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1.13. CORPORATE GOVERNANCE IN JAPAN

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1.13.1. Overview of the Legal Framework of Corporate Governance in Japan

Traditionally, the Japanese governance system has been classified as a stakeholder governance system, which is typical in a code-law (or civil-law) country (La Porta et al., 1998; Ball et al., 2000). The stakeholder governance system is a contrast to the shareholder governance system prevalent in the common-law countries. In the stakeholder governance system, in addition to the shareholders, the other stakeholders can influence the management through cross-shareholding among affiliated firms, trading partners, and the main banks (Shleifer and Vishny, 1997; Hoshi and Kashyap, 2001). In particular, the main banks play a central role by collecting private information on borrowers, solving agency problems, and providing monitoring and insurance services[119].

However, during the long stagnation period that began after the collapse of the economic bubble in the beginning of the 1990s, Japan transformed its economic and business environment, including its corporate governance structure. In particular, the revised Commercial Code of 2001 and the Company Code of 2005 enabled Japanese firms to choose a committee system in which three committees (nominating committee, compensation committee, and audit committee) are placed above the board of directors (Itami, 2005). Under the committee system, the board of directors is responsible for management supervision, while executive officers are responsible for business management. The nominating committee determines the contents of the proposals, related to the election and dismissal of directors, for a shareholders meeting. The compensation committee determines remunerations for executive officers. The audit committee prepares audit reports related to the execution of duties by executive officers. However, a limited number of companies employed this new system.

Following a series of corporate scandals, including Seibu Railway (2004), Kanebo (2004), and Livedoor (2005), the Financial Instruments and Exchange Act of 2006 was enacted, which requires listed companies to submit annual securities reports, quarterly securities reports, and internal control reports. The listed firms are required to have financial statements audited by accounting auditors and also necessitated to establish an effective internal control system[120]. In addition, the Tokyo Stock Exchange (TSE) required listed companies to release a Corporate Governance Report.

However, the above steps failed to decrease the number of corporate scandals. After the scandal of Olympus Corporation in 2011, the second major corporate governance reform was initiated under the government's Japan Revitalization Policy.

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[118] I would like to thank Konosuke Shimamoto for his excellent research assistance. All remaining errors are my own.

[119] A summary of the enormous amount of literature on the main bank system in Japan is provided by Aoki and Patrick (1995), and Hoshi and Kashyap (2001), among others.

[120] Nishizaki et al. (2012) report that stock prices react negatively to the disclosure of internal control weaknesses (ICW) after controlling for other information released close to the disclosure date, audit quality, and other firm attributes. They conclude that the disclosure of ICW is informative to the market because it is less frequent and exceptional in Japan.

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The revised Company Act of 2014 set stricter requirements on outside directors and outside statutory auditors (*kansayaku*), and introduced a softer alternative committee system, a company with audit and supervisory committees. Although the new system was criticized by the foreign investors for its incompleteness (Shibuya, 2016), according to the Japan Exchange Group, as of June 2016, 414 listed firms have chosen the new system and transformed into a new company with audit and supervisory committees, as compared to the 69 listed companies that chose to be the former company with three committees.

Under the Company Act of 2014, Japanese companies could choose one of the three forms of organizational structures: a company with three committees; a company with audit and supervisory committees; or a company with a *kansayaku* board. The last form of company with a *kansayaku* board is a system unique to Japan, where a company is legally required to have a *kansayaku* board, as well as a board of directors and an accounting auditor. To monitor the decisions made by the directors and the executive officers, the *kansayaku* board members are obliged to attend the meetings of the board of directors, without holding voting rights, and have the right to request reports on the business of the company, in order to investigate its operational and financial status. The term of office of the *kansayaku* board members is stipulated to four years, which is longer than two years for the office of directors. The *kansayaku* board is required to include outside auditors to secure independence and quality monitoring.

In addition, the Council of Experts Concerning the Japanese Version of the Stewardship Code, a group set-up by the Financial Services Agency (FSA), published a document called the "Principles for Responsible Institutional Investors «Japan's Stewardship Code»" (the Stewardship Code) in 2014. The goal of this document was to promote increased involvement of institutional investors in the companies that they invest in. As of December 2016, 214 asset management firms signed up for the Stewardship Code (Table 1.13.1). The Stewardship Code expects institutional investors to set a clear investment policy (Principles 1 and 7), and identify and manage their conflicts of interest (Principle 2). In addition, the active dialogue is called for between companies and investors (Principles 3 and 4). The enhanced understanding of circumstances surrounding the companies is expected to change investors' voting behaviour (Principles 5 and 6).

