

The Influence of Institutional Investors on Corporate Governance and Firm Performance: Evidence from Japan

Mitsuru Mizuno

Nihon University, Japan

Hajime Shimizu

Osaka University of Economics, Japan

Abstract

Using data of firms listed on the First Section of Tokyo Stock Exchange during FY2005-FY2010, we examine the influence of institutional investors on corporate governance and the relationship between institutional investors and firm performance in Japan. Institutional investors have become active in strengthening corporate governance with an eye of enhancing corporate value since the beginning of 2000s. They exercise the voting rights at the general shareholders' meeting and some of them engage in dialogue with investee companies. The results of our analysis suggest that corporate governance was improved by institutional investors. It was also found that there is a statistically significant difference between the change in institutional investors' shareholdings and firm performance during the analysis period. By dividing the firms into five groups from the viewpoint of the increase in the ownership share of institutional investors, we found that the mean value of ROE is higher in group 5, indicating that the group with the highest increase of institutional ownership during FY2005-FY2010 shows better performance than other groups. This indicates that institutional investors select firms for investment based on the expected performance of ROE and enhance value creation of investee firms by monitoring activity.

Keywords: *institutional investors, corporate governance, firm performance*

INTRODUCTION

Institutional investors have a lot of influence in the management of corporations because they are entitled to exercise the voting rights in a company. They can actively engage in corporate governance in order to enhance the value of investee firms. The objective of this study is to examine the role played by institutional investors in the reform of corporate governance and firm value. Specifically, we consider the relationship between improvement of corporate

governance and firm's value creation and investment behavior of institutional investors. Corporate governance reform has been promoted with the intention of improving the corporate value through shareholder-oriented management style. Governance guidelines and monitoring by institutional investors is expected to affect the improvement of corporate performance. Relationship between corporate governance and stock price performance is not clear, in spite of abundant empirical research that has been made so far in a number of countries.

Generally speaking, institutional investors have a tendency to invest in companies keen on improving governance structure. As such, the strength of governance might have an impact on funding activities of companies. International reputation for corporate governance of Japanese companies is not high because outside directors are not obliged (Asian Corporate Governance Association, 2008). International Corporate Governance Network (ICGN) approved a "Statement of Principles on Institutional Shareholder Responsibilities" in 2007. The Statement sets out the ICGN's view on the responsibilities of institutional shareholders both in relation to their external role as owners of company equity, and also in relation to their internal governance. The Statement also claims that "Institutions that comply with the enlarged principles will have both a stronger claim to the trust of their end beneficiaries and to the exercising of the rights of equity ownership on their behalf."

In Japan, there is an issue on improving the transparency of the exercise of voting rights at the shareholders' meeting. Tokyo Stock Exchange (TSE) made a request in October 2009 to improve the transparency of the exercise of voting rights by publication of the results. In addition, TSE announced a policy that listed companies have to register at least one person as independent director and/or auditor either from outside directors or from statutory auditors unrelated to management by March 2010. The debate on corporate governance has become more active since the mid-1990s in Japan. The influence of the main bank was weakened by the collapse of the bubble economy in the early 1990s, while on the other hand, that of institutional investors, *inter alia*, foreign institutional investors, has become strong. Japanese companies had to respond to the demands of institutional investors with an increase in the incentives for executives and accelerated decision-making by introducing stock option plans and executive officer system as well as an increase in the dividend. Japanese corporate governance system has reached a major turning point in 2002. The companies were allowed to select a corporate structure, either US style committee-based or company auditor corporate structure by the revision of the Commercial Code. However, the percentage of companies that have

selected the corporate structure with committees was only 2.6% as of December 2012 among the companies listed on the First Section of TSE.

With the internationalization of corporate activities and global asset allocation of foreign investors, there is a need to develop governance structure which meet the requirements of institutional investors and enhance corporate value. In light of international trends, responding positively to strengthen corporate governance leads to the confidence of Japanese companies by institutional investors. It is believed that a positive impact on business activities would be felt, if capital markets are reactivated by brisk investment of institutional investors. This paper analyzes empirically the influence of institutional investors on corporate governance and firm value during the six years from FY 2005 and FY2010. The contributions of this paper are three-fold. The first contribution is that corporate governance was actually improved by institutional investors. The second is that the paper employs a dynamic analysis of the changes of share ownership of institutional investors during FY2005-FY2010 for the examination of improvement of corporate governance and firm performance, instead of conventional static analysis which employs share ownership of institutional investors at a specific date. The third is to appreciate the investment behavior, *inter alia*, criteria on investment in and value creation of firms through monitoring activity by institutional investors in Japan.

The study consists of six parts. In the following section, institutional investors and corporate governance is discussed. Section 3 reviews the preceding researches on corporate governance and institutional investors. In section 4, the research design and methodology employed in the study is explained. Section 5 presents the results and discussion. The last part concludes the study with general remarks.

INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE

Japanese firms had been characterized by main bank system and cross-shareholdings up to the early 1990s. Morck and Nakamura (1999) pointed out that Japan's main bank and financial keiretsu system left corporate governance largely in the

Table 1: Trend of ownership by type of investors

Fiscal Year	Financial Institutions	City & Regional Banks	Trust Banks			Life Insurance Firms	Non-life Insurance Firms	Securities Firms	Business Firms	Foreigners	Individuals
				Invest. Trusts	Pension Trusts						
2000	39.1	10.1	17.4	2.8	5.5	8.2	2.7	0.7	21.8	18.8	19.4
2001	39.4	8.7	19.9	3.3	6.0	7.5	2.7	0.7	21.8	18.3	19.7
2002	39.1	7.7	21.4	4.0	5.8	6.7	2.6	0.9	21.5	17.7	20.6
2003	34.5	5.9	19.6	3.7	4.5	5.7	2.4	1.2	21.8	21.8	20.5
2004	32.7	5.3	18.8	3.9	4.0	5.4	2.2	1.2	21.9	23.7	20.3
2005	31.6	4.7	18.4	4.4	3.6	5.3	2.1	1.4	21.1	26.7	19.1
2006	31.1	4.6	17.9	4.7	3.5	5.4	2.2	1.8	20.7	28.0	18.1
2007	30.9	4.7	17.5	4.9	3.5	5.5	2.2	1.6	21.3	27.6	18.2
2008	32.0	4.8	18.8	5.0	3.5	5.3	2.1	1.0	22.6	23.5	20.5
2009	30.6	4.3	18.4	4.7	3.4	5.0	2.0	1.6	21.3	26.0	20.1
2010	29.7	4.1	18.2	4.4	3.2	4.5	1.9	1.8	21.2	26.7	20.3
2011	29.4	3.9	18.6	4.5	3.0	4.3	1.8	2.0	21.6	26.3	20.4

Source: Tokyo Stock Exchange (2012)

hands of creditors rather than shareholders. The influence of the main bank on firms has declined in the wake of bubble burst in the beginning of 1990s, while the shareholders of firms, inter alia, institutional investors including foreign investors have begun to assume more importance in exerting an influence on firms (Mizuno, 2010). Of particular significance was a dramatic increase of foreign investors, majority of which are institutional investors, whose share rose from 7.7% in 1993 to 28% in 2006 (Table 1). On the other hand, with the exception of trust banks which include investment trust and pension funds, other financial institutions such as commercial banks, regional banks, life insurance, etc. decreased their ownership share. This increasing international ownership has a great impact on corporate governance in Japan (Ahmadjian 2007). The Japanese firms responded to the demand of institutional investors by adopting a system such as non-statutory executive officers and independent statutory auditors.

Influenced apparently by foreign institutional investors, Japanese institutional investors have also kept an eye on corporate governance. The Pension Fund Association (PFA) of Japan has taken an initiative in adopting the corporate governance guideline and has exercised their voting rights based on the guideline. Table 2 shows the results of exercise

of shareholder voting rights of PFA portfolio companies in June 2010. PFA voted to oppose or abstained from voting in 487 company proposals, with an opposing vote ratio of 18.1%, which increased from 12.4% compared to the previous year. The increase in the ratio of votes against company proposals is partly attributed to a considerable decline in the number of proposals regarding partial amendments to articles of incorporation from 828 in 2009 to 167 in 2010, in which PFA generally voted in favor, resulting in the overall higher vote ratio against the proposals, and partly to a higher vote ratio against the proposals such as appropriations of retained earnings and revisions of executive remuneration. The ratio of votes against proposals on the payment of retirement allowances to directors and corporate auditors increased to 25.8% in June 2010 from 22.0% in the previous year. Likewise, the ratio of votes against proposals on granting stock options increased to 14.1% from 11.1% compared to the previous year. The PFA opposes granting stock options in cases where it does not lead to the improvement of earnings performance. The overall results indicate that companies have to make efforts to further improve corporate governance to meet the requirements of PFA.

Table 2: The results of exercise of shareholder voting rights of PFA portfolio companies

Company Proposals	Approved	Opposed/ Abstained	Opposing Ratio	Subtotal
Appropriation of retained earnings	529	66	11.1%	595
Partial amendments to articles of incorporation	152	15	9.0%	167
Appointment of directors	492	*1 242	33.0%	734
Appointment of corporate auditors	354	*1 55	13.4%	409
Allowance of retirement bonuses	115	40	25.8%	155
Revision of executive remuneration	79	10	11.2%	89
Granting of stock options	55	9	14.1%	64
Appointment of accounting auditors	8	0	0.0%	8
Restructuring related *2	14	0	0.0%	14
Other company proposals *3	400	50	11.1%	450
Company proposals Total	2,198	487	18.1%	2,685

Shareholder proposals	10	72	*4 12.2%	82
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*1 Includes partial opposition. *2 Mergers, business transfers/takeovers, stock swaps, stock transfers and company spin-offs.

