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The Limits of Shareholder Value?

Hedge Fund Activism in Japanese Listed Companies

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By John Buchanan,
Dominic Chai
and Simon Deakin

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Abstract

Activist hedge funds have been successful in generating high returns for shareholders in the USA through direct engagement with management. Their strategy requires the cooperation of other shareholders and a supportive regulatory environment. In Japan, where these conditions are absent, they have been less successful. Japanese managers continue to see the long-term growth of the firm, and not the maximization of shareholder value, as their main objective, while many shareholders hold their stakes for business-related reasons, not for investment. The recent Japanese experience suggests that there are limits to the global diffusion of the Anglo-American shareholder value model.

Introduction

Activist hedge funds appear to have succeeded where other institutional investors have failed in raising levels of returns to shareholders. In the USA their interventions achieve positive abnormal returns which are linked to sales of assets and the refocusing of business strategies by the companies they target. Evidence of their longer-term impacts on the profitability of target companies is more equivocal, but they have been described as a highly effective way of reducing managerial agency costs and imposing financial discipline on firms (Brav, Jiang, Partnoy, & Thomas, 2006, p.9; Klein & Zur, 2009).

Activist hedge funds first appeared in the Japanese market in the early 2000s. They advocated the return of surplus cash to shareholders and questioned management's right to set strategy unilaterally. The foreign funds that predominated after 2002 were initially successful in generating above-market rates of return through a mixture of dividend increases and other pay-offs. But subsequently they encountered resistance from managers, indifference from other shareholders, and a skeptical government and public. In late 2008 a number of their positions were unwound, partly because their investors needed cash as the global financial crisis took hold, but also because of an increasingly unwelcoming environment. Some interventions had yielded good returns and some had not. The more fundamental problem was that hedge fund activism

had signally failed to shift the practice of Japanese corporate governance on to the Anglo-American path.

The recent setbacks experienced by activist hedge funds in Japan could be explained by the opposition of entrenched interests in the business and political elites to external pressures for corporate governance reform. We consider such an explanation to be misleading. The deeper question is why there was no consensus for more far-reaching change. The answer lies, we suggest, in the durability of the large Japanese corporation – the so-called ‘community firm’ – and the structures that have grown around it. It is the capacity of this model to deliver tangible benefits for a range of societal interests, including shareholders, which accounts for its continued legitimacy, and for the limited headway made by hedge fund activism.

In addition to carrying out a review of the (limited) literature on hedge fund activism, we use three main data sources to support our analysis. The first consists of quantitative data on hedge fund stakes in listed Japanese companies, drawn from the Thomson Reuters dataset, and financial and accounting data on the same firms, drawn from the Worldscope dataset. This gives us an initial picture of the extent of hedge fund involvement in the Japanese market. Our second consists of a hand-collected database of activist hedge fund interventions in Japan that we have compiled from Japanese press reports and other relevant sources including the Japanese Financial Services Agency’s Electronic Disclosure for Investors’ Network (EDINET) database. We use this for a more accurate picture of the extent of hedge fund activism, as opposed to that of the hedge fund sector more generally, and to provide detailed case-study accounts of selected interventions. Our third source is made up of just over 100 interviews with managers of listed companies, investors (including hedge funds), industry association representatives and policy-makers, carried out between 2003 and early 2009 (see Buchanan and Deakin, 2009), which provide background material on changing perceptions of corporate governance issues in Japan during this period.

Hedge Fund Activism: Origins, Nature and Effects

A working definition of a hedge fund is “an actively managed, pooled investment vehicle that is open to only a limited group of investors and whose performance is measured in absolute return units” (Connor & Woo, 2003, p.1). Their origins are usually traced to the American private investment companies of the 1920s or to Alfred Winslow Jones’ private investment partnership, founded in the 1940s (Partnoy & Thomas, 2006, pp.23-4). Their closed nature means that they largely avoid regulatory supervision of the kind which applies to pension funds and mutual funds. Unlike the latter (in the US context), they are not required to diversify their holdings or to return capital to investors more or less on demand. Investor ‘lock-ups’ of two years or more are not uncommon. Nor are they subject to ‘prudential’ investment guidelines or to the strict fiduciary standards which apply to pension funds in Britain and America (Brav, Jiang, Partnoy, & Thomas, 2008, p.1735).

A recent study estimated total assets under management by hedge funds to be approximately US\$2,500,000 million as of June 2008 (AIMA, 2008, p.16), with a majority of these deployed in the USA (FT, 2006). Activist hedge funds are a distinct group within this sector and, in terms of investment volume, are thought to constitute only around 5% of the total (Marcel Kahan & Rock, 2007, p.1046). They typically operate by taking large stakes in selected target companies (10% was the median in Brav et al.'s study covering the USA between 2001 and 2006) and engaging directly with management on matters which include business strategy, capital structure, asset sales and adherence to corporate governance standards. They are not short-term investors; holdings of up to four years are not uncommon. They call for the return of cash surpluses to shareholders in the form of increased dividends and share buy-backs, and encourage firms to increase their leverage. Because they do not normally seek to take control of their targets through hostile takeover bids (although, as we shall see, this has happened in Japan) their strategy depends for its success on gaining the cooperation of management concerned and of other shareholders. Shareholder activism is not confined to hedge funds. In the United States, pension funds such as CalPERS (Jacoby, 2007) and 'value investors' of various kinds (Pound, 1992) offer other examples. However, since the early 2000s hedge funds have offered a distinctive form of activism which appears to have been more successful in generating returns for shareholders than the alternatives.

