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Japanese Corporate Governance Reform: A Comparative Perspective

Bruce E. Aronson

Japan has been widely criticized as being slow to reform a corporate governance system that seemingly remains fixed on the interests of employees over shareholders and unresponsive to recent global trends such as the spread of independent directors. This article seeks to present a more nuanced and balanced view of the ongoing evolution of Japanese corporate governance.

This article discusses how analysis of Japanese corporate governance is hampered by the lack of both an agreed-upon standard for evaluating change in Japan and data concerning important governance practices, such as the actual role of company auditors (kansayaku). The main focus, however, is on describing and evaluating experimentation at leading individual Japanese companies that seeks to address monitoring and other fundamental issues of corporate governance in Japan by developing a “hybrid” system of governance. This system attempts to combine the best elements of the board management and monitoring models, i.e., the information access of insiders and the independence of outsiders, in a way that results in real board discussion and management oversight.

The article goes on to identify and briefly discuss three key issues that may be critical in influencing the future direction of Japan's corporate governance system and practices: the role of domestic

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HASTINGS BUSINESS LAW JOURNAL
institutional investors, the development of a standardized hybrid model, and the adjustment of Japanese corporate governance to the demands of globalization.

1. INTRODUCTION

From a foreign investor’s perspective, Japan may appear to be stuck in an unresponsive corporate governance system that favors employees over shareholders and has poor monitoring of management. This view of an “unchanging” Japan is symbolized by the largely fruitless debate during the past fifteen years over whether to establish a legal requirement for one outside/independent director at Japanese listed companies. Japan’s failure to do so marks it as an

1. In this article, an “outside director” refers simply to directors who are not executives or employees of the corporation. “Independent directors” refers to outside directors who additionally have no material relationship with the corporation as measured by the relevant independence standard. Such standards typically exclude individuals in certain categories. The standard of the Tokyo Stock Exchange (“TSE”) enumerates five categories of individuals who would generally not be independent, such as business managers, individuals from major clients, outside professionals whose organizations are major clients, major shareholders, and close relatives. TOKYO STOCK EXCH., ENFORCEMENT RULES FOR SECURITIES LISTING REGULATIONS (2013), available at http://www.tse.or.jp/english/about/rules/b7gie600000044tu-at/securities_listing_enforcement_rules.pdf.

2. Beginning in 2010, at least one of the outside company auditors (kansaraka) or outside directors had to satisfy the definition of independence under TSE listing standards. The requirement for each listed company to have at least one independent director or company auditor was promulgated on December 30, 2009 as an amendment to the TSE’s listing regulations. The rule calls for each listed company to have one outside director or outside company auditor (as defined in the Companies Act) “who is unlikely to have conflicts of interest with general investors.” TOKYO STOCK EXCH., ENFORCEMENT RULES FOR SECURITIES LISTING REGULATIONS (2013), available at http://www.tse.or.jp/english/about/rules/b7gie60000044tu-at/securities_listing_regulations_2013_07_17.pdf. In August 2012, a Subcommittee at the Ministry of Justice in charge of proposing amendments to the Companies Act adopted a form of a “comply or explain provision,” which would require a reporting company with any outside directors to explain its reason for the lack of outside directors. In an additional supplementary resolution, the Subcommittee also recommended that the TSE adopt a rule requiring at least one independent director for all listed companies. See THE MINISTRY OF JUSTICE, Homusho, Minbyoku, Sanjichitsu [MINISTRY OF JUSTICE, CIVIL AFFAIRS BUREAU, COUNCILORS’ OFFICE], Kaisha Hoei No Min Osaka Ni Kan Suru Yokoan [DRAFT OUTLINE OF AMENDMENTS TO THE COMPANIES ACT] (2012), available at http://www.moj.go.jp/content/000108109.pdf. The accompanying resolution is referenced in a new TSE listing, Atsushi Saito, Statement by President and CEO in Response to the Draft Outline of Amendments to the Companies Act, TOKYO STOCK EXCH. (Aug. 1, 2012), http://www.tse.or.jp/english/news/09/20120801_a.html. These recommendations were subsequently incorporated into a bill to amend the Companies Act, which was formally
outlier among Asian countries. This seeming unwillingness to consider change comes despite both recurring corporate governance scandals such as the recent Olympus case and generally poor performance by Japanese companies, as reflected in common measures such as return on equity.

However, this critical viewpoint is incomplete in three respects. First, it is based on universal applicability and acceptance of a U.S. or “Anglo-Saxon” model of corporate governance and the experiences and assumptions that underlie such a model. Second, functional comparisons with the U.S. are complicated by a lack of data and understanding of the actual working of a number of important features of Japanese corporate governance, such as the role fulfilled by internal company auditors (kansayaku). Third and most


5. Although return on equity, or ROE, is a widely used measure for shareholder return, it has historically not been important in Japan. Japanese managers tend to be risk-averse and hoard cash to ensure the survival of their company and reassure stakeholders such as employees, rather than invest cash to produce income for shareholders or return excess cash directly to shareholders. See Anna Kitanaka & Toshiro Hasegawa, Japan Tries to Alter the Market’s DNA, Businessweek, Jan. 30, 2014, http://www.businessweek.com/articles/2014-01-30/japan-uses-new-stock-market-index-to-put-companies-focus-on-roes. Average ROE for Japanese companies during the period 2003-2013 was six percent for Japanese companies and 12.6 percent for companies worldwide. Id. A frequently cited generalization is that ROE for Japanese companies is roughly half that of U.S. and European companies (i.e., eight percent versus fifteen percent). See, e.g., Japanese Stock Markets Have the Potential to Double through the Improvement of ROE. SPARX Asset Management Co., (Feb. 2014), http://www.sparxgroup.jp/sparxview/Japanese20Stock20Markets20Have20the20Potential20to20Double20through2020the20Improvement20of20ROE.pdf. However, a new emphasis on ROE through a new stock index created by the TSE, investment policies by Japan’s largest pension fund, and other factors may provide stronger incentives for Japanese management to reconsider their policies regarding the use of investment funds. Id.

6. There is no universally accepted English translation of kansayaku. This article uses
importantly, a number of leading Japanese companies are responding to changing business conditions and demands for corporate governance reform in interesting and imaginative ways that are not yet reflected in legal requirements applicable to listed Japanese companies.

This article seeks to achieve a more nuanced and balanced view of Japanese corporate governance and its reform by discussing and supplementing, where possible, the three shortcomings noted above. In particular, I focus on the issue of changing corporate governance practices at leading Japanese companies that have been active in addressing basic corporate governance issues, such as the function of the board of directors.

This article is divided into four sections. The first section discusses the questions of the appropriate standard for comparing U.S. and Japanese corporate governance systems, differing backgrounds and goals of the two systems, and the fundamental issues of Japanese corporate governance. The second section discusses our lack of data on some important Japanese corporate governance practices, with a particular focus on the role of kansayaku. The third section explores experimentation at leading individual Japanese companies to address monitoring and other fundamental issues of corporate governance in Japan, as well as the possible emergence of a “hybrid” system of governance. The fourth section identifies and briefly discusses three key issues—the role of domestic institutional investors, the development of a standardized hybrid model, and the adjustment of Japanese corporate governance to the demands of globalization—that may be critical in influencing the future direction of Japan’s corporate governance system and practices.

