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Institutional Evolution in Corporate Governance: The Case of Hedge Fund Activism in Japan

By John Buchanan, Dominic Chai and Simon Deakin

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John Buchanan, Dominic Chai and Simon Deakin

Centre for Business Research, University of Cambridge

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Abstract

We move institutional theory in an evolutionary direction in order to get traction on two unresolved questions in the comparative study of business systems: how far national systems are converging or diverging, and what the implications of continuing diversity are for managerial practice and business performance. An evolutionary perspective suggests that diversity in corporate governance reflects the adaptation of institutional forms to local business environments, implying a limit to global convergence. We use the recent failure of hedge fund activism to take root in Japan as an empirical illustration of our argument.

1. Introduction

Over the past decade or so a very large empirical literature has looked at the extent of institutional diversity across national systems, and attempted to gauge its significance for management practice and economic outcomes. Pressures for global convergence have also been extensively studied. There is, however, little or no consensus on some critical questions: whether national systems are converging or diverging, and whether the remaining (or resulting) institutional differences can account for observed variations across countries in the way firms are run and how they perform. This knowledge gap is linked, we suggest, to a more fundamental theoretical failure: a failure to produce a tractable theory of institutional change in the context of business systems. In this paper we move institutional theory in a more explicitly *evolutionary* direction in an attempt to advance understanding of these issues.

Evolutionary theories in the biological sciences can explain a number of features of living systems: in particular, how traits which are common to most members of a species are passed on with a high degree of consistency from one generation to the next (inheritance); why, notwithstanding the stability of most inherited traits, differences within a given population occur (variation); and how it is that particular traits, over successive generations, come to prevail over others (selection). The value of this approach lies in the account it simultaneously gives of the diversity of living systems and of the processes which drive evolutionary change over time. Social scientists studying institutions identify a similar agenda: the aim is to understand, on the one hand, ‘the complexity and diversity of overall institutional arrangements across [national] economies’, while at the same time providing an account of ‘the mechanism of institutional evolution/change in a framework consistent with an equilibrium view of institutions, but

allowing for the possibility of the emergence of novelty' (Aoki, 2001: 2-3). Evolutionary concepts can be invoked, we suggest, to address these questions in a way which will permit core hypotheses to be identified and empirically tested.

For a theory of business institutions to qualify as evolutionary in the sense just described it must be capable of explaining why certain features of those institutions persist through time; how institutional forms come to vary across business systems; and the mechanisms of selection which act upon those forms and which give rise to differences in their persistence and diffusion across space and time. To do this, some prior issues have to be addressed. It is necessary first to define precisely what we understand by 'institutions' and to distinguish them from other analytical categories, in particular from those relating to the strategies and preferences of actors. Secondly, an account must be given of the functions performed by business institutions, and of the relationship between those functions and particular institutional forms. Thirdly, careful attention has to be paid to notions of fitness in this context, and to the danger of confusing the persistence of certain traits with their optimality.

We set out the elements of our theoretical approach in section 2 below. This part seeks to justify the use of biological analogies to understand business institutions, and explains the relevant theoretical concepts. In section 3 the focus turns to the identification of specific hypotheses, drawing on our theoretical approach, which can help guide empirical research. In section 4 these hypotheses are tested in the context of a case study of recent institutional evolution in Japanese corporate governance.

2. Towards an evolutionary theory of business systems

Agency-theoretical approaches to the study of business systems offer an account of institutional change which is parsimonious and which produces clear prediction. However, it is significantly incomplete its account of the way institutions work. This incompleteness is reflected in its limited predictive power: its core hypotheses on the extent of convergence and divergence of institutions are not being borne out by empirical research.

Competition between firms and, at a higher level, between national systems, is seen as the principal mechanism of selection. Competition acts in a way which is generally (but, as we shall see below, erroneously) viewed as analogous to the role of natural selection in biology. At the macro level, competition between firm and systems ensures the survival and dissemination of more efficient forms of business organization at the expense of those which are less efficient. At a micro level, the selection process is driven by the behaviour of private actors in choosing those contractual forms which maximize returns under conditions of uncertainty. Corporate governance rules embody solutions to the problems of asymmetric information between principals (shareholders) and their agents (managers). Agency theory predicts that the more successful solutions (such as the shareholder value norm) will eventually win out over inferior alternatives. Thus global convergence of corporate governance institutions is to be expected (Hansmann and Kraakman, 2001).

A good reason to be sceptical of agency theory is that this predicted convergence has not taken place (Aguilera and Jackson, 2006). Agency theory has no good explanation for the persistence of diversity across corporate governance systems. Barriers to convergence may exist in the form of opposition from interest groups and from rigidities in national and transnational institutions. However, if selection mechanisms were working as agency theory predicts, these obstacles should gradually be eroding away. As a growing number of empirical studies suggest (including our own, below), this has not been the case over the past decade. Agency theory fails not only to explain the very great extent of diversity across systems viewed historically, but the more recent failure of convergence initiatives.

The failure of agency theory is linked to its inadequate treatment of the institutional framework. Institutions are understood as the outcome of choices made by strategic actors in response to particular features of the environment in which they operate. The technological requirements of firms and the division of labour to which these give rise are seen as universally relevant determinants of corporate governance forms. This approach is deficient in that it fails to treat institutional features of local environments as variables capable, in their own right, of shaping the parties' choices. If, instead, the solutions arrived at by the parties are 'responsive not only to the technological environment but also to the 'institutional environments' hidden in parameters specifying the objective functions of the principal and agent' (Aoki, 2001: 18), a different picture emerges. Now the persistence of diversity is not the result of barriers to efficient global convergence; instead it reflects the viability of local solutions to the different variants of the coordination problem.

