

Revising the Japanese Commercial Code:

A SUMMARY AND EVALUATION OF THE REFORM EFFORT

Mark Poe, Kay Shimizu,
Jeannie Simpson

INTRODUCTION

Over the course of the last decade, the Japanese government has tried a wide range of schemes intended to reinvigorate the economy. Among the more widely publicized attempts have been the slashing of interest rates to near zero percent,¹ massive government expenditures on public works projects,² deficit spending at unprecedented levels,³ and the distribution of shopping coupons worth \$165 to the elderly and families with children, with the goal of stimulating consumer spending.⁴ None of these efforts has had a lasting effect on the national economy, and the search for a remedy continues. Concurrently, much hope has been pinned on a comprehensive reform effort dubbed the “Big Bang.”⁵ The scope of the Big Bang is very broad, including reforms in banking, capital markets, insurance, and

accounting standards.⁶ Although not explicitly part of the Big Bang, another significant reform effort seeks to revise Japan’s Commercial Code. The Commercial Code has been revised numerous times in the postwar period, but the current effort would result in the most significant changes in fifty years.⁷

The proposed revisions to the Commercial Code are numerous and wide-ranging, but can be loosely grouped into two categories—those that address corporate structure and deal mechanics, and those that address corporate governance.⁸ This paper seeks to provide a summary and evaluation of the proposed revisions to the Commercial Code, discusses the extent to which those revisions have been adopted by Japanese companies thus far, and speculates about other changes that must occur in corresponding laws and institutions to support the Commercial Code revisions.

¹ Chiaki Nishiyama, “Tax Cuts Put Japan on Track,” *JAPAN TIMES*, 20 July 1999.

² Hugh Cortazzi, “Japan on the Verge of Change?,” *JAPAN TIMES*, 17 Nov 1999.

³ Cortazzi.

⁴ Sheryl WuDunn, “Japan Announces \$195 Billion Plan to Revive Economy,” *N.Y. TIMES*, 16 Nov 1998, at A1.

⁵ The program was announced in 1997 by then Prime Minister Ryutaro Hashimoto. It takes its name from the British financial reform package of 1986, which proved moderately successful in stimulating the British economy.

⁶ Michael Bacon, Peter Dyaico & Asahi Yamashita, “Japanese Capital Markets and the ‘Big Bang’,” <<http://www.orrick.com/about/offices/Tokyo/article2.htm>> (1998).

⁷ Mark D. West, “The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States 47” (2000) (unpublished manuscript), available at <<http://papers.ssrn.com/sol3/delivery.cfm/>>; *NIHON KEIZAI SHINBUN*, *Commercial Code to Get Revamp*, 11 September 2000.

⁸ Thanks to Tony Zaloom of Tokyo’s Mori Sogo Law Firm for this categorization scheme. Mr. Zaloom is the chairperson of the American Chamber of Commerce in Japan’s Commercial Code Task Force Committee, and has been a substantial source of insight during the preparation of this paper.

I. THE MOVEMENT TO REFORM JAPANESE CORPORATE LAW

A. Brief History of Reform Efforts

Japanese corporate law has always been modeled after that of Western countries. Japan's first declaration of a corporate code came in 1899, after the Japanese government commissioned a German scholar named Hermann Roesler to write a draft based on the German code.⁹ That code went through several revisions during the first half of the 20th century, but was largely discarded after World War II, in part because the U.S. Occupation forces believed that the nature of Japanese corporations was one of the factors that led to Japanese aggression preceding the war. In its place, Occupation officials encouraged Japan to adopt a more democratic corporate governance structure. The primary architects of the new code were officials in the Supreme Commander for the Allied Powers' (SCAP) Legal Section. In an interesting historical quirk, three of the five officials in charge of drafting the code were trial lawyers from Illinois and graduates of the University of Illinois.¹⁰ As a result, the Japanese Commercial Code closely resembles the Illinois code. Rather than simply imposing the code, SCAP sought the input of Japanese officials, scholars, and business organizations. But although the Americans made several compromises,¹¹ the final draft of the code that the Diet adopted in May of 1950 was essentially a replica of the Illinois code.

Since the war, the Commercial Code has been revised 22 times, eleven of which have been substantial reforms,¹² but the current reform effort is widely viewed as the most thorough overhaul in the lifetime of the code. Editors at Japan's leading economic newspaper, the *Nihon Keizai Shimbun*, routinely refer to the current effort as "the first

major revision of the Commercial Code in 50 years."¹³ The latest round of reform efforts might be considered to have begun with the collapse of the bubble economy in 1993, but the level of interest in corporate reform has crescendoed only in the past few years. In April of 2001, Japan's Ministry of Justice released an interim proposal for reforming the Commercial Code that packages together dozens of changes in all areas of the code, many of which mark a shift away from the five main characteristics of the traditional Japanese corporate environment: bank-centered capital markets, *keiretsu*-controlled stock ownership patterns, administrative guidance, insider-dominated board of directors, and weak external monitoring of corporate management.

B. The Players in Corporate Law Reform

Due to the potential political and economic impact of an overhaul of the Japanese Commercial Code, many parties have taken an interest in the reform process, and have sought to have their interests adequately represented. As would be expected, government bureaucrats, business organizations, academics, and actors representing foreign interests are currently jockeying for influence over the final legislation that will be proposed to the Diet. The proposals supported by these various groups are often conflicting, and few proposals have unanimous support. Rather than attempting to list each reform proposal supported by each party, this section first gives a short description of the process by which legislation is generated, followed by a brief description of the general interests of each of the main actors.¹⁴

1. The process of generating legislation

A large part of the legislation that is introduced to the Diet is generated by *shingikai*

⁹ West, 11.

¹⁰ West, 12.

¹¹ West, 16-17.

¹² West, 26.

¹³ "Commercial Code to Get Revamp," *NIKKEI WEEKLY*, 11 Sept 2000; "Business Calls for Faster Legal Revision," *NIKKEI WEEKLY*, 23 Oct 2000.

¹⁴ The descriptions of the actors' interests are based in large part on characterizations given by Tony Zaloom. Any inaccuracies, though, are the fault of the authors.

advisory committees and bureaucrats working in the various cabinet ministries. Which ministry drafts a given proposal is largely determined by the subject-matter of the legislation. Almost every corporate law revision in the postwar period has come solely from the Ministry of Justice (MOJ) and is the work of three or four officials,¹⁵ but because the current reform effort is so sweeping, officials from other ministries have been seconded to MOJ to collaborate in the development of the legislation.¹⁶ The standard route of a Commercial Code revision begins with a standing advisory committee of the MOJ called the Legislative Committee.¹⁷ The Legislative Committee oversees two smaller panels, the Commercial Code and the Company Law Subcommittees. The appropriate subcommittee solicits opinions from interested groups, discusses and develops an outline for the change, then presents it to the full Legislative Committee, which publicly presents the proposal and again receives comments before the bill is drafted by MOJ. The bill is then submitted to the cabinet for approval before being sent to the Diet for deliberation and enactment. Although ministry officials have the final say in shaping legislation for the Diet, the advisory committees are an extremely influential, if not determinative, part of the process.¹⁸

2. Ministry of Justice

The Ministry of Justice is the most significant actor in the current reform effort. It is a rather conservative organization, and is hesitant to enact any sudden, radical changes. For example, in its most recent proposal, the MOJ has suggested that rather than do away with the failed *kansayaku* auditor system, it would allow corporations to choose between keeping their *kansayaku* in a strengthened

form, or selecting *one* outside director. The MOJ is also not as open to foreign participation as some of the other ministries, and has refused to allow ACCJ (American Chamber of Commerce in Japan) to participate in its advisory committee meetings.¹⁹

The MOJ has drawn some criticism for not acting quickly enough in proposing actual reform legislation to the Diet.²⁰ Although it refers to the current reform effort as the *bappon kaikaku*, or “drastic reform,” the iterative process by which it develops legislation can take a considerable amount of time; some of the elements of its April, 2001 interim proposal have been pending for as long as four years. Part of the problem is that its advisory councils are hesitant to make bold changes to the Commercial Code, and instead have worked very incrementally.²¹

3. Ministry of Economics, Trade, and Industry

Although its former embodiment, MITI, had long been known as a stalwart defender of the status quo, METI has been a surprisingly progressive proponent of corporate law reform. According to Tony Zaloom, Chair of the American Chamber of Commerce in Japan’s (“ACCJ”) Commercial Code Task Force Committee, METI is now “the major force behind the reforms” and is advocating for a more accountable, market-oriented approach to corporate governance.²² Since METI is largely responsible for Japanese industrial policy, perhaps it is feeling additional pressure to turn Japan’s economy around, and has decided that reform of the Commercial Code is one step in that process. Although it is not directly involved in shaping legislation to submit to the Diet, METI has seconded several employees to MOJ to participate in the development of legislation.²³ In addition, METI has its own Commercial Code advisory

¹⁵ West, 36.