Table 1.13.1. Institutional investors signed up for the Stewardship Code

	May 2014	***Nov. 2015***	***July 2016***	***Dec. 2016***
Trust banks	6	7	7	7
Investment managers	86	141	150	152
Insurance companies	19	22	22	22
Pension funds	12	24	26	26
Others	4	7	7	7
Total	*127*	*201*	*212*	*214*

Source: Financial Services Agency (2016)

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In 2015, the TSE formulated Japan's Corporate Governance Code (the CG Code) and set its five general principles to be as follows:

1) securing the rights and equal treatment of shareholders;
2) ensuring appropriate cooperation with stakeholders other than shareholders;
3) ensuring appropriate information disclosure and transparency;
4) outlining the responsibilities of the board;
5) engaging in dialogue with shareholders.

As of December 2016, 504 companies (19.9% of 2,533 companies listed in the first and second sections of the TSE) fully complied with the CG Code, and 2,143 companies (84.7%) complied with more than 90% of the CG Code[121]. In addition, Principle 4.8 of the CG Code states that companies should appoint at least two independent directors. Owing to these changes, according to the Japan Association of Corporate Directors (JACD), as of August 2016, more than 80% of the firms listed in the first section of the TSE[122] had multiple independent outside directors.

Considering these developments, this chapter reviews the changes in governance of Japanese companies, which have been stimulated by the government's initiatives in the last decade. The rest of this chapter describes the following issues: ownership structures in Section 1.13.2; market for corporate controls in Section 1.13.3; board of directors' practices in Section 1.13.4; directors' remuneration practices in Section 1.13.5; shareholders' rights protection in Section 1.13.6; shareholder activism in Section 1.13.7; corporate governance and firm performance in Section 1.13.8; and corporate social responsibility (CSR) in Section 1.13.9.

1.13.2. Ownership Structures of Japanese Companies

Traditionally, the majority of the shares in Japanese companies have been held by stable investors, such as affiliated companies, including the main banks. The unique feature of the ownership structure of such companies has been characterized by cross-shareholding among affiliated companies (Aoki and Patrick, 1995; Hoshi and Kashyap, 2001). The cross-shareholding structure is useful to lock-in control among long-standing business partners or affiliated companies in a business group (*keiretsu*). However, after the collapse of the economic bubble in the 1990s, Japanese companies experienced remarkable changes in their ownership structures, which include a decrease in the traditional cross-shareholding between banks and firms, and an increase in outside investors, such as foreign shareholders and individual investors. According to Nishiyama (2016), the cross-shareholding ratio declined from 30% in the early 1990s to 10.7% in March 2016. In terms of the market value, the Japan Exchange Group (2016) reports that the ratio of foreign shareholders increased from 7% in 1985 to 29.8% in 2015 (Table 1.13.2). The ratio of Trust Bank, a representative of domestic institutional

[121] Japan Exchange Group: http://www.jpx.co.jp/english/equities/listing/cg/.
[122] The TSE operates five markets. The first section deals with large companies; the second section deals with mid-sized companies; Mothers deals with high-growth startup companies; JASDAQ deals with startup companies in general; and the TOKYO PRO Market deals with professional investors. According to the TSE, at the end of April 2017, considering the first section (all five markets of the TSE), market capitalization and the number of listed firms amounted to 565.4 (586.8) trillion yen and 2,019 (3,560), respectively.

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investors, also increased from 2.5% to 18.8% in the same period. However, the share of insiders, proxied by city and regional banks, and insurance companies, decreased from 20.9% and 16.4% to 3.7% and 4.7%, respectively.