Viewing institutions as causal variables in their own right means taking seriously their separation from the preferences and strategies of actors. Institutions are normative structures of varying degrees of formality, ranging from informal routines at one extreme, to formal rules embodied in laws and regulations at the other (North, 1990). As such they are the simultaneously the outcome of actors' strategies, while also shaping those same strategies. In the short run, institutions appear as exogenous constraints on individual behaviour. In the long run, on the other hand, institutions are endogenously generated on the basis of the values, beliefs and practices of agents; in other words, they are the expression of practices which are widely observed, or values and beliefs which are widely shared, in a given society.

An influential theory which sees institutional variables as strongly exogenous to economic conditions is the legal origins hypothesis. This maintains that the legal infrastructure of a given country – its constitution, its court system, the nature of its legislature, and the structure of the legal professions – independently shapes the content of its laws on, among other things, corporate governance, with further consequences for patterns of economic development. Most countries in the world have inherited these core features of their legal infrastructure from a small number of parent systems whose were diffused through conquest, colonization and transplantation in the course of the eighteenth and nineteenth centuries. Systems with an English common law origin are said to favour the protection of property and contract rights against state intervention, while those with roots in the French or German civil law tend to accommodate the interventions of an activist, developmental state. In the corporate governance field, these different traditions are reflected, it is argued, in the pro shareholder-value approach of the US

and UK, in contrast to the stakeholder-orientated approach of France and Germany and the systems whose laws they influenced (La Porta et al., 2008).

The empirical validity of the legal origins hypothesis has been much disputed. Nor is it plausible to see legal systems as entirely exogenous to economic and political conditions in a given country. The direction of causation can flow both ways, with the content of corporate governance rules being influenced by the timing of industrialization relative to legal change (Ahlering and Deakin, 2007), by differences in corporate ownership structures (Armour et al., 2010), and by political variables such as voting systems (Pagano and Volpin, 2001) and the make-up of interest group coalitions (Roe, 2001; Soskice and Iversen, 2010). For current purposes, what is of most interest is the plausible claim institutions pose constraints on the strategic options of business actors. Firms in different countries are faced with radically different corporate governance regimes, and, at least in the short run, have to adapt their organisational structures and modes of financing to those constraints (La Porta et al., 1998).

Although institutions exhibit persistence, they are also characterised by variation of the kind on which environmental selection can operate. In biology, the Darwinian ‘algorithm’ of retention, variation and selection explains how evolution can occur notwithstanding a very high degree of faithful copying of hereditary information from one generation to the next. Random variations in the genetic composition of the members of a population are capable of producing a range of traits, the more ‘successful’ of which are then selected through differential survival rates. The process can be understood in functional terms as the encoding in genetic structures of information about ‘what works’ in a given environmental setting, and its intergenerational transmission through the reproduction of the species. ‘Successful’ traits are just the ones which ‘fit’ a particular environment. A rapid change in environmental conditions can render previously successful adaptations irrelevant, while those organisms which survive are those which *happen to be* well equipped to the new context.

This model can help in explaining the evolution of economic institutions. The value of using the genetic model in this context, is both to invoke a potentially useful analogy and also to act ‘as a pointer to a general evolutionary theory, which can have many different applications’ (Luhmann, 2004: 231). There is no need to assume a one-to-one match between biological and social mechanisms, and the use of the biological model in the context of the study of business systems should take into account knowledge of social processes. With these caveats, the model can be applied to generate the following proposition:

Institutions encode information about strategies which have been more or less successful in dealing with coordination problems. Institutionalisation ensures that this information is preserved and transmitted, but at the cost of constraining the range of variations which occur within the system. The set of feasible solutions to future problems is limited by the parameters implicit in earlier ones. Environmental selection acts on this limited range of options to produce solutions which tend to be only qualifiedly efficient, and hence sub-optimal.

3. Explaining institutional change: core hypotheses

It follows from what has just been said that institutions are adaptive, in the sense of co-evolving alongside features of the economic and social context in which they operate, but also path-dependent, that is, shaped by their own history and trajectory. Thus institutions are not in perfect synchrony with their environment. There is a trade-off between institutional stability and certainty, which facilitates coordination, and institutional innovation and adaptation in response to changing external conditions. Where institutions acquire a high degree of stability, they can cease to be directly responsive to external change (*lock-in*). Change, when it comes, will be episodic and turbulent (*punctuated equilibrium*), rather than continuous and incrementalism. Change of this (first) kind will be triggered by exogenous shocks coming from, for example, the political system, new forms of competition, or new technologies. On this basis we generate our first hypothesis:

Hypothesis 1. The greater the stability of institutions, the more likely it is that institutional change is episodic and turbulent, rather than continuous and incremental.

In addition, a distinction can be drawn between institutions according to the degree of their formality. At one extreme are explicit, written norms which are ‘script-coded’ in textual form, as in the case of statutory legal norms (Deakin and Carvalho, 2010). At the other are social norms and tacit conventions which depend on the shared understandings of agents about the state of the world and about each other’s beliefs, preferences and intentions (Young, 1995). Formal institutions operate as highly stable repositories for knowledge about ‘what works’ in a given context. Formal institutions are more or less successful depending on how responsive they are to wider societal shifts, that is to say, on their capacity for receiving and processing information about societal practices, and producing solutions which are viable in practice. However, their very formality distances them the application of norms. There is again a trade off between stabilization and variation in the production of norms. More highly formalised laws and regulations have limited capacity to bring about wide social change; to be effective, they must do so in conjunction with changes in less formal, social norms, which are more directly informed by agents’ preferences and beliefs. The most effective legal changes are those which go with the grain of changes which are happening anyway in society. Thus we have:

Hypothesis 2. Formal institutional change is more effective the greater the extent to which it reflects changes already occurring in societal norms and practices.

So far we have mainly been considering how institutions emerge out of and operate in particular national contexts. Yet, a very frequent phenomenon is for institutions to be transplanted from one national or regional context to another. Conscious transplants of this kind may consist of highly formal legal or regulatory institutions (company laws, securities regulations, corporate governance codes) or particular transaction-types (such as share options, takeover bids, or activist shareholder interventions). The success of transplants of this kind is a function of how far there is continuity across ‘home’ (transplanting’) and ‘host’ (receiving) systems. Where there is continuity of legal or regulatory institutional mechanisms, formal convergence (institutions becoming formally similar) between home and host systems is likely. However, functional convergence (institutions operating in the same way) can only occur where there is continuity at

the level of informal institutions and of societal practices. Formal convergence can occur alongside the persistence of functional divergence across home and host systems. Thus:

Hypothesis 3. The success of transplants in generating change depends on how far there is continuity of societal practice across home and host systems.