The article concludes that the popular critical view of corporate

“company auditor” since that is the term utilized in Japan’s Companies Act in a translation project sponsored by the Ministry of Justice. English translations of rules and reports on the TSE use the term “statutory auditor,” and the industry association of kansayaku changed its recommended translation in 2012 from “corporate auditor” to “audit & supervisory board member.” THE JAPAN CORP. AUDITORS ASS’N, NEW RECOMMENDED ENGLISH TRANSLATION FOR “KANSAYAKU” AND “KANSAYAKU-KAI” (2012), available at http://www.kansa.or.jp/en/ns12 1023.pdf (no English term fully or accurately describes their function without further explanation).
governance in Japan, which is based on the overall lack of progress on highly visible issues such as a requirement for outside directors, fails to capture significant reform and evolution in governance practices. Traditional, large Japanese companies have been at the forefront of experimentation with a hybrid model in response to both corporate governance issues and changing business necessities. To date, however, there is no corporate governance code or other means of spreading these new best practices more widely among Japanese companies. The future direction and progress of corporate governance reform may depend on the three key issues discussed in the fourth section: the role of domestic institutional investors, the development of a standardized hybrid model, and the adjustment of Japanese corporate governance to the demands of globalization.

II. FUNDAMENTAL ISSUES OF JAPANESE CORPORATE GOVERNANCE FROM A COMPARATIVE PERSPECTIVE

A. STANDARD OF COMPARISON FOR THE U.S. AND JAPAN

As a preliminary matter, it is worth noting that the board of directors in every corporate governance system has two somewhat contradictory functions: advising management and monitoring management. The corporate governance model in the U.S. has evolved to a monitoring model where that function is strong but the role of providing advice to management is relatively weak. In Japan and many other countries with stakeholder systems, the board tends to focus more on management issues at the expense of the monitoring function. It is therefore an unsurprising result that from a comparative perspective, the most fundamental issue facing Japanese corporate governance may be characterized as how to build on the existing system in a realistic way to strengthen the monitoring function.

Although the above comparison may seem relatively straightforward, it has proven difficult to find a consistent standard

7. See discussion infra notes 18, 20, and accompanying text.
8. See discussion infra notes 23–27 and accompanying text.
9. See generally ACGA WHITE PAPER, supra note 3.
for comparison of Japan and the U.S. Past efforts at analysis of Japan have also been hampered by our exaggerated views of Japan’s dramatic or “unique” success through the 1980s followed by an equally extreme view of subsequent failure, and a long-standing emphasis on cultural explanations with a corresponding view that “law doesn’t matter.”

This problem with comparisons has been pronounced in the field of comparative corporate governance. The field began in the early 1990s as American scholars sought to study the secrets of Japan’s success. A decade later, the overwhelming theme of comparative corporate governance literature was the nearly opposite idea of convergence, i.e., that globalization and competition would result in systems in industrialized countries converging to approximate an American corporate governance system that was now seen as the global standard. Japan was now criticized for not effecting a transformation to a shareholder-oriented system that resembled the then successful U.S. model.

Following the 2008 financial crisis, we have an opportunity to provide a more dispassionate and nuanced analysis of the functioning and evolution of Japanese corporate governance. In Japan, the U.S.

11. See Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10, 45 (1991) (developing a theory of path dependence that emphasized how political and historic factors kept corporate governance systems on separate paths, in part to explain why (unlike in Japan or Germany) powerful financial institutions did not play a significant role in U.S. corporate governance); Ronald J. Gilson & Mark J. Roe, Understanding the Keiretsu: Overlaps Between Governance and Industrial Organization, 102 Yale L.J. 871, 874 (1993) (attributing Japan’s “success” in corporate governance to embedding good governance practices into its industrial structure in the supposed absence of developed legal mechanisms).
model of corporate governance is no longer viewed as the exclusive global standard.\(^1\) Although still influential, the U.S. model has been largely replaced by a multi-polar view. Over the last few years, English law influence in the field of corporate governance has become prominent. This is reflected, for example, in a new comply or explain approach to the requirement for one outside director.\(^5\) in the recent enactment at the Financial Services Agency ("FSA") of a Stewardship Code that focuses on the role of asset managers and other financial intermediaries in engaging with portfolio companies on behalf of their investors or beneficiaries,\(^6\) and in a recently initiated process to draft a new corporate governance code.\(^7\)

14. I have argued in the past that the English approach that focuses more on soft law governance codes and enforcement through a comply or explain mechanism may be a better fit for Japan than the American hard law approach as exemplified by Sarbanes-Oxley. See Bruce E. Aronson, What Can We Learn from U.S. Corporate Governance? A Critical Analysis, 2 U. TOKYO J.L. & POL. 41, 56 (2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920865.

15. See supra note 2.


B. DIFFERENT HISTORICAL EXPERIENCES, SYSTEMS, AND GOALS

Although we frequently contrast the U.S. and Japan as having a shareholder-oriented system with a monitoring board versus a stakeholder-oriented system with a management board, both systems have evolved over time. Evolution in the U.S. from a business advisory board to a supervisory board was prompted by concerns over actual and potential conflicts of interest between management and shareholders. Such concerns were highlighted by the hostile M&A boom in the 1980s and by Delaware court decisions that emphasized the role of independent directors in dealing with these conflicts. The rise of activist institutional investors in the 1990s provided additional emphasis on board independence and the protection of shareholder interests. The monitoring model, with its emphasis on the role of independent directors, also provided benefits to management: defenses against takeovers became widespread and management compensation steadily increased.

Our image of corporate governance in Japan reflects the successful postwar model, in which the main bank and a cross-shareholding system both supported management’s informal promise of lifetime employment and provided contingent monitoring that intervened if the company became financially distressed. However, since this system did not exist in prewar Japan, questions remain as to how widespread and effective this model was in practice even during the heyday of postwar Japan. The institutions supporting such a

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20. See generally Lawrence E. Mitchell, The Trouble with Boards, in PERSPECTIVES ON CORPORATE GOVERNANCE (F. Scott Kieff & Troy A. Paredes eds., 2010) (arguing that the monitoring board model provides the strongest liability shield for directors and leaves actual power with management).

system have greatly declined.  

Nevertheless, there has been a relatively consistent preference by Japanese businesses for an active insider-oriented board. The primary purpose of current corporate governance reform in Japan might best be described as improving business competitiveness and performance to provide value to stakeholders, with a secondary goal of mandating protection of shareholder interests as necessary to provide a counterbalance to increased management discretion. Japan has had no M&A boom, no significant activism by domestic institutional investors, and no court cases that raise strong concerns about potential conflicts of interest and that would require, or provide substantial practical benefits for, the introduction of a substantial number of independent directors. Reflecting the Japanese priority on business performance, both critics and supporters of Japan’s efforts at corporate governance reform have characterized two-thirds of reform measures since 1996 as “pro-management” and one-third as “pro-shareholder.”


23. In corporate governance reports to the TSE, the goals cited by a majority of listed companies were transparency (69.1 percent), shareholders (60.0 percent), and corporate value (53.3 percent). TOKYO STOCK EXCH., TSE-LISTED COMPANIES WHITE PAPER ON CORPORATE GOVERNANCE (2013), available at http://www.tse.or.jp/rules/white-paper/b7gje6000005ob1-at/b7gje6000005uk_m8.pdf [hereinafter TSE WHITE PAPER].