Table 1.13.2. Shareholding at market value by investor category

Survey year	***1985***	***1990***	***2000***	***2010***	***2015***
No. of companies	1,833	2,078	2,587	3,616	3,613
City & Regional Banks	20.9%	15.7%	10.1%	4.1%	3.7%
Trust Banks	2.5%	9.8%	17.4%	18.2%	18.8%
Insurance Companies	16.4%	15.9%	10.9%	6.4%	4.7%
Business Corporations	28.8%	30.1%	21.8%	21.2%	22.6%
Foreigners	7.0%	4.7%	18.8%	26.7%	29.8%
Individuals	22.3%	20.4%	19.4%	20.3%	17.5%
Other Institutions	2.1%	3.4%	1.6%	3.1%	2.9%

Source: Japan Exchange Group (2016), and Suto and Takehara (2014)

The investors from the United States of America (the U.S.) and the United Kingdom (the U.K.) mainly comprised of institutional investors, who jointly held approximately 60% of the total foreign equity investments in Japan from the past 20 years (Bank of Japan, 1996-2015). Their governance logics and interests are shareholder oriented and are thus different from those of stakeholder-oriented domestic shareholders. Based on the data of firms listed in the first section of the TSE between 2005 and 2010, Saito (2015) shows that firms with a higher foreign ownership tend to have a larger number of outside directors on their board. Using the data between 2006 and 2012, Desender et al. (2014) reveal that the relationship between board independence and audit fees is positive only when there is a high level of foreign ownership, and that the influence of foreign ownership is particularly strong in firms which do not have large domestic owners, and have high levels of risk and show poor performance.

1.13.3. Market for Corporate Controls (Mergers and Acquisitions)

Before the 1990s, mergers and acquisitions (M&As) were less popular in Japan, when compared to the U.S. and Europe. However, since the latter half of the 1990s, Japan also welcomed a big wave of M&As. According to Recofdata (2017), the number of M&As involving Japanese companies increased by double digits every year in the latter half of the 1990s, and were recorded at over 2,500 in the mid-2000s. After showing a decrease following the financial crisis in 2008, the number of M&As once more reached over 2,500 in 2016. In addition, the value of cross-border M&As has surged for the last ten years, as low interest rates in Japan have allowed businesses to pursue larger deals (*Nikkei*, 2017a). These big deals include the purchase of ARM Holdings by the SoftBank Group, and the purchase of beer-making operations in Eastern Europe by a British chip designer and Asahi Group Holdings in 2016.

The number of tender offer bids (TOBs) increased after 1998, and reached over 100 in 2007, and thereafter decreased after the financial crisis of 2008. Although the number of hostile takeovers in Japan before 2000 was relatively few, they captured

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attention in the 2000s, as symbolized by the attempts of Steel Partners Japan Strategic Fund in 2003, and Murakami Fund and Livedoor in 2005; until 2008, when major foreign funds withdrew from the Japanese markets after the Lehman crisis.

One important reason for the recent increase in M&As in Japan is institutional change. To revitalize industries that were fatigued by the collapse of the bubble economy, the Japanese government revised the applicable laws and accounting systems to enhance M&As. In 1997, the Antimonopoly Act was amended to approve of holding companies, and the Commercial Code was amended to simplify merger procedures. Further, in 1999, the Commercial Code and the tax system were revised to permit corporate acquisitions using equity swaps and equity transfers for Japanese firms, though these were not permitted for foreign firms. Furthermore, the amendment of the Law on Special Measures for the Revitalization of Industrial Dynamism in 2003 allowed cash-out mergers and triangular mergers, where the acquiring firm provides shares of its parent firm (instead of its own shares) to shareholders of the target firm. This triangular merger had no restrictions with regard to the nationality of the parent firm of the target firm, and thus removed the restrictions on foreign firms involved in cross-border M&As.

Inoue et al. (2013) examine whether M&As by Japanese firms have positive wealth effects on shareholders of the acquiring firms, by using the data on 658 domestic and 73 cross-border control acquisitions announced in the period between 2003 and 2010. They find that M&As by Japanese firms enhance shareholder wealth. The wealth effects were larger in cross-border acquisitions targeting developing countries and in acquisitions achieving full control of targets. They conclude that acquisitions by Japanese firms were efficient investments. Chikamoto et al. (2013, 2016) examine market reactions to Chinese acquisitions of Japanese firms between 1990 and 2009, and the U.S. acquisitions between 1996 and 2011. They find that both types of M&As tend to increase the stock prices of the Japanese targets, and that market reactions are significantly greater for the U.S. acquisitions when compared to the Chinese acquisitions. They conclude that market reactions increase for the acquirers operating in a developed country with high-quality institutions and corporate governance. Suzuki (2015) estimates the private benefits of control from stock price changes from approximately 262 TOB announcements between 1990 and 2011, finding positive results after 2006. He also reports that the estimated value of the private benefits is positively associated with the acquiring company's high share ownership before the TOB deal, but negatively associated with the presence of a block holder and a high share ownership ratio resulting from the TOB deal.

