Institutional investor cliques and their voice in Japan: A fact finding

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Abstract:

This study examines how sub-communities of institutional investors (‘cliques’) play a governance role through their coordinated engagement via-à-vis Japanese firms. Based on the five-percent ownership threshold for defining a link in the investor network, we identify several cliques among institutional investors investing in Japanese firms. We show that the largest clique of each firm votes on behalf of shareholder’s value at shareholder meetings. We also find that institutional investors in the same clique vote in the same direction more frequently than institutions which do not belong to the same clique. These findings suggest that institutional investors coordinate their voting behaviors to enhance value-increasing managerial decisions.

1 Introduction

Institutional investors take collective actions when engaging with investee management.[1] Although institutional investors have a crucial role for corporate governance (Aggarwal et al., 2011), there are obstacles to achieve alignment of interests between shareholders and managers. These challenges include the free-rider problem among dispersed shareholders, insufficient information for effective monitoring, and the risk of harming existing business relationships with investee firms (Dimson et al., 2023). Due to these issues, a single institutional investor could not have enough incentives or capabilities to exercise its monitoring role. Through coordinated engagement, investors can share the costs to mitigate the free-rider problem, share information necessary for precise evaluation, and share the risks associated with their relationships with investee firms among coordinated shareholders (e.g., Bajo et al., 2020; Crane et al., 2019; Kedia et al., 2021).

Prior studies have explored institutional investor coordination through both explicit and implicit means (e.g., Becht et al., 2017; Dimson et al., 2015; Doidge et al., 2019; Kedia et al., 2021; Song and Szewczyk, 2003; Wong, 2020). While explicit coordination includes campaigns by formal organization of institutional investors or wolf pack activism, implicit coordination means behind-the-scenes collaboration among institutions, which is difficult to observe. Among these, Crane et al. (2019) successfully develop a method to identify the coordinating group of investors (i.e., investor clique) using institutional block ownership data. They overcome the difficulty in operationalizing implicit coordination and spur further investigations on the impact of clique ownership, such as its implications for crash risk (Liu et al., 2024).

How the coordinated actions of institutional investors work in Japan are unclear. Unlike the U.S., Japan is characterized by a stakeholder-centric and relational corporate culture, which has historically

[1] Black and Coffee (1994), Gillan and Starks (2000), and Giannetti and Laeven (2009) show anecdotal evidence on coordinated engagement of institutional investors.

rendered shareholder voice less effective. Previous studies have shown that hostile, U.S.-style governance approaches, such as hedge fund activism, have often failed to significantly improve the performance of Japanese firms (Becht et al., 2017; Hamao and Matos, 2018; Miyachi and Takeda, 2021). In case where the risk of business relationship losses is disproportional, coordination makes it less costly for member institutions to take a more aggressive stance toward investee management. By contrast, if cliques in Japan prefer a milder stance, the presence of coordinated institutions may not necessarily be associated with hostile methods such as objecting votes.

To examine the empirical question, this study tests how the coordinated actions of institutional investors influence management decisions in Japan. Specifically, we seek to determine whether and how coordinated engagement by investor sub-communities operates effectively within Japan's unique corporate culture, offering insights that could inform global governance practices.

Our findings are summarized as follows. First, we find that the presence of institutional investors increases the votes against management proposals in shareholder meetings. Second, we show that the investor cliques increase (decrease) the objection rate vis-à-vis 'bad proposal' ('good proposal'). Third, the voting behaviors of an institutional investor in a clique are aligned with those of other institutional investors in the same clique. These findings suggest that institutional investors in a clique coordinate their voting behavior to achieve their strategic purposes. This coordination behavior appears to mitigate negative externality driven by free rider problem among shareholders.

This paper is organized as follows. The next section reviews the prior literature and develops hypotheses. Section 3 explains the data and empirical methodologies, and Section 4 provides empirical results. We conclude this paper with Section 5.

2 Hypothesis

2.1 Prior literature

This study relates to the literature on corporate governance by examining shareholder 'voice' and 'exit.' According to Shleifer and Vishny (1986), dispersed shareholders with small ownership stakes, who act independently, lack the incentives to bear the costs of monitoring management. In such situations, simply selling shares, or 'exit,' can serve as an alternative mechanism to pressure management into prioritizing shareholder value (Admati and Pfleiderer, 2009).