¹⁶ Interview with Tony Zaloom, chair of the ACCJ’s Commercial Code Task Force Committee (May 4, 2001).

¹⁷ West, 36.

¹⁸ West, 33.

¹⁹ Interview with Tony Zaloom.

²⁰ “Business Calls for Faster Legal Revision,” THE NIKKEI WEEKLY, 23 Oct 2000.

²¹ Interview with Tony Zaloom.

²² Interview with Tony Zaloom.

²³ Interview with Tony Zaloom.

committee that feeds into the MOJ process, and it has allowed Mr. Zaloom to participate in its deliberations as the ACCJ's representative.

4. Ministry of Finance

Because of the wide range of reforms that have been suggested in the current revision movement, the Ministry of Finance (MOF) is necessarily involved in the effort. It has its own advisory committees to develop and evaluate reform proposals, and it continually consults with MOJ. Many of the proposed reforms, including almost anything that affects stock, directly implicate matters of MOF jurisdiction, and will only succeed if MOF gives its assent. MOF seems generally supportive of the effort to reform the Commercial Code. It was the lead ministry in enacting the financial reforms of the "Big Bang," being partly motivated by fear that Japanese financial products were falling behind those from the United States and Europe.²⁴ If it believes that Japan is losing a similar race in the area of corporate structure and governance, one would expect it to support the changes sought by MOJ and METI.

The unclear hierarchy between the ministries lends itself to a certain amount of confusion. For example, some of the corporate governance proposals from MOJ distinguish between companies not based on whether they are privately or publicly owned, but based on their size, even though that criterion is not especially helpful for corporate governance purposes. The reason for doing so, apparently, is to avoid any conflict that might arise should the MOJ directly interfere with MOF jurisdiction over publicly traded companies.²⁵

5. Keidanren

The Japan Federation of Economic Organizations, or *Keidanren*, is the most influential business organization in Japan and has traditionally been a very conservative organization, dominated by the bastions of Japanese industry like steel companies and auto manufacturers.²⁶ *Keidanren's* membership includes 800 of Japan's largest corporations and 100 trade and industrial organizations.²⁷ Although it has been fully supportive of changes that would remove restrictions on corporate structure and financing, since it is dominated by incumbent managers, it is leery of corporate governance changes and other revisions that would allow for greater external control of management. For example, *Keidanren* strongly opposes any suggestion that companies should be required to add outside directors to corporate boards, insisting that outsiders would never have sufficient expertise and understanding of the business to adequately supervise it.²⁸ Instead, *Keidanren* insists that accountability can be sufficiently increased by strengthening the existing *kansayaku* system by, for instance, increasing the number of *kansayaku* and requiring that at least half of them be outsiders to the firm.²⁹ Similarly, *Keidanren* is seeking to once again restrict the derivative suit rules that were relaxed in 1993, to make it harder for shareholders to directly challenge board decisions.³⁰

As a balance against their desire to maintain control, however, *Keidanren* members must weigh their need for external sources of capital, especially as their ability to rely on bank-financing declines. *Keidanren* position papers thus make some

²⁴ Bacon, Dyaico, & Yamashita.

²⁵ E-mail from Nick Benes, ACCJ, to ACCJ Commercial Code Task Force Committee members (May 27, 2001) (on file with authors).

²⁶ Interview with Tony Zaloom.

²⁷ West, 30.

²⁸ Keidanren, *Summary of the "Points of Discussion Relating to Corporate Governance in Japanese Public Companies (Interim Report),"* policy paper (Nov. 21, 2000), <<http://www.keidanren.or.jp/english/policy/2000/061.html>> [hereinafter Keidanren, *Interim Report*].

²⁹ Keidanren, *Urgent Recommendations Concerning Corporate Governance,* policy paper (Sept. 16, 1997), <<http://www.keidanren.or.jp/english/policy/pol067.html>> [hereinafter Keidanren, *Urgent Recommendations*].

³⁰ Interview with Tony Zaloom.

concessions to shareholders, calling for such things as the acceptance of foreign accounting standards³¹ and the need to “build corporate governance that places even more importance on shareholder value.”³² The organization recognizes that it must increasingly look to foreign sources of capital, and notes that one trend in capital markets is the “increase in the number of foreign investors, who have greater voice.”³³

6. American Chamber of Commerce in Japan

Now in its 54th year, the ACCJ is an organization of more than 3200 American business people and has been the most active foreign influence on the direction of corporate reform in Japan.³⁴ The organization has formed a special committee to evaluate and make proposals to the Ministry of Justice, and actively distributes its viewpoints to the business press.³⁵ The ACCJ’s interest in corporate reform seems to be motivated by the desire to increase the similarity between Japanese and American corporate law so that foreign businesses and investors will be better able to predict the outcomes of their activities. In fact, a close look at the proposals suggested by the ACCJ reveals that nearly all of them are direct transplants from American corporate law.

The ACCJ represents both investors and those who are seeking business opportunities in Japan. Among the many ways that American investors would benefit through some of the proposed reforms is through having Japanese boards of directors held more directly accountable to the shareholders’ interests. Many people believe that the legal revisions will lead to better-managed companies that will in turn make more

money for their shareholders. Perhaps an even stronger incentive for ACCJ members is that a similar body of corporate law and clearly compatible goals would make it easier for American corporations to deal with their Japanese counterparts in business transactions.³⁶ As an example, when American and Japanese businesses merge or enter into joint ventures in the current environment, there can be considerable confusion as to the proper corporate purpose and direction. This confusion would likely be reduced if both the American and Japanese managers agreed that they were individually accountable for the performance of the venture, and that their primary goal was the maximization of shareholder value.

7. Shareholder Groups

Among all of the parties representing their interests in the current reform effort, there is one conspicuous absence—the shareholders themselves. The ACCJ and CalPERS play a limited role in representing shareholders, but there is apparently no domestic counterpart to these groups that is taking an active role. The absence of shareholders is quite ironic, especially given the fact that many of the reform proponents claim that corporate shareholders will be the primary beneficiaries of the reforms. Although one would probably not expect individual investors to have sufficient incentive to become actively involved in the decision-making process, domestic institutional investors such as pension plans and fund managers would seem to have a lot at stake in the outcome. Whether their absence is properly attributed to legal restraints, a culture of shareholder

³¹ Keidanren, *Toward Creating a Competitive Capital Market*, policy paper (Nov. 24, 1999), <<http://www.keidanren.or.jp/english/policy/pol112.html>>.

³² Keidanren, *Urgent Recommendations*.

³³ Keidanren, *Interim Report*. It is unclear whether *Keidanren* means to say that foreigners have a greater voice due to their increasing numbers, or that foreigners are generally more demanding and vocal shareholders. More than likely, both of these things are true.

³⁴ American Chamber of Commerce in Japan website, <<http://www.accj.or.jp/default.asp>>.

³⁵ Interview with Tony Zaloom; ACCJ, *Commercial Code Task Force Meeting Minutes* (Sept. 1, 2000), <<http://www.accj.or.jp/News/viewNews.asp?XID=3182>>.