1.13.4. Board of Directors' Practices

Economic theory suggests that one of the important roles of the board of directors is to reduce agency costs. As an owner of the company and in order to enhance firm value, shareholders want to monitor the management. The board of directors is expected to act on behalf of the shareholders to monitor and restrict the activities of management to ensure behaviour that maximizes shareholder value. However, the conventional boards of

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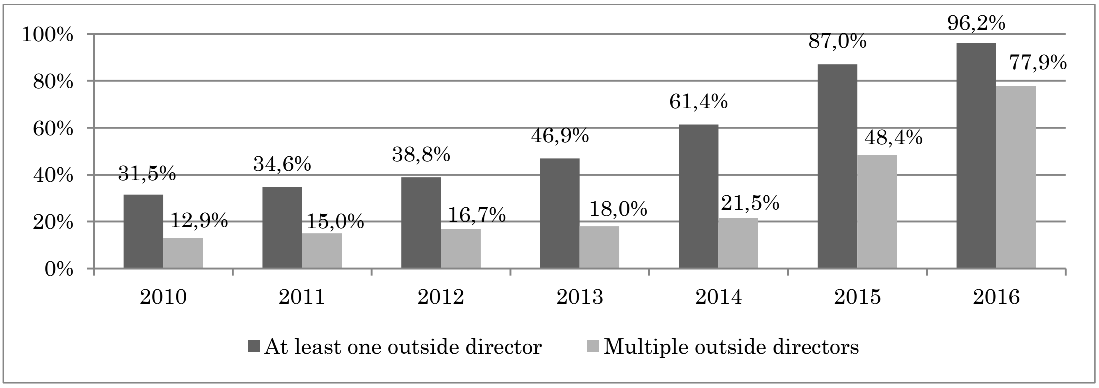
directors of Japanese companies can be defined as a "management board" with functions centered on making business management decisions. To separate the supervisory and operational functions, in 1997, Sony Corporation, an electronic company, introduced the executive officer system, which rapidly spread in the late 1990s. However, for many companies, the appointment of few independent outside directors did not alone bring fundamental changes to the role of the board of directors. Thus, the next step was to transform the conventional board of directors (the management board) into a monitoring board that specialized in the supervision of the management.

Considering these developments, the corporate governance reforms undertaken in the 2010s, focused on the reforms of boards of directors that promoted the appointment of independent outside directors. As explained in previous sections, following the revised Company Act of 2014 and the CG Code of 2015, the number of companies that included outside directors on the board increased rapidly. According to the TSE, as of June 2016, among 3,500 listed companies (1,958 companies listed in the first section of the TSE), 2,045 companies (1,525) had multiple outside directors and 3,070 companies (1,883) had at least one outside director (Figure 1.13.1).

Figure 1.13.1. Companies listed in the first section of the TSE with outside directors



Source: Tokyo Stock Exchange (2016).

Using the data of firms listed in the first section of the TSE between 2005 and 2010, Saito (2015) finds that firms with a large size, high foreign ownership, outside auditors, and high market-to-book ratio are more likely to have outside directors on their board. He also analyses the selection of outside directors, coming from various backgrounds, including other firms' executives, bankers, lawyers, academics, accountants, consultants, or bureaucrats. He reports that (1) information technology companies are less likely to hire outside directors from banks as they are less dependent on bank loans; (2) firms with a high business risk tend to have lawyers as outside directors'; and (3) firms with high overseas sales tend to appoint former bureaucrats. He concludes that Japanese companies choose outside directors for the directors' advice.

In contrast to the rapid increase in outside directors, the diversification of the board members is not sufficient in Japanese companies. The Japan Revitalization Strategy

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encourages companies to employ more female directors and managers by stating that listed companies should have at least one female director on their board. Owing to this government initiative, according to the 2015 Population Census[123], the number of female directors in Japan increased to more than 700 thousand, which accounted for 24.4% of the total number of corporate directors. However, according to the World Economic Forum's Global Gender Gap Index 2016, Japan ranked 111 among 144 countries[124].