Brav et al., analyzing a dataset containing over 1,000 interventions by activist hedge funds in US companies over the period between 2001 and 2006, find evidence of abnormal positive returns to shareholders in the 'announcement window' around the disclosure that a fund had taken a 5% or more stake in a target company (a 'Schedule 13D filing' with the SEC). The average abnormal return was in the 7-8% range 20 days after the filing. The highest returns were achieved by interventions aimed at the sale of assets; next came those which addressed business strategy. The lowest returns were for interventions concerned with capital structure and corporate governance standards. Brav et al. also calculated returns to funds over the period they held shares in targets. The median return was no better than the market benchmark after adjusting for size, but the upper quartile of deals did substantially better and offered "much more upside than the corresponding downside of the lower quartile" (Brav, Jiang, Partnoy, & Thomas, 2008, pp.1760 and 1775-7).

As Brav et al. point out (2008, p 1730), these results are different from those obtained in studies of activism by pension funds and mutual funds, which generally failed to find evidence of increased returns to shareholders (see Romano, 2001 for an overview). Pension funds have tended to see their role in terms of raising standards across the market as a whole, through the promulgation and dissemination of standards relating to such matters as board structure and takeover defenses. This is a strategy consistent with their broadly diversified holdings (Jacoby, 2009) but which appears to be weakly linked, if at all, to improved financial performance at firm level (Bhagat & Black, 2001). By contrast, hedge funds seem able to deliver enhanced shareholder value in the firms they target by using their sizable stakes to put direct pressure on target managers (Brav, Jiang, Partnoy, & Thomas, 2008, p.1772).

The longer term impacts of hedge fund activism are less clear. Brav et al. find, on average, a negative impact on profitability and return on assets in target firms immediately following interventions by reference to the performance of firms in control groups, but a recovery in both to pre-event levels by the end of the first year and a small improvement by the end of the second year. Klein and Zur, analyzing a sample of hostile hedge fund interventions, report declining profitability and earnings in the year following the event and no recovery thereafter. Both studies argue that, whatever the outcomes in terms of profitability, shareholders benefit: “hedge fund appear to address agency costs associated with excess cash balances by increasing dividends and the target’s leverage” (Klein & Zur, 2009, p.225).

Studies differ in their assessments of the wider social benefits of hedge fund activism. Brav et al. (Brav, Jiang, Partnoy, & Thomas, 2008, p.1774) argue that “the presence of... hedge funds and their potential for intervention exert a disciplinary pressure on the management of public firms to make shareholder value a priority”. They find no negative impacts on creditors and some evidence of transfers of wealth from senior managers to shareholders, but do not study the effects of interventions on the workforce more generally in target firms. Bratton, who analyses over 100 US interventions in the period 2001 to 2006, reported that activist hedge funds “have shifted the balance of corporate power in the direction of outside shareholders and their financial agendas”. He cautiously concludes that they are “an important experiment in corporate governance” (Bratton, 2007, pp.23 and 54).

Certain features of the US corporate governance environment and regulatory framework have been favorable to the emergence of hedge fund activism since the early 2000s. One of these is the rise of independent boards. By 2000 almost 70% of directors on the boards of US-listed companies were independent, an increase from around 30% in 1980, and by 2002 a combination of stock exchange rules and legislation had made it mandatory for listed companies to have a majority of independents on the main board and audit committee. As Gordon puts it, one of the main functions of independent directors in the US context is “to enhance the fidelity of managers to shareholder objectives, as opposed to managerial interests or stakeholder interests”. Their presence makes it less likely that the management of a listed company can simply say “no” in the face of a hedge fund intervention (J. Gordon, 2007, p.1469).

Secondly, the changing structure of share ownership in the USA has made hedge fund activism more feasible than it would otherwise be. Ownership of shares in US-listed companies by pension funds and mutual funds, which was at the 50% level in 1980, had reached 70% by 2000 (J. Gordon, 2007, p.1568). As we have seen, activism by pension funds has not been particularly successful in generating supra-normal returns at target companies. In these circumstances, the institutions have been increasingly prepared to shift their support to the hedge funds, which they see as being better placed to achieve the desired re-ordering of managerial priorities. The presence of supportive institutional investors in listed companies makes it unnecessary for activist hedge funds to mount takeover bids in order to release shareholder value, as an earlier generation of corporate raiders had to do (Brav, Jiang, Partnoy, & Thomas, 2006, p.4).

A third relevant factor is the absence of significant legal or regulatory barriers to corporate restructuring in the US environment. There are no codetermination mechanisms for the expression of worker voice of the kind found, for example, in most continental European countries (see Rogers & Streeck, 1995), and limited legal provision for severance pay. As a result, target companies cannot credibly invoke employee or other stakeholder interests as a way of deflecting hedge fund interventions.