³⁶ Interview with Tony Zaloom.

passivity, or to other reasons,³⁷ their absence from the debate is noteworthy.³⁸

C. Proposed Revisions of Japanese Corporate Law

Over the last several years, there has been a plethora of proposals for various revisions to Japanese corporate law. For brevity's sake, this paper highlights four significant proposals by presenting each proposal, and where necessary, describing it, explaining the rationale behind it, identifying its main proponents and opponents, and commenting on its status, likelihood of adoption, and other features. These proposals are in various stages of advancement. Some of them have already been adopted, some are contained in a tentative package of proposals released by MOJ in April 2001, and some may never be enacted. In addition, the reader should be cautioned that the descriptions are not based on complete information, and might therefore contain inaccuracies.

1. Deal Mechanics Proposals

(1) Proposal: Facilitate Mergers/Corporate Restructuring

Description: Japanese corporate law is full of restrictive rules that impede corporations from acquiring each other and from changing their corporate structure. Partly as a result, Japanese companies have long been conglomerations of completely dissimilar operations and enterprises.³⁹ One of the

legal roadblocks was that Japan had long had a ban on pure holding companies, fearing that that structure would lead to anti-competitive business practices. The Diet lifted the ban in 1997, so that now it is much easier for corporate parents to reorganize and trade their business units.⁴⁰

For a few years following the sanctioning of holding companies, impediments to effective reorganization remained. Japan has historically lacked a share exchange system, so that a single hold-out shareholder could prevent a firm from purchasing another as a wholly owned subsidiary. In 1999 the Diet passed a bill that allowed for compulsory share exchange if endorsed by a two-thirds majority of the shares present at a shareholder's meeting. The bill also granted appraisal rights to dissenters.⁴¹

Another impediment to efficient corporate structuring was that until 2000, Japan had no provisions regarding corporate spin-offs, which allow a corporation to divide itself into separate companies.⁴² The absence of spin-off provisions became a pressing issue as the economy continued to stagnate, and corporations increasingly needed to streamline themselves by divesting of unprofitable divisions.

Obstacles to mergers still exist, especially for international corporations. Japan has complicated rules concerning cross-border share exchanges, and although the ACCJ and the U.S. government have persistently called for the simplification of the rules, the April 2001 reform package released by MOJ failed to make any allowance for such transactions.⁴³

³⁷ Side-By-Side Comparison of USG Submission on Commercial Code Issues and Summarized Contents of Ministry of Justice Interim Report 7 (May 11, 2001) [hereinafter USG Submission] (report distributed by U.S. embassy personnel, on file with authors).

³⁸ Mark J. Roe, Economic Competitiveness and the Law: Article and Comment: Some Differences in Corporate Structure in Germany, Japan, and the United States, 102 YALE L.J. 1977-79 (1993); Bernard S. Black, Legal Theory: Is Corporate Law Trivial?: A Political and Economic Analysis, 84 Nw. U.L. Rev. 542 (1990).

³⁹ Dean A. Yoost & Ross Kerley, "Japan's Changing Landscape," PricewaterhouseCoopers bulletin (1998), <http://211.14.130.185/other_research/JapansChangingLandscape.html> [hereinafter Yoost & Kerley, Changing Landscape].

⁴⁰ Yoost & Kerley, "Changing Landscape".

⁴¹ West, 55.

⁴² West, 55.

⁴³ USG Submission.

Rationale: It is believed that a relaxation of the rules governing corporate organization will encourage the consolidation and restructuring of corporations, leading to increased competitiveness of Japanese industry.⁴⁴ This streamlining allows corporations to concentrate on their core businesses, and to jettison enterprises that aren't performing well.

Proponents/Opponents: Every major interest group appears to support the liberalization of rules that unnecessarily restrict corporate structure. Although such deregulation would seem to reduce the power of the governmental bureaucracy, it appears that the ministries have put aside their jurisdictional jealousy in favor of reinvigorating the national economy. As for the failure to ease cross-border transactions, one can speculate that it is motivated by old-fashioned national protectionism.

Comments: Many of the most glaring impediments to corporate reorganization seem to have been resolved over the last decade, probably due to the lack of any strong interest groups opposed to such reform. Although these reforms would seem to be quite significant in terms of stimulating the economy, there has not been significant improvement at the national level since these reforms were enacted. Perhaps the extent of the overhaul is so great that corporations have not had sufficient time to make use of the liberalizations.

(2) Proposal: Reduce the level of cross-shareholding

Description: The traditional practice of cross-shareholding is being attacked in several ways. First, beginning in 2002, new corporate accounting rules will require that cross-held

shares be assessed at their market value rather than their book value.⁴⁵ Because the market value is much more volatile than the book value, banks and corporations are expected to have incentive to divest of their cross-holdings. Especially if the economy continues to stagnate, corporations can be expected to attempt to unload these depreciating assets and invest the cash in more profitable endeavors.⁴⁶

Regulators from Japan's Financial Services Agency are proposing to take a more direct tack to encourage banks to sell their cross-held shares. In June of 2001 the agency unveiled its proposal to require that a bank's shareholdings be less than the value of its capital holdings.⁴⁷ The proposal would require banks to divest of all excess shares over a three-year period, a present total of more than 10 trillion yen.⁴⁸

Rationale: Untangling the web of cross-shareholding is expected to have positive effects both on deal mechanics and on corporate governance. From the deal mechanics side, mergers and acquisitions will become easier as the percentage of shares in a firm's market float increases. When a majority of companies have more than a majority of their outstanding shares in the open market, one would expect that a market for corporate control would develop, which would in turn tend to increase the accuracy of share-pricing. From a purely corporate governance standpoint, directors will need to be more attentive to shareholders and share value because they won't be able to count on support from cross-holdings. In sum, the untangling of cross-held shares is expected to force managers to focus primarily on shareholder value.

Proponents/Opponents: There have been few, if any, vocal opponents of reducing the level of cross-shareholding. The government

⁴⁴ "Government OK's Bill to Revise Commercial Code," *JAPAN ECONOMIC NEWSPAPER*, 8 Mar 1999.

⁴⁵ Ginko Kobayashi, "Academic Criticizes Government Stock Plan," *THE DAILY YOMIURI*, 6 Feb 2001, at PC3.

⁴⁶ Yoost & Kerley, "Changing Landscape."

⁴⁷ Gillian Tett, "Japan Plans to Force Banks to Sell Equities," *FIN. TIMES*, 14 June 2001 at 11.

⁴⁸ Tett.

ministries, the ACCJ, and institutional investors all strongly support the idea.⁴⁹ Although it wouldn't seem that the incumbent managers who control *Keidanren* would benefit from untangling the web, they have not actively opposed the suggestion.

Comments: Reducing the level of cross-shareholding will probably have as significant an impact on Japanese corporate behavior as any of the other proposed reforms. In an environment of extensive friendly cross-shareholding, minority shareholders are essentially frozen out of all decision-making authority. Moreover, fostering the relationship between the cross-shareholders takes precedence over assuring maximum return to shareholders. If the currently cross-held shares are entirely divested, many of the enigmatic aspects of Japanese corporate behavior may disappear as well.

It appears that the cross-shareholdings are already beginning to unwind. Through 1999 and the first half of 2000, major banks sold cross-held shares of a total value of more than 4 trillion yen.⁵⁰

2. Corporate Governance Proposals

(1) Proposal: Require publicly-traded companies to add independent directors to their boards

Description: Probably no proposal has been more controversial than the suggestion that corporations be required to have independent directors on their boards. There have been a

variety of specific proposals, from CalPERS and the Corporate Governance Forum of Japan's recommendation that independent directors comprise a majority of the board,⁵¹ to the MOJ's proposal in April, 2001 that all large companies be required to have *one* independent director on their board.⁵² The ACCJ has alternatively proposed that companies be allowed to eliminate the *kansayaku* if they add outside directors that total one-third of a board's membership.⁵³

Rationale: Independent, outside directors are thought to not be as beholden to the insiders of a corporation as directors who have spent their entire career with the firm. Outside directors, having less allegiance to employees and less interest in increasing corporate perquisites, are expected to serve as the shareholders' representatives in board decision-making. The proponents of independent directors predict that they will increase corporate prosperity and limit self-dealing and agency costs.