Transplants may trigger a number of reactions in the environment of the host system. When considering the interaction of formal and informal institutions, two types of reaction are possible. One is the realignment of informal institutions with more formal (transplanted) ones. The other is the opposite: the alignment of formal institutions with informal ones. In this second case, the transplant is adapted to local conditions, not vice versa. As a result we identify the following two alternative hypotheses:

Hypothesis 4a. Where transplants are successful, there is a realignment of informal institutions with formal ones.

Hypothesis 4b. Where transplants are unsuccessful, there is a realignment of formal institutions with informal ones.

4. Case study: hedge fund activism as a corporate governance transplant

We now turn to our case study. Hedge fund activism emerged in the 2000s as a then novel response to the coordination problem at the heart of corporate governance, the conflicting interests of managers and shareholders (Jensen, 1986: 323). Contrary to many expectations, earlier innovations in corporate governance, including the rise of independent boards and concentration of ownership among institutional investors, had failed to raise real returns to shareholders. The rise of hedge fund activism was ‘the great, shining beacon of hope’ in this ‘otherwise bleak landscape’ (Macey, 2008: 272). In the USA, positive abnormal returns to shareholders were found to be linked to asset sales and the refocusing of strategies at firms targeted by activist hedge funds. On closer investigation, it was not clear that these interventions had improved the operating performance of target companies, or that activist funds were doing better than rival investment models. Such doubts were, however, put to one side. Activist hedge funds were widely viewed as the most complete expression yet of the power of capital markets to drive efficient outcomes in the corporate sector.

In the wake of the financial crisis of 2008, withdrawals by investors and share price declines brought about a sizable decline in the value of assets under hedge fund control, with the effect on activist funds being particularly severe. At the same time governments and regulators began to consider new constraints on the investment practices typical of hedge funds, activist or otherwise. Nevertheless, a recent post-crash assessment suggests that ‘offensive shareholder activism in all likelihood will remain a feature of US corporate governance’ (Armour and Cheffins, 2009: 31 and 37).

Our case study focuses on US-style confrontational hedge fund activism in Japan. This provides us with an illustration of the role of institutional transplants in the corporate governance field,

and hence an opportunity to test our hypotheses. We begin by outlining the nature of hedge fund activism and assessing its impact in the USA, where it originated, and also in the UK and continental Europe, before considering its impact in Japan and the reasons for its failure to take root there. 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.

4.1 Hedge fund activism: American and European origins

A hedge fund is essentially an investment club governed by private contract, and therefore beyond the scope of many regulatory requirements, in which investors, who accept increased market risk and an initial restriction on early withdrawal, mandate fund managers whose remuneration is weighted to performance through bonuses to exploit any legitimate opportunities for exceptional gains over an agreed benchmark, usually through a pre-advised investment strategy which may include borrowing or use of derivative instruments. A recent study estimated worldwide assets under management by hedge funds to be approximately US\$2,500,000 million as of June 2008 (AIMA, 2008:16), with the majority believed to be deployed in the USA (FT, 2006). Morgan Stanley suggested that in late 2008 redemptions had reduced this figure by some US\$400,000 million with more reductions expected in the wake of the Madoff scandal in the USA, although signs of recovery were observed in the course of 2009 (FT, 2009a, FT, 2009b).

Activist hedge funds are a distinct group within the hedge fund sector as a whole and, in terms of investment volume, are thought to constitute only around 5% of the total (Kahan and Rock, 2007, p.1046). Their characteristics have been studied extensively in their home market of the USA (Kahan and Rock, 2007, Bratton, 2007, Clifford, 2007, Brav et al., 2008, Klein and Zur, 2009, Greenwood and Schor, 2009, Armour and Cheffins, 2009). They typically operate by taking large stakes in financially healthy and usually relatively small target companies (5-10% was observed in Brav et al.'s (2008) study covering the period 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 normal. 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 control of their targets through hostile takeover bids, their strategy depends for its success on either gaining the cooperation of management or

that of other shareholders, or a combination of the two. At the same time, there is evidence that they derive their best returns when they can precipitate a takeover by a third party: ‘hedge funds invest in small, undervalued companies with the ultimate goal of seeing those targets bought out’ (Greenwood and Schor, 2009: 374).

This description of hedge fund activism does not entirely capture its wider, functional role. There is a sense in which activist hedge funds are core institutions of a ‘financialized’ economy in which firms are managed with a view to maximizing shareholder value (Cappelli, 2009: 7). Hedge fund activism offers a particular type of solution to the principal-agent conflict which arises when companies generate a substantial surplus in the form of free cash flow: ‘the problem is how to disgorge the cash rather than investing it at below the cost of capital or wasting it on organizational inefficiencies’ (Jensen, 1986: 323). The emergence of this kind of activism in America and Britain during the 1990s and 2000s could not have occurred had the shareholder value norm not become widely accepted in the corporate governance theory and practice of that period.

4.1.1 The American context

Activism conducted by private investment vehicles run by professional managers with a view to returning a surplus to investors in a collective fund is recent, even in the USA. Although some of today’s most prominent funds, including Steel Partners, to which we return below, were founded in the course of the ‘deal decade’ from the early 1980s to the early 1990s, hedge fund activism became widespread only in the 2000s (Armour and Cheffins, 2009: 20). Certain features of the US corporate governance and regulatory environment favored its emergence. One of these was the rise of independent boards. By 2000 almost 70% of directors on the boards of US-listed companies were non-executives, an increase from around 30% in 1980 (Gordon, 2007: 1474), 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. There is only weak evidence, at best, of a link between independent boards and improved corporate performance (Bhagat and Black, 2001). Nevertheless, independent directors did make a difference: they were there ‘to enhance the fidelity of managers to shareholder objectives, as opposed to managerial interests or stakeholder interests’ (Gordon, 2007: 1469). Their presence made it less likely that the management of a listed company could simply say ‘no’ in the face of a hedge fund intervention.