The UK has its own tradition of shareholder activism, with examples including the UK Active Value Fund, which in the 1990s took large stakes in listed companies and agitated for changes aimed at enhancing share prices, and the Hermes Focus Fund, which engages with target managers in selected under-performing firms on issues of business strategy (see Becht et al., 2008). There has been a steadily rising incidence of press reporting on ‘hedge fund activism’ since the early 2000s (Armour & Cheffins, 2007, p.67). Shareholder activism received a high public profile in 2007 when the US fund run by Nelson Peltz was credited with persuading the board of Cadbury Schweppes to sell off its US drinks business. A British based fund manager, unconvinced by the board’s claim that it was already considering such a move, wrote: A world where a 3 per cent activist shareholder could have this degree of influence on the board of a listed UK business is a different one from the one I have known for the past 35 years. I do not think the relationship between UK companies and their shareholders will ever be the same again (Bolton, 2007).

Activism was also growing on the European continent during this period. In 2005 The Children’s Investment Fund (TCI), based in the UK, led a campaign which resulted in the abandonment of Deutsche Börse’s attempt to acquire the London Stock Exchange, in favor of increased distributions to shareholders, and the subsequent resignation of both its CEO and chairman. Following TCI’s intervention, Deutsche Börse enjoyed a sustained rise in its share price to late 2007. In 2006-7 TCI successfully promoted the merger of Euronext (incorporating the Paris, Amsterdam and Lisbon stock markets) with the New York Stock Exchange, and in 2007 it acted as a catalyst for the sale of the Dutch bank ABN Amro to a consortium comprising the Royal Bank of Scotland, Fortis and Santander, delivering an estimated 50% increase on the target’s early 2007 share price. TCI’s interventions were widely supported by institutional shareholders (Marcel Kahan & Rock, 2007, p.1092).

Hedge fund activism in Japan: what were the triggers?

The first investments made by foreign hedge funds in Japan were made in late 2002 by the US-based fund, Steel Partners, all in mid-sized companies. Steel Partners subsequently targeted some larger companies, and TCI began interventions in two large utilities in late 2005 and 2006. According to the Thomson Reuters database, by 2007 over 3% of firms listed on the Tokyo Stock Exchange had a hedge fund shareholding of at least 5% (see Table 1: Japanese law requires the disclosure of an acquisition of 5% or more in a listed company, and any subsequent variations of 1% or more in the extent of such holdings). Not all of these represent funds engaging in shareholder activism. Hedge funds may also take large stakes in order to engage in

risk-arbitrage or in bankruptcy-related reorganizations (Brav, Jiang, Partnoy, & Thomas, 2008, p.1738). In order to get a clearer picture of the extent of activism, we supplemented the Thomson Reuters data with our own database of hedge fund interventions. By doing so we were able to exclude 15 of the cases listed by Thomson Reuters, leaving us with 60 activist interventions in total as at the end of 2007 (Thomson Reuters' data on hedge fund interventions in Japan is only available for the end of calendar year 2007). Of these, the vast majorities - just over 80% by value – were undertaken by American or British funds (see Figure 1).

Insert Table 1 and Figure 1 about here

While the extent of holdings by hedge funds in Japanese listed companies is substantially below equivalent levels in the US and British markets (see Table 1), they are significantly greater than those observed in each of the main continental European markets. This prompts the question of why the Japanese market has been the focus of such interest.

The Japanese ‘Community Firm’: Obstacle or Opportunity?

At first sight, limited influence exercised by external shareholders over the management of listed companies in Japan should have been a significant obstacle to activism. The core employees of these companies see them as communities which they join for life (Dore, 1973, p.222; Inagami & Whittaker, 2005, pp.1-5). In the immediate post-war period, the need for economic recovery led large companies to establish themselves as the long-term focus of their employees' concerns, offering job security and internal advancement in return for loyalty and the subordination of personal interests to those of the company. The resulting spirit of “corporate hegemony” was “stronger and more enduring in Japan since the early 1960s than anywhere in the world” (A. Gordon, 1998, p.196).

This communitarian ethic came to be reflected in corporate governance structures. Boards were overwhelmingly executive and internally appointed; managers saw their role as “working for the long-term prosperity of the firm (i.e. all its employees, present and future), there by enhancing their own reputation within the firm, and hence their chances of being one of the division directors appointed to the Board” (Dore, 2000, p.27). Where there were external directors,¹ they tended to be seen as advisers, or were associated with major customers or suppliers. During the Second World War, in order to prioritise industrial output, shareholders in Japan had been excluded from control of the companies in which they had invested. The post-War recovery was guided by government ministries and financed by banks, leaving shareholders outside the nexus of power (Okazaki, 1999, p.125). The exceptions to this were shareholders who invested for commercial rather than portfolio motives, such as suppliers, customers and banks, who used their shareholdings to underpin their business interests, rather than for investment income. A related development was the custom of stable or cross shareholdings that

¹ The Japanese expressions *shagai torishimariyaku* and *gaibu torishimariyaku* denote externality but not independence and we translate them as ‘external directors’

developed among these interested parties creating friendly shareholding blocs predisposed to support management (Sheard, 1994, pp.310-20). As the Japanese economy prospered, profitable companies felt no need for governmental support and from the 1970s were turning to the capital markets to replace bank loans (Aoki, 1988, pp.258-97; , 1994, p.135). By the end of the 1980s, management at many companies operated largely free from external interference of any kind unless commercial problems forced them to return to government or the banks for support; this has been described as a system of “contingent governance” in which external intervention only occurred when incumbent management had clearly failed (Aoki, 1994, pp.122-4).