The least cited among the twelve listed goals was stakeholder value (6.6 percent); monitoring and supervision was cited by 36.6 percent. Id. I suspect many Japanese businessmen take the view that in a stakeholder system the oft-cited goal of enhancing corporate value refers to enhancing value for all stakeholders. For example, one commentator explains that enhancing corporate value is a two-step process involving (1) expanding the corporate “pie” of future earnings and (2) equitably dividing the pie among stakeholders. Kazuhiro Takai, “Kansa Inkai Setchi Gaisha” no Kaikin [Removal of Prohibition on “Company with Audit Committee”], 1900 SHOJI HOMU 13, 13 (2010).

24. The one notable activist institutional investor in Japan during the 2000s was the Pension Fund Association. However, it effectively withdrew from that activity in 2010. See generally Sanford M. Jacoby, Convergence by Design: The Case of CalPERS in Japan, 55 AM. J. COMP. L. 239 (2007); see also Bruce E. Aronson, A Japanese CalPERS or a New Model for Institutional Investor Activism? Japan’s Pension Fund Association and the Emergence of Shareholder Activism in Japan, 7 N.Y.U. J.L. & BUS. 571 (2011).

25. A Japanese Supreme Court decision in 2009 on a management buyout case illustrates both the potential for serious conflicts of interest in Japan and the uncertainty in how to address such conflicts. See In re Rex Holdings Co., Ltd., 1326 KINYU HANREI 35 (2009), translated in BUSINESS LAW IN JAPAN—CASES AND COMMENTS, INTELLECTUAL PROPERTY, CIVIL, COMMERCIAL AND INTERNATIONAL PRIVATE LAW 299 (Moritz Balz et al., eds., 2012).

26. See Milhaupt, supra note 13 (stating that about two-thirds of the changes were
The corporate governance purpose in Japan of improving business’ competitiveness to add corporate value, as opposed to the U.S. emphasis on dealing with potential conflicts of interest, has serious practical consequences. The Japanese approach highlights the long-standing issue of the relationship between corporate governance and business performance. The lack of proof of a clear and consistent correlation has been an important factor in the resistance of Japanese business organizations, such as Nippon Keidanren, to requirements for a minimum number of outside directors and to the lack of overall progress in new legal requirements for Japanese corporate governance.27

Different historical experiences, expectations, and institutions in Japan and the U.S. all contribute to the question that most puzzles foreign institutional investors in Japan: Why are Japanese companies often considered unresponsive to foreign shareholders despite the substantial share of the Japanese market now held by such international investors?28

The answer to this question reflects the lack of a new model or

management-friendly “flexibility enhancing amendments” and about one-third were shareholder-friendly “monitoring enhancing amendments”). See also ZENICHI SHISHIDO, CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY 310, 313–14 (Masahiko Aoki et al., eds., 2007) (characterizing the majority of changes as “demand-pull” reforms requested by business and a minority as “policy-push” reforms to protect shareholders).

27. Most of the empirical research in the U.S. has found no correlation between improved business performance and good corporate governance measures like a greater number of independent directors. See, e.g., Sanjai Bhagat & Bernard S. Black, Non-Correlation Between Board Independence and Long-Term Firm Performance, 27 J. CORP. L. 231 (2002). It should be noted that research in the U.S. has focused more on the question of the value provided by a supermajority of independent directors. However, business groups in Japan further use this argument to oppose a requirement for any outside directors. Some Japanese commentators have highlighted recent empirical research by Takuji Saito that does find a correlation between the addition of the first outside director into an all-insider Japanese board and improvements in operating performance and firm value. See TAKUJI SAITO, FACULTY OF ECON., OKAYAMA UNIV., PRESENCE OF OUTSIDE DIRECTORS, BOARD EFFECTIVENESS AND FIRM PERFORMANCE: EVIDENCE FROM JAPAN (2009), available at http://s3.amazonaws.com/zanran_storage/www.e.okayama-u.ac.jp/ContentPages/47804533.pdf (in English). See also Aronson, supra note 4, at 122–25 and accompanying text; Bruce E. Aronson, Corporate Governance Models and Practices in Japan and East Asia: Proceedings of a Panel Discussion, 27 COLUM. J. ASIAN L. (forthcoming 2014), available at http://ssrn.com/abstract=2395059 (for citations to similar research in Korea).

28. In Japan the share of the equity market held by foreign investors has increased from under five percent in 1990 to twenty eight percent in 2012. See infra Table 1.
generally accepted paradigm for Japanese corporate governance despite the marked weakening of the Japanese postwar model. Although the system of lifetime employment has substantially declined, one often continues to encounter an attitude by Japanese managers that core employees (and perhaps friendly “stable” shareholders) are the “real” long-term stakeholders while shareholders who are motivated by financial return on investment are mere short-term investors. The cross-shareholding system, although substantially weakened, still provides support for company management. Individual shareholders tend to be apathetic and support management. Most significantly, domestic institutional shareholders in Japan have been complacent, despite poor corporate performance by portfolio companies. This often creates a situation of “Japanese versus foreigners” in which managers of Japanese companies can successfully portray themselves to both shareholders and the Japanese media as defenders of Japanese tradition against greedy, profit-oriented foreigners who care nothing about the company’s employees or Japanese society.

29. The distinction is often phrased as “shareholders” versus “investors,” with an implied greater distinction between those two groups than is commonly assumed in the U.S.

30. The biggest decline has occurred in bank shareholdings in friendly companies; cross-shareholding by business corporations has also declined, but not as dramatically. See infra Table 1. Thus, cross-shareholding may still aid management at some Japanese companies. In particular, activist funds tend to target small and medium-sized companies, rather than large corporations, and cross-shareholding remains more prevalent at smaller companies. See Gen Goto, Legally Strong Shareholders of Japan, 21 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 125, 126–28 (2014).

31. The most famous attempt at a hostile takeover of a Japanese company by a foreign entity, Steel Partners I.I.C’s bid for Bulldog Sauce Co., Ltd., is often cited as clear evidence of the hostility to foreign takeovers and the lack of a market for corporate control in Japan. In that case the company’s issuance of warrants as part of a poison pill defense that was approved by a large majority of shareholders was upheld by Japan’s Supreme Court. See Bulldog Sauce Case, Saito Saisansho [Sup. Ct.] Aug. 7, 2007. (kyo) no. 30, SAIKON SAIBANSHO HANREISHU MINSHU 1809, available at http://www.courts.go.jp/english/judgments/text/2007.08.07-2O007.28-Kyo-No30.html (Japan). For comments on the case, see, e.g., Nels Hansen, Japan’s First Poison Pill Case: Bulldog Sauce v. Steel Partners: A Comparative and Institutional Analysis, 26 J. JAPANESE L. 139 (2008); David Alan Makman, Changes in Corporate Governance are Having an Effect in Japan, THE NAT’L J.L., Sep. 1, 2008, available at http://makmanmatz.com/wp-content/uploads/2013/06/Changes-in-Corporate-Governance.pdf. Even more than the Supreme Court’s decision, foreign shareholders took special note of the prior Tokyo High Court decision which labeled Steel Partners as an “abusive acquirer.” See Hansen, supra note 31. Individual shareholders of Bulldog Sauce also apparently voted overwhelmingly in favor of management’s poison pill despite it being against their economic interest, i.e., management
C. FUNDAMENTAL ISSUES IN JAPANESE CORPORATE GOVERNANCE

There are two basic issues of board structure that appear to be fundamental for Japanese corporate governance and its reform. The first issue is whether the board of directors sufficiently fulfills its monitoring function. The second issue is the closely related question of whether the Japanese kansayaku serve as a reasonable substitute for independent directors to fulfill this role.