*3 Share buy-backs, reductions in legal reserves, capital increase through third-party allotment, capital reductions, reverse stock splits, approvals of financial statements, payments of executive bonuses, appointment of substitute corporate auditors and adoption of anti-takeover measures. *4 The ration of affirmative votes.

Source: Pension Fund Association (2010)

LITERATURE REVIEW

Institutional investors as corporate monitors are a focus of many studies and research. It is widely argued that institutional investors are an important corporate governance mechanism that improves firm performance, as they possess both the ability and the incentive to monitor and discipline corporate managers (Ping & Wing, 2011). Rose (2007) justifies the effectiveness of institutional investors as a corporate governance tool based on the grounds that institutional investors might discipline management, because the free-rider problem associated with dispersed ownership is alleviated. However, literature on institutional investor's influence on corporate governance in Japan is rather limited. Mizuno and Tabner (2009) discuss the evolution of institutional investor's influence on corporate governance in Japan. Pioneer work on institutional investor in Japan was carried out by Omura, et al. (2001) and Yonezawa & Hashimoto (2002). The former clarified the institutional investor's behavior and a change in attitude based on the survey and revealed that the behavior varies depending on the type of institutional investors. The latter pointed

out that the guideline on the voting is required in order to exercise voting rights in earnest. Miwa (2006) and Seki (2005) argue that institutional investors have become active in accordance with legal changes in order to strengthen the monitoring functions in Japanese companies and they have grown to substantial size and own significant percentages of individual companies. Ueda (2007) describes that institutional investors seek greater disclosure and accountability in terms of performance and corporate governance. The shareholder activism of institutional investors was initiated by foreign investors followed by Japanese institutional investors. The institutional investors and corporate governance in various countries is described in the book entitled "The institutional investors and corporate governance" (edited by Baum, et al., 1993). The Centre for European Policy Studies (1995) points out that international diversification and increasing cross-border activity of institutional investors can be instrumental in changing corporate governance standards as a result of the active stance towards investment that is required by local laws and codes. Mallin (2007) pointed out that there has been a general increase in the level of engagement

of institutional investors with their investee companies.

In UK, the Cadbury (1992) Committee considered institutional investors as having a special responsibility to try to ensure that its recommendations are adopted by companies, stating that 'we look to the institutions, in particular, to use their influence as owners to ensure that the companies in which they have invested comply with the Code'. Similarly, Greenbury (1995) and Hampel (1998) Committees emphasized an important role played by institutional investors in ensuring corporate governance. The Combined Code (2003) principles of good governance state the following concerning institutional shareholders:

- (1) Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives;
- (2) When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention; and
- (3) Institutional shareholders have a responsibility to make considered use of their votes.

Moreover, Financial Reporting Council of UK (2012) sets out the principle of institutional investors which require them to publicly disclose their policy on how they will discharge their stewardship responsibilities. Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration.

Three-quarters of institutional investors say that board practices are at least as important as financial performance when they evaluate companies for investment (Coombes and Watson, 2000). Over 80 percent of them say that they would pay more for the shares of a well-governed company than for those of a poorly governed one with a comparable financial performance. It is, therefore, surmised that there exists a positive relationship between good corporate governance and institutional investor's attitudes. But a question arises as to whether companies with a high ratio of institutional ownership outperform those with lower institutional

ownership. So far, various studies suggest that there has been no strong evidence of correlation between share ownership of institutional investors and financial performance of firms. However, a company with good corporate governance is more likely to attract investment from institutional investors compared to poorly governed companies (McKinsey & Co, 2002). Another question is whether institutional investor activism targeted at specific companies brings about better performance. Shareholders are growing increasingly active in the United States and elsewhere because they believe that better corporate governance will bring them higher rewards. Daily, et al. (1996) found no significant relationship between firm performance measured by abnormal stock price returns, return on assets, or return on equity and ownership by institutions as a whole, or ownership by activist institutions. However, Nesbitt (1994) reports positive long-term stock price returns to firms targeted by CalPERS. Opler and Sokobin (1997) find significant above-market performance in the year after targeting. In spite of the fact that the amount of activism has increased during the past decade, a majority of the studies could not find a link between monitoring and an increase in firm performance.