But while the persistence of community firms in Japan, long after their equivalents had been marginalized in America (see Jacoby, 2007) was in one sense an obstacle to the hedge funds, it also provided them with an opportunity. Focused primarily on maintaining the long-term growth of the firm, management at many listed companies had accumulated large cash balances and maintained low dividend payouts (Pinkowitz & Williamson, 1999, p.15; Rajan & Zingales, 1995, pp.1427-8). Stock market declines in the 1990s meant that these companies’ shares were cheap relative to their asset base, and this trend has persisted: in July 2007, 22% of first section listed companies on the Tokyo Stock Exchange were thought to be trading below book value (Bloomberg, 2007).

Thus there were, in principle, cash surpluses available for reallocation. The question was to how to access them.

The Regulatory Framework: Corporate and Employment Law

The regulatory framework offered a way in. The Japanese model of corporate governance is not legally mandated and Japanese corporate law is, on the face of it, highly accommodating to shareholder interests. The core content of corporate law is derived from amendments made to the commercial code in the early 1950s which were drawn directly from US models (West, 2001). From a legal point of view, community firms are simply joint stock companies with a structure entirely familiar to American and British investors from their home markets. Shareholders with a 1% holding can submit proposals to the annual general meeting and those with 3% can call for an extraordinary meeting. In most cases, a simple majority of participating shareholders is entitled to appoint the board and to dictate the level of dividend payouts, while a majority of two thirds can vote to alter the company’s capital structure. In many respects, shareholder rights in Japan are superior to those provided by the Delaware laws which apply to most US-listed companies (see Siems, 2008).

The pattern is repeated in the area of labor and employment laws. There is no codetermination in the sense of mandatory representation of employees on the board, and legal provision for consultation with employee representatives over corporate restructuring is a recent development, going back to 2000. The practice of “lifetime employment” is just that: a practice. Until 2003 it was case law, rather than legislation, which laid down the circumstances under which dismissal was regarded as ‘abusive’, and although dismissal for economic reasons is still regarded a matter of last resort, the courts place corresponding stress on the freedom of

management to change job definitions and redeploy workers to new tasks as demand requires (Araki, 2009). Whatever the conventional position may be concerning respect for the interests of core workers in large Japanese companies, they enjoy fewer legal rights than their counterparts in mainland European systems, most of which offer a mix of codetermination and strong employment protection (see Deakin, Lele, & Siems, 2007).

Changes in the Corporate Governance Environment in the Early and Mid-2000s

In addition, the wider corporate governance environment began to change from the early 2000s in ways which appeared to indicate convergence with the American and British systems. Firstly there were changes to structures of share ownership. Levels of foreign ownership increased, at the same time as many of the stable and cross-shareholdings began to unravel. The average level of stable shareholdings expected to support management fell from 45.6% of the market in 1990 to 38% by 1999 and continued to fall thereafter (NLI Research, 2004). At the same time, the ratio of foreign ownership rose from 4.7% in 1990 to 18.6% in 1999, and this trend also continued (National Stock Exchanges, 2008a). The two phenomena were linked, as it was the more profitable firms and those which made greater use of external finance through the stock market which had the greatest increase in foreign ownership and were the first to unwind previously stable and cross-shareholdings. These foreign shareholders were mostly pension funds and other institutions which were investing for returns, unlike the Japanese shareholders who often had business interests of one sort or another at stake in the company, and their holdings were more frequently traded, giving them a disproportionate influence over stock price movements (Ahmadjian, 2007, p.133).

Secondly, radical changes appeared to be taking place in board structures. Sony's decision in 1997 to reduce its board size, increase the number of external directors and distinguish between the supervisory duties of the board and the management of the firm, which was entrusted to a new class of "corporate executive officers", seemed to usher in a new era. After the collapse of the investment "Bubble" in the early 1990s, Japan's tradition of corporate governance had been discredited. Many companies copied Sony in reducing the size of their boards and nominating their former junior directors as corporate executive officers. A new legal structure was introduced in 2003 in the form of the so-called "company with committees system." This required formal segregation of supervision and execution and created board sub-committees for nomination, remuneration and audit, on which the majority of directors had to be external. However, the opposition of Japan's leading economic association, the Keidanren, ensured that this system was only optional. Moreover, it made no requirement for a majority of external directors on the main board, nor did it prevent internal directors from also being executives. By July 2008 only a net 110 companies had opted into it (JCAA, 2008). However, with the growing use of external directors and the separation of supervision and execution across the corporate sector as a whole, there is surprisingly little difference, in practice, between corporate governance practices in those firms which have formally adopted the new legal structure and those which have not (J. Buchanan & Deakin, 2008, p.79; J. Buchanan & Deakin, 2009).

Thirdly, there were the beginnings of a market for corporate control. The bid by the internet service provider Livedoor for control of Nippon Broadcasting System in 2005, while unsuccessful, demonstrated that hostile takeovers were not impossible. When Nippon Broadcasting System responded to Livedoor's bid by attempting to issue share warrants to a friendly third party, in an attempt to dilute Livedoor's holding, the courts granted an injunction blocking the move on the grounds that it constituted an illegitimate attempt by the board to alter the composition of the shareholder body. Although the Livedoor ruling left open the possibility of defensive action in response to a hostile bid, the decision was novel, in the Japanese context, for its implication that shareholders might determine the outcome of bids (Hayakawa & Whittaker, 2009).