Recent studies suggest that not all investors act independently. Investor coordination can be conceptually divided into two categories: investor networks with central institutions and 'cliques,' which are highly interconnected groups. Studies on cliques emphasize the interconnectivity of all institutions within the group. Studies on the network with central institutions highlight the significance of information sharing and network centrality for firm valuation and crash risk (Bajo et al., 2020; Gong and Liu, 2023; Li and Jiang, 2022). Crane et al. (2019) pioneer the study of investor cliques, including implicit coordination, by analyzing block ownership data among institutions.

The rationale behind coordinated engagement is multifaceted, as discussed in Dimson et al. (2023). The benefits of coordination include increased voting power, reduced research costs due to information sharing and risk-sharing among institutions (Dimson et al., 2015). However, coordination also involves costs, such as free riding by 'follower' institutions, coordination costs among heterogeneous investors, regulatory challenges, and the potential for opportunistic behavior by fund managers. As a result, institutional investors form cliques only when the benefits of doing so outweigh the associated costs.

The benefits and costs of coordinated engagement are likely to depend on the economic and social context. This study aims to shed light on the coordinated engagement of institutional investors in Japanese firms, exploring how Japan's unique context influences these dynamics.

2.2 Hypothesis development

Japan has traditionally been characterized by a stakeholder-oriented and relational corporate culture. Consistent with this characterization, shareholders of Japanese firms have rarely voted against management proposals or submitted shareholder proposals. Ahmadjian (2007) argues that foreign shareholders in Japan have taken a gentle approach to governance primarily due to social norms rather than legal barriers. The coordination of investors could mitigate conflicts of interests in this context. If coordinated shareholders can share the risk of impairing existing business relationship with investee firms, the presence of clique is expected to facilitate dissenting votes on management proposals, particularly those with significant concerns about weak governance.

Hypothesis 1: *The ownership of institutional investor clique is positively associated with dissenting votes for management proposals, especially for proposals with significant concern of entrenchment*.

To determine whether investors harmonize their voting behavior within a clique, we also focus on the similarities in their voting patterns. If clique members are highly interconnected and coordinate their behavior toward the policies of the investee management, the institutions would likely cast their votes consistently with other institutions in the same clique.

Hypothesis 2: *Institutional investors tend to vote for (against) proposals when other institutions in the same clique vote for (against) the proposals*.

3 Research design

3.1 Data

We obtain the data of firm-level ownership details, proposal-level voting results, institutional investors-level voting actions, and firm-level financial attributes from multiple data sources.

First, firm-level ownership data are obtained from FactSet Workstation provided by Quick Inc. This data contains detailed institutional ownership for individual listed firms based on publicly available fund prospectus. Second, we obtain the data of proposal-level voting results at shareholder meetings for individual listed firms from Nikkei NEEDS Kabunushi Sokai Kanren Data. This data contains percentage of objecting votes in the total effective votes and various proposal attributes, like flags indicating takeover defense proposals, director appointments, and shareholder-initiated proposals, at shareholder meetings. Third, voting actions by institutional investors for individual proposals at shareholder meetings of firms which they invest in are obtained from Shoichi Tsumuraya's website.[2] The 2017 revision of Japan's Stewardship Code required institutional investors on a comply-or-explain basis to reveal their voting actions at proposal level. Thus, Tsumuraya's website reports voting outcomes of the institutional investors who comply the revised policy for voting disclosure of Japan's Stewardship Code. Fourth, we obtain financial data of Japanese listed firms from Nikkei NEEDS Financial Quest. This data is extensively used in many studies using samples of Japanese firms.

Based on these data, we construct two datasets: proposal- and institutional investor-level dataset. The primary sample of proposal-level dataset consists of all the proposals voted during shareholder meetings for the period from 2015 May to 2022 June, whereas the institutional investor-level dataset

[2] http://tsumuraya.hub.hit-u.ac.jp/special02/index.html.

covers the period from 2017 June to 2022 June because of the availability of granular data on institutional investors' voting actions.