Proponents/Opponents: *Keidanren* staunchly opposes the idea of allowing outsiders to meddle with a company's strategic planning. Instead, the organization seems to think that companies should be able to opt for outside directors should they desire them.⁵⁴ The ACCJ, CalPERS, and individual investors strongly support the revision, so long as a meaningful number of independent directors is required.⁵⁵ Caught in the middle, the MOJ and other regulators have tended to avoid the issue.⁵⁶ Even though independent directors are

⁴⁹ CalPERS Corporate Governance Market Principles, Japan, (2000) [hereinafter CalPERS Principles], available at <<http://www.thecorporatelibrary.com/docs/calpers/corporate%20governance%20market%20principles%20japan.html>>; Tett; Interview with Tony Zalom.

⁵⁰ Kobayashi.

⁵¹ CalPERS Principles; Corporate Governance Forum of Japan, *Corporate Governance Principles: A Japanese View* (interim report) (1997), at <<http://papers.ssrn.com/sol3/delivery.cfm/98041401.pdf?abstractid=76148>> principle 8B.

⁵² USG Submission.

⁵³ American Chamber of Commerce in Japan, Commercial Code Task Force Committee, *Revision of the Commercial Code – Corporate Governance*, (Feb. 28, 2001), at <<http://www.accj.or.jp/News/viewNews.asp?XID=3781>> [hereinafter ACCJ, *Revision*]; Benes.

⁵⁴ Interview with Tony Zalom; Keidanren, *Interim Report*.

⁵⁵ In one of the position papers it has circulated, the ACCJ cites a study by the Life Insurance Association that reveals that 84% of stockholding investors "believe that the most desirable and effective way to improve corporate governance would be to install outside directors to the board." ACCJ, *Revision*.

⁵⁶ Interview with Tony Zalom; ACCJ, *Revision*.

considered in the 2001 MOJ proposal, it is clear that MOJ does not fully support the idea, or it would have required something more than a single token outsider.

Comments: Whether corporations should be forced to add outside directors will probably remain a major area of discussion for the duration of the reform effort. But even if independent directors are not required by law, many corporations will probably add them voluntarily, especially those firms seeking foreign capital and listing on American stock exchanges. Even domestically, if other factors (such as cross-shareholdings and derivative suits) change, market forces might express a strong preference for outside directors.

(2) Proposal: Strengthen the role of the *kansayaku*

Description: As an alternative to adding independent directors to corporate boards, several groups have proposed that the role of *kansayaku* simply be strengthened. *Keidanren* has suggested that the number of *outside kansayaku* be increased from the current one to at least half of the total number.⁵⁷ *Keidanren* would also have the definition of outside auditor made stricter by excluding anyone who has ever worked for the corporation or its subsidiaries. The LDP subcommittee on corporate governance proposed similar changes.⁵⁸

Rationale: Advocates of the *kansayaku* system believe that *kansayaku* can fulfill a similar role to outside directors by cautioning the board when it approaches an ethical misstep. They do not believe, however, that anyone but inside directors who are familiar with a company's operations should have a vote in management matters. The ACCJ characterizes *Keidanren's* support for

strengthened *kansayaku* as an excuse to avoid adding outside directors to corporate boards.⁵⁹

Proponents/Opponents: At this point, it appears that *Keidanren* and a few members of ministry advisory committees are the only ones who still have faith in the *kansayaku* system. Foreign interests are strongly opposed to having *kansayaku* be a required element of their Japanese subsidiaries, believing that it is entirely redundant to their already outsider-dominated boards.⁶⁰ Even the MOJ appears to have lost some faith in *kansayaku*; its April 2001 proposal makes *kansayaku* optional for corporations that have majority-outsider audit committees.⁶¹

Comments: As the idea of independent directors gains support, the institution of the *kansayaku* will most likely fade away. *Kansayaku* are simply not vested with enough power and authority to prevent insider-dominated boards from doing whatever they want to do.

II. EMBRACING REFORMS - TO WHAT EXTENT?

The extent to which corporations have embraced the Commercial Code reforms remains questionable. While adherence to the legal requirements may create an illusion of compliance and rapid change, whether or not the intended results will emerge remains to be seen. The following section provides insight into the extent to which Japanese corporations have responded to the reforms as well as some of the barriers to reform that remain.

A. Responses to Deal Mechanics Proposals

1. Proposal: Facilitate mergers/corporate restructuring

⁵⁷ *Keidanren, Urgent Recommendations.*

⁵⁸ ACCJ, *Revision.*

⁵⁹ ACCJ, *Revision.*

⁶⁰ Benes.

⁶¹ USG Submission.

Current Response: Increase in M&A (Mergers and Acquisitions) activity

(a) merger procedures

i. The amendments

In an effort to provide Japanese corporations with organizational flexibility, on October 1, 1997, the Japanese government amended the Commercial Code to simplify and rationalize merger procedures. Prior to this amendment, a company was required to notify all the creditors individually of its merger plans and give them the right to raise objections. Now, a company has only to put a notice in a daily newspaper. Previously, a company also had to hold a shareholders' meeting both before and after a merger. Now, it has to hold a meeting only before a merger. In addition, a company does not have to hold a shareholders' meeting in the case of a small merger.^{62, 63}

ii. Large immediate reaction to amendments

The year following the amendment saw a strong increase in M&A activity in Japan generally, and perhaps most dramatically in the international arena, with a number of high profile acquisitions by foreign companies. Statistics estimate the increase in the number of overall M&A transactions at approximately 30 percent.⁶⁴ Average deal sizes more than doubled from about -4.8 billion yen in 1997 to -9.8 billion yen in 1998. The average size of transactions by foreign companies increased even more sharply from about -10 billion yen in 1997 to over -31.5 billion yen in 1998.

In terms of the types of transactions, the greatest growth overall occurred in the form of stock acquisitions and business transfers (*eigyo hikiuke*), including spin-offs of company business divisions. However, asset acquisitions remain a popular structure for

acquisitions by foreign acquirers, particularly where the target company is distressed or failing and the acquirer wishes to avoid assuming liability for bad assets and potential hidden liabilities.⁶⁵

iii. Decline in activity in 1999-2000

In more recent years, M&A activity in Japan has slowed down, perhaps as a result of the continuing economic slump in Japan as well as declining economic situations abroad, particularly in the United States. M&A activity in Japan in 2000 more than halved compared to 1999, according to figures compiled by Thomson Financial Securities Data.⁶⁶ Deals announced by November 2000 with a Japanese involvement were worth 104,588 million US dollars compared to 229,748 million US dollars in 1999.

iv. Reforms continue despite decline in high profile M&A activity

While the pace of M&A activity has slowed down considerably over the past couple of years, the decline in volume and number of transactions does not necessarily signify a halt to reforms. Many analysts foresee a continuation of the financial problems now afflicting the Japanese economy for at least the near- to medium-term. M&A activity will continue to increase as pressures to restructure and consolidate grow more and more intense in the times ahead.

In fact, there are strong signs that M&A activity is broadening out in Japan as corporate restructuring starts to permeate the economy. While the expected rush of foreign-led deals is not going to happen, the Japanese market continues to evolve slowly. The pace of corporate restructuring in Japan

⁶² A small merger refers to a case where the new stock issued by the acquiring company is less than 1/20 of its total stock.

⁶³ Hidehiko Nishiyama, "Japan's Regulatory Reforms: Part II," October 2000 1 (2000), at <<http://www.jetro.org/inside/10Oct2000.html>>.

⁶⁴ Grant Finlayson and Makiko Ushijima, "M&A in Japan", Orrick.com, at <<http://www.orrick.com/about/offices/tokyo/article1.htm>> (1999).

⁶⁵ Nishiyama.