Shifting Attitudes to Shareholder Activism

There was a related shift in perceptions of activist shareholders. For much of the post-war period shareholder activism had been viewed as a form of extortion of the kind carried out by "stock cornerers" (*shite*) who would buy large parcels of shares in the expectation that other shareholders would buy them out, or the "AGM operators" (*sokaiya*) who would threaten to disrupt general meetings (Kester, 1991, pp.252-4; Milhaupt & West, 2004, pp.109-139). When T. Boone Pickens bought 20% of Koito Seisakusho in 1989-90 and attempted to use his shares to get board-level representation, he was identified with this extortionist tradition and the business establishment and public opinion closed ranks against him (Tricker, 1994).

However, sentiment had changed sufficiently by 1999 for Yoshiaki Murakami and his partners to set up M&A Consulting (the "Murakami Fund"), an activist fund which was noted for its willingness to embark on public campaigns against managements which it felt were withholding shareholder value. By 2005 the Murakami Fund held positions in 52 companies most of which had relatively high ratios of foreign ownership. In 2006 the Fund was wound up following an admission by Murakami of insider dealing, but by that stage the Fund had "done much to impress on the management of large Japanese corporations the need to raise shareholder value, an area that had received very little attention until then, and to encourage a change in management's attitude" (Osaki, 2006).

The Characteristics of Target Firms

On the basis of the preceding analysis, we would expect hedge fund activism in Japan to have followed broadly similar lines to that in the United States. How far is this prediction borne out, firstly, by the nature of the firms targeted for intervention?

Insert Table 2 about here

Table 2 reports the results of a probit regression which estimates the impact of particular firm characteristics on the likelihood of a firm being targeted for an intervention. The Table shows the independent variables, the probit coefficients and the marginal probability change

induced by a one-standard deviation change in the values of the covariates from their respective sample averages. The independent variables include firm size (market capitalization in billions of yens), Tobin's q (the sum of market value of equity and book value of debt divided by the sum of book value of debt and book value of equity at the yearend), dividend yield (the value of dividends paid during the year divided by the market value of the firm at year end), return on equity (net income divided by the book value of equity at year end), the debt ratio (total debt divided by total assets), capital expenditure (total capital expenditure scaled by total sales), cash (the ratio of total cash and cash equivalents to total assets), and insider ownership (defined by reference to the proportion of shares held by strategic entities that maintain close relationships with management, a category which includes corporations, holding companies, and company officers and directors). The dependent variable is a binary that equals one if there is hedge fund activism targeting the company and zero for non-targets, for the following year 2007 (that is, all covariates are lagged by one year). The sample consists of 2,041 non-financial, non-newly listed firms. The targets are the 60 firms with a 5% or more hedge fund holding.

The results show that activist hedge funds in Japan target smaller firms with low debt, low insider ownership, high profits and high cash reserves. The finding on insider ownership confirms that funds try to find companies which do not have shareholder blocks likely to support management, a finding consistent with the results obtained by Brav et al. (2008) for the US case. It appears that activist hedge funds followed the same logic of selection that they applied in the USA. One particular aspect – that is not at variance with the US experience but is more extreme in Japan – is the importance of cash: a one-standard deviation in the cash to total assets ratio is associated with a 3.97 percentage point increase in the probability of being targeted, other things being equal.

Case Studies

We look at two case studies to illustrate the approaches to intervention undertaken by activist funds in Japan. They were both high-profile events which triggered a number of legal and regulatory issues and significantly influenced public attitudes to hedge fund activism and the issue of corporate governance in general; they are chosen partly for these reasons. In addition, they reflect the types of outcomes which hedge funds achieved, ranging from success in the form of a pay-out designed by management to protect the autonomy of the target firm, to failure in the form of exit without apparent profit in the face of managerial and governmental resistance.

Bull-Dog Sauce

Steel Partners' intervention in Bull-Dog Sauce (Bull-Dog), a small manufacturer of Worcester sauce and other condiments and a household name in Japan, lasted from July 2003 until March 2008. Bull-Dog had a market capitalisation below net asset value, no financial debt, and 47.4% of its total assets were in cash or investments. Initial negotiations between Steel Partners and Bull-Dog's management were not publicised but on May 16 2007, Steel Partners, who then held approximately 10.5%, announced their intention to bid for all the shares they did not already own, offering a premium of about 20% over the May 14 closing price. Steel Partners stated that they had no intention to interfere in the daily running of the target (Nikkei, 2007d).

What made this intervention distinct, and attracted enormous public attention in Japan, was the sequence of events that followed the bid. Bull-Dog's management expressed itself puzzled as to Steel Partners' intentions in wishing to acquire the company and asked formally whether this would increase "corporate value". In June the management decided to contest the bid and proposed as a defense measure to issue three stock options per existing share to all shareholders, with the proviso that Steel Partners alone could not exercise their rights but would be compensated in cash in line with the price implied by the bid. This was approved as a special resolution by over 80% of shareholders at the AGM on June 24 (Nikkei, 2007c; Ryūtsū Shimbun, 2007).