Gompers, et al. (2003) found that in 1991-99, investors going long on well-governed firms, as defined by an index combining 24 different aspects of corporate governance, while shorting poorly-governed ones, would have enjoyed an unusually high annual return of 8.5%. Similarly strong returns were found for a trading strategy based on a narrower list of what reformers consider the six core elements of good corporate governance, such as making the company's whole board face re-election each year, and not having any "poison pill" defenses against takeovers. However, a recent study by Bebchuk, et al. (2010) doubts the results of the research by Gompers, et al. by repeating the study for 2000-08. It finds that, in contrast with the 1990s, neither the 24-factor index nor the six-factor one would have helped investors beat the market. They argue that the disappearance of the good-governance premium during the past decade is actually a sign that investors have woken up to the importance of governance. They think that this was due to a huge increase in discussion on the issue in the

media in 2001-02, following the Enron and WorldCom scandals and the publication of the Gompers study. As a result, they argue, early in the decade differences in the quality of governance between different firms were fully incorporated in their share prices. Since this adjustment was a one-off, well-governed firms' shares have not subsequently outperformed the market.

RESEARCH DESIGN AND METHODOLOGY

Selection of firms and grouping

In order to analyze the changes in the ownership share of institutional investors on corporate governance and performance of Japanese firms, the voting guidelines of the Pension Fund Association (PFA) of Japan, one of the largest institutional investors, are employed and to what extent Japanese firms have adopted the guidelines are examined. The PFA announced the voting guidelines in 2003, which were revised in 2007 and 2010. In this paper, the data of the firms are those which were continuously listed on the first section of TSE from April 2005 to March 2011 and are constructed using NEEDS -Cges and financial reports of the firms. The total number of firms inspected was 1,334 companies excluding banks and financial institutions. Traditionally, the relationship between institutional investors and corporate governance and/or firm performance has been studied in relation to the structure of ownership share at a certain date. The feature of this study lies in the dynamic analysis by examining the effect of the change of ownership share of institutional investors on corporate governance and firm performance during FY2005 and FY2010, rather than the traditional static analysis using the ownership share at a certain date. Types of typical institutional investors include pension funds, trust banks, insurance companies, investment advisors and investment trusts.

It can be said that the revision of the Commercial Code on corporate governance in Japan began in the first half of 1990s, and the reform made substantial progress in late 1990s and early 2000s. Although corporate governance in Japan has improved by a series of reform efforts, it has been pointed out that it is still not far enough. Thus, by examining the six years from FY2005 to FY2010,

we are able to grasp further the chronological progress. The check-items of corporate governance are prepared by reference to the voting guidelines of PFA, through which verification is possible. While the years inspected are FY2005 and FY2010 for the check-items of corporate governance, the relationship between the changes in the ownership share of institutional investors and firm performance covers six-year period from FY2005 through FY2010. First, the relationship between the changes in the ownership share of institutional investors and firm performance is looked into. Second, the firms are divided into five groups as below from the viewpoint of an increase in the ownership share of institutional investors:

- a. group 1: first quintile-the least increase in the ownership share of institutional investors (266 firms)
- b. group 2: second quintile-the second least increase in the ownership share of institutional investors (267 firms)
- c. group 3: third quintile- the middle increase in the ownership share of institutional investors (267 firms)
- d. group 4: fourth quintile-the second highest increase in the ownership share of institutional investors (267 firms)
- e. group 5: fifth quintile-the highest increase in the ownership share of institutional investors (267 firms)

Check-items of corporate governance and financial indicator

The following items in FY2005 and FY2010 are investigated. The PFA introduced the guideline on defensive measures against takeover in 2007. Therefore, item i is added in FY2010.

- a. whether a firm is adopting the three committee based structure or corporate auditor structure; the PFA states that firms adopting the committee based board structure shall be positively appraised;
- b. whether a system of non-statutory executive officers is introduced or not in the case of a firm adopting corporate auditor structure;
- c. whether outside directors exist or not in the case of a firm adopting corporate auditor structure; the PFA states that at least one

Table 3: Summary of Check-items

No	Items	Check-items	FY2005, FY2010	
			Committee based firm	Auditor based firm
1	Board structure	Adoption of three committees structure	◎	—
2		Adoption of corporate auditor structure	—	◎
3		Introduction of non-statutory executive officers	—	◎
4		Introduction of outside directors	—	◎
5		No. of directors	◎	◎
6	Mgt. incentives	Introduction of stock option	◎	◎
7	Executives' remuneration	Disclosure of total executives' remuneration	◎	◎
8		Disclosure of each executive's remuneration	◎	◎
9	Outside director	Independence	◎	◎
10	Outside auditor	Independence	◎	◎
11	Defensive measures against corporate takeover	Approval by board of directors or not	◎	◎

Note: ◎ denotes applicable.

third of directors should be outside directors;

- d. whether corporate auditors are of an independent stance with no material interests whatsoever in the company concerned or not;
- e. the number of directors; the PFA states that the board of directors should consist of an appropriate number of directors, namely under 20, so that every member of the board can participate in active discussion leading to a logical conclusion and decision;
- f. whether a firm is introducing the stock option or not; the PFA states that companies adopting the stock option shall be positively appraised;
- g. whether there is a disclosure of total executives' remuneration or not;
- h. whether there is a disclosure of each executive's remuneration or not; and
- i. whether defensive measures against corporate takeover have been introduced by judgment of the board of directors without obtaining an authorization at the general shareholders' meeting or not.