⁶⁶ David Ibson, "SURVEY - FOREIGN INVESTMENT IN JAPAN: M&A 'rush hour' falls flat: INVESTMENT", *FINANCIAL TIMES*, 17 November 2000 (2000), at <<http://news.ft.com/ft/gx/cgi/ftc?pagename=View&c=Collection&cid=FTD4NZ6J2FC&title=Foreign-Investment-in-Japan&pagetag=2ctfijj§iontag=na/ctyind&gaid=001117001593>>.

⁶⁷ Ibson.

is very low compared to the United States or Europe. In Europe, M&A activity as a percentage of GDP was 18 percent last year (1999), in the United States it was 14 percent, while in Japan it was 6 percent.⁶⁷

While sizeable deal-making was dominated by banking and telecommunications in 2000, this year a number of new sectors are starting to show signs of life, such as smaller telecoms, insurance, pharmaceuticals, and vehicle parts. In addition, areas such as the hospitality industry, retailing and consumer finance are beginning to revive.

Furthermore, there are a number of short-term factors that indicate that the pace of restructuring could pick up. For example, the four leading banks' cross shareholdings in Japanese companies will continue to be unwound, freeing long-held scrip. In addition, new accounting regulations that mean assets must be marked to market for the first time should also help highlight possible acquisition targets as distressed companies are flushed out of the system. However, most bankers say the fundamental motivating force behind the creation of a buoyant and flourishing M&A market will be the eventual realization inside Japanese companies that they need to improve their returns on capital.⁶⁸

(b) M&A law - Anti-Monopoly Law

The Japanese government also amended the Anti-Monopoly Law, effective January 1, 1999, to increase the size of M&A that must be reported to the Japan Fair Trade Commission (JFTC). Before, all mergers had to be reported in advance, and acquisitions by companies whose combined assets exceeded Yen2 billion (\$18 million) had to be reported after the fact. Now, the reporting is required only when a company whose total assets are over Yen10 billion (\$90 million) merges with or acquires a company whose assets are over Yen1 billion (\$9 million).⁶⁹

As a result of this amendment, the number of M&A reported to JFTC decreased dramatically. The number of mergers reported in advance in 1999 dropped to less than one tenth of 2,300, which was the number for 1996. The number of acquisitions reported after the fact dropped from 9,400 in 1996 to 1,600 in 1999.

In addition, JFTC issued guidelines for M&A in December 1998 to clarify the application of the law and to improve predictability. The old threshold that basically prohibited mergers resulting in a market share of 25 percent or more was rescinded. Now, not only market share, but other factors are also considered, such as rank in the market, the number of competitors, and the possible emergence of new competitors. The possibility of imports is also taken into account.

2. Proposal: Reduce the level of cross-shareholding

Current Response: Falling cross-shareholding rates

Cross-shareholding rates have been gradually falling in recent years, as banks and other shareholders, forced by economic conditions to pursue higher profits, are redirecting funds away from less-productive investments in affiliated companies.⁷⁰ Since the late 1980s, the ownership structure of Japanese companies has been changing. Specifically, the shareholding by domestic corporations, especially financial institutions, has been diminishing significantly.⁷¹

The successive deterioration in share prices and profits of Japanese companies in the 1990s highlighted the costs of cross-shareholdings. Such holdings worsen efficiency in asset management and expose the asset value and profit of a holder company to share price volatility. Additionally, the damaged capital base of banks post bubble economy has made it more

⁶⁸ Ibison.

⁶⁹ Nishiyama.

⁷⁰ CalPERS, "Principles for Good Governance in Japan," Japan Market Principles, at <<http://www.calpers-governance.org/principles/international/japan/page06.asp>> (1999).

⁷¹ "OECD Corporate Governance Statistics," OECD, at <<http://www.oecd.org/daf/corporate-affairs/governance/statistics.htm>> (2000).

difficult for banks to keep a substantial amount of corporate shares.⁷² Cross-shareholding by banks heavily influenced their close relationships with the client companies, thereby weakening their ability to conduct effective monitoring of the client company management.

The reduction in the share of strategic holders has been filled by the increase of pure investment purpose holders. Among them, foreign investors have increased their share remarkably. Their share now reaches 10 percent of total stocks of listed companies. Pension funds have also expanded their holdings, though they still hold less than 4 percent. The increase of holdings by such investors translates into the erosion of the stable ownership structure, thus increasing the influence of shareholders to the management.⁷³

i. Cross-shareholding has declined

According to a report from the NLI Research Institute, at the end of fiscal year 1999, the cross-holding ratio stood at 10.53 percent in value (2.69 percent decline from the previous year), and 11.22 percent in share count (1.20 percent decline).⁷⁴ These ratios marked new lows since the survey's inception, and indicate that cross-holdings continue to unwind at a rapid pace. Similarly, the long-term holding ratio — a broadly defined cross-holding ratio which includes not only the confirmed cross-holdings but one-sided shareholdings by financial institutions, and one-sided shareholdings of financial stocks by other companies — also reached new lows of 37.87 percent in value (2.03 percent decline) and 34.71 percent in share count (2.16 percent decline).⁷⁵

ii. Both banks and business companies are unwinding

A breakdown of the decline in cross-holding ratio (value based) by shareholders

shows that banks held 1.05 percent less of business company stocks, while business companies held 0.90 percent less of bank stocks, business companies held 0.32 percent less of stocks in other business companies, and other cross-holdings fell 0.42 percent. When cross-holdings began declining from fiscal 1996, business companies first began selling bank stocks, followed by banks selling business company stocks. But in fiscal 1999, both banks and business companies are actively unwinding cross-holdings in each other.

iii. Corporate group companies are slower to unwind cross-holdings

The cross-holding ratio of companies affiliated with corporate groups fell 1.54 percent to 20.25 percent, compared to a 2.56 percent decline among non-affiliated companies to 6.77 percent. This result indicates that depressed stock prices in the post-bubble period have triggered unwinding starting with tenuous cross-holdings, which grew in the bubble period for reasons other than the conventional objectives of stabilizing management and cementing business partnerships.

iv. Keiretsu cross-holdings decline significantly

Cross-holding ratios fell 2.01 percent to 22.96 percent for the Mitsubishi group, 3.45 percent to 23.00 percent for the Sumitomo group, 3.51 percent to 16.21 percent for the Fuji group, 0.68 percent to 16.38 percent for the Dai-Ichi Kangyo group, and 2.96 percent to 14.33 percent for the Sanwa group. The sole exception was the Mitsui group, whose ratio rose 2.26 percent to 23.01 percent. But even Mitsui's ratio would have declined when excluding the extraordinary factor of change in major shareholders of group companies. The number of companies with some form of

⁷² Takahiro Yasui, "Corporate Governance in Japan and its Relevance to the Baltic Region," OECD, at <<http://www.oecd.org/daf/corporate-affairs/governance/in-baltics/yasui.pdf>> (October, 1999).

⁷³ Yasui.

⁷⁴ Hideaki Inoue, "Companies Continue to Unwind Cross-Shareholdings - The Fiscal 1999 Cross-Shareholding Survey," NLI Research, at <<http://www.nli-research.co.jp/eng/resea/econo/eco0010a.pdf>>

⁷⁵ Inoue.

⁷⁶ "Management embracing idea of outside directors," *THE NIKKEI WEEKLY*, 16 July 2001 ÷ 5 (2001), at <<http://www.nni.nikkei.co.jp/AC/TNW/Search/Nni20010716GY7H4FIN.htm>>.

confirmed cross-holdings continued to decline moderately to 2,290 companies under the new standards, or 92.6 percent of all surveyed companies (1.1 percent decline from previous year).

v. Barriers to further reform - why some may oppose less cross-holdings

Compared to cross-holding structures in which corporate shareholders act as silent partners, the expected trend toward shareholder value focused on share prices and corporate management will heighten the importance of return on equity, disclosure practices, and investor relations activities by companies. However, while these issues are crucial for Japan's corporate system to conform to global standards, their implementation will take much time. As a practical matter, concrete measures need to be considered to avoid any negative effects in the short term.

vi. Absorption of Unwound Cross-Holdings

A major concern in unwinding cross-holdings is the potential negative effect on stock prices from releasing massive amounts of previously untraded shares. Thus partly from the viewpoint of stabilizing share prices, attention has focused on measures to absorb of these shares. There are two options: share repurchases and share contributions to pension funds.