The question of whether to create a legal requirement for a minimum number of independent directors has dominated the debate over Japanese corporate governance for over a decade. The argument for such a requirement is often based on the assumption, generally held by foreign institutional investors, that Japan’s kansayaku are unable to effectively fulfill a monitoring role.32 Kansayaku are criticized as lacking authority since they have no vote at board meetings and cannot hire or fire the CEO or directors.33 They may be relatively effective on compliance matters such as scrutinizing proposed transactions for accounting or legal issues.34 They are often characterized as being weaker, however, in the important areas that have not been emphasized in Japan to date like handling conflicts of interest and monitoring top management.35

In addition, all sides in the debate over requiring outside directors in Japan agree that simply adding an outside director to the existing board structure is likely to have limited impact on corporate decision-making or monitoring of management.36 It is also necessary to provide such outside directors or other monitors of management with the necessary environment and means to fulfill their role and ensure an actual strengthening of the board monitoring function.37

bought out Steel Partners’ shares at a substantial premium to market (a kind of “legal greenmail”) and this repurchase essentially occurred at the expense of general shareholders. See Goto, supra note 30, at 17.
32. ACGA WHITE PAPER, supra note 3, at 18.
33. Id.
34. See, e.g., Aronson, supra note 27, at 244–45.
35. Id.
37. Following the Olympus scandal, the TSE made a new, if modest, proposal with the stated goal of “fortifying the environment to facilitate independent board member functions.”
Such an environment would include providing sufficient access to information, greater litigation risk, or some other incentive to encourage monitors to raise issues that may challenge the views of corporate management and additional outside monitors, such as professional service providers functioning as gatekeepers.38

The second fundamental issue is the failure at many Japanese companies to separate the board’s management and monitoring functions, as many Japanese boards meet frequently and remain involved in actively managing the day-to-day business of the company.39 This can result in Japanese directors having a fiduciary duty to monitor themselves as managers of the business, which naturally tends to weaken the board oversight function.

A specific issue related to the above two fundamental questions is the role of the president in Japanese companies and, in particular, their power of appointment.40 The president in a Japanese corporation often has unchallenged power (although no formal legal authority) over top-level personnel appointments, including his successor as president, directors, and kansayaku.41 In addition, once a president leaves his post, it is not unusual for such an individual to linger as a consultant or adviser for many years. This raises the issue of the actual influence of such an ex-president, who at that time has no legal or formal authority whatsoever, on his hand-picked successor president and on company policies and practices.42 Any such influence is completely opaque and presents a significant corporate governance issue.


38. See Aronson, supra note 4, at 129–39.

39. See id. at 125–27.

40. See id. at 127–29.

41. By law, a company’s president has no formal role in the selection of his successor or directors other than his one vote as a director on the board to elect a representative director (generally equivalent to president). Directors are formally elected by shareholders at the annual general meeting of shareholders. See Companies Act, Law No. 86 of 2005, art. 329, para. 1 (Japan).

42. See Sumitaka Fujita, President of Japan CFO Ass’n and Sosuke Uno, Esq., Partner, Nagashima Ohno & Tsunematsu, Remarks at The Board Director Training Institute of Japan and Hitotsubashi ICS Joint Seminar: Comparing Audit Committees to Kansayaku Boards (Mar. 6, 2014).
The president’s power of appointment is also an important corporate governance issue because of its potential impact on the actual independence of any monitor of management under the Japanese system. Much of the debate in Japan focuses on whether outside directors or kansayaku can act as a more effective monitor and contrasts their roles. However, if both kansayaku and outside directors are effectively appointed by the president, they in fact share the risk that they may lack real independence.

The continuing questions revolving around these fundamental issues do not mean that there has been no overall change or progress in Japanese corporate governance. It would be fair to say that Japan, being somewhat skeptical of the role of corporate governance in business performance and in the efficacy of “one size fits all” legal requirements, has focused primarily on increasing public information disclosure and transparency.\(^43\) In addition, there has been some strengthening of fiduciary duties by incorporating a clear responsibility for oversight of internal controls.\(^44\) There have also been some useful voluntary structural changes such as a significant reduction in board size, with a corresponding increase in importance of officers who do not serve on the board of directors.\(^45\) Nevertheless, there is a question as to whether Japan should be taking more dramatic measures in light of overall poor business performance, demands of foreign shareholders in a globalizing capital market, and repeated scandals such as in the Olympus case.

III. WHAT DO WE (NOT) KNOW ABOUT CORPORATE GOVERNANCE PRACTICES IN JAPAN?

Debates on corporate governance issues are frequently unsatisfying due to a lack of sufficient data on relevant practices. It is

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\(^{43}\) Such efforts include an overhaul of Japan’s securities law in the mid-2000s for the purpose, *inter alia*, of improving information disclosure. *See* Kinyu Shohin Torihiki Ho [The Financial Instruments and Exchange Act], Law No. 65 of 2006 (Japan).

\(^{44}\) The board of directors must create an overall policy for internal controls and this responsibility may not be delegated. *See* Companies Act, Law No. 86 of 2005, art. 362, para. 5 (Japan).

\(^{45}\) For example, the average size of the board of directors of listed companies has gradually declined to 8.13 persons in 2013. *TSE WHITE PAPER, supra note 23, at 22.*
very difficult to compare actual practices in the United States and Japan due to the difficulty in firmly grasping the reality in either system. Many of the issues are not subject to easy quantification or measurement. Much of what we know is through anecdote, with actual practices likely varying significantly among companies.

For example, boards in the U.S. are now dominated by independent directors, but are they truly independent? The definition of independence focuses on preventing certain material (i.e., economic or financial) relationships and does not extend to personal relationships or other circumstances. This problem is essentially unsolvable, with organizations like the Organisation for Economic Co-Operation and Development (“OECD”) stating that the goal is to have “independently minded” directors. Such a goal could not be achieved by mechanical application of any existing definition. Related issues would include questions such as whether nomination committees truly make appointments without any CEO influence and whether compensation committees operate independently in light of very generous executive compensation practices.

Discovering and quantifying actual practices is even more difficult in Japan. For example, there is no data on the common practice of the “lingering” (ex-)president, including position, length of term, and, most importantly, the power actually exercised by such


47. See, e.g., Corporate Governance Principles: Asian Roundtable on Corporate Governance, Bangkok, Thailand, ORG. FOR ECON. CO-OPERATION AND DEV., (“OECD”) (Sept. 14–15, 2006), http://www.oecd.org/da/9/ff/corporategovernanceprinciples/asianroundtableoncorporategovernancebangkokthailand.htm (noting that one topic of discussion was “how to motivate directors to be ‘independent-minded’”) (last visited Oct. 18, 2008). The OECD’s corporate governance principles, which must be sufficiently general to apply to a wide variety of corporate governance systems, merely state that “[b]oard should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflicts of interest.” OECD, CORPORATE GOVERNANCE: A SURVEY OF OECD COUNTRIES, 89 (2004), available at http://www.oecd.org/corporate/ca/corporategovernanceprinciples/21755678.pdf. With respect to the standard for independence, the OECD Principles simply note that many countries use solely “negative” criteria to exclude certain individuals as lacking independence, but encourage the complementary use of “positive” examples of qualities that will increase the probability of effective independence.” OECD, PRINCIPLES FOR CORPORATE GOVERNANCE 64 (2004), available at http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf.
individuals. Although we know that boards in Japan meet often and tend to approve rather detailed matters of daily management, the actual standard for matters that require board approval is an internal standard at each Japanese company.\textsuperscript{48} We also have no real data on meetings of management conferences (keiei kaigi) that generally proceed board meetings to help management (i.e., the president) finalize decisions, despite the potential for such conferences to make board meetings more formalities.\textsuperscript{49}

However, our greatest lack of data related to Japanese corporate governance involves the actual role of kansayaku. This is a great necessity precisely because of the popular debate about the effectiveness of kansayaku and whether Japanese corporate governance would be better served by placing a greater emphasis on outside directors. As a starting point, I note that the kansayaku association, Japan Audit & Supervisory Board Members Association ("JASBA"), has some 5,800 largely corporate members and 7,600 registered individuals.\textsuperscript{50} They represent a powerful force and remain popular with the bulk of Japanese companies. It is likely unrealistic to promote any reform program that is based on the abolition of kansayaku and their replacement with outside directors in the near future.\textsuperscript{51} This only increases the need for a better understanding of their actual function and their current and potential contribution to corporate governance in Japan.