3.2 Institutional investor clique in Japan

Our main independent variable is a sum of equity ownership across institutional investors within a clique. In the network theory, a clique is defined as a group of closely and mutually connected nodes. In a social network, the occurrence of a clique is an indication of highly cohesive sub-community. Following the study of Crane et al. (2019), we identify a link between two institutional investors if they each hold more than five percent of the equity stake in a given firm at the end of December every year. Then, we apply a greedy modularity algorithm to detect groups (cliques) in the network connecting institutional investors (Blondel, 2008). The algorithm allows us to identify cliques of institutions only on an annual basis.

After identifying institutional investor cliques, for each firm we calculate the fraction of equity ownership of institutions belonging to each clique. Then, we focus on equity ownership of the largest institutional investor clique (*max_c)* in the firm. We assume that the largest clique is a potentially most effective unit of governance either through voice or exit, like the largest block shareholder.

3.3 Other variables

We use two main dependent variables for the proposal- and proposal-institution-level tests, respectively. The former uses aggregate voting outcome of all voting shareholders for each firm's proposal, and the latter uses each institutional investor's votes cast for each proposal.

The dependent variable of the proposal-level test is the rate of objecting votes (*obj_r)*, which captures a magnitude of shareholders' oppositions against the proposal. We measure the variable as the portion of objecting votes in the total number of effective votes for each proposal in a shareholder meeting. The greater the objection rate is, the greater the number of opposing votes is for the proposal.

Using the objection rate as the dependent variable, we also examine how the impact of an institutional investor clique changes depending on the characteristics of proposals at shareholder meetings. We focus on four types of proposals: an adoption or a continuation of a takeover defense (*d_madef*); a shareholder-initiated proposal (*sh_pro*); an appointment of a female director (*d_female*); and a reappointment of an outside director with an attendance problem (*d_attend*). A takeover defense is likely to be an entrenchment device for managers, thereby inducing larger objecting votes from institutional investors (e.g., Brickley et al., 1988). Since we cannot predict whether cliques likely support any shareholder-initiated proposals, we delegate this to an empirical question. Gantchev and Giannetti (2021) report that gadfly proposals destroy firm value, while proposals on average are value-enhancing. An appointment of a female director likely receives smaller objections from clique investors because of diversity consideration (Gow et al., 2023). Finally, a reappointment of an outside director with an attendance problem weakens a monitoring function of the board, and thus we expect larger objections from clique investors. Symbolically, Institutional Shareholder Services Inc. stipulates in their voting guideline for Japanese stocks that they recommend institutions to vote against directors whose attendance is below 75%. We classify individual proposals into the four types based on the proposal categories provided by Nikkei NEEDS Kabunushi Sokai Kanren Data.

We use the following four control variables as possible covariates that may impact our estimation. The firm with larger size (*lasset*) tends to receive more attentions from investors and media, leading to more stringent voting results. The lower the financial performance (*roa*) is, the higher the objection tends to be against proposals on average. The higher the debt ratio (*debtr*) is, the more disciplined the managers tend to be, leading to smaller objecting votes. Institutional investor ownership (*sum_inst*) is the sum of percentage fractions of all institutional investors in the equity stake of the firm. The higher the institutional ownership is, the more objections the firm tends to receive because of

institutions' tighter scrutiny.

For the proposal-institution-level test, the dependent variable (*vote_y*) and the main independent variable (*vote_x*) are defined as follows. For any pairs (x , y) of institutional investors holding an equity stake in the firm, a dummy variable, *vote_x* (*vote_y*), is equal to one if an institutional investor x (y) votes favorably for a proposal at a shareholder meeting of the firm which the institution invests in and zero otherwise. Using these variables, we examine whether any pairs of institutional investors in the same clique tend to vote in the same direction more frequently than institutional investors which do not belong to the same clique. The detailed definitions of variables are provided in Appendix.

3.4 Regressions

To test the impact of cliques' ownership on the consequences of voting, we estimate the following regression model:

$$obj\_r_{ijt} = \alpha_1 \, max\_c_{it} + \mathbf{\Gamma} \, \boldsymbol{z}_{\mathbf{it}} + \phi_i + \tau_t + \varepsilon_{ijt}, \quad (1)$$

where the dependent variable is objection rate (*obj_r*) for a firm i's proposal j in year t. The independent variable of our interests is the fraction of the largest institutional investor clique in the equity stake (*max_c*). The vector $\boldsymbol{z}$ represents a bundle of control variables: firm size, firm financial performance, institutional ownership, and debt-to-asset ratio. The other two variables are firm- and year-fixed effects (ϕ_i and τ_t, respectively).