Steel Partners challenged this arrangement through the Tokyo District Court, which rejected their arguments on June 28. Steel Partners appealed to the Tokyo High Court but their appeal was dismissed on July 9. On August 7, a further appeal, to the Supreme Court, was dismissed. The judgment of the Tokyo High Court attracted the greatest attention. The judge observed that although a joint-stock company was, in theory, a for-profit organisation that maximised its corporate value and paid it out as dividends to shareholders, a company could not realise a surplus except through association with employees, suppliers and consumers. It was permissible to treat an "abusive acquirer" in a discriminatory way (Miyake, 2007, pp.187-191; Nikkei, 2007e). Steel Partners lost the case and their bid consequently failed, but the special payment they received from the company in July 2007, totalling ¥2,300 million, caused dismay in business and political circles. A civil servant told us in 2007:²

...that company's operating profit is only ¥500 million, you know. They paid out four year's worth of money...as a matter of principle, paying out money to someone trying to buy you is to sanction greenmailing. So while saying that they were opposed to it, Bull-Dog Sauce effectively sanctioned greenmailing.

J-Power

TCI began to buy shares in J-Power, a large Japanese electrical utility with a strong hydroelectric presence and nuclear generation plans, in 2006. J-Power, formerly owned by the state and other utilities, had been privatised and listed in 2004. Its IPO had created a high ratio of foreign institutional shareholders; in a TSE submission dated September 30, 2006 it described its foreign shareholders as "in excess of 30%" including 4.57% held by TCI. In other respects, J-Power was not a typical hedge fund target. Its market capitalisation of ¥621,365 million as at March 31, 2006 was much greater than its net asset value, it had gearing of approximately 2.9 times, and only 7.4% of total assets were in cash or investments.

By March 7, 2007, TCI held 9.9% of J-Power, just short of the legal barrier of 10% above which, as a foreign entity, it would require ministerial permission to own further shares in a

² We draw here, and in subsequent sections, on our interview material (see Buchanan and Deakin, 2009).

utility. On March 9 TCI recommended to J-Power that its annual dividend be raised from ¥60 to ¥130 per share. Management rejected this suggestion on the grounds that it was premature to raise the dividend before future profits were assured (Nikkei, 2007a). Exchanges between TCI and J-Power's management were publicised on their respective websites and widely notified to the press.

At the AGM on June 27, J-Power's shareholders rejected the proposal to raise the dividend, although some 30% supported it. J-Power's management reiterated its willingness to increase the dividend in the future, once profits were sufficiently robust (Nikkei Sangyō, 2007). On November 22 TCI wrote to the president of J-Power saying that the company's corporate value was in decline and recommending appointment of external directors and other measures. J-Power's management replied with arguments justifying its position and in January 2008 formally rejected external board candidates proposed by TCI. Meanwhile, TCI continued to press for change and on January 15 applied to the Japanese authorities, through the Ministry of Economy, Trade and Industry (METI), for authorisation to increase its shareholding to 20% (Nikkei, 2008f). No similar requests had been refused in the past but METI soon extended the review period to May 2008 (Nikkei, 2008b). In March 2008, while METI continued to study its request, TCI submitted 127 pages of proposals for improvement in corporate strategy and structure to J-Power.

On April 16 the Japanese authorities formally advised TCI not to raise its shareholding in J-Power beyond 10%, expressing concern that TCI's increased ownership and influence might put at risk stable power supplies and the future of J-Power's planned nuclear plant. TCI proposed compromises but the sub-committee studying the request appeared to focus on TCI's allegedly short-term objectives (Nikkei, 2008e; Nikkei Sangyō, 2008a). TCI wrote to the UK government seeking formal support for its position and publicly queried the Japanese government's decision (FT, 2008b). In May it increased pressure on J-Power's management with multiple initiatives: it requested J-Power's statutory auditors to investigate recent price reductions by the company, the recent increase in cross-shareholdings, and alleged failure to achieve financial targets; the statutory auditors announced their decision that no action was appropriate in June. It also wrote to the president suggesting that J-Power had agreements with its cross-holding counterparties regarding prices that were contrary to the interests of other shareholders (Nikkei, 2008a, 2008g). At the AGM on June 26, 2008, TCI proposed an increased dividend (as a dual structure of either ¥120 or ¥80 per share), a share buy-back, limits to cross-shareholdings, and appointment of three external directors; these proposals were defeated (Nikkei Sangyō, 2008b). It was reported that support for TCI's proposals had fallen generally to the 20% range, though exceeding 30% for its proposal that external directors should be appointed, an aspect that J-Power's management had already announced that it would study (Nikkei, 2008d).

On July 14 TCI finally accepted the Japanese authorities' decision that it might not increase its shareholding (Nikkei, 2008c). There were no further public developments until October 31, 2008, when TCI sold its 9.9% shareholding to J-Power. Japanese corporate law permits shareholders who object to a major reorganisation of assets to enjoin the company to buy their shares at a "fair price" and TCI was able to take advantage of J-Power's absorption of an

Australian subsidiary in order to do this. The price paid was in excess of the then market price, but was estimated by the press to represent a loss to TCI of some ¥12,500 million before costs (FT, 2008a; Nikkei, 2008h).