In fact, we know very little about kansayaku. As an initial matter, we do not have a clear idea of who they are.\textsuperscript{52} The Companies Act

\textsuperscript{48} As a matter of law, the board must make decisions on four important categories of business matters, including, for example, the sale or acquisition of "important" (or "significant") property and any "significant" borrowing. See Companies Act, Law No. 86 of 2005, art. 362, para. 4, no. II (Japan). There is no rule or regulation helping to define "significant," and in practice the minimal amount required for board approval can be relatively small. See, e.g., Aronson, supra note 4, at 125 n.135.

\textsuperscript{49} See, e.g., Aronson, supra note 4, at 131 nn.153–55 and accompanying text.

\textsuperscript{50} Japan Audit & Supervisory Bd. Members Ass’n, Association Brochure 1 (2014).

\textsuperscript{51} The recent amendment to Japan’s Companies Act also enacted an additional optional corporate "one committee" structure in which the kansayaku Board of Audit would be upgraded to an Audit and Supervision Committee of the Board of Directors. See supra note 2.

\textsuperscript{52} Companies disclose biographical information on kansayaku in their annual securities filings and proxy voting materials. However, to the best of my knowledge, no one has compiled and analyzed such data. The TSE includes a question on the relationship between the reporting company and outside kansayaku in the annual corporate governance reports that are required
requires that half or more of the *kansayaku* at large companies must be outsiders. But who are they? This is an important question, as their independence, competence, and effectiveness may be influenced by their background. For example, an “outside” *kansayaku* dispatched from a parent company may be quite knowledgeable and willing to speak out about perceived problems at a subsidiary or question its management. My impression is that a substantial number of outside *kansayaku* come from the company’s “main bank.” They may be knowledgeable about the company’s financial situation and in a position to monitor financial decisions, but do they have a sufficiently independent mindset to actually do so?

In addition to the basic question of who are *kansayaku*, we are also uncertain as to what they do. This should be a critical issue in the ongoing debate about the effectiveness of *kansayaku* and comparing their function to that of outside directors. As noted above, the most common comment about *kansayaku* from global institutional investors is that they attend, but have no right to vote at, board meetings and also cannot fire the company president. However, it is a popular anecdote among large Japanese companies with good corporate governance that a negative comment by a *kansayaku* at a board meeting does, in fact, prevent a company from proceeding with a proposal. Further, according to this view, company management does not, in their own mind, distinguish clearly between the roles of outside *kansayaku* and outside directors, as both groups question a

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53. Companies Act, Law No. 86 of 2005, art. 335, para. 3 (Japan) (a board of auditors must contain a minimum of three auditors).

54. This is my impression both from JASBA gatherings I have attended and from remarks of the chairman of JASBA. See Junji Ota, Chairman, JASBA, Panel Discussion at Japan CFO Ass’n, 13th CFO Forum Japan: Considering Japan’s Corporate Governance (Dec. 5, 2013) (noting that kansayaku as a group could also utilize the expertise and knowledge of the main banks of Japanese companies in performing their function).

55. See ACCA WHITE PAPER, supra note 3, at 18.

variety of management proposals and practices. But even if this is true for some companies, how many?

There is some hope that this situation of unfruitful formal debates based on limited knowledge of actual practices will improve. Over the past two years, JASBA has begun to make greater efforts to explain the role of kansayaku, including producing materials in English on its website. In 2013, JASBA conducted an initial, partial survey of members that contains glimpses of a possible broader role for some kansayaku. This may lead to additional surveys that are more complete and useful. At the same time, the Asian Corporate Governance Association (“ACGA”) produced a new report on the role of kansayaku in Japan in October 2013 that is a more balanced effort to compare the actual function of kansayaku with that of independent directors.

There may also be additional useful areas for research. For example, some knowledgeable observers believe that we may need to broaden our analysis to go beyond a narrow comparison of the roles of outside kansayaku and outside directors to focus on the key issue of the overall investment in personnel and resources for risk management at American and Japanese companies. According to this view, it is the relative lack of overall investment by Japanese companies in risk management personnel and systems in business units, rather than the role of kansayaku, that represents a significant weakness in Japanese corporate governance.

57. On the other hand, as noted earlier, both outside kansayaku and outside directors in Japan also potentially share a common fundamental problem relating to their independence due to their both typically being selected by the company president. See Ishimura, supra note 56.
61. Supra note 42.
62. Id.
IV. CORPORATE GOVERNANCE PRACTICES AT LEADING JAPANESE CORPORATIONS: THE EMERGENCE OF A HYBRID FORM OF GOVERNANCE

A. BOARD STRUCTURE AND CHANGING PRACTICES

In the absence of detailed data on practices, it would be tempting to classify corporate governance at Japanese corporations in accordance with formal board structures. Since 2003, Japanese companies have a choice of corporate structures: their traditional “company with auditors” structure, which has no required outside directors and instead utilizes kansayaku to monitor management, and a new, alternative “American-style” “company with committees” structure that requires a majority of outside directors on each of three required board committees (audit, compensation, and nomination committees) in place of the kansayaku.63

An overwhelming majority (some ninety-eight percent) of Japanese companies have elected to retain the company with auditors structure,64 and this is often cited as a strong indicator of the unwillingness of Japanese companies to reform corporate governance practices. However, it is in the traditional companies where interesting reforms are occurring. This is often described as the recent emergence of a “mixed” or hybrid system in which traditional Japanese companies voluntarily add a number of outside directors in an effort to combine insiders’ information with outsiders’ independence to achieve more effective board functioning.65

In addition, many “Japanese-style” practices and reforms are similar at leading companies regardless of whether the formal corporate structure is one of a company with auditors or a company with committees. These corporate governance practices include, among others, greater separation of the management and supervisory roles of the board of directors. Japanese businessmen at leading companies often see greater similarities, rather than differences, in

64. As of 2013, only 2.2 percent of listed companies had adopted the optional company with committees structure. TSE WHITE PAPER, supra note 23, at 15.
65. See infra Figure 1.
emerging corporate governance practices at leading companies regardless of their formal board structure.  

B. CAUSES OF CHANGE AT LEADING JAPANESE COMPANIES

Substantial changes at leading Japanese companies result from a combination of factors: loss of support of institutions underlying the postwar system such as a decline in cross-shareholding and stable shareholders, a corresponding increase in foreign shareholders with demands for corporate governance reform, and business necessity, as major Japanese corporations become larger, more complicated, and more global.