To examine how clique shareholders vote for (against) the proposal which is likely to improve (impede) the shareholders' value, we estimate the following regression:

$$obj\_r_{ijt} = \beta_1 \, max\_c_{it} + \beta_2 \, max\_c_{it} \times 1(proposal_{ijt}) + \beta_2 \, 1(proposal_{ijt}) + \Gamma \, \mathbf{z}_{\mathbf{it}} + \phi_i + \tau_t + \varepsilon_{ijt}, \quad (2)$$

where we add the interaction term between maximum clique ownership and an indicator reflecting a category of a proposal which we consider to be relevant to shareholder value (1($proposal_{ijt}$)). The indicators used in the analysis are four dummy variables (*d_madef*, *sh_pro*, *d_attend* and *d_female*,), each of which takes one if the proposal is on takeover defense, a shareholders-initiated one, on reappointment of an outside director with an attendance problem, or on a female director appointment, and zero otherwise, respectively. The vector of controls and fixed effects are same as Model (1).

We investigate whether any pairs of institutional investors holding an equity stake in the firm tend to vote in the same direction more frequently when they are in the same clique than when they are not. Specifically, using all unique pairs (x, y) of institutions that vote on the same proposal, we regress the voting action (*vote_y*) of one randomly chosen institution from the pair on the other (*vote_x*), as in the following regression model.

$$vote\_y_{ijkt} = \gamma_1 vote\_x_{ijkt} + \gamma_2\, vote\_x_{ijkt} \times same_{ijkt} + \gamma_3\, same_{ijkt} + \phi_i + \tau_t + \varepsilon_{ijkt}, \quad (3)$$

where *vote_x* (*vote_y*) is equal to one if x (y) votes for a proposal j in firm i in year t for k_{th} institution pair corresponding to x and zero otherwise. The dummy variable *same* is equal to one if institution x and y belong to the same clique and zero otherwise. Our interest is the interaction term between *vote_x* and *same*, which represents how much the voting behavior of institutional investors in a clique is harmonized with those within the same clique. The sample period covers 2017-2022. Firm and year fixed effects are included. Standard errors are clustered within the firm.

4 Results

4.1 Descriptive statistics

Table 1 shows the descriptive statistics and correlation matrix of the variables used in our tests. All variables are measured at the firm-year-proposal level. All continuous variables are winsorized at (0.01, 0.99). The mean (median) of *max_c* is 5.1% (3.3%), whereas the mean (median) of *sum_inst* is

12.1% (8.5%). Thus, the maximum clique ownership is less than a half of the institutional ownership both in the mean and median. However, the correlation between the two variables is high at 0.889.

4.2 Proposal-level test

Table 2 shows the regression results of the objection rate (*obj_r)* on the maximum clique ownership (*max_c*) and other control variables for the period from 2015 to 2022. In Column (1), the clique ownership *max_c* is positively related to the objection rate *obj_r*, indicating that cliques generally adopt a more stringent stance toward proposals at shareholder meetings. The estimated coefficient of 0.001 suggests that a one standard deviation increase in maximum clique ownership (5.485 percent) raises the objection rate by 0.5 percentage points.

Columns (2) to (5) introduce interaction terms between the maximum clique ownership *max_c* and dummy variables representing different proposal attributes 1(*proposal*). Column (2) shows that for proposals on takeover defense, the estimated coefficient on clique ownership *max_c* is 0.014 (= 0.001 + 0.013). This suggests that a one standard deviation increase in maximum clique ownership leads to a 7.68 percentage point increase in the objection rate. In column (3), for shareholders' proposals, the coefficient is 0.0025 (= 0.0005 + 0.002), indicating a 1.37 percentage point increase in the objection rate for the same change in clique ownership *max_c*. Column (4) shows the coefficient of 0.002 (= 0.001 + 0.001), suggesting a 1.1 percentage point increase in the objection rate with a one standard deviation change in maximum clique ownership.