Secondly, the changing structure of share ownership in the USA encouraged hedge fund activism. Ownership of shares in US-listed companies by pension funds and mutual funds, which was at 50% in 1980, had reached 76% by 2007 (Conference Board 2008). Activism by pension funds was not particularly successful in generating supra-normal returns at target companies (Romano, 2001). But hedge funds, as private investment clubs, were largely free of the prudential constraints under which most institutional investors operated. In these circumstances, the institutions were increasingly prepared to shift their support to the hedge funds in their dealings with management, and also to invest directly in them.

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

4.1.2 Diffusion to Europe

The UK is considered to be the second market for hedge fund activism after the USA (see Table 1). It has independent directors, similarly powerful institutional investors, and low barriers to restructuring. Moreover it 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 more quietly with boards of selected under-performing firms on issues of business strategy (see Becht et al., 2008). Shareholder activism received a high public profile in 2007 when a fund run by Nelson Peltz was credited with persuading the board of Cadbury Schweppes to sell off its US drinks business.

 Insert Table 1 about here

However, the incidence of public, confrontational activism in the UK appears to be much lower than in the USA. The founder of a UK activist fund explained this difference to us in 2009 as the result of the greater degree of legal protection which shareholders enjoy in the UK - notably with regard to their powers to remove directors - making it unnecessary for investors to employ the kind of public and confrontational approach which US funds often see as needed to put pressure on management. Major UK institutional shareholders feel more confident in stimulating change through private negotiation, a point made to us separately by a major investor and by an investors' association in interviews in 2009. Consequently activists are seldom given unqualified support unless they have chanced on a situation where prolonged negotiation has failed to deliver satisfaction to shareholders. Stronger shareholder rights should make the UK an even more attractive market for activists than the USA but, in practice, the confidence that these rights appear to give UK institutional investors in private negotiations has effectively reduced the level of cooperation that they feel obliged to extend to overt activists in order to obtain their objectives.

Activism has been growing in continental Europe. In 2005 the UK-based fund TCI (The Children's Investment Fund) 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 until 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. These interventions were reported to have been widely supported by institutional shareholders (Kahan and Rock, 2007:1092). The *Hedge Fund Journal* noted 'around 55 activist funds in Europe' in 2007, but most of these seemed to be pursuing less openly confrontational strategies (Kerr, 2007). Laxey Partners, a UK-based activist hedge fund, has made interventions in Switzerland, but appears to be facing concerted opposition from targets and regulators (FT, 2008a).

4.2 The transplantation of hedge fund activism to Japan

We now turn to the Japanese case. Hedge fund activism began in Japan with the establishment of a local fund in 1999: the 'Murakami Fund' which we discuss further below. A number of foreign activist hedge funds, notably Steel Partners, who began their Japanese interventions in 2002, and some Japanese funds, subsequently entered the market. 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). Not all large hedge fund holdings of this type are an indication of activism; some of them are interventions by 'value funds' which prefer to identify trends rather than to provoke them. Hedge funds can also take large stakes in order to engage in risk-arbitrage or bankruptcy-related reorganizations (Brav et al., 2008: 1738). In order to get a clearer picture of the extent of activism in Japan, we supplemented the Thomson Reuters data with information drawn from press reports and hedge fund websites. By doing so we were able to exclude 15 cases where there was insufficient proof of activism, 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 2007 but this is the high point of hedge fund activism in Japan to date). Of these 60 interventions, the vast majority – over 80% by value – were undertaken by American or British funds (see Figure 1).

 Insert Figure 1 about here

While the market value of holdings by all 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.

4.2.1 The Japanese 'community firm': obstacle or opportunity?

At first sight, the limited influence exercised historically 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 saw them as 'communities' which they joined for life (Dore, 1973: 222, Inagami and Whittaker, 2005: 1-5) and 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)’ (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. Shareholders who invested for commercial rather than portfolio motives, such as suppliers, customers and banks, used their shareholdings to underpin their business interests, rather than for investment income. Cross shareholdings developed among these interested parties, creating friendly shareholding blocs predisposed to support management (Sheard, 1994: 310-20). Post-War Japanese industry has been portrayed as controlled by government ministries and banks but, 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: 258-297, Aoki, 1994a: 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, 1994b: 122-24).

But while the persistence of community firms in Japan, long after their equivalents had been marginalized in America (see Jacoby, 2005), was in one sense an obstacle to the hedge funds, it also provided them with an opportunity. Focused primarily on maintaining the long-term survival of the firm, management at many listed companies had accumulated large cash balances and maintained low dividend payouts (Pinkowitz and Williamson, 1999: 15, Rajan and Zingales, 1995: 1427-8). Stock market declines in the 1990s meant that these companies’ shares were cheap relative to their asset base, and this trend 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 within undervalued companies.

4.2.2 The regulatory framework in Japan: corporate and employment law

The regulatory framework posed no problems. The Japanese model of communitarian corporate governance is not legally mandated and Japanese corporate law is outwardly accommodating to shareholder interests. The core content of corporate law is derived from amendments made to the originally German-inspired 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).

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

The pattern is repeated in the area of labour 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 (Araki, 2009).

4.2.3 Changes in the Japanese corporate governance environment

In addition, the wider corporate governance environment in Japan had begun to change in ways which appeared to indicate convergence with the American and British systems and implied growing acceptance of their values. 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, 2008). 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 some kind at stake in the company, and their holdings were more frequently traded, giving them a disproportionate influence over stock price movements (Ahmadjian, 2007:133).

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 post-war tradition of corporate governance had seemed 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 November 2009 only a net 111 companies had opted into it (JCAA, 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’s management 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 and Whittaker, 2009).

