

4 Institutional Investors and Corporate Governance

YUMIKO MIWA

1. Introduction

Corporate governance—how and by whom a corporation is controlled and ultimately who owns the corporation—has become common in Japan. In the United States, shareholders and management share the responsibility of corporate governance. On the contrary, in Japan corporate governance seems to include stakeholders, which comprise employees, creditors, customers, etc.

Until recently it was generally asserted that the Japanese corporate governance system had been effective because the management of a corporation could be monitored by banks and other corporations within the cross-stock holding system. Currently, the Japanese corporate governance system is undergoing changes in search of a more effective system. In Japan, the institutional investor has become involved in the corporate governance system using the shareholder proxy vote.

Also, institutional investors have another way to check the corporations in the stock market, classified as socially responsible investment (SRI). SRI is an investment method targeting companies that conduct their activities with corporate social responsibility (CSR), investing in companies which value CSR, and not merely taking corporate earnings from the marketplace.

2. The Transition of the Shareholder's Position in the Corporation

In 1932, Adolf A. Berle and Gardiner C. Means examined the phenomenon of “separation between ownership and control” of corporations in their monumental work on the corporation, *The Modern Corporation and Private Property*.¹ It can be argued that the most enduring theme of this work is the divorce of ownership from the control of the modern corporation. Berle and Means examined

¹ Berle and Means (1932), p. 66.

the concentration of economic power and the dispersed stockholding in the 1920s in America. They wrote about the concept of separation between ownership and control of a corporation, and applied the new form of corporation that was controlled by management.

Under what circumstances, then, had management control of a corporation been created? Originally, what kind of rights to control corporations did shareholders have? First, I will explore the general historical change of the control of a corporation under the corporate law.

The structure of a corporation under modern corporate law was established at the end of the nineteenth century. It is held that this structure reflected the democratic idea of a state: "mutual independence of the three powers of the legislature, the executive and the judiciary." Similarly, in a corporation there is the separation of the three powers of the shareholders' meeting, directors, and auditors. Of the three, the shareholders' meeting has the highest and most powerful function in deciding corporate matters. Directors can execute business according to the decisions made in shareholders' meetings; auditors oversee the execution of business by directors. In theory, every shareholder attends the shareholders' meetings to freely discuss corporate matters, to vote, and ultimately decide the course of the corporation.²

However, ownership and management cannot but separate in a corporate system because of its form. Under modern corporate law, the control of corporations could be left to shareholders through shareholders' meetings. However, because the resolution of the meeting is based on the capital majority, a corporation is controlled by the shareholder owning the shares comprising that majority. For example, if the control of a corporation depended upon the election of directors, the person owning the majority of issued stocks of a corporation would have the power of control, because the election of directors needs a majority of votes.

In addition, an entrepreneur shareholder who can solicit proxy cards and exercise their voting rights on behalf of shareholders who have no interest in the management of a corporation can control the corporation without holding the majority of issued stocks. Moreover, when a corporation becomes huge and shareholding is dispersed more widely, such an entrepreneur shareholder no longer exists. In this situation, the person who is capable of soliciting the proxy and exercising voting rights on behalf of shareholders can control the corporation. That is management.

Finally, management itself can control a corporation. In this way, shareholders who originally had the power to control the corporation have become similar to renters. As a result, the phenomenon of separation between ownership and control emerges.³

²Kitazawa (1976), p. 208.

³Berle and Means (1932), pp. 66–83.

Now we return to the issue of American corporate law. Under American corporate law, management has the power to not only exercise business control but also decide general policy. However, it does require the agreement of shareholders regarding basic intentions concerning the organizational structure of the corporation. The function of election of directors (management) is left to the shareholders. Accordingly, this illustrates the mechanism by which shareholders control management. This is the general underpinning of American corporate law.⁴ However, it should be noted that as Berle and Means pointed out, this kind of system is fictional, because management can be self-perpetuating. This is called the “management-control corporate organization.”⁵ Two different approaches to change this situation have been considered. One is to strengthen and amend the power given to shareholders to oversee management. This approach assumes that the mechanism by which shareholders control management under current corporate law is not entirely ineffective and tries to reestablish the idea of corporate law, i.e., the control of management by shareholders. This idea is called shareholder democracy, or alternatively, corporate democracy.