The loss of friendly, stable shareholders is the important factor that is easiest to measure (See Table 1 in appendix). Shareholdings of listed companies by main banks (i.e., city and regional banks) declined from a steady fifteen percent during the 1990s to an insignificant level today. They have been replaced by foreign shareholders, whose share of the stock market has increased from five percent in 1990 to twenty-eight percent today. Although, as noted above, while global institutional investors complain that their influence with management at Japanese companies remains weak compared to the size of their shareholdings, the long and continuing decline of the cross-shareholding system is beginning to have an impact. This is particularly true for major Japanese corporations with global operations who tend to have a relatively large percentage of foreign shareholders. 

An important factor that is often overlooked in discussions of Japanese corporate governance is the business necessity for large Japanese corporations to reform their governance structure and processes. As noted above, one significant characteristic of traditional board functioning at Japanese corporations is the board’s close involvement in day-to-day operations of the company. The matters they discuss and approve are often relatively small and the result is

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66. See generally Aronson, supra note 4, at 143-45.

67. For example, there is a correlation between a higher ratio of foreign shareholding and a greater number of outside directors among Japanese listed companies. See TSE WHITE PAPER, supra note 23, at 24, 26.
more frequent meetings than at a typical U.S. company.\textsuperscript{68} Such an approach becomes increasingly infeasible as Japanese companies become larger and more international.

One of the major methods Japanese companies have adopted to address the issue of board function is to utilize the equivalent of intermediate “holding” companies. Occasionally, this is accomplished by the use of operating subsidiaries and actual holding companies. However, this division also often occurs within the same corporation as major product lines are divided into a number of internal strategic business units (in Japan, they generally use the English term “company” to describe such internal business units) (See Figure 1 in appendix). Most day-to-day decisions are made by each “company” with respect to its business, and the board of directors of the corporation deals primarily with capital allocation and other strategic issues.\textsuperscript{69} Although pushing down day-to-day decisions from the main board to a lower level is not directly related to structural corporate governance issues like the number and role of outside directors, it is generally large, sophisticated companies that adopt both sets of measures.

Other common approaches were mentioned above. Nearly all large Japanese companies have taken voluntary action to significantly reduce the size of their board from large boards of twenty to forty directors a few decades ago to an average of 8.13 directors for listed companies today.\textsuperscript{70} Partly as a result, a new class of executive officers (who are not directors) has assumed an increasingly important managerial role at all large Japanese companies. While this is essentially required for companies with committees, it has also occurred voluntarily, even if to a lesser extent, at traditional companies with auditors.\textsuperscript{71}

\textsuperscript{68} See supra note 39.
\textsuperscript{69} See, e.g., supra note 56.
\textsuperscript{70} See TSE WHITE PAPER, supra note 45 and accompanying text.
\textsuperscript{71} The Companies Act requires that companies with committees have at least one executive officer (shikkyovaku) and one representative officer with authority to represent the corporation (a role filled in traditional companies with auditors by a representative director who is chosen from among the directors). See Companies Act, Law No. 86, art. 402, para. 1; Companies Act, Law No. 86, Art. 420, para. 1 respectively. There is no provision in the Companies Act regarding executive officers at companies with auditors.
C. ONGOING EXPERIMENTATION WITH A HYBRID FORM

The future of Japanese corporate governance may lie in the development of hybrid systems that are intended to combine the best elements of the board management and monitoring models. The specific goal of this hybrid approach is to form a system that combines the information access of insiders with the independence of outsiders in a way that results in real board discussion and management oversight. Japanese businessmen also see functional similarities between reforms being adopted by individual companies, regardless of whether by traditional companies with auditors or by “American-style” companies with committees.72

Although there is no clear definition of a “hybrid” system in Japan, it typically applies to a traditional company with auditors that has several independent directors and at least one board committee, in particular a nomination committee (See Figure 1).73 In addition to these structural features that are not required by law, the role of kansayaku (which are legally required) also generally functions more effectively. This includes not only outside kansayaku, but also inside kansayaku who are thoroughly familiar with corporate affairs, as outsiders access to information is often cited as the biggest obstacle to the effective functioning of outside directors (and other potential monitors such as outside kansayaku) at Japanese companies.

New corporate governance practices are not limited to the traditional companies with auditors. The small minority of companies with committees have also modified a number of practices so that they work more effectively in the Japanese context. As a result, some practices at companies with committees do not necessarily fit with Americans’ image of how board committees should operate.

The clearest example is the function of the key nomination

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72. See Aronson, supra note 4, at 144 n. 212 and accompanying text. Rather than a stark choice between corporate structure, many Japanese businessmen emphasize similarities in the practical responses by Japanese companies to corporate governance issues and business necessities regardless of formal board structure. Id.

73. The Asian Corporate Governance Association, in noting a trend toward hybrid boards among traditional companies with auditors in Japan, broadly cites companies with one or more external directors and/or which “are establishing functional board committees.” See AGCA WHITE PAPER, supra note 3, at 18.
committee at both types of companies. The nomination committee is the most commonly cited reason for the unpopularity of the company with committee structure since it theoretically supplants the president’s prerogative to make high-level personnel appointments. Hybrid companies with auditors have established nomination committees with outsiders for the purpose of screening the president’s preferred choices to ensure they are based on the merits and not on cronyism (See Figure 1). Such a process subjects the president’s approved candidates to substantive review by outside directors.

This “Japanese-style” role of the nomination committee may, in fact, be similar to the actual operation of nomination committees at “American-style” companies with committees. Such “American-style” nomination committees reportedly also engage in vetting candidates chosen by management (the president or chairman) and generally do not seek to independently identify and screen potential candidates.

Both types of companies have also moved to limit the board’s involvement in day-to-day operations. The reason stated most oft is to make decision-making more efficient, i.e., place officers in charge of day-to-day management and have the board focus on strategic issues. Two of the best-known examples of companies with committees, Sony and Toshiba, both began with the creation of executive officers in 1997, well before the availability of the company with committee structure in 2003. As noted above, some companies with auditors have achieved similar results by creating intermediate “companies” for daily decision-making, by shrinking the size of their boards and by utilizing executive officers (which are neither legally required nor provided for in the Companies Act for companies with auditors) (See 74. See Aronson, supra note 4, at 127 n. 141.
75. For example, Asahi Glass Co., Ltd., a well-known hybrid, is a company with auditors that has established a nomination committee and a compensation committee. The nomination committee currently consists of four directors, composed of the president and three outside directors. See Figure 1 (the company president does not, “in principle,” participate in committee discussions.).
76. See Aronson supra note 4, at 1-45 n. 215.
77. See supra note 69.
78. See, e.g., Gilson & Milhaupt, supra note 63, at 349–50.
Figure 1).

There is also a commonality concerning the value placed on insiders with long experience and full access to information combined with the independence of outsiders. As noted above, for companies with auditors, this is reflected in the voluntary introduction of several outside directors and board committees to act as the independent outsiders. However, many companies with committees have gone in the other direction and sought to bring insiders onto the board to interact closely with independent directors. This important role for nonexecutive directors (i.e., former company executives who have no current executive position) is now unknown in the U.S. although it is regularly discussed and utilized in the U.K.\(^\text{79}\) For example, Toshiba emphasizes an equal division between executive directors and nonexecutive directors in keeping with the concept of combining insider expertise and authority with outsiders.\(^\text{80}\)

The use of nonexecutive directors by companies with committees often extends to the audit committee. Unlike those in the U.S., audit committees in Japan generally are not composed entirely of outside directors, but rather include insiders or nonexecutive directors.\(^\text{81}\) This practice reflects the importance of providing insider (or ex-insider) information and reinforces the impression that Japanese companies place a value on the role and function of "kansayaku" (and, in particular, inside "kansayaku") that is not shared or appreciated by

79. For example, Principle A4 of the UK corporate governance code is entitled "non-executive directors" and independent directors are referred to as "independent non-executive directors." See FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE (Sept. 10, 2012).