Morikawa (2014) investigates the determinants of the number of female and foreign directors in Japanese companies, based on the Survey of Corporate Management and Economic Policy conducted by the Research Institute of Economy, Trade, and Industry; and the Basic Survey of Japanese Business Structure and Activities conducted by the Ministry of Economy, Trade, and Industry for the fiscal year 2011. He reports the following findings: (1) listed and long-established companies, subsidiaries of parents, and unionized companies are less likely to appoint female directors; (2) owner-managed companies tend to have female directors and chief executive officers (CEOs); and (3) foreign directors tend to be hired by foreign-owned companies and companies engaged in overseas operations.

1.13.5. Directors' Remuneration Practices

Directors' remuneration can be discussed using the principal-agent framework. When ownership and management are separated, shareholders expect managers to maximize firm value, while managers pursue their own reputation and interests. In addition, shareholders may not be able to observe managers' behaviour. In order to solve the conflicts of interests between shareholders and managers under information asymmetry, the remuneration should be determined by business results, and in order to match the interests of managers with those of shareholders, companies tend to employ annual incentive compensation, such as performance-based bonuses and long-term incentive compensations, including stock compensations and cash-based mid-term performance bonuses.

According to the Commercial Code in Japan, the board of directors was responsible for determining the value of executive compensation. Executive compensation mainly consisted of cash salary and cash bonus, while stock-based compensation was not used until the revised Commercial Code of 2001 introduced the stock acquisition rights system. Among prior studies examining the determinants of Japanese executive compensation, Nakazato et al. (2011) use the data based on the income tax paid by the richest executives in 2004, reporting that executive pay is positively associated with firm size, and is not significantly related to the accounting profitability or stock returns.

The CG Code of 2015 states that the remuneration of the management should include incentives such that it reflects mid- and long-term business results and potential risks, and promotes healthy entrepreneurship. The CG Code of 2015 also

[123] 2015 Population Census: http://www.stat.go.jp/english/data/kokusei/.
[124] World Economic Forum: http://reports.weforum.org/global-gender-gap-report-2016/rankings/.

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suggests that the proportion of remuneration that is linked to mid- and long-term results, and the balance of cash and stock, should be set appropriately. Despite the emphasis on performance-based compensation, pay levels and practices for Japanese CEOs are rather different from those for the CEOs of other major developed countries. According to Morita et al. (2016), among Japanese companies with annual revenues over one trillion yen, the average CEO salary is one-tenth of their U.S. counterparts. The key difference in compensation levels mainly results from the fact that Japan's incentive compensation is lower than that of the other major developed countries. In particular, performance-based compensation accounts to less than half of the total direct compensation in Japan; approximately 70% in France, Germany, and the U.K.; and approximately 90% in the U.S.

However, as stated in the CG Code of 2015, several Japanese companies reviewed their remuneration systems. According to Willis Towers Watson (2016), the number of companies that decided to issue stock options as stock-based compensation, increased from 81 in 2009 to 407 in 2016; the number of companies that introduced executive compensation of the Board Incentive Plan Trust increased from 4 in 2013 to 223 in 2016; 607 companies listed in the first section of the TSE established compensation committees, following the recommendation of the JACD; and the number of companies adopting equity-based executive compensation, including stock options trust plans and restricted stocks, is estimated to reach approximately 1,100 by the end of June 2017 (*Nikkei*, 2017b). We note that the big increase comes from newly-introduced alternatives-stock ownership plans arranged in trusts that emerged in 2012 and restricted stocks introduced in April, 2016. These changes are expected to impact executive pay practices.

1.13.6. Shareholders' Rights Protection

The shareholders' legal rights are quite strong under the Company Act of 2015 (Goto, 2014). In order to control dividend payments, replace the board of directors, and access a corporate ballot, shareholders have the rights to alter a corporate charter without board consent. To amend a corporate charter provision, though the shareholders do not require board consent, they require an affirmative vote on the special resolution at a shareholders' meeting. This means that without board consent, the shareholders can introduce a charter provision that grants them the power to make decisions on ordinary business matters, the power for which is usually given to the board. Using charter amendments, shareholders can also delegate to the board the responsibility for decisions on dividend pay-outs.

However, shareholders' power to set executive compensation is rather limited in Japan (Goto, 2014). Although the Company Act stipulates that compensation of directors shall be fixed by a resolution in a shareholders' meeting, case law has limited the scope of this shareholder right. Moreover, there is no mandatory disclosure of individual compensation, except for directors of publicly traded companies who receive a compensation of 100 million yen or more.