4.2.4 Shifting attitudes to shareholders and shareholder activism

Since the 1970s, leading Japanese companies have turned increasingly to the capital markets for their funding. This has led to establishment of specialized IR departments and a growing awareness of shareholders as a resource that must be cultivated. There is still a big difference between the largest companies and smaller ones which lack this capital market exposure, but indifference to portfolio shareholders and their interests is no longer acceptable as a public stance. Simple average dividend yields for first section companies on the Tokyo Stock Exchange have more than doubled since 1998 (TSE, 2009). In this sense Japanese companies have much in common with those of other East Asian economies where there is a pragmatic balancing of demands from the global and local environments (Young et al. 2004: 31).

There has been 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: 252-4, Milhaupt and West, 2004: 109-39). When T. Boone Pickens bought around 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 an estimated 56 companies, most of which had relatively high ratios of foreign ownership (Maezawa, 2005). 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).

4.3 Hedge fund tactics: evidence from the characteristics of Japanese target firms

On the basis of the preceding discussion, we would expect hedge fund tactics in Japan, inspired and often instigated as they were by American funds, to have followed broadly similar lines to those in the USA. We can see how far this prediction is borne out by looking at the characteristics of the firms targeted for intervention.

We base our analysis on quantitative data on the 60 interventions recorded by Thomson Reuters as at the end of 2007, with financial and accounting data on the targets from 2006 (to reflect the public information available to these funds prior to investing), from the Worldscope database. This gives us a picture of activist hedge fund involvement in the Japanese market at a key chronological point during our period of study when it was still unclear whether the funds’ interventions were going to be successful.

 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), 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 year end), 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 results show that activist hedge funds in Japan targeted smaller firms with low debt, low insider ownership, high profits and high cash reserves. The finding on insider ownership confirms that activist funds tried to find companies which did not have shareholder blocks likely to support management, a finding consistent with the US results obtained by Brav et al. (2008) and also for a wider range of countries including Japan (Judge et al., 2009). It appears that activist hedge funds followed the logic of selection which originated in the USA. One particular aspect - that is not at odds 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. What becomes clear from this analysis is that activist hedge funds were applying the tenets of finance theory to a group of targets whose financial structures indicated that they operated with little regard for shareholder value in the sense that the funds understood it but were at the same time, by virtue of their shareholder structures and their desire to preserve the community firm, apparently open to activist shareholder pressure.

4.4 From rise to fall: the trajectory of activist hedge fund interventions in Japan

Our examination of the Thomson Reuters data gives an indication of what motivated activist hedge funds in Japan at the end of 2007. We now examine more closely the pattern of activist interventions - what the activist funds actually did and the reactions they provoked - over a longer period. Here we can draw on an extensive supply of data covering a variety of funds, often with very different strategies, and we have concentrated on the most confrontational of them, whose interventions attracted the greatest public attention over a specific period, in order to provide a more concise account. As demonstrated in Figure 2 below, the Japanese financial press devoted much of its coverage of this sector to matters involving only two foreign activist

hedge funds during the period 2002-2008: the US fund Steel Partners and the UK fund TCI. Of these two funds, Steel Partners implemented far more interventions than any other fund, either foreign or Japanese, during the period. In the USA they had been seen as an investor in small companies in the US\$100 million market capital range, although their founder, Warren Lichtenstein, told *Business Week* in 2005 that he proposed to aim at larger targets of around US\$2,000 million thereafter (Business Week, 2005). Between 1995 and 2005 they are believed to have filed 13D forms at 63 US companies (Kruse and Suzuki, 2009: 4). TCI had already demonstrated its skill in extracting value from large companies in Europe; it attracted particular interest when it confronted the management of two large companies in Japan to demand revision of their financial strategies. Other activist hedge funds, both foreign and Japanese, invested during the same period. Liberty Square, another US activist hedge fund, both acted as co-owner of Steel Partners' Japanese fund and also on occasions made its own distinct investments in Japanese companies, demonstrating that there could be more than one way to approach the market. These quieter funds had relatively sparse coverage in the Japanese media, as Figure 2 shows. Our focus is on the public clash between exponents of shareholder value and the managers of the community firm which is strongly associated with the two cases of Steel Partners and TCI.

 Insert Figure 2 about here

Our main source here is our own dataset of interventions where shareholdings exceeded 5% (exceptionally we have investigated below that level where the intervention had a particularly high public profile), from roughly 2000 until mid-2009, derived from funds' submissions to the Japanese Financial Services Authority (FSA) through its Edinet system,² press reports, and announcements by the funds and their targets. We also draw on material from over 100 interviews with managers of listed companies, investors, 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. Eleven of these interviews (including follow-up visits) were held with directors of activist hedge funds operating in Japan or with the management of their targets.

The principal interventions by Steel Partners and TCI between 2002 and 2008 are shown in Figure 3 below. We present these data as timelines for the known interventions, by target company, noting the estimated timing of first purchases, any tender offer made, whether a major payout was achieved, and the timing of exit, if any. In all cases but one we have used the date at which the fund first reached a shareholding of 5% or more as the proxy for the start of the intervention, and the date on which its shareholding fell below 5% as the proxy for its exit. It is possible that shares were accumulated below the 5% level over a much longer period before the formal notification, and also that shareholdings were maintained after our assumed exit point at a

² Japanese law requires 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, to the FSA, which makes the information available through Edinet (Electronic Disclosure for Investors' Network). Records are only retained for approximately five years.

lower level. However, this would not be normal activist hedge fund behavior, and we have been unable to identify any examples of it through press and other sources. The exception is TCI's intervention in Chubu Electric, where the large market capitalization of the target effectively kept TCI's investment below the 5% level. The arrows on the far right of each timeline indicate whether the intervention was 'successful', which we define as either generating a major payout or an uplift of 10% or more over the share price at the start of the intervention either at exit or as at 31st December 2008 where the intervention still continued (indicated by a pointer in the chart). Where there was no major payout and 'success' rested on the share price movement, our conclusions are of course only a rough guide: share prices at our defined start and exit points, or at 31st December 2008, will not reflect the precise mix of investments held by the fund. It could also be argued that a 10% return, often over several years, is unlikely to be seen as especially successful by most hedge fund investors.