80. At present, Toshiba has eight executive (inside) directors and eight nonexecutive directors. Among the nonexecutive directors, four are former employees and only the other four qualify as outside directors. See Corporate Governance, Toshiba, http://www.toshiba.co.jp/csr/en/governance/governancenotes.htm (last visited Oct. 21, 2014). Under the Companies Act a current or former executive director, executive, officer or employee of a company or any of its subsidiaries is excluded from the definition of outside director. See Companies Act, Art. 2, Item 15. Nonexecutive directors are valued as important former (well-informed) Toshiba officials who are senior to, and can more easily question, the current top management even though they do not qualify as outside directors under the Companies Act. See Aronson, supra note 4, at 117 n. 97.

81. For example, two of the three current members of the audit committee of Nomura Holdings, Inc. are outside directors, while the third member is a nonexecutive director (i.e., former employee). See Corporate Governance, Nomura Holdings, Inc., http://www.nomura holdings.com/investor/cg/committee.html (last visited Oct. 21, 2014).
global institutional investors.

These developments suggest the potential emergence of a new model of Japanese corporate governance. Japanese companies that have adopted a form of the hybrid model report that their corporate governance practices are readily accepted by global institutional investors without the skepticism displayed with respect to traditional Japanese companies. However, many questions remain unanswered. The most fundamental issue is trying to judge the extent to which these new best practices have spread among Japanese companies. This is difficult to measure and precise data is not available.

One estimate given by a knowledgeable observer portrays a “Tale of Two Cities” in which practices have diverged between large, global companies and smaller domestic companies. According to this view, some ten to twenty percent of Japanese companies have adopted “good” corporate governance practices. As these are large companies, they command a significant percentage (seventy percent to eighty percent) of the market capitalization of the Tokyo Stock Exchange and are the prominent investment choices for global institutional investors. In this connection, it will be interesting to see if a new stock index launched in Tokyo at the beginning of 2014 will be successful in its aim of appealing to global investors and improving corporate value. Companies included in the new “JPX-Nikkei Index 400” are selected based on quantitative factors such as return on equity and liquidity and also given quality points for governance issues.

The dark side of this story of “A Tale of Two Cities” is that it leaves a significant number of Japanese companies with corporate governance and business practices that are both potentially weak at monitoring management and also not well suited for the international expansion plans being formulated and implemented by many mid-

82. See, e.g., remarks of K. Ishimura, supra note 56.
83. E-mail to the author from Hiroshi Komori, Associate General Manager, Business Advisory Department, Sumitomo Mitsui Trust Bank, Limited (Dec. 13, 2013) (on file with author).
84. For the TSE’s news release concerning this new index, see Start of Calculation and Publication of New Index “JPX-Nikkei” Index, TOKYO STOCK EXCH., http://www.tse.or.jp/english/news/17/1131106_b.html (last updated Nov. 6, 2013).
sized Japanese companies. In addition, from a global investors’ perspective, this means that outsiders can invest with confidence in large Japanese exporters whose fortunes are already tied to the global economy but have greater difficulty investing in domestically oriented Japanese companies to achieve diversification of risk.

V. FUTURE DIRECTION IN JAPANESE CORPORATE GOVERNANCE

Whether these promising recent practices at individual Japanese companies will coalesce and develop into a new model of Japanese corporate governance depends on a number of factors. The three trends I am following closely are briefly discussed below.

A. THE ROLE OF DOMESTIC INSTITUTIONAL INVESTORS

It is difficult to promote the widespread use of corporate governance improvements in Japan when pressure for reform is perceived to come primarily from foreign investors. This always leaves corporate management with the option of playing the gaijin card and acting as the defender of traditional Japanese interests regardless of whether that is an accurate assessment of management’s behavior. The well-known Bulldog Sauce case is one rather extreme example of that phenomenon.

Even though domestic Japanese institutional investors suffer from the same generally poor performance of Japanese portfolio companies as do global institutional investors, there is very little institutional activism in Japan. Yet, as seen in Table 1, assets held by asset management companies, particularly trust banks, have been growing steadily. At the same time, as noted above, the FSA has promulgated a Stewardship code based on the U.K. model that deals with the obligations of asset managers to engage with portfolio companies on behalf of their investors.

86. See supra note 31.
87. See supra note 16.
If I had to pick one key issue concerning the future direction of Japanese corporate governance, it would be the extent to which Japanese domestic institutional investors step up and more actively question management of portfolio companies and work to improve both governance and performance.88

B. DEVELOPMENT OF A HYBRID MODEL

Although there are now many interesting practices at individual Japanese companies, there is considerable variation among companies and no clear definition of the nascent hybrid model. One of the biggest challenges facing Japanese corporate governance in the near future is to find a way to standardize and spread these best practices so that a clear standard model emerges. One promising approach would be to again turn to the U.K. model, i.e., promulgate a corporate governance code and enforce it through a comply or explain procedure for listed companies.89 Such codes have now become widespread and represent a better fit for Japan than a “one-size-fits-all” hard law approach taken by the Sarbanes-Oxley Act in the United States. Although codes do not provide a panacea and have their own issues, a corporate governance code, which has been recommended for Japan by the ACGA, in now being drafted.90

Japan has already initiated a comply or explain approach with regard to the specific issue of requiring one outside “director” at listed companies.91 however, Japan’s political economy of corporate governance reform will present a challenge to expansion of the comply or explain approach to cover an entire corporate governance

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88. Japan’s Pension Fund Association was widely regarded as the sole activist among institutional investors during the 2000s. See supra note 24. Currently, the largest asset manager in Japan (and Asia) is Sumitomo Mitsui Trust Bank, Limited., with assets under management of $456 billion USD as of June 30, 2013. Symposium, Capital Markets and the Law in Japan: Legal Reform and Corporate Governance, Seiji Kawazoe, Associate General Manager, Sumitomo Mitsui Trust Bank, Limited (Oct. 18, 2013). However, some bank officials acknowledge that they have generally done a poor job on corporate governance issues to date, although they have plans to become substantially more active in that area. Hiroshi Komori, Associate General Manager, Sumitomo Mitsui Trust Bank, Limited, Global Management and Response to Foreign Institutional Investors, Business Research Institute (Dec. 12, 2013).

89. See supra note 17.

90. See ACGA WHITE PAPER supra note 3. See also supra note 17.

91. See supra note 2.
code. In many countries, the securities regulator drafts a corporate
governance code and requirements for disclosure relating to comply
or explain with code provisions promulgated by the stock exchange. In Japan, however, the FSA is relatively weak compared to the
Ministry of Economy Trade and Industry (“METI”), the business
lobby Keidanren, and the Ministry of Justice (“MOJ”), which is in
charge of amendments to the Companies Act. It therefore remains
to be seen how the FSA-TSE’s current project to adopt a corporate
governance code in the near future will work in practice.

C. ADJUSTING MANAGEMENT AND GOVERNANCE TO
GLOBALIZATION

Given Japan’s aging (and shrinking) population, Japan’s
domestic market is destined to contract over time. In response,
virtually every Japanese company has a plan to shift a substantial
portion of its business overseas over time. One of the biggest
challenges contained within this effort is modifying prior domestic
management and governance structures and practices to effectively
manage multinational corporations.