Considering the election and removal of directors, the default rule is a majority

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standard, where a majority of votes cast by shareholders can reject a candidate proposed by the management or remove any director at any particular time. Shareholders also have the right to submit proposals in shareholders' meetings. In addition, shareholders who hold three per cent or more of the company's voting rights for six months or longer can demand that directors call an extraordinary meeting. Shareholder derivative lawsuits are permitted as an exception to the general rule, in which the board of directors have the right to raise a claim on behalf of the corporation. Within this limited scope, plaintiff shareholders face few restrictions to initiate derivative lawsuits.

Recently, the CG Code of 2015 set the first principle of the rights and equal treatment of shareholders. Under this principle, companies should take appropriate measures to secure the rights, and equal treatment of minority and foreign shareholders. Thus, Goto (2014) concludes that shareholders' rights in Japan, under the Company Act, are among the strongest in the world. Although foreign investors tend to criticize Japanese companies for not paying sufficient attention to shareholders' interests, the problem does not lie in the legal rights, but in conventional practices, such as cross-shareholding.

1.13.7. Shareholder Activism

Historically, the management of listed companies in Japan tended to have friendly and stable shareholders, who did not sell their stocks, and rather supported the management. In addition, more than nine out of ten listed companies held their shareholder meetings on the same day in the 1990s (Tabuchi, 2014)[125]. This practice was previously justified by the companies as a protection against professional racketeers (*sokaiya*) who sought to extort money from companies by threatening them to disrupt the shareholders' meetings. However, the police have since cracked down on the *sokaiya*. Although the *sokaiya* no longer pose a threat, since cross-holdings have gradually dissolved, shareholder activism started to gain attention as activist investors took a hostile approach against managements. Typically, activist shareholders take the following measures to influence the management: closed engagement; public campaigns; shareholder proposals; empty voting; litigation; and hostile takeovers. Among these measures, empty voting never made an improper resolution or voted down a proper item of agenda in Japan (Matsushita, 2016).

Previous shareholder activism campaigns include hostile takeovers attempted toward Shoei Company Limited by Murakami Fund in 2000, Nippon Television Network Corporation by Livedoor and Murakami Fund in 2005, the Bull-Dog Sauce Company Limited by Steel Partners Japan Strategic Fund in 2007, when the first poison pill was exercised, and the Electric Power Development Company Limited (operating under the brand name J-POWER) by the Children's Investment Fund (TCI) in 2007. These attempts were not successful as the target companies had stable shareholders and public opinion was generally against hostile takeovers (Matsushita, 2016). Another example is the proposal of share exchange between Tokyo Kohtetsu Company Limited,

[125] In 2017, less than three out of ten listed companies held their shareholder meetings on the same day (Nishiyama, 2017).

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and the electric furnace steel maker, Osaka Steel Company Limited, the majority of whose shares were owned by Nippon Steel in 2007. This proposal was rejected as a result of a proxy fight waged by the Japanese activist fund Ichigo Asset Management, which opposed the share exchange (Nakamoto, 2007). In addition, foreign fund managers sided with Olympus Corporation's ousted president, Michael Woodford, who demanded answers for the accounting fraud of 2011 (Tabuchi, 2014).

Hamao et al. (2011) examine 916 activism events, where 34 activist funds targeted 759 companies between 1998 and 2009. Approximately three quarters of the events intensified between 2004 and 2007. In terms of the number of filings, the top activists were Sparx, Atlantis, and Murakami. Among 34 activist funds, eight were run by Japanese nationals and 17 were reported to have a hostile attitude. Among 916 events, 356 cases (39%) were regarded as hostile cases. Hamao et al. (2011) show that unlike the U.S. market, firms subject to activism are targeted for their high cash balances and under-leverage. In other words, activist funds aim to reduce cash holdings, which were very high when compared to other advanced countries[126], and increase dividends and share buybacks.