 Insert Figure 3 about here

Certain conclusions emerge from Figure 3. The first six 'successes' by Steel Partners (indicated by upward arrows) all result from interventions begun no later than early 2004 and from which the fund achieved a clear exit. Of the next five 'successes', the Nakakita Seisakusho intervention, begun in the second half of 2004 and taken to an exit in mid-2008, is the exception: all of the remaining four interventions marked as 'success' were continuing situations without major payouts as at 31st December 2008 that had been static for at least four years, where the share price happened to have risen. The overall impression is of initial success followed by lack of progress in a market where the ideal situation is a fast turnaround for a high return. As the head of another fund described it to us later in 2009: 'They're stuck. That's several years of being stuck, that is.'

Four of the significant payouts achieved by Steel Partners from their earliest interventions used tender offers to apply pressure to management. One especially high-profile intervention was Steel Partners' investment in Bull-Dog Sauce from July 2003 to March 2008. After submitting a tender offer in May 2007, Steel Partners applied unsuccessfully to the courts for injunctions against plans to dilute their holdings, ultimately receiving a special payment from the company in July 2007 of ¥2,300 million (approximately US\$18.9 million). The outcome was, on the face of it, successful, but the litigation surrounding the Bull-Dog intervention marked the start of a backlash against Steel Partners in particular and confrontational activism in general. The judgment issued by the Tokyo High Court observed that although a joint-stock company was, in principle, a for-profit organization that maximized its corporate value and paid it out as dividends to shareholders, a company could not realize a surplus except through association with employees, suppliers and consumers. The judge ruled that it was permissible to treat an 'abusive acquirer' that threatened this balance in a discriminatory way (Miyake, 2007, pp.187-91, Nikkei, 2007). Steel Partners - and indeed all activist hedge funds in Japan - had less recourse to tender offers after this point. In May 2007 Warren Lichtenstein had observed to *Nihon Keizai Shimbun* that he wished to 'enlighten' Japanese management regarding the need to pay higher dividends - a remark subsequently repeated before a large professional audience at a conference in Tokyo, which attracted widespread unfavorable comment in Japan (Nikkei Business, 2007). After the

conclusion of the Bull-Dog Sauce litigation, in September 2008, he was reported as taking a different approach, expressing apparent regret for lack of communication with target managements in the past and signaling a move to clearer and more frequent contacts (Nikkei Weekly, 2008).

Another feature illustrated by these timelines is that Steel Partners moved their attention from exclusively small targets to larger companies such as Sapporo, Citizen, and Brother from the latter half of 2004. In these cases, management strategy rather than the allocation of accumulated reserves became the main point of contention. By the end of 2008, Steel Partners had sold their shares in Citizen and Brother, apparently at a loss, and were confronted with an increasingly uncooperative management at Sapporo. In January 2009 it was reported that Steel Partners had reduced their shareholdings in 13 companies, falling below the 5% level in seven cases, and the exits shown in 2008 are mostly the result of this, rather than indicating successful investment outcomes. Analysts speculated that the fund's customers were short of liquidity and were withdrawing cash, but it was also suggested that they had invested too widely in Japan and needed to reorganise their portfolio (Reuters, 2009).

TCI came later to Japan and applied its strategy of pressure for change at larger companies by investing in two utilities. It appealed publicly to institutional shareholders when it was rebuffed by management. Neither target had a low market capitalization or excess cash, but TCI identified strong cash flow as a route to higher dividends financed by debt. The first such investment, in Chubu Electric, from late 2005 to late 2007, is believed in the market probably to have broken even but the second, in J-Power, from late 2006 until late 2008, was estimated by the press to represent a loss to TCI of some ¥12,500 million (approx. US\$124.4m) before costs (FT, 2008b, Nikkei, 2008). In neither case was TCI able to obtain the agreement of management or of a majority of shareholders to its proposals for increased dividends and, at J-Power, it also became entangled in an ultimately unsuccessful attempt to obtain permission from the Japanese government to exceed the 10% limit for any single non-resident shareholder in utilities, which are designated of national strategic importance.

4.5 The anatomy of activist hedge fund failure

We now consider two complementary sets of explanations for the failure of confrontational hedge fund activism in Japan: factors operating at firm level, which include the reactions of managers and shareholders, and factors operating at the level of the wider corporate governance environment. We draw here on our interview material. For reasons of confidentiality, company and personal names are not given unless a public statement was made, but we have used information relevant to the interventions by Steel Partners and TCI.

4.5.1 Attitudes of managers and shareholders

Firstly, there appears to have been an initial degree of acceptance among targeted managers that the funds' interventions had some merit. As one of them put it to us, '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.’ The president of Yushiro, one of Steel Partners’ first targets, commented in January 2009 that the experience had been beneficial and had created an enduring creative tension in his company (Nikkei, 2009).

But, secondly, most managers found the funds’ focus on shareholder returns as a mechanism for improving corporate performance ultimately unconvincing, thereby limiting 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...’ To these managers, ‘improving the company’ was only partially a financial consideration.

Thirdly, there was a consistent refusal to prioritize shareholders’ interests. As the president of Hi-Lex, a company targeted by Steel Partners, observed 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).

The president of another company expressed a widely held philosophy to us in the same year:

I always say that there are broadly speaking three sets of stakeholders in our company: one is the shareholders, another is the customers, and the third is the employees, including the management. I think the most important element of managing the company is to keep these three - this triangle - in balance. In order to maintain that stability and proceed with both growth and stability in balance with one another, a company, for example, that just pays attention to its shareholders and continually applies its profits to those shareholders will end up withering away at some stage in the future.