In contrast, the second approach suggests that the current concept of corporate law no longer has any significance and a new system is required.⁶ Shareholder democracy insists that shareholders should participate in corporate governance actively and play the role of management monitor. To accomplish this goal, various measures are considered.

First, the disclosure of information to each shareholder is necessary for them to judge adequately the behavior of management and the proposals that are submitted during the meeting. Second, a system by which shareholders can exercise easily their voting rights according to their own decisions is necessary. Third, a system by which shareholders can communicate easily among themselves is needed, since each shareholder owns a fraction of the stocks. The Full Disclosure principle under the SEC proxy rule and its part, the shareholder proposal rule (rule 14a-8(4)), were legislative efforts to satisfy these requirements.⁷

Recently, American institutional investors have used the shareholder proposal rule.⁸ What does this phenomenon mean? If management control is based on the assumption of the non-exercise of voting rights and the power of soliciting proxies, once institutional investors exercise their voting rights according to their own decisions, management control will disintegrate and the control of a corporation will fall into the hands of institutional investors. Next we will examine the incentive of institutional investors to participate in corporate governance matters and determine their level of success.

⁴ Clark (1986), pp. 93–109.

⁵ Berle and Means (1932) p. 78.

⁶ Dent (1985) p. 2.

⁷ Maeda (1974) p. 460.

⁸ Clark (1990) p. 79.

3. The Check System from the Investment: Socially Responsible Investment

In recent years, socially responsible investment (SRI) has garnered attention worldwide. SRI is an investment method targeting companies that conduct their activities with corporate social responsibility (CSR), investing in companies which value CSR, and not just taking corporate earnings from the marketplace. CSR signifies operating a business by interacting positively and consulting with equity stakeholders concerning corporate environmental policies, strict adherence to the law, consideration of human rights, consumer response, maintaining a positive work environment, contributing to the region, etc.

In the modern era with globalization of corporate activities, cries of concern about this international influence are growing louder. In the 1990s, ocean waste from Royal Dutch oil storage facilities and low wages paid by Nike in developing countries became international problems. With this kind of multinational company problems as a backdrop, interest in CSR increased. In 1999 the UN Secretary General Kofi Annan advocated the Global Compact, nine principles regarding human rights, labor, and environmental issues. In 2000, the OECD revised its standard of conduct for multinational companies, and in 2001 the ISO (International Standards Organization) began to consider standardization of CSR. In the same year the European Commission proposed promotion of CSR, and there was a move toward standardization of CSR.⁹

In the United States also, because of the collapse of Enron and WorldCom, which were representative of U.S.-style businesses, the move strengthened to reexamine the way management should carry on in order to maximize shareholder value. And with recognition in the United States of the need to promote inclusion of CSR in business as a backdrop, the role of government has decreased, and businesses have ventured out to make use of public resources like schools, which until now had been outside the parameters of the market.¹⁰

In Japan too, stock brokerage loss compensation problems appeared at the beginning of the 1990s, and after that more problems, such as financial industry scandals, appeared, putting corporate social responsibility into question; in 1991 the Keidanren (Japan Federation of Economic Organizations—currently The Japan Business Federation) set up the Charter for Good Corporate Behavior, which companies were expected to follow. However, after that, scandals in Keidanren-member companies erupted one after another, and in May 2004 it revised the charter for the third time, with contents including social justice and environmental management stressing CSR even more. The Keidanren insisted that companies should proceed with involvement in CSR autonomously, and took a position opposing standardization or legislating CSR.¹¹ The Japan Association

⁹ *Nihon Keizai Shinbun* “Good management—Question about CSR,” Jan. 14, 2004.

¹⁰ *Nihon Keizai Shinbun* “CSR and the future of the corporation,” Oct. 19, 2004.

¹¹ *Nihon Keizai Shinbun* “The importance of CSR,” May 18, 2004.

of Corporate Executives issued its Corporate White Paper in 2003, clearly spelling out the importance of CSR. Interest in CSR is high among individual companies, and when the *Nihon Keizai Shinbun* canvassed about 1000 major large companies in FY 2003, about 45% had begun involvement in CSR, while a mere 2.8% responded that it “wasn’t necessary.”¹²

In today’s world, recognition of CSR is increasing and many companies are making CSR integral in their businesses. Against this background, influence on companies is increasing through lively interest in SRI by institutional investors; in other words, the power of investment.