Check-items are summarized in Table 3.

There are a number of financial indicators to gauge firm performance including a share price return, ROA, ROE, and Tobin's q. In this study, ROE

is used as proxy of firm performance.

RESULTS AND DISCUSSION

Influence of the increase of ownership by institutional investors on corporate governance

It was found that during the period of FY2005-FY2010 institutional investor's ownership decreased from 25.9% to 22.5% and the change of institutional investor's ownership share in each group during the same period is shown below:

Group 1: -51.5%~-9.09% mean: -15.72%

Group 2: -9.09%~-4.06% mean: -6.29%

Group 3: -4.06%~0.90% mean: -2.42%

Group 4: -0.88%~2.13% mean: 0.52%

Group 5: 2.16%~31.14% mean: 6.87%

Table 4 represents the summary of survey results. The number of firms with the three committee based structure remains only 32 and 34 in FY2005 and FY2010 among 1,334 firms, which accounts for 2.4% and 2.5% respectively, indicating there is a sense of resistance to the adoption of a company with three committees. When viewed from the increase of ownership share by institutional investors, group 5 shows the highest ratio of adopting three committee based structure, albeit the percentage is mere 3.4% and 4.1% in FY2005 and FY2010. Type of corporate auditor structure, namely, the alternative of three committees based

Table 4: Summary of survey results

Check-items	FY2005	FY2010
1. A firm with the three committee based structure and a firm with corporate auditor structure		
No. of firms with the three committee based structure	32	34
No. of firms with corporate auditor structure	1,302	1,300
2. A firm adopting non-statutory executive officers and a firm not adopting non-statutory executive officers, both of which fall under corporate auditors structure		
No. of firms adopting non-statutory executive officers	690	887
No. of firms not adopting non-statutory executive officers	612	413
3. A firm introducing outside directors and a firm not introducing outside directors, both of which fall under corporate auditor structure		
No. of firms introducing outside directors (out of which independence is verified)	483 (385)	648 (567)
No. of firms not introducing outside directors	819	652
4. A firm with more than one third directors are from outside and a firm with less than one third directors are from outside , both of which fall under corporate auditor structure		
No. of firms with more than one third directors are from outside	51	99
No. of firms with less than one third directors are from outside	1,251	1,201
5. Independence of outside auditors*		
No. of firms in which independence of outside auditors is verified	1,253	1,273
No. of firms in which independence of outside auditors is not verified	49	29
6. A firm with more than 20 directors and a firm with less than 20 directors*		
No. of firms with more than 20 directors	25	11
Average no. of directors	9.9	9.0
7. A firm introducing stock option and a firm not introducing stock option		
No. of firms introducing stock option	454	340
No. of firms not introducing stock option	880	994
8. Disclosure of total executives' remuneration	all	all
9. Disclosure of each executive's remuneration	0	0
10. No. of firms introducing defensive measures against corporate takeover as of the end of fiscal year	29	542

Note 1: * denotes applicable to a firm which falls under corporate auditor structure

Note 2: RECOF data are used for no. 10.

structure, is adopted at a higher proportion by group 3 compared to other groups. Non-statutory executive officer system was first introduced by Sony in 1997, and it has spread rapidly since then. The objective of introducing it is to enhance corporate governance by separating execution from decision making function. In FY2005, about 53% of firms excluding the three committee based structure adopted it, and this ratio has risen to more than 68% in FY2010, intimating that firms have responded to the demands of PFA. It is observed that in group 1, 48 firms newly adopted non-statutory executive officer system during the 6 year-period, the highest number among the groups, al-

though adoption ratio of non-statutory executive officer system of group 1 was the lowest in FY2005. However, no statistical significant difference was noted between the groups. On outside directors, 37.1 % of firms excluding a firm with three committees introduced them in FY2005. This ratio has risen to 49.8% in FY2010, suggesting that firms have responded to the demands of institutional investors. Using Pearson's χ^2 test, it was found that there is not a statistically significant difference between the groups as to the adoption of outside directors. Although the number of companies with more than one-third outside directors rose to 99 in FY2010 from 51 in FY2005, still it accounts for only

7.6% of the surveyed firms. There were 385 firms with outside directors with a certain degree of independence in FY2005. The number substantially increased to 567 in FY2010, reflecting the attitude of firms to meet the demands of institutional investors. The number of directors per company in FY2010 stood at 9, a decrease of approximately one person compared to that in FY2005. PFA states that the number of directors should be less than 20 people. According to this criteria, 11 companies are yet to meet it in the fiscal year 2010.