(a) *Repurchase of shares*

The fiscal 1994 revision of the Commercial Law allows share repurchases. This and the introduction of stock options are expected to alleviate supply and demand imbalances caused by unwinding. In fact, suspension of the tax on imputed dividends in fiscal 1995 made repurchases practicable for companies. Between fiscal 1996 and 1999, share repurchases of 439 companies totaling 2.34 trillion yen were reported in the *Nikkei Shinbun*. However, there was no correlation between changes in cross-holding ratios and share repurchases, and thus we cannot confirm that repurchases contributed to the unwinding of cross-shareholdings.

(b) *Contribution to pension funds*

Since the accounting rules for retirement benefits were adopted in March 2001, companies are now required to record pension and retirement lump-sum reserve shortfalls as liabilities, and amortize them over a maximum of 15 years. Sony and other companies who have adopted SEC standards in their accounting rules have already been contributing cross-held shares to their underfunded pension funds. The development of trust products and establishment of accounting rules are expected to expand the use of this method significantly, thereby helping to alleviate unwinding to some extent. However, many companies are trying to reduce liabilities through early amortization. Based on data from the *Nikkei Kaisha Joho*, planned amortization of liabilities were estimated to reach 7.57 trillion yen in the March 2001 term, but decline to approximately one trillion yen from the March 2002 term, and thus have only a transitory effect in unwinding cross-holdings.

With efforts to unwind tenuous cross-holdings almost at an end, further progress in unwinding cross-holdings will require not only share repurchases and contributions to pension funds, but addressing issues for stabilizing management such as the scheduling of annual general meetings and exercising voting rights. Unless these issues are specifically addressed, the unwinding of cross-holdings may cause unnecessary confusion to corporate management. In addition to long-term reforms in the corporate system such as enhanced disclosure and investor relations activities, Japan must also address more immediate concerns such as share price volatility and management stability.

B. *Responses to Corporate Governance Proposals*

1. Proposal: Require publicly-traded companies to add independent directors to their boards

Current Response: Independent directors and the corporate-officer system

As noted in Part I, most Japanese boards are very large and composed exclusively of

inside company executives. Such a governing body is inefficient and ineffective from the independent shareholders' point of view. In the past, the cross-shareholding system ensured many Japanese companies a majority of pro-management shareholders. As more banks which are major shareholders of their clients' companies divest of these cross-holdings, the Japanese traditional composition of the board of directors must also evolve to better serve its independent shareholders.

Key reforms aimed at improving the functioning of the board of directors include a) the introduction of independent directors and b) the adoption of the corporate officer system. The importance of the reforms of the boards of directors far outweigh those of retirement payouts for directors or the appointment of auditors, as these boards form the core of corporate governance. The following section will discuss these two reforms in turn.

a) The introduction of independent directors

According to firms listed on the first section of the Tokyo Stock Exchange who were surveyed in June 2001 by *The Nihon Keizai Shimbun*, 38 percent of the 740 companies that gave valid responses said they had appointed directors from outside their companies.⁷⁶ Only 16.9 percent of companies listed on the first section of the Tokyo Stock Exchange said they were against legislation obliging firms to employ an outside director, compared with 33.1 percent in favor.⁷⁷ Though big names like Sumitomo Chemical Co., Teijin Ltd. and the Japan Federation of Economic Organizations opposed the idea, the survey showed the practice is spreading rapidly.

Indeed news of the hiring of independent directors has become more frequent and common. More than half the board members at well-known large

companies such as Hoya Corp., Square Co., Densai-Lambda KK and Seiyo Food Systems Inc. are from outside the companies.⁷⁸ Kinki Nippon Railway Co., SSP Co. and five other firms hire more than five outside directors. Chugai Pharmaceutical Co. will soon have a former executive of U.S. pharmaceutical giant Merck & Co. join its board, while Shin-Etsu Chemical Co. will take on the former chairman of Dow Chemical Co. at the end of this month.

Some of the problems remaining despite the reforms include the following:

a. Top executives continue to dominate boards

Supervisory functions exercised by boards will not be strengthened even with the adoption of corporate-officer systems or appointments of outside directors as long as top executives continue to dominate boards. To protect shareholders, it is essential for directors to be able to press for bold management changes when performance deteriorates. Hence the need for an independent director.

b. Lack of pressure from institutional investors

There is a lack of pressure from institutional investors. Western companies have strengthened their boards' supervision of top executives under strong pressure from pension funds and other institutional investors. In contrast, even at Japanese companies that have implemented board reforms, top managers themselves have led reforms of corporate governance before institutional investors intensified pressure.

c. Lack of appropriate/experienced people

Almost all of the companies Walden, an asset management company, surveyed

⁷⁷ "Corporate Japan Moving Toward Management Reform: Survey", *NIHON KEIZAI SHINBUN MORNING EDITION* 15 June 2001 ÷ 2 (2001), at <<http://www.nni.nikkei.co.jp/AC/TNKS/Search/Nni20010615D15JF625.htm>>. [hereinafter NKS, *Corporate Japan*]

The survey was based on 740 valid responses from 1,464 companies listed on the TSE's first section as of May 28. Companies that close books in March were asked to answer based on their projections after annual shareholders meetings.

⁷⁸ NKS, *Corporate Japan*.

said that they had no independent directors and were not contemplating adding any soon.⁷⁹ Many cited the lack of qualified independent directors. While Walden’s expectation of US companies is that at least half of the directors should be independent, Walden cannot support over 90 percent of Japanese director slates due to a lack of independent directors in conjunction with little advance notice of proxy agendas.⁸⁰

d. Some other things need to change to make independent directors effective.

Last autumn, Tokyo Electron Ltd. set up a nomination committee composed of representative managing directors and directors holding concurrent posts of chairmen of related companies, giving it the authority to select candidate directors and recommend them to the board. Company presidents have generally had the exclusive right to appoint and dismiss top executives and directors. They also had considerable discretion on management decisions. But these privileges are bound to decline as shareholder rights become stronger.

An interim draft plan for Commercial Code revision emphasizes strengthening the supervisory functions of boards of directors, partly by mandating the appointment of outside directors. However, if the current system allowing presidents to act arbitrarily remains untouched, supervision cannot be reinforced effectively.

b) The introduction of the corporate officer system

A corporate officer is a person who is appointed as an executor or performer of the actual business activities in a company. The corporate officer is appointed in a board meeting, with no particular director having the discretion of removing an executive officer from his/

her position. Concurrently the senior executive officer is usually a director on the board, and the top executive officer is the CEO, which is almost the equivalent of a president of a company.

An increasing number of companies have also introduced the corporate officer system, which organizationally separates the board and the management in order to clarify the role of the board.⁸¹ The function of directors is to establish strategy or basic plan of the company and to watch or supervise its performance, while the executive officers perform everyday business operations.

Adoption of the corporate executive officer system is designed to facilitate speedier decision-making on the business front while clarifying the responsibilities,

FOR IMMEDIATE RELEASE

JT Accelerates Reforms of Management System to Enhance

Corporate Value and Corporate Governance

TOKYO, May 17, 2001 — Japan Tobacco Inc. (JT) (TSE: 2914), aiming to transform itself into “a global growth company that efficiently and effectively develops diversified, value-creating businesses,” today took new steps in its company-wide reform of its management systems. These reforms are specifically directed at enhancing corporate value and corporate governance.

The changes announced today — third stage in a series of recent reforms — aim to separate the functions of company-wide management strategy decision-making from business-operation execution and to reinforce each, in order to facilitate faster and higher quality decisions and execution.

⁷⁹ “International Corporate Governance,” Walden Asset Management : Emerging Issues, at <<http://www.waldenassetmgmt.com/social/topics/99114.html>> (November, 1999).

Walden Asset Management Nov 1999 [hereinafter WALDEN, *Corporate Governance*]

⁸⁰ WALDEN, *Corporate Governance*.