If one considers, for example, tobacco companies in the United States, which are on the frontline of criticism, they have boosted profits and shifted huge costs to the public. Institutional investors like the gigantic CalPERS, the California Public Employees’ Retirement System, have demanded that companies eliminate these costs, and this is one reason companies have turned toward CSR. SRI amounts have reached about \$2 trillion in the United States and about \$3 trillion worldwide. Amy Domini, who developed the world’s first SRI stock index, the Domini 400, has attracted a wide range of capital with the mottoes of “changing society through stock investment” and “investors changing corporate management,” and has garnered interest in her method of investing by selecting companies with a high level of social contribution in areas like the environment and human rights.

In recent years, large-scale institutional investors such as pension funds in Europe and the United States have adopted this kind of investment method. In Japan too, the Tokyo Metropolitan School Personnel Mutual Aid Association began an SRI in 2003 to invest in companies which contribute to the region through education and which actively promote and support their employees’ education.¹³

Through this kind of stock investment, investors are trying to promote corporate management that will fulfill its social responsibility and indeed change society, and expectations on institutional investors are ever increasing to have the right to make investment decisions and have the right to say something to corporate management.

3.1 SRI Funds in Japan

The first SRI in Japan was the Eco Fund, established in August 1999 by Nikko Asset Management. After that, Asahi Life Asset Management began to sell Asu no Hane in September 2000, a true SRI fund that evaluates additional social aspects, such as consumer response, employment, and social contributions. As of December 2003, publicly subscribed investment trusts had established 18 such funds.

¹² *Nihon Keizai Shinbun* “Good management—Question about CSR,” Jan. 14, 2004.

¹³ *Nihon Keizai Shinbun* “CSR and the future of the corporation,” Oct. 19, 2004.

Market capitalization in publicly subscribed SRIs was ¥60 billion in March 2003 when stock prices hit their recent lows. This is one third of the ¥200 billion at the peak period in 1999.¹⁴ Total assets of investment trusts as of the end of September 2004 were about ¥14 trillion, and for the approximately 2500 established funds, the amount invested in SRI funds was extremely small, although it was expected to increase in the future due to continuing corporate scandals and increasing foreign equity shareholder stakes.¹⁵ Yet the majority of investment results for SRI investment trusts that have been established up to this point were down by double digits, and for the individual investor they are not currently viewed as attractive items.

SRI investment by institutional investors has recently begun. In 2003 the Tokyo Metropolitan School Personnel Mutual Aid Association contributed ¥2 billion of the ¥84-billion reserves in its pension fund as a special investment fund and began investing by establishing a self-directed investment SRI fund. The SRI fund carries out investment in companies based on their evaluation of such societal aspects as taking care of the environment. In July 2003 Sumitomo Trust & Banking became trustee for the ¥2.5-billion Sustainable Growth SRI fund, combining the pension funds of KDDI and Shinsei Bank. Then in December 2003 Fukoku Mutual Life Insurance Company, and in January 2004 Mitsui Asset Trust Bank announced they would establish SRI funds for their pension plans.¹⁶

In July 2003, according to the results of a questionnaire conducted by Sumitomo Trust & Banking of corporate pensions which institutional investors represent, about 65% of the pension funds look upon SRI funds as more than “one possible consideration,” a relatively high rate for something where the awareness is not high. And a very high 47% responded “agree” to the statement “SRI’s are a new excess revenue source.” These two data mean that for corporate pensions, when they are confident that SRIs are a source for returns, SRIs can become an investment objective. In other words, this suggests the possibility that in the future, SRIs can assume the position of an active investment for Japan’s pension funds. The key to this, though, is whether they can maintain performance as an active investment means.¹⁷

In this way, Japan’s institutional investors are demonstrating a constructive posture toward SRIs. In the midst of this, the Pension Fund Association and the Pension Fund Association for Local Government Officials decide by themselves how to exercise their voting rights in a positive way and, without any direct corporate influence, thereby have something to say about CSR in each and every corporate governance principle.