In column (5), the coefficient on clique ownership is not statistically different from zero (= 0.001 – 0.001). To further clarify the impact of clique ownership, we examine the coefficient on the dummy variable 1(*proposal*). The coefficient on the dummy and its interaction with clique ownership are –0.007 and –0.001, respectively, indicating that institutional investors within cliques tend to support female director

appointment proposals more than other categories of investors.

Overall, these results are generally consistent with Hypothesis 1. One remark is that for shareholder-initiated proposals, the steeper slope of *max_c* suggests that clique shareholders do not necessarily align with all shareholder proposals.

4.3 Proposal-institution-level test

Table 3 reports the regression results of institutional investors' voting coordination at individual proposal level at the shareholder meetings for the total period 2017-2022 and the two subperiods 2017-2019 and 2020-2022. The coefficients on the interaction term (*vote_x* × *same*) are significantly positive at the one percent level for all periods. For the result from the total period shown in (1), the estimated coefficient of 0.0817 suggests that the probability of harmonizing the voting behavior of institutional investors within a clique is 8.2 percentage points higher than for those outside the clique. Considering that the baseline probability of harmonization between institutional investors not in a clique is 25.6 percent (as indicated by the coefficient on *vote_x*), the marginal effect is substantial.

The result indicates that institutional investors tend to vote in the same direction with higher probability when they belong to the same clique than when they do not. We interpret this as strong evidence of institutional investor coordination within cliques and being consistent with Hypothesis 2.

5 Conclusion

This study investigates how sub-communities of institutional investors play a governance role through their possibly coordinated engagement with investee firms in Japan. Unlike the U.S., Japan has been characterized with stakeholder-centric and relational business culture. Following the methodology of Crane

et al. (2019) for identifying cliques in the institutional investor network, we examine whether and how the behind-the-scenes engagement by institutional investors in a sub-community works in a Japanese context.

Defining a link between two institutions as holding more than five percent in the equity stake of at least one firm, we identify several cliques of institutional investors on an annual basis. We find that the largest cliques tend to vote less favorably to takeover defense and the reappointment of attendance problem outside directors at shareholder meetings, whereas more favorably to the appointment of female directors. These results are consistent with governance-enhancing behavior of cliques. In contrast, clique shareholders do not necessarily agree with shareholder-initiated proposals.

We also examine whether any pairs of institutional investors tend to vote in the same direction at shareholder meetings more frequently when they belong to the same cliques than when they do not. We find evidence that regarding voting on individual proposals there is coordination among institutional investors within a clique. This finding is particularly important considering a relatively high correlation between the maximum clique ownership and institutional ownership. Put another way, the result implies that coordination occurs not only because they are institutional investors but because they are in the same clique.

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Table 1 Descriptive Statistics

Panel A: Statistics

	Mean	SD	Median	Min	Max
max_c (%)	5.097	5.485	3.299	0.000	24.363
sum_inst (%)	12.054	12.221	8.499	0.000	49.217
lassets	10.8361	1.8251	10.6916	7.1507	15.5060
roa	0.0571	0.0640	0.0530	-0.2191	0.2520
debtr	0.4629	0.1927	0.4604	0.0846	0.8892
obj_r	0.0303	0.0534	0.0098	0.0001	0.3280
d_madef	0.0030				
sh_pro	0.0073				
d_female	0.0235				
d_attend	0.0149				

Panel B: Correlations

	max_c	*sum_inst*	*lassets*	*roa*	*debtr*	*obj_r*
max_c	1.0000					
sum_inst	0.8890	1.0000				
lassets	0.4723	0.6204	1.0000			
roa	0.1820	0.2119	0.0352	1.0000		
debtr	-0.1078	-0.0938	0.1703	-0.3109	1.0000	
obj_r	0.1478	0.1569	0.1728	-0.0586	-0.0002	1.0000

Basic statistics and correlations of main variables during the period 2015 - 2022. All continuous variables are winsorized at (0.01, 0.99).

Table 2 Investor clique and objection rate.

