclosure. Of the three, only disclosure is significantly related to performance (Miyajima, 2006). Disclosure and transparency are add-ons that can be adapted to the existing Japanese corporate system with minimal disruption to incentive systems and to the ethos of stakeholder governance. In other words, one reason that CalPERS made only modest headway in Japan was its rigid adherence to a governance model developed under different circumstances.

Conclusions

Institutional investors play an important role in transmitting shareholder-value principles to overseas markets. In Japan, CalPERS worked with various local organisations to change prevailing governance standards in line with what it had achieved in the United States. Although CalPERS had mixed success, it planted a seed that is sprouting in the form of pension fund activism by domestic groups like the PFA.

Over time, the cost of pursuing market-wide activities led CalPERS to do more targeting of individual Japanese firms, with relational investing being the ultimate expression of that tendency. In this realm, governance principles took a back seat to more direct efforts to redistribute corporate rents to shareholders. Perhaps in the final analysis that's what governance change by CalPERS has always been about.

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Sanford M. Jacoby is Howard Noble Professor of Management, Public Policy, and History at UCLA and Omron Fellow at the Institute for Technology, Enterprise and Competitiveness (ITEC) at Doshisha University. He is interested in issues related to labour and corporate governance, especially from comparative and historical perspectives.