Activist Hedge fund withdrawal from the Japanese market

In the autumn of 2008 Steel Partners issued detailed written recommendations to some seven companies in which they held significant stakes, including a proposal for a friendly takeover of Noritz Corporation. However, they then withdrew their offer for a friendly takeover of another company, Sapporo, where they had intervened for several years. By January 2009 they had reduced their holdings in a majority of the firms they were investing in, and had exited completely from three. They are estimated to have sold shares totaling ¥150,000 million, out of a total holding of ¥390,000 million during 2008 (Reuters, 2009). TCI, in addition to selling its holding in J-Power, had already exited another utility, Chûbu Electric, apparently without making any share price gain. A Japanese investor to whom we spoke on the subject of activist hedge funds in early 2009, following up on earlier meetings, saw the situation starkly as a general market disruption:

So last time we met, many of these questions made great sense but today I'm not so sure whether some of them are still meaningful or not. In fact, not just hedge fund activists, but the hedge fund industry as a whole has almost collapsed.

Part of the background to the disposal of holdings by hedge funds has undoubtedly been the financial crisis that developed during 2008. This has undermined their funding base. A survey by Deutsche Bank on the hedge fund sector as a whole reported investors' expectations that some US\$200,000 million would be withdrawn worldwide in 2009, after a net withdrawal of US\$155,000 million in 2008 (FT, 2009). The Japanese market is not unaffected by this wider trend. However, there are additional factors at work which help to explain why hedge fund activism has recently been scaled back there.

Attitudes of managers and shareholders

The first of these factors is the inability of activist hedge funds to change attitudes among managers and shareholders. In some cases, managers accepted that the arguments put by the funds had merit. As one of them put it to us, "looking at the two and a half years we were dealing with [the fund], for about the first year and a half I think there was a fairly constructive discussion about what kind of financial strategy we should pursue in order to utilize our capital as efficiently as possible and raise returns for the benefit of both investors and management". But this was as far as managers were prepared to go in terms of a rapprochement with funds. The financial orientation of the funds placed a limit on what could be achieved through dialogue. As we were told,

We realize that, obviously, they chose [us] as an investment target purely as a means to raise their own returns and that all this talk of “improving the company” was just talk and personally I did not really grasp what they meant by their way of exiting.

Hedge fund interventions did not shift the predominantly communitarian perspective of managers. As a senior officer at a company which had successfully seen off an activist fund put it to us in early 2009:

[Our company] does not accept that shareholders deserve priority. It sees its purpose as manufacturing good products and its priorities are: 1. delivery to consumers; 2. keeping its workforce focused and content; 3. contributing to society and public infrastructure; and then 4. paying any remaining surplus to shareholders.

Such views were aired publicly from time to time, as in the comment of the president of a Japanese company targeted by Steel Partners in 2006:

There’s not a single employee in our company who thinks he is working for the shareholders. The attitude is that this is hard work and we’re doing it for our customers. That’s how it all pulls together (Kobe Shimbun, 2006).

Nor were the hedge funds able to gain the cooperation of other shareholders. The managers of hedge funds we spoke to and who commented publicly viewed their activism as increasing shareholder value for the benefit of the investors in general, as well as ensuring the more efficient allocation of capital. As one of them put it to us, responding to claims that the funds were short-term orientated:

To call the funds “short-term” is to have a massive neglect for why you have a stock market in the first place. The stock market is to trade, so if you push their logic to the very end, which is that everyone is “long-term” – meaning they don’t sell their shares – then there is no stock market.

Why then were other shareholders reluctant to give the funds their support? Corporate shareholders still account for 21.3% of shares held in Japanese listed companies (National Stock Exchanges, 2008b), and many of these are stable blocs which are not held for investment but in order to maintain business relationships, a pattern which is also widespread among insurers and other financial investors. Cross-shareholdings, after nearly two decades of decline, began to increase again from 2007 as part of the move to put takeover defenses in place (Hayakawa & Whittaker, 2009). Japanese pension funds are not as active as their American counterparts in promoting corporate governance issues. One such fund, the Pension Fund Association, has been active in raising issues of board structure and takeover defenses, but the Government Pension Investment Fund, the largest in the world with total assets of ¥116,629,900 million as at 31 December 2008, held only 9.46% in domestic equities (GPIF, 2009) and has been openly averse

to intervening in the companies in which it invests (Jacoby, 2009). Even foreign institutions have not offered unreserved support for hedge fund interventions, as the indicated by the opposition of Institutional Shareholder Services to Steel Partner's call for an increased dividend at Brother Industries in 2007 (Nikkei, 2007b).

The inability of TCI to win over other shareholders was critical in the J-Power case that we discussed above. In the Bull-Dog Sauce intervention, which ended profitably for Steel Partners, it was nevertheless the unwillingness of the company's other shareholders to oppose its management which made the tender offer necessary and which led to the pay-off which did much to discredit activist tactics in general. As one investor said to us:

They have made Japanese companies pay attention to the shareholders: this is their advantage. Another aspect, at the same time, is that they have destroyed constructive discussion between the company and investors in Japan.

The Reaction in the Wider Corporate Governance Environment

There has also been a marked change in conditions for activism. The most tangible sign of this is the widespread adoption of anti-takeover defenses among Japanese listed companies. Partly in response to the legal rulings in the Livedoor and Bull-Dog Sauce cases, and to the publication of guidelines on anti-takeover defense strategies by a study group set up with government encouragement in 2005, companies rushed to adopt poison-pill type mechanisms permitting the issuing of dilutive warrants or shares if unwelcome acquirers achieved a certain level of ownership. By the middle of 2008, 450 companies had such schemes in place and a further 90 were planning to introduce them at their AGMs (Yomiuri, 2008). Unlike poison pills in the US context, which some have argued essentially operate "in the shareholders' interest" (M. Kahan & Rock, 2002) Japanese-style poison pills seem to be intended to protect management from interference by shareholders, such as activists, who challenge their strategy. These are not seen as "regular" investors; as an officer of an employers' association told us in 2007, "if... shareholders demand unreasonable dividends or changes in the management, then I think that this becomes a scenario where they are acting as hostile acquirers rather than as shareholders".