In Japan, ban on stock option was lifted in 1997 and the company which introduces it has remarkably increased since then. But, surprisingly, there was a decrease of 114 firms in adopting stock option during the period of six years. Therefore, the penetration rate of stock option declined to 25.5% in FY2010 from 34.0% in FY2005. The decline is attributed partly to the sluggish stock market and partly to a change of accounting in 2006 which obliges granting stock option as an expense. Thus, as an incentive to the management, there is an increasing trend towards compensation plan linked to financial performance. The decline rate of stock option was the highest at group 1, in which 39 firms abolished the plan. Disclosure of executives' compensation has been encouraged in the annual report since FY2003. It was found that although all the firms disclosed total executives' compensation, none of them disclosed individual executive's compensation. In March 2010, the Financial Service Agency of Japan announced that individual name and amounts of compensation of executives of listed firms who receive more than 100 million yen have to be disclosed. As a result of this measure, the company submitting the financial statements had to ensure a transparent system of financial compensation from the accounting period of FY2010.

Among the firms with corporate auditor structure it was found that 97.8% of them adopted independent outside directors in FY2010 compared to 96.2% in FY2005, indicating the firm's behavior to accommodate to the requirements of institutional investors. In December 2009, TSE announced a new listing rule obliging firms to ensure the independence of one or more directors and/or statutory auditors in an effort to strengthen corporate governance. At present, all the firms listed on the first

section of TSE have already complied with the new listing rule. Among the independent directors and/or statutory auditors, about 70% of them belong to the category of statutory auditors and the rest to directors.

Defensive measures against corporate takeover have become a major topic of voting since 2005. The PFA made its position clear on defensive measures against corporate takeover from the viewpoint that they might lead to self-protection of corporate managers in April 2006. Defensive measures against corporate takeover without an approval at the general shareholders meeting have to be sufficiently explained, and if not, PFA would oppose the appointment of directors. In addition, as a condition of an approval for introducing defensive measures against corporate takeover, PFA demand deliberation and decision by outside directors to eliminate the arbitrariness of managers and a 2-3 year sunset clause. The survey results show that 29 firms introduced defensive measures against corporate takeover as of the end of FY2005, however, the number of companies introducing them dramatically increased to 409 by the end of FY2007, suggesting a sense of vigilance toward corporate takeover during the three years. The majority of firms introduced defensive measures against corporate takeover by the resolution at the general meeting of shareholders, implying that they responded to the demands of institutional investors. According to the survey of RECOF (2012), provider of comprehensive M&A services, the number of firms which introduced defensive measures against corporate takeover reached its peak of 569 in 2008 equivalent to around 15% of all the listed firms, and declined year by year to 519 as of the end of May 2012. The main reason for the discontinuation of defensive measures against corporate takeover is that information and time required for negotiation, and the objective of defensive measures, is now available to some extent by the revision of the 'Financial Instruments and Exchange Act' which became effective in 2008. Moreover, the majority of firms believe that enhancement of corporate value by improving management efficiency and use of capital would lead to secure the common interests of the shareholders, and trust they are the best defensive policy.

Table 5: Descriptive statistics

	INST_ CHANGE	INST_ FRGN_ CHANGE	INST_ DOME_ CHANGE	FRGN_ CHANGE	FRGN_ CORP_ CHANGE	CROSS_ CHANGE	ANTEI_ CHANGE	BRD_ CHANGE	ID_ CHANGE	EROE3_ CHANGE	ROE05_10
Mean	-3.40	-1.26	-2.13	-1.24	0.03	0.62	1.50	-0.90	0.26	-0.66	4.06
Median	-2.37	-0.79	-1.28	-0.78	0	0	0.87	0	0	0.05	4.93
Maximum	31.14	29.37	35.92	29.37	27.68	25.31	54.77	13	6	213.85	36.81
Minimum	-51.15	-34.47	-47.74	-34.47	-11.71	-26.10	-53.86	-19	-6	-159.73	-190.19
Std. Dev.	8.41	6.71	6.10	6.68	1.39	4.80	8.64	2.90	0.91	15.49	10.33

Relationship between the change in the ratio of share ownership of institutional investors and firm performance

To look into the above relationship the following variables are used for the statistical analysis and the acronym of variables used in the analysis appears below.

Acronym of variables:

INST: ownership share of institutional investors

INST_FRGN: ownership share of foreign institutional investors

INST_DOME: ownership share of domestic institutional investors

FRGN: ownership share of foreigners

FRGN_CORP: ownership share of foreign corporation

CORSS: ratio of cross shareholding

ANTE: ratio of stable shareholding

BRD: number of board members

ID: number of outside directors

EROE3: excess returns over the three year average ROE adjusted by industry and firm size

XXX_CHANGE: subtraction of 2005 from 2010 figures

As shown in Table 5, domestic institutional investors, on average, have reduced the shareholding ratio compared to foreign institutional investors during the analysis period. However, standard deviation in domestic and foreign institutional investors is at 6.1% and 6.7%, indicating that the stock replacement was carried out relatively frequently with virtually the same degree. On the other hand, foreign corporations did not change the shareholding ratio so much, as evidenced by the small number of a standard deviation of 1.4%. The standard

deviation of stable shareholders, which were assumed to be inactive traders, was higher in the analysis period than institutional investors, suggesting that there was more buying and selling compared to them. In addition, surprisingly, relatively high standard deviation of 4.8% was observed in the cross-shareholding shareholders. As a measure of firm performance, the mean of ROE during 2005-2010 (ROE05_10) and the excess returns of the mean of ROE for the three years up to the year 2010 subtracted by the excess returns of the mean of ROE for the three years up to the year 2005 after adjusting the size and industry (EROE3_CHANGE) are used.