	Dependent variable: obj_r				
		Bad proposal			Good proposal
1(*proposal*):		*d_madef*	*sh_pro*	*d_attend*	*d_female*
	(1)	(2)	(3)	(4)	(5)
max_c	0.001***	0.001***	0.0005***	0.001***	0.001***
	(0.0002)	(0.0002)	(0.0001)	(0.0002)	(0.0002)
max_c×1(*proposal*)		0.013***	0.002**	0.001***	-0.001***
		(0.0010)	(0.0010)	(0.0002)	(0.0001)
1(*proposal*)		0.105***	0.234***	0.005***	-0.007***
		(0.0070)	(0.0130)	(0.0010)	(0.0010)
sum_inst	-0.0001	-0.0001	-0.0001	-0.0001	-0.0001
	(0.0001)	(0.0001)	(0.0001)	(0.0001)	(0.0001)
lassets	0.001	0.001	0.002*	0.001	0.001
	(0.0010)	(0.0010)	(0.0010)	(0.0010)	(0.0010)
roa	-0.030***	-0.029***	-0.027***	-0.030***	-0.030***
	(0.0060)	(0.0060)	(0.0060)	(0.0060)	(0.0060)
debtr	0.0001	-0.0002	0.001	0.0001	0.0001
	(0.0040)	(0.0040)	(0.0040)	(0.0040)	(0.0040)
Firm FE	yes	yes	yes	yes	yes
Year FE	yes	yes	yes	yes	yes
n	233,056	233,056	233,056	233,056	233,056
R^2	0.0067	0.0496	0.1635	0.0073	0.0083

This table shows the OLS regression results of the objection rate on the largest clique ownership and various firm and proposal attributes during the period 2015 - 2022. Firm and year fixed effects are included. Errors are clustered within the firm. Standard errors are shown in parentheses. *p<0.1; **p<0.05; ***p<0.01

Table 3 Institutional investors' voting coordination.

Dependent variable: *vote_y*						
	(1) 2017-2022		(2) 2017-2019		(3) 2020-2022	
Variable						
vote_x	0.2562	***	0.2293	***	0.2789	***
	(0.0118)		(0.0137)		(0.0102)	
vote_x×same	0.0817	***	0.0843	***	0.0551	***
	(0.0047)		(0.0051)		(0.0038)	
same	-0.0778	***	-0.0856	***	-0.0493	***
	(0.0044)		(0.0049)		(0.0033)	
Firm FE	yes		yes		yes	
Year FE	yes		yes		yes	
n	31,605,228		18,938,717		12,666,511	
R-squared (Overall)	0.4143		0.3759		0.4425	
F-statistic	521.73		536.67		412.58	

This table shows the results of the panel OLS regression of an institutional investor *y*'s voting on an institutional investor *x*'s voting. *vote_x* (*vote_y*) is equal to one if *x* (*y*) votes for a proposal and zero otherwise. *same* is a dummy variable which is equal to one if *x* and *y* belong to the same clique and zero otherwise. The sample period covers 2017-2022. Firm and year fixed effects are included. Errors are clustered within the firm. Standard errors are shown in parentheses. ***p<0.01

Appendix

Table A1 Variable

Variable:	Definition:
max_c	Percentage fraction of the largest institutional investor clique in the equity stake.
sum_inst	Sum of percentage fractions of all institutional investors in the equity stake.
lassets	Natural logarithm of total assets.
roa	Ordinary profit divided by total assets.
debtr	Total liabilities divided by total assets.
obj_r	Ratio of objecting votes relative to all votes for each proposal in a shareholder meeting.
d_madef	Dummy variable which is equal to one if the proposal in a shareholder meeting is an adoption (continuation) of a M&A defense and zero otherwise.
sh_pro	Dummy variable which is equal to one if the proposal in a shareholder meeting is classified as a shareholder proposal and zero otherwise.
d_female	Dummy variable which is equal to one if the proposal in a shareholder meeting is an appointment of a female director and zero otherwise.
d_attend	Dummy variable which is equal to one if the proposal in a shareholder meeting is a reappointment of an outside director with an attendance problem and zero otherwise.
vote_x (*y*)	Dummy variable which is equal to one if institutional investor *x* (*y*) votes favorably for a proposal and zero otherwise
same	Dummy variable which is equal to one if institution *x* and *y* belong to the same clique and zero otherwise