More generally, it would seem that the alignment of the Japanese system with aspects of Anglo-American practice in the mid-2000s was more formal than real. The tentative emergence of a market for corporate control was met by the rapid take-up of takeover defenses (Hayakawa & Whittaker, 2009). While the numbers of outside directors grew, they continued to act largely as they did before, as advisers or as representatives of related business interests, and not as advocates for external shareholders. Changes to managerial structures flowing from the spirit of Sony's 1997 reforms and the company with committees law in 2003 resulted in the slimming down of boards and a clearer separation between monitoring and execution, but they were undertaken not with a view to reducing agency costs but in order to streamline decision-making within large firms. This was not a repudiation of the community firm, so much as an attempt to renew it (J. Buchanan & Deakin, 2008; J. Buchanan & Deakin, 2009). The internalist orientation

of management remained in place even as these changes were being made (John Buchanan, 2007, p.33), as did the practice of lifetime employment for core workers (Araki, 2009). Under these circumstances, the environment for hedge fund activism turned out to be not as attractive as it might have seemed.

Conclusions

In the mid-2000s, many observers assumed that Japan's convergence with Anglo-American corporate governance practice was just a matter of time (Ahmadjian, 2003, p.216). This now seems unlikely. In late 2008 Iwao Nakatani, economist and former chairman of Sony, and previously a strong advocate of financial capitalism, wrote in the introduction to a much-discussed book:

It is not that I have come to deny the whole idea of structural reform itself. However, I have reached the point where I cannot accept reform that fosters a widening of disparities and has no concern that for the sort of things that destroy the social values which Japanese society has nurtured hitherto (Nakatani, 2008, p.32).

Nakatani's reference to social values implies that the Japanese community firm is the product of widely-held assumptions about the nature and function of the modern corporation, which are at odds with those held in America or Europe. While this is no doubt the case, reference to "social" or "cultural" conditions should not divert attention from the material interests which the community firm continues to serve. It enjoys legitimacy because it seen as delivering material benefits to a number of groups, including managers and core employees but also many shareholders. If this ceased to be the case, the system would be ready for change.

From the point of view of mainstream finance theory, the outcomes described in our paper are evidence of rent-seeking by managerial insiders and of the resistance of key actors in the Japanese system to much-needed structural reforms. Our position is that the situation is more nuanced. The mainstream critique views the Japanese experience through a particular perspective, namely that of the Anglo-American pattern of corporate governance. As we have seen, this perspective is not universally valid as a description of corporate governance practice. Perhaps, moreover, there is more to this than just the perceptions of managers and other actors. The Japanese approach to the governance of the publicly-held corporation may prove to be more sustainable for the companies concerned and for a range of wider societal interests than the alternative. At a time of flux in corporate governance, there may be wider lessons from the recent Japanese experience.

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Table 1: Global Hedge Fund Presence in 2007

Stock Exchange	Firms with hedge fund presence ¹
New York	47.08%
London	12.92%
Tokyo	3.22%
EURONEXT ^a	2.32%
Frankfurt	1.76%

^a Euronext include Amsterdam, Brussels, Lisbon and Paris Stock Exchanges

¹ Percentage of firms with hedge fund presence = (number of firms with 5% or more hedge fund ownership) / (total number of firms in the market) *100.

Figure 1: Activist Hedge Fund Presence in Japanese Stock Market (in US\$ million)

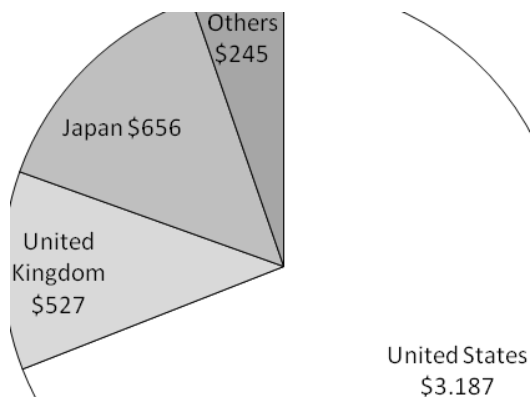


Table 2: Probit Analysis of Targeting

	Activist Hedge Fund Targets	
	Coefficient	Marginal Probability
Firm Size	-0.001 ** (-3.38)	-0.003%
Tobin's q	-0.082 (-1.85)	-0.398%
Dividend Yield	0.124 (1.71)	0.601%
Return on Equity	0.119 * (2.45)	0.574%
Debt Ratio	-1.003 * (-2.42)	-4.844%
Capital Expenditure	-0.024 (-0.03)	-0.118%
Cash Holdings	0.822 * (1.98)	3.970%
Insider Ownership	-0.011 *** (-3.87)	-0.052%
Intercept	-1.511 *** (-7.85)	
Observations	2041	
Wald Chi-squared	40.13 ***	
Pseudo R-Squared	6.63%	

Notes: Significant at the *p<0.05; **p<0.01; ***p<0.001 level; t-statistics are shown in parentheses