Table 6 represents correlation matrix of various variables. As expected, the change in ownership share by foreign institutional investors and that of by foreigners has a very high correlation coefficient of 0.98. The change in ownership share of foreign institutional investors and that of foreign corporation has a moderately negative correlation coefficient of -0.12. In this regard, it is meaningful to analyze by separating the share ownership of foreign institutional investors and foreign corporation. Looking into the correlation with the performance, moderate correlation coefficient of 0.22 is observed between EROE3_CHANGE and INST_CHNAGE and both foreign and domestic institutional investors' correlation with EROE3_CHANGE is also moderate. However, there is virtually no correlation between FRGN_CORP_CHANGE and EROE3_CHANGE. Further, the change of ratio of stable shareholding (ANTEI) has a negative correlation with EROE3_CHANGE. On the other hand, although the correlation with ROE05_10 and INST_CHNAGE is moderate, the correlation between ROE05_10 and INST_DOME_CHANGE is quite small.

Table 6: Correlation matrix

	INST_CHANGE	INST_FRGN_CHANGE	INST_DOME_CHANGE	FRGN_CHANGE	FRGN_CORP_CHANGE	CROSS_CHANGE	ANTEI_CHANGE	BRD_CHANGE	ID_CHANGE	EROE3_CHANGE	ROE05_10
INST_CHANGE	1										
INST_FRGN_CHANGE	0.70	1									
INST_DOME_CHANGE	0.61	-0.14	1								
FRGN_CHANGE	0.70	0.98	-0.11	1							
FRGN_CORP_CHANGE	-0.01	-0.12	0.13	0.08	1						
CROSS_CHANGE	-0.07	-0.07	-0.02	-0.07	0.01	1					
ANTEI_CHANGE	-0.40	-0.29	-0.23	-0.28	0.06	0.13	1				
BRD_CHANGE	0.07	0.08	0.02	0.08	0.00	0.01	0.03	1			
ID_CHANGE	-0.01	0.00	-0.02	0.00	-0.03	-0.01	0.03	0.10	1		
EROE3_CHANGE	0.22	0.13	0.16	0.13	-0.01	0.00	-0.10	0.04	-0.02	1	
ROE05_10	0.19	0.19	0.05	0.19	-0.01	0.03	-0.04	0.13	0.05	0.18	1

Table 7: Summary of regression results-EROE3_CHANGE as dependent variable

	1		2		3	
	coefficient	p-value	coefficient	p-value	coefficient	p-value
C	0.943	0.051	0.951	0.049	0.955	0.048
INST_FRGN_CHANGE	0.352	0	0.347	0	0.338	0
INST_DOME_CHANGE	0.461	0	0.466	0	0.457	0
FRGN_CORP_CHANGE			-0.196	0.518	-0.188	0.536
ANTEI_CHANGE					-0.022	0.670
BRD_CHANGE	0.120	0.405	0.121	0.403	0.124	0.389
ID_CHANGE	-0.258	0.572	-0.260	0.569	-0.255	0.577
R ²	0.047		0.047		0.046	

EROE3 has been adjusted by industry and firm size. Accordingly, there is no need to control the firm size or industry. Significant correlation between the change in domestic and foreign institutional investors and the change in EROE3 is noted (Table 7). The change in the number of stable shareholders, board of directors, and the number of outside directors did not have an impact on the change in EROE3.

Table 8 shows the result of multiple regression analysis. The mean ROE during 2005- 2010 is defined as the dependent variable. Similar to EROE3, the change in domestic and foreign institutional

investors' shareholding has a significant positive correlation.