Fourthly, neither Steel Partners nor TCI were generally able to assemble sufficient support from shareholders for their various AGM motions. One exception was at Aderans, where Steel Partners succeeded by a narrow majority in blocking the reappointment of the president and other board members, although the closeness of this result in spite of widespread dissatisfaction with the president’s record is itself significant. For the most part, Japanese shareholders considered that it was not in their interests to challenge internal management. Notwithstanding the changes which have occurred to shareholder ownership structures since the 1990s, significant blocks are still held by shareholders who have shared business interests with the company, and relatively few by pure portfolio investors. But even in companies with substantial holdings by overseas investors, such as J-Power, hedge funds were unable to garner sufficient support.

4.5.2 The reaction in the wider corporate governance environment

A series of defensive reactions occurred, the most tangible sign of which was the widespread adoption of anti-takeover defenses among Japanese listed companies, which had already begun in response to the tentative emergence of a market for corporate control (Hayakawa and

Whittaker, 2009). In the wake of the legal rulings in the Livedoor and Bull-Dog Sauce cases and 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 shareholders’ interest’ (Kahan and Rock, 2002: 871), Japanese-style poison pills seem to be intended to protect management from interference by shareholders, including activists, who challenge their strategy. These shareholders are not seen as ‘regular’ investors; as an officer of an 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 perceived alignment of the Japanese system with aspects of Anglo-American practice in the mid-2000s was more formal than real. There was no general acceptance of shareholder value as the ultimate corporate goal. 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 formal 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 (Buchanan and Deakin, 2008, Buchanan and Deakin, 2009). The internalist orientation of management remained in place even as these changes were being made (Buchanan, 2007: 33), as did the practice of lifetime employment for core workers (Araki, 2009). In short, the environment for hedge fund activism was not as welcoming as it might have seemed, and it deteriorated further after the Bull-Dog Sauce litigation as a direct response to the tactics employed there.

5. Assessment

We are now in a position to return to our hypotheses. On the basis of an evolutionary reading of institutional theory, we first of all deduced the following that there is *a trade off between stability and adaptability in institutions, as a result of which highly stable institutions are more likely to change in ways which are episodic and turbulent than incremental and continuous* (hypothesis 1). The Japanese case provides partial evidence for this view. There is a case for seeing the events of the second half of the 2000s – the new, if short-lived, legitimacy of hostile takeover bids in the aftermath of the Livedoor case, and the rise of hedge fund activism after the Bull-Dog Sauce case – as exogenous shocks administered to a system which had, up to this point, exhibited a high level of rigidity. On this basis, the past few years have been a period of rapid change following the previous period of stasis, characteristic of ‘punctuated equilibrium’. Yet, at the end of this period there has been no fundamental transformation in favour of a new set of accepted norms and conventions. The extent of change has been limited.

One reason for this is that the earlier period was not one of stasis after all. The so-called traditional or post-war model of governance did not stand still during the 1990s and 2000s. Although bank-led monitoring was in decline during this period and governmental institutions played a less directly interventionist role than in previous decades, new mechanisms were emerging to take their place. With legal encouragement, the managerial structure of the so-called community firm was changing as firms reduced the size of boards, appointed greater numbers of outside directors, and drew a clearer distinction between monitoring and execution. But these changes were implemented with a view to modernizing the community firm, not replacing it with the shareholder-value orientated model (Buchanan and Deakin, 2008).

Our second hypothesis was that *formal institutional change is more successful to the extent that it expresses changes already occurring within society*, and this is linked to the third, which predicted that *transplants are more successful where there is continuity of practice between home and host countries*. Transplants are an extreme example of formal institutions which face an implementation problem when removed from their original context. The failure of hedge fund activism to take root in the Japanese context highlights the wide divergences which continue to exist between Japanese practices on the one hand and Anglo-American ones on the other. It also puts into sharp relief the limited relevance of shareholder activism as a governance mechanism. From the point of view of agency theory, shareholder activism has universal value as a means of reducing the conflict of interest between shareholders and managers. The evidence from the Japanese case suggests, however, that hedge fund activism is better viewed as a phenomenon with limited relevance outside its original Anglo-American context.

Our case study also provides a striking illustration of the importance of looking beyond formal institutions when evaluating how corporate governance mechanisms work. Superficially, Japanese corporate governance institutions of the mid-2000s looked very similar to those of the US and UK, which had had provide a congenial environment for activist strategies. Japanese firms were joint stock companies which formally acknowledged the principle of shareholder priority. Japanese corporate laws were being formally aligned with US norms, and a growing proportion of the stock of Japanese listed companies was held by overseas shareholders who treated their holdings as portfolio investments. Yet, as we have seen, this largely pro-shareholder *formal* environment was largely irrelevant to the way in which local actors perceived the roles of managers and shareholders, and only marginally shaped their responses to the hedge funds' interventions. As the response to the Bull-Dog Sauce and J-Power cases illustrates, the failure of activist interventions to bring about a shift in beliefs and expectations led to *a realignment of the formal and informal institutions in favour of the latter* (supporting our hypothesis 4b). Company law was adjusted to the social model of the community firm, not the other way round.

6. Conclusion

In this paper we have used an evolutionary account of institutional theory to explain the persistence of cross-national diversity in corporate governance. We presented a theory of business institutions as context-specific solutions to coordination problems. In the short run, institutions are exogenous constraints shaping actors' strategies; in the longer run, they are

endogenous to agents' values, practices and beliefs. There is a trade-off between the stability of institutions and their capacity for variation; as a result, institutional rigidities can lead to the persistence of sub-optimal mechanisms. However, institutional diversity is not just the result of local impediments to the implementation of globally efficient norms. Just as often, the transplantation of a supposedly optimal model outside its original context results in the failure of implementation.