More recently, activist shareholders targeted companies with large market capitalization (Matsushita, 2016). For instance, Third Point, one of the most well-known activist hedge funds in the U.S., proposed Sony Corporation to carve out its entertainment business and make an offering of shares to the public in the entertainment business, although Sony Corporation refused to accept this proposal in 2013 (Sakoui, 2014). Third Point also proposed FANUC Corporation, a robotics company, to conduct a buyback of a large number of its shares and increase the amount of dividends. This proposal might have prompted FANUC Corporation to take the proposed action in 2015 (Harding, 2015). In addition, Third Point announced the acquisition of a major stake in Seven & I Holdings Company Limited in 2015, urging its board to separate the struggling Ito-Yokado supermarket chain from the group, in order to improve its corporate value; and to oppose the former CEO, Toshifumi Suzuki's bid to remove Ryuichi Isaka as the head of the profitable Seven-Eleven operation (*The Japan Times*, 2016).

In 2015, C&I Holdings Company Limited, which was related to the Murakami Fund, submitted a shareholder proposal to Kuroda Electric Company Limited, an electronic trading company, to elect four outside directors nominated by C&I Holdings Company Limited. Although this proposal did not pass at the extraordinary shareholders' meeting, shareholders who owned 40% of the voting rights voted for the proposal (Lewis, 2015)[127]. Another activist fund, Effissimo Capital Management, brought a derivative action to recover for damages caused by the directors of Nissan Shatai Company Limited, claiming that the directors violated their duties when the company deposited a large amount of cash in a subsidiary of Nissan Motor Company Limited, the parent company of Nissan Shatai Company Limited, although the

[126] Aoyagi and Ganelli (2014) report that the average ratio of cash holdings to market capitalization of listed companies was more than 40% during 2004-12 in Japan, which was much higher than 15-27% in other Group of Seven (G7) countries. In the end of fiscal 2015, cash holdings by listed companies rose to a record (Nikkei, 2016).

[127] Later in 2017, shareholders of Kuroda approved a proposal by Reno, another large activist fund related to Murakami, which proposed that Kuroda accept one external director of its choosing (Nikkei, 2017c).

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Yokohama District Court dismissed the case in favour of the directors in 2012[128]. Finally, Stardust, an affiliate of the private-equity company MBK Partners, completed a tender-offer for Tasaki & Company Limited a jeweller, in 2017 (*Nikkei*, 2017d).

After the release of the Stewardship Code of 2014, Japanese institutional investors started actively participating in shareholders' meetings. A well-known example is the annual shareholders' meeting of Otsuka Kagu Limited, a furniture retailer, in 2015, where a feud over the sales policy within the firm's founding family culminated between the founder and chairman, Katsuhisa Otsuka, and his daughter and the firm's president, Kumiko Otsuka. Major institutional investors, including insurance companies and pension funds, clearly supported the president's proposals (*The Japan Times*, 2016).

Matsushita (2016) summarizes that the common objectives of shareholder activism in Japan were to improve capital efficiency and corporate governance. Thus, activist shareholders tended to demand a buyback to increase the amount of dividends, carve out unprofitable businesses, or change business strategies. In addition, they occasionally advocated changes in corporate governance by increasing the number of outside directors and employing stock-price-linked remuneration of directors. Matsushita (2016) expects that the number of shareholders supporting the management could decrease in the future as more cross-holdings are dissolved, and warned that managements of listed companies should take into account the possibility that they will be targeted by activist shareholders.

1.13.8. Corporate Governance and Firm Performance

Until now, we reviewed the ongoing governance reforms in Japan. However, there is limited empirical evidence that has examined whether and how the change in governance triggered by the reforms improved corporate performance. The exceptions to this are the following two studies: Aoyagi and Ganelli (2014), and Kato et al. (2017). Aoyagi and Ganelli (2014) study the relationship between corporate cash-holdings and corporate governance in Japan. Using the data of non-financial companies between 2000 and 2013, they show that better corporate governance, reflected in the "Proprietary Bloomberg Score,"[129] reduces cash holdings, suggesting that Japan's corporate governance reforms are likely to reduce high corporate cash holdings, and choose a more efficient use of resources.

Kato et al. (2017) examine whether and how pay-outs and cash holdings are related to corporate governance in Japan, by using the data of listed non-financial companies between 1990 and 2011. Their study shows that, on average, Japanese companies have reduced their cash holdings and increased their pay-outs after 2000. They also report that good governance proxied by foreign ownership, management ownership, and ownership by financial institutions is negatively associated with cash holdings, and positively related to pay-outs and operating performance, reflected in return on assets (ROA) and Tobin's Q,

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[128] Nissan Shatai Company Limited's press. Retrieved February 13, 2013 from the World Wide Web: http://www.nissan-shatai.co.jp/EN/IR/PDF/NEWS/20130213_hanketsu_kekka_E.pdf.