Next, one-way ANOVA and multiple comparison analysis is conducted to examine the difference between the groups by classifying the firms into five groups in accordance with the change in ownership share of institutional investors as mentioned in section 4.1. The descriptive statistics of the relationship between the change in the ratio of ownership share of institutional investors and firm performance appear in Table 9. The mean value of ROE employed to measure the financial performance is higher in group 5, indicating that the group with the highest

Table 8: Summary of regression results-ROE05 10 as dependent variable

	1		2		3	
	coefficient	p-value	coefficient	p-value	coefficient	p-value
C	4.946	0	4.941	0	4.894	0
INST_FRGN_CHANGE	0.296	0	0.297	0	0.302	0
INST_DOME_CHANGE	0.133	0.004	0.132	0.004	0.134	0.004
FRGN_CORP_CHANGE			0.052	0.797	0.050	0.805
CROSS_CHANGE					0.089	0.123
BRD_CHANGE	0.378	0	0.378	0	0.375	0
ID_CHANGE	0.457	0.132	0.460	0.130	0.465	0.125
R ²	0.053		0.052		0.053	

Table 9: Descriptive statistics

		Number of firms	Mean	Standard deviation	Maximum	Minimum
ROE	1	266	1.66	12.44	33.15	-104.91
	2	267	3.80	13.80	31.38	-190.19
	3	267	3.94	9.43	36.81	-78.71
	4	267	4.23	6.92	31.86	-24.89
	5	267	6.68	6.33	32.01	-2.87
	total	1334	4.06			

Table 10: One-way ANOVA

		Sum of square	Degree of freedom	Mean square	F-ratio	P-value
ROE	between groups	3398.013	4	849.503	8.135	.000***
	within groups	138788.744	1329	104.431		
	total	142186.757	1333			

Note: *** denotes statistically significant at the 1% level.

increase of institutional ownership share shows better performance than other groups. This indicates that institutional investors select firms for investment based on the performance of ROE, which has correlation with share price. We also conducted to examine the difference between the groups by classifying the firms into ten groups in accordance with the change in ownership share of institutional investors, and we obtained the same results, namely, institutional investors select firms for investment based on the performance of ROE.

In order to examine whether there is a significant difference between the groups one-way ANOVA was carried out (Table 10). Since the

Table 11 : Multiple comparison of ROE

Dependent variable: ROE		group	group	P-value
Tamhane	1	2		.463
		3		.162
		4		.033**
		5		.000***
	2	1		.463
		3		1.000
		4		1.000
		5		.021**
	3	1		.162
		2		1.000
		4		1.000
		5		.001***
	4	1		.033**
		2		1.000
		3		1.000
		5		.000***
	5	1		.000***
		2		.021**
		3		.001***
		4		.000***

Note: ** denotes statistically significant at the 5% level and *** denotes at the 1% level.

equality of variances is not confirmed by F-test, differences in mean values in ROE were assessed with Tamhane multiple comparison procedure. The results of the assessment show that a statistically significant difference was observed at 1% level between the group 1, 3, 4, and the group 5, and at 5% level between the group 2 and the group 5. It was

also found that a statistically significant difference was observed at 5% level between the group 1 and 4 (Table 11). Thus, it is confirmed that the institutional investors selected the investee firms by attaching high priority to ROE.

CONCLUDING REMARKS

Global equity markets are increasingly dominated by institutional investors, which have become an important factor affecting the corporate management. Domestic as well as foreign institutional investors have become vocal and keen to exercise the voting rights to perform fiduciary responsibility. Firms can no longer ignore the voice of institutional investors in structuring corporate governance system. In this paper, attempts are made to clarify to what extent firms are responding to the requirements of institutional investors. We found that, overall, corporate governance has improved because of the influence of institutional investors. However, they are yet to be satisfied with the governance system, inter alia, non-existence of outside independent director and foreign institutional investors are skeptical on the role of statutory auditors. In actualities, selection of investee companies and subsequent monitoring activity has become more important to enhance firm performance and maximize the return on investment. After adjustment of industry and firm size, it is found that there is a significant correlation between the change in domestic and foreign institutional investors ownership share and the excess returns of ROE, while there is little correlation between the change in the ownership of stable shareholders, the change in the number of board of directors, the change in the number of the outside directors and the excess returns. Moreover, classifying the firms into five groups from the viewpoint of the changes in the ownership share of institutional investors, it is found that the mean value of ROE is higher in group 5, indicating that the group with the highest increase of institutional ownership share during FY2005-FY2010 shows better performance than other groups. This indicates that institutional investors select firms for investment based on the expected performance of ROE in combination with the monitoring activity of the investee firms to enhance corporate value. As corporate activities be-

come globalized, international portfolio investment of foreign institutional investors is likely to further increase in the foreseeable future. It is expected that the shareholding of institutional investors will rise in Japan due to an increase in investment trust and the ageing society. If there is a positive correlation between good corporate governance and institutional investors' behavior, an enhancement of corporate governance will reactivate the capital market of Japan, thus making a favorable impact on economic activities in general. In this regard, Japanese firms are called upon to work on strengthening corporate governance.

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Mitsuru Mizuno is Professor of the Faculty of Graduate School of Business, Nihon University, Japan. mizuno.mitsuru@nihon-u.ac.jp
Hajime Shimizu is Lecturer of the Faculty of Information Technology and Social Sciences, Osaka University of Economics, Japan. hshimizu@osaka-ue.ac.jp