We illustrated our theoretical approach with an account of the recent failure of hedge fund activism to take root in Japan. We trace this failure to a disjunction between the conditions in which hedge fund activism originally emerged in Anglo-American systems, and the very different context to which it was transplanted in the Japanese case. The significance of our study is not, however, confined to a consideration of the Japanese situation. A lesson to draw from our work is that the tendency of corporate governance researchers and policy makers to treat the US case as the benchmark against which other systems are measured has become a serious barrier to understanding. Hedge fund activism is an example of a distinctively American practice which has been confused with a global one. Confrontational activism originated in the USA, where a particular environment encouraged it. The superficial resemblance of the environment in some other countries, including Japan, to that of the USA, led to its adoption there, but with results which were far from successful, and were even counter-productive, in the sense of triggering the reactions that we have described. The outcome is hard to explain if the convergence of systems on US practice is seen as inevitable, but much more straightforward if we take seriously evidence of the resilience of national systems in the face of globalizing influences.

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Table 1
Global Hedge Fund Presence in 2007

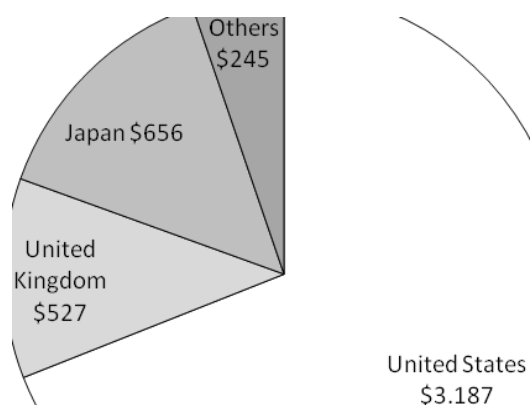
Stock Exchange	Firms with Hedge Fund Presence ^b
New York	47.08%
London	12.92%
Tokyo	3.22%
EURONEXT ^a	2.32%
Frankfurt	1.76%

^a EURONEXT includes Amsterdam, Brussels, Lisbon and Paris Stock Exchanges.

^b 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.

*Source: Authors' calculations using Thomson Reuters and Worldscope datasets.

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



*Source: Authors' calculations using Thomson Reuters and Worldscope datasets.

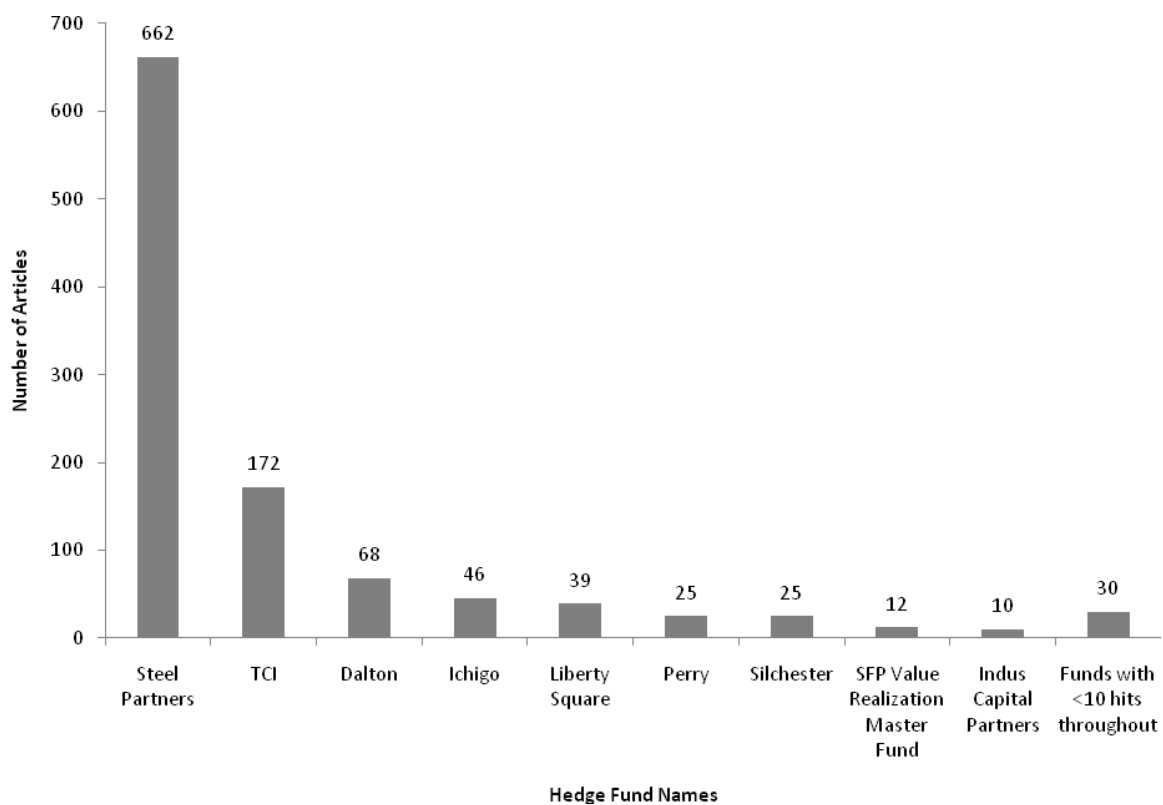
Table 2
Probit Analysis of Targeting

	Activist Hedge Fund Target	
	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	2,041	

Wald Chi-squared	40.13	***	
Pseudo R-Squared	6.63%		

*Notes: Activist hedge fund target is an indicator variable equal to 1 if there is hedge fund activism targeting the company during the following year. Firm size is market capitalization in billions of Yen; Tobin's q is 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 year end; Dividend yield is the value of dividends paid during the year divided by the market value of the firm at year end; Return on equity is net income divided by the book value of equity at year end; Debt ratio is total debt divided by total assets; Capital expenditure is total capital expenditure scaled by total sales; Cash is the ratio of total cash and cash equivalents to total assets; Insider ownership is 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. Significant at the * $p < 0.05$; ** $p < 0.01$; *** $p < 0.001$ level; robust t-statistics are shown in parentheses.

Figure 2
Incidence of articles in Nikkei 2002-2008



*Source: Nihon Keizai Shimbun

Figure 3: Hedge Fund Interventions by TCI and Steel Partners 2002-2008