There is considerable variation in the situations of Japanese
companies concerning integration of international operations. Some
Japanese companies, such as the major trading companies, already
have substantial experience with global operations that are
reasonably well integrated. Other companies have developed
international business, but within the framework of a separate
international division that is removed from the company’s normal
decision-making and oversight structure and procedures. As the
international portion of the business expands and assumes a greater

92. For a global listing of corporate governance codes, see Index of Codes, EUR. CORP.
93. See supra note 17.
94. For example, Mitsubishi Corporation, one of the leading trading companies, has over
600 subsidiaries and affiliates, with a well-established, global system for internal audit and
controls that integrates overseas operations. Yoshihito Yoshizawa, General Manager, Internal
Audit Department, Mitsubishi Corporation, Internal Audit and Internal controls at Mitsubishi
Corporation, Business Research Institute (Dec. 7, 2012). See also Corporate Profile: Fact Sheet,
2014).
importance in overall operations, it becomes necessary to subject international operations to regular controls and “reintegrate” it with domestic operations in a unified structure. Some other large Japanese corporations have internationalized rather suddenly through very substantial overseas acquisitions that present the challenge of finding the appropriate means of integrating a separate, established foreign corporation with its own history and procedures into the main corporate structure.

In the initial phase of international expansion, the focus may typically be on how to apply Japanese policies and procedures to overseas subsidiaries and operations. However, as international operations grow, it will become necessary to modify decision-making and policies into a system that may be more effective globally than the original, domestic-oriented Japanese system. How Japanese companies respond to the challenge of internationalization of business operations will have a potentially significant impact on Japanese corporate governance and ultimately on the future business success of Japanese companies.

VI. CONCLUSION

The popular critical view of a Japanese corporate governance system that is stagnant fails to capture change and ongoing evolution over the past fifteen years. One important and continuing theoretical issue is the lack of a consistent, appropriate standard for evaluating Japanese corporate governance and measuring change. Governance

95. One example is YKK Group, an unlisted Japanese company that is a global leader in zippers and fasteners. International operations have grown to become a very significant portion of business activity and must now be integrated into the “main” governance structure. Katsuya Yumoto, Vice President, Legal and IP Department, YKK Corporation, “Reconsideration of Authority and Decision-making in the Localization of Global Management” at YKK, Business Research Institute (Aug. 28, 2013). See also Corporate Profile, YKK. http://www.ykk.com/ english/corporate/group/index.html (last visited Oct. 20, 2014) (noting that eighty-eight of 108 affiliated companies and a majority of employees are located overseas).

96. One examples would be Japan Tobacco Inc., which acquired both the non-U.S. tobacco business of RJR Nabisco Inc. in 1999 (one of the largest overseas acquisition by a Japanese company) and Gallaher Group Plc. in 2007, and which has a separate overseas headquarters in Geneva for its international operations. Its international arm, Japan Tobacco International, has over 27,000 employees and operates in 120 countries. See, e.g., JTI at a glance. JTI, http://www.jti.com/our-company/jti-at-a-glance/ (last visited Oct. 21, 2014).
in Japan may indeed seem backward and unresponsive when measured by formal board structure, including the number and role of outside directors and the choice by an overwhelming majority of Japanese corporations to continue the traditional structure of a company with auditors rather than change to an “American-style” company with committees.

Use of the role of independent directors as the sole or primary criterion to evaluate corporate governance systems is problematic. Such an approach reflects a standard based on American experience and development of corporate governance with the purpose of dealing with conflicts of interests to protect shareholders, and with resulting practical benefits for companies utilizing independent directors. The experience and goals in Japan are different, although they do not provide a better basis for comparisons. The focus in Japanese corporate governance on business performance and increasing “corporate value” for stakeholders is also problematic, particularly given the uncertain relationship between corporate governance and business performance.

In addition to the lack of a common or accepted standard for evaluation of governance systems, another fundamental problem in evaluating corporate governance is the lack of data related to actual practices. This is a problem everywhere, but is particularly acute in Japan with respect to the role of institutions such as kansayaku. Critics focus on shortcomings in the formal legal authority of kansayaku compared to outside directors, while Japanese defenders cite anecdotal evidence of a broader and more significant role for kansayaku.

The importance of kansayaku in Japan and the lack of data on their actual role make this area an important one for future research on Japanese corporate governance. The scrutiny given to kansayaku is justified since Japan has been the sole country in Asia to make extensive efforts over three decades to strengthen the role of kansayaku as the main monitor of management, rather than increasing the number of outside directors to augment or replace such a supervisory board. It does appear that recently all sides to this debate have begun to provide more data and make more balanced, functional comparisons between kansayaku and outside directors. Hopefully, this trend will continue and strengthen in the future.
This article identifies three fundamental issues for Japanese corporate governance: the popular debate on strengthening the monitoring function in Japanese corporations, separation of the board’s business advisory and monitoring functions, and dealing with the president’s informal power to make top-level appointments and to linger beyond his term in office. A decade ago, it was thought that all three of these issues would be addressed by the new company with committees structure; however, this new structure proved highly unpopular reportedly due to the envisioned role of the nomination committee.

Somewhat surprisingly, it has been the large traditional companies that have been at the forefront of evolution in Japanese corporate governance. This change has been caused by a combination of decline in institutions supporting the postwar system, outside pressure for corporate governance reform, and, most importantly, increasing business necessity to reform board practices to deal more effectively with increasingly large, complex, and global business organizations. But such change, not being legally required, has occurred through experimentation at individual companies and there are significant variations in approach.

Attempting to generalize these changes in practice over the past decade results in a focus on a “hybrid” form of governance. “Hybrid” generally refers to companies with auditors that add a number of outside directors and a nomination committee. Functionally, this is a method to create an alternative to the unpopular company with committees structure that can nevertheless deal effectively with the three fundamental corporate governance issues facing Japanese companies discussed herein. At the same time, however, companies with committees have proceeded to modify the board committee approach to conform more closely with preexisting corporate governance practices in Japan.

These ongoing trends may result in a kind of functional convergence in which corporate governance practices at “hybrid” companies with auditors begin to resemble actual practices at companies with committees. Such convergence has the potential to produce a new model of Japanese corporate governance, at least at large corporations, to replace the classic postwar model and deal effectively with current governance issues. However, at present, there
is no law or guideline that sets forth the features of such a model, and it remains unclear if a new corporate governance code or other measures to help spread best practices will define a new model of Japanese corporate governance in the near future.

The biggest factor that may determine the future direction and results of experimentation in corporate governance structures and practices among large Japanese companies is whether, or to what extent, domestic Japanese institutional investors become more active in demanding change at Japanese companies. This, in part, relates back to the prior question of whether a “standardized” hybrid model that encapsulates spreads best practices can be produced in Japan. Finally, the pace at which Japanese companies expand internationally and make corresponding modifications to their management and governance systems represents a separate set of business pressures that may have an increasing effect on Japanese corporate governance.

Corporate governance in Japan is by no means stagnant despite the relative lack of progress on certain highly visible issues such as the role of outside directors. Japan was the first non-Western country to develop economically, with its own experience and traditions, and remains the most advanced country with corporate governance and other systems that arguably differ the most from those in the U.S. As such, it should continue to provide a rich source of opportunities for deepening our understanding of corporate governance from a comparative perspective.
Table 1. Shareholder Ownership in Japan

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(Note) The number of Total Banks are included in that of City & Regional Banks in and below 1984 Survey

Figure 1. Hybrid Model—Asahi Glass Corporation