¹⁴ Adachi and Kanai (2004) pp. 83–85.

¹⁵ Investment Trust Association (2004).

¹⁶ *Nihon Keizai Shinbun* “Investment into the CSR Fund,” May 27, 2003.

¹⁷ Adachi and Kanai (2003) pp. 85–91.

3.2 *Evaluating the Performance of Japan's SRI Funds*

As discussed previously, with investment results in SRI funds in Japan registering a double-digit decline or more, they are not attractive items for investors. However, this is more a problem confined to a certain point in time, and performance is not a problem that is limited to SRIs. In 2003 Morningstar, which is a company that rates investment trusts, developed an SRI index for Japanese stocks, and it has enjoyed a favorable reputation since it began on May 30, 2003. Looking at returns from May 30, 2003 to the end of December in the same year, the Morningstar SRI (MS-SRI) stood at 26.57%, two percentage points higher than the 24.58% for the TOPIX.

Morningstar back-tested the previous 10 years for the MS-SRI (an investment simulation going back to March 1993 for the May 2003 portfolio), and the results show that the MS-SRI would have been 20.56 percentage points higher than the TOPIX rate of -44.97%.¹⁸

Based on research up to this time, the performance of the U.S. SRI funds and SRI indices in the 1990s do not show results worse than market indices. Moreover, it has been verified that the returns on SRI indices developed in recent years in Japan also are better than the performance of traditional stock market indices. This shows that there is no contradiction between institutional investors selecting SRIs as investments and fulfilling their fiduciary responsibility. And when it comes to having a different investment universe, it shows that in recent years SRIs have become an important investment for institutional investors who are trying to make alternative investments more positive.

SRIs are one social system which influences the way corporate governance should be, and manifest a relationship by which the company is influenced by the equity stakeholder, and at the same time influences the equity stakeholder, that is, SRIs are a model of mutual enhancement between company and equity stakeholder.¹⁹

For example, on examining an eco-fund, one sees that it rates a company's environmental policy objectively. The company implements its environmental policy and promotes its environmental policy information disclosure in a positive manner. The eco-fund again evaluates the results. By generating positive feedback, the eco-fund plays the role of an impetus towards a sustainable society.

4. Conclusion

The phenomenon of separating the functions of corporate ownership and corporate control is common to the countries in which capitalism has developed. With the development of capitalism, the control of corporations has fallen into

¹⁸Adachi and Kanai (2003) p. 91.

¹⁹Tanimoto (2003) pp. 239-244.

management's hands. Management can perpetuate itself in management-control corporations. It has been said that shareholders do not have any functions of control of corporations.

However, institutional investors have grown to substantial size and own significant percentages of individual corporations. Therefore, it has become more rational for institutional investors to monitor management. Institutional investors can use their voting right to change the corporate governance. This is called "shareholder activism."

Institutional investors have another way to change the corporation: SRI. This way includes more stakeholders. In recent years SRI has become an important investment for institutional investors who are trying to make alternative investments more positive. SRI could be a very good way to change corporations from within the capital market for a sustainable society.

References

- Adachi E, Kanai T (2003) CSR Management and SRI. Kinyuzaiseijijyoukenkyukai.
 Adachi E, Kanai T (2004) CSR Management and SRI [J]. Seisansei Shuppan.
 Berle AA, Means GC (1932) The Modern Corporation and Private Property. Transition Publishers, New Brunswick (reprinted in 1991).
 Clark R (1986) Corporate Law. Little Brown, Canada.
 Clark S (1990) Why Dale Hanson Won't Go Away, Institutional Investor, April.
 Dent GW (1985) SEC Rule 14a-8: A study in Regulatory Failure, 30 New York Law School Rev. 1.
 Kitazawa M (1976) A Study on Company Law [J]. Yuhikaku, Tokyo.
 Maeda S (1974) A Study on Corporate Control [J]. In: Otori T (ed) The Problems on Business Law. Yuhikaku, Tokyo.
 Tanimoto K (2003) Introduction to SRI [J]. Nihon Keizai Shinbunsha.