[129] The "Proprietary Bloomberg Score" includes the measure of board size, ratio of outside directors, and disclosure quality.

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while the opposite is true for poor governance proxied by bank loans.

1.13.9. Corporate Social Responsibility (CSR)

Traditional Japanese companies possess ethical self-discipline passed down over generations while conducting business. The most famous discipline is the "triple satisfaction" among three stakeholders: sellers, buyers, and the society. By satisfying the interests of these stakeholders, companies are expected to establish and maintain long-term business relationships by assuring product quality, contributing to social causes, and providing employment to the society, among others. Although the traditional main banking system did not urge companies to disclose information to the outsiders, following the unwinding cross-shareholding and the increase of institutional investors, the disclosure of non-financial information has gradually been introduced since the late 2000s, and includes disclosures, such as Corporate Governance Reports and International Control Reports. In parallel, large companies sought to strengthen investor relations and began to issue CSR reports voluntarily.

One of the notable moves by Japanese businesses was that the Japan Business Federation (*Keidanren*) incorporated several ISO[130] 26000 elements into the fifth edition of its Charter of Corporate Behaviour released in 2010. ISO 26000 is ISO's standard on an organization's public responsibility, and was published in 2010. This standard clarifies the social responsibility by setting seven core subjects: organizational governance, human rights, labour practices, the environment, fair operating practices, consumer issues, and community involvement and development. Later, Japan adopted ISO 26000 as an official standard following its adaptation of JIS[131] in 2012. According to the survey conducted by the CSR Forum, Japan, more than half of the 200 respondents use ISO 26000 or *Keidanren*'s Charter of Corporate Behaviour (CSR Forum Japan, 2014). Another CSR survey conducted on approximately 2,000 companies by the Tokyo Foundation, found that many companies pursue issues related to the environment, human rights, and (domestic) women's advancement, while fewer companies address issues on (domestic) poverty and hunger (Tokyo Foundation, 2014).

The change has been accelerated by the Japan Revitalization Strategy. Japan's Stewardship Code of 2014 and the CG Code of 2015 indicate that institutional investors are expected to conduct sustainable investments. In addition, in 2015, the Government Pension Investment Fund, the world's largest pension fund, became a signatory of the Principles for Responsible Investment (PRI)[132], which was launched by the United Nations Global Compact in 2006. The PRI highlight the role of institutional investors in environmental, social, and governance (ESG) issues, and advise investors to actively use their rights to improve ESG issues of the companies they invest in. According to the Japan Sustainable Investment Forum (2016), among 1,633 PRI signatories globally, 53 were Japanese as of the end of 2016. As of 2016, the balance of total sustainable investment was 57.05 trillion yen in Japan, of which 56.25 trillion yen were made by

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[130] ISO stands for the *International Organization for Standardization*.
[131] JIS stands for the Japanese Industrial Standards.
[132] Details of the PRI are provided in the UN webpage: https://www.unpri.org/.

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domestic institutional investors.

Motta and Uchida (2017) examine the relationship between the CSR ratings and the ownership structures of Japanese firms between 2006 and 2011. They use the Toyo Keizai CSR database, which is based on the firms' responses to questionnaires on the following four issues: environment, social engagement, corporate governance, and employment relations. They find that institutional ownership in 2005 is positively associated with the likelihood of subsequent improvements in environmental ratings and that this improvement is more evident in domestic institutional investors who signed up for the PRI. In contrast, they do not provide robust evidence on the relationship between the CSR ratings and foreign ownership.

Suto and Takehara (2014) examine the effects of foreign ownership on the corporate social performance (CSP) of Japanese firms listed between 2007 and 2011. Unlike Motta and Uchida (2017), they find a more positive relationship between the CSP and foreign ownership, when compared to the relationship between the CSP and domestic ownership, by using different CSP indices, which were based on the following five dimensions: employee relations, social contributions, organization security and product safety, internal governance and risk management, and environmental preservations. To summarize, prior studies report that corporate governance tends to affect CSR activities of Japanese companies. However, whether foreign or domestic investors provide more positive influence remains an empirical question.

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