⁸¹ Yasui.

performance standards and achievement evaluation for each executive officer.⁸²

Executive officers, appointed by the board of directors, are charged with carrying out individual tasks, including corporate management, business operations, and work involving regional operations departments. While their status remains employees, their remuneration and bonuses will be commensurate with their contributions to corporate management and performance, pursuant to clarification and evaluation of their responsibilities and achievements.

A survey by *Nihon Keizai Shimbun Inc.* shows that 35.7 percent of companies listed on the first section of the Tokyo Stock Exchange have introduced corporate officer systems, while 14.1 percent are considering the same move.⁸³

In 1997, Sony Corporation adopted the executive officer system for the first time in Japan, then 180 companies among the top listed 2,500 companies followed within two and half years. Furthermore, more than 1,000 companies are observed to follow them in a couple of years.⁸⁴

The rapid diffusion of the corporate officer system indicates that a growing number of firms have reduced the number of directors to intensify discussions and quicken decision-making. Among companies which have introduced the system, Shimizu Corp. slashed its number of directors to nine from 45 in fiscal 1998, and Itochu Corp. reduced the number to 12 from 45. NKK Corp., Asahi Breweries Ltd. and Mitsubishi Chemical Corp. cut their boards by more than 70 percent from five years earlier. Daiwa Securities Group Inc., which moved into a holding company system, managed a 87.5 percent cut.

Other companies which have yet to adopt the system are nevertheless moving to downsize upper management to allow quicker decision-making. Mitsubishi Heavy Industries

Ltd. now has 27 senior managers, down from 39 five years earlier.

So far there has been no legal descriptions about an executive officer system in Japan, but as investor demands intensify in a sluggish economy, the executive officer system may be established as a de facto standard way of corporate management.

The rapid diffusion of the adoption of independent outside board of directors and the introduction of the corporate officer system can be seen in many company advertisements attempting to improve their image through advertised corporate governance reforms. The case of Japan Tobacco Inc.⁸⁵ well illustrates this point.

On May 17, 2001, Japan Tobacco Inc. released the following statement:

Highlights of the management organizational reforms included:

1. Ensuring the qualification of individuals appointed to the board and a reduction in its members from 24 to 11, already reduced from 31 last year.
2. The introduction of a corporate (executive) officer system. The role of executive officers is intended to be clearly delineated with officers being assigned responsibilities for business execution in their respective area of authority, based on the board's corporate-wide management strategy.
3. The establishment of an advisory committee. An advisory committee comprised of qualified outside individuals is intended to be established by October. This committee will advise JT on the mid-to long-range direction of company business and other important matters.
4. The reorganization of the corporate headquarters. Corporate Headquarters will

⁸² NKS, Corporate Japan.

⁸³ NKS, Corporate Japan.

⁸⁴ Kanzo Kobayashi, "Executive Officer of a Japanese Corporation" (*translated*), at <http://www.nti.co.jp/~kobakan/contents/executiveofficer_j.html> (April 2, 2000).

⁸⁵ Japan Tobacco Inc., with sales in the year ended March 31 2001 of US \$36 billion (translated at a rate of US \$1 = Yen 123.90), is one of the world's largest manufacturers of tobacco products and has three of the world's top five brands in its product portfolio. Since its privatization in 1985, it has actively diversified its operations into pharmaceuticals and foods.

be reorganized in order to produce faster and higher quality business execution. The existing alignment will be reorganized into a new organizational structure with units that have clearly defined functions aimed at increasing efficiency and strengthening various corporate functions, including communication with stakeholders, in an effort to increase corporate brand value.

JT's advertisement is typical of the companies attempting reforms in its corporate structure.

2. Proposal: Strengthen the role of the *kansayaku*⁸⁶

A few reform-minded businessmen want Japan to get rid of its system of compliant board appointments, called *kansayaku*, in favor of American-inspired independent directors. In theory, the *kansayaku* keep an independent eye on the activities of a board of directors. In practice, there is precious little objective oversight.

Reformers had been hoping that competition in the marketplace would drive out the weaker Japanese system, forcing the *kansayaku* to naturally disappear. However, the business establishment, helped by the government, is trying to avoid the prospect of truly independent directors. They hope that a currently proposed bill would weaken the shareholder-lawsuit system, strengthen the *kansayaku* and get rid of all debate about any possible alternatives.

III. NECESSARY CHANGES TO LAWS, INSTITUTIONS, & CULTURE RELATED TO THE COMMERCIAL CODE

Legal reforms occur within a larger system of laws, institutions, and culture. Isolated reforms can flounder if they are

contrary to the stream of the larger system. Are the current Japanese Commercial Code reforms and proposed reforms isolated and doomed, or are there sufficient shifts in the larger system to support the Commercial Code changes? Section A of Part III looks at tax law, accounting standards, employment law, and bankruptcy law as they relate to the Commercial Code reforms, and Section B of Part III describes the culture of disclosure and activist institutional shareholders needed to encourage the Commercial Code reform goals.

A. Necessary Reform in Surrounding Laws

1. Proposal: Facilitate Mergers / Corporate Restructuring

(a) Tax Code and Accounting Standard Reforms

Changes in the Tax Code and accounting standards are needed to support corporate restructuring by providing incentives to encourage companies to take advantage of new measures.⁸⁷

Corporate Reorganization and Consolidated Taxation Background. In Japan, tax rules regarding reorganization previously treated mergers favorably but spin-offs unfavorably. Thus, for instance, two companies, A and B, which both had appreciated assets, could merge into a single company without paying corporate income tax on the amount of asset appreciation. Once they merged, however, they could not divide into companies A and B without paying income tax at the corporate level.⁸⁸ Thus, in addition, even after Commercial Code revisions allowed corporate restructuring, the risks of considerable tax burdens arising from corporate spin-offs left the reforms unenticing.⁸⁹

⁸⁶ Yasui.

⁸⁷ Hideki Kanda, "Path Dependence and Comparative Corporate Governance: Taxes and the Structure of Japanese Firms: The Hidden Aspects of Income Taxation", 74 WASH. U.L.Q. 393, 393-394 (1996). See also *Main Points of the Report for FY 2001 Tax Reform Submitted by the Government Tax Commission to Prime Minister Mori* (December 13, 2000), at <<http://www.mof.go.jp/english/tax/tax2001/tax2001a.pdf>> [hereinafter *MOF Tax Reforms*].

⁸⁸ Kanda, 399.

⁸⁹ American Chamber of Commerce Japan, Japan-America Cooperative Conference Committee Views, "Improve the Tax System to Respond to the Internationalization of Business," (Sept. 29, 2000), at <http://www.accj.or.jp/News/view_News.asp?XID=3219> [hereinafter *ACCJ, Improve Tax System*].

Furthermore, prior tax rules regarding parent-subsidiary taxation also encouraged integration. If the business operations of P, S1, and S2 were put within a single entity, such entity could offset profits against losses. However, once S1 and S2 were maintained as separate corporate entities, there was no way of offsetting the losses.⁹⁰ Thus, for example, when a profitable firm would spin off a red-ink business, the parent's gains would increase and consequently increase corporate and other taxes.⁹¹ In effect, disincentives in the Tax Code, not simply the Commercial Code, previously constrained firms from pursuing the most efficient corporate structures.

Corporate Reorganization Tax Reforms.

Tax reforms submitted by the Ministry of Finance (MOF) were created to facilitate the corporate spin-offs allowed in the 2000 revisions to the Commercial Code.⁹² The tax rules took effect as of April 1, 2001 and allow for the tax-free restructuring of corporate operations under certain circumstances.⁹³ The new framework simplifies the legal procedures for creating spin-offs and consolidating operations, while offering tax breaks,⁹⁴ including allowing companies to carry over the profit and loss of assets transferred in the restructuring of companies under certain conditions.⁹⁵ This reform brings Japanese Tax Code more into

line with the U.S. Tax Code where companies may merge or divide without paying income taxes at the corporate level.⁹⁶ The effect of the corporate reorganization tax reform is already apparent. Firms are increasingly splitting businesses along product lines or geographical areas and spinning off unprofitable divisions.⁹⁷

Consolidated Accounting Standards Reform for Tax Purposes. In addition to the corporate reorganization tax reforms, the consolidated accounting standards for tax purposes slated to come into force in April 2002 will permit losses at affiliates and subsidiaries to be written off against income, effectively reducing total tax bills⁹⁸ and making Japanese Tax Code more similar to U.S. Tax Code.⁹⁹

The consolidated accounting standards in Japan will likely encourage more companies to switch to the holding company structure¹⁰⁰ or to spin off subsidiaries.¹⁰¹ While the corporate reorganization reforms have already made it easier for firms to spin off unprofitable divisions, the holding company structure will become a viable option upon the introduction of the consolidated taxation system.¹⁰²

In sum, the 2001 Tax Code reforms giving favorable tax treatment to reorganization and the forthcoming 2002 Tax Code reforms regarding tax-related consolidated accounting standards give businesses more options for ownership structures.¹⁰³ Without these Tax

⁹⁰ Kanda, 399.

⁹¹ "Firms Rush To Reorganize Under New Corporate Spinoff Rules", *NIHON KEIZAI SHIMBUN*, 27 March 2001, at <<http://www.nni.nikkei.co.jp/AC/TNKS/Search/Nni20010326D26JFF05.htm>> [hereinafter NKS, *Reorganize*].

⁹² "MOF Tax Reforms; FY 2001 Tax Reform: Main Points", Ministry of Finance, 20 Dec 2000, at <<http://www.mof.go.jp/english/tax/tax2001/tax2001a.pdf>> [hereinafter MOF, *Tax Outline*].

⁹³ Dean A. Yoost and Ross Kerley, "Mergers and Acquisitions: Japan", *INTERNATIONAL FINANCIAL LAW REVIEW*, March 2001, at <<http://www.legalmediagrÖ/default.asp?Page=1&cIndex=O&SID=1404&M=3&Y=200>> [hereinafter Yoost & Kerley, *M&A*].

⁹⁴ NKS, *Reorganize*.

⁹⁵ *MOF Tax Reforms*.

⁹⁶ Kanda, 399; Yoost & Kerley, *M&A*.

⁹⁷ "Corporate Spinoffs: Legislation Accelerates Corporate Restructuring," *NIHON KEIZAI SHIMBUN MORNING EDITION*, 26 June 2001, at <<http://www.nni.nikkei.co.jp/AC/TNKS/Search/Nni20010626DNBN626H.htm>> [hereinafter NKS, *Corporate Spinoffs*].

⁹⁸ NKS, *Corporate Spinoffs*; *MOF Tax Reforms*; Yoost & Kerley, *M&A*.

⁹⁹ Kanda, 398-399; Yoost & Kerley, *M&A*.

¹⁰⁰ NKS, *Corporate Spinoffs*.

¹⁰¹ John Ehara, Address at the American Chamber of Commerce Luncheon at the Tokyo American Club in Tokyo, Japan (June 6, 2001).

¹⁰² Seita Sakamoto and Akikazu Tanaka, "Verdict Out on Listing of Subsidiaries", *THE NIKKEI WEEKLY*, 15 Jan 2001, at <<http://www.nni.nikkei.co.jp/AC/TNW/Search/Nni200201155MQ1G3FIN.htm>>.

¹⁰³ Sakamoto & Tanaka.

Code reforms accompanying the liberalizing measures in the Commercial Code, companies would not have sufficient financial incentives to take advantage of more efficient corporate structures.

Share Exchange and Transfer Tax Reforms. In October 1999, to provide for the smooth restructuring of corporate groups, the Diet passed legislation allowing companies to swap stock to complete acquisitions,¹⁰⁴ and, in coordination, the MOF Fiscal Year 2001 Tax Reform introduced favorable tax treatment for such stock-swap acquisitions. It allows companies to defer recognition of gain arising from asset transfers and, thus, to defer the tax.¹⁰⁵

However, such favorable treatment extends only to transactions involving domestic entities,¹⁰⁶ while companies using foreign-listed shares as consideration are not eligible for the preferential tax treatment. This requirement makes it significantly less attractive for foreign-listed companies to engage in merger or acquisition transactions in Japan since it either renders M&A transactions less efficient when using listed shares as consideration, or may make it prohibitively expensive by forcing foreign companies to use cash.¹⁰⁷ Equal application of these tax measures to foreign and Japanese companies would encourage an increase in foreign capital investment, and, as a result, this is an area of tax law that needs to be revised to support the Commercial Code reforms.¹⁰⁸

(b) *Employment Law Reforms*

In Japan, employment is an important issue for reform as it is one of the so-called

“three ugly ducks” in the economy: excessive debt, excessive assets, and excessive employment.¹⁰⁹ As the Commercial Code reforms set the stage for corporate reorganization, they will have an impact on employment practices. In fact, corporate reorganization has already begun affecting employee compensation systems and labor unions.¹¹⁰ However, Japanese courts have consistently held that laying off workers during a business slowdown may constitute unfair dismissal.¹¹¹ If the courts continue to hold against businesses that lay off workers during slowdowns and restructuring, then companies may find it more costly to pursue competitive structures than to maintain an excessive workforce.

In only one instance have employment regulations been amended to correspond with changes in the Commercial Code. In conjunction with reforms facilitating corporate restructuring, Japan adopted the Labor Contract Succession Law, which defines rules for transfer of employment incidental to corporate spin-offs. In order to reconcile the need for orderly corporate spin-offs with the need for protecting workers, the Law obligates companies to give recognition, within a certain scope, to worker opposition to transfer of employment and to respect the wishes of workers.¹¹² Beyond this, no specific Labor Law reforms have been proposed or implemented.

(c) *Bankruptcy Law Reforms*

As one of the Commercial Code reforms’ goals is giving companies the financial and structural flexibility needed to pursue corporate restructuring, it is important to consider the bankruptcy system. A

¹⁰⁴ Sakamoto & Tanaka.

¹⁰⁵ *MOF Tax Outline*.

¹⁰⁶ American Chamber of Commerce, “Cross-Border Stock-For-Stock M&As”, (June 1, 2001), at <<http://www.accj.or.jp/News/viewNews.asp?XID=4103>> [hereinafter ACCJ, *Stock Swap*].

¹⁰⁷ ACCJ, *Stock Swap*.

¹⁰⁸ ACCJ, *Improve Tax System*; Jason Singer, “U.S. Group Urges Japan To Relax M&A Rules,” *THE ASIAN WALL STREET JOURNAL*, 31 May 2001, at M1.

¹⁰⁹ Yasuhisa Shiozaki, “Death Spiral, How To Escape It?,” Speech to International Trade and Policy Forum, Economic Strategy Institute, Washington, D.C., Apr. 27, 1999, at <<http://www.y-shiozaki.or.jp/report/report3/990427.html>>.

¹¹⁰ NKS, *Corporate Spinoffs*.

¹¹¹ “Labor Laws”, JETRO, at <<http://www.jetro.go.jp/iv/e/japan/laws/labor1.html>>.

¹¹² JAPAN EXTERNAL TRADE ORGANIZATION (JETRO), HISTORY AND DIRECTION OF AMENDMENTS TO THE COMMERCIAL CODE AND PRINCIPAL ECONOMIC LAWS 40 (2001), 12 [hereinafter JETRO].

competitive economy needs a bankruptcy law that holds failing companies accountable to creditors and yet allows them to reorganize into successful enterprises.

The Japanese bankruptcy system has seen both court-initiated changes in the efficiency of bankruptcy proceedings from around 1998, as well as legislative reforms in the bankruptcy laws themselves in 2000. First, as an example of court-initiated changes, while Japanese courts typically take more than a year to determine whether or not to begin a corporate reorganization procedure, some courts have adopted a fast-track approach in significant reorganization cases, including those for *Tokai Kogyo*, *Daito Kogyo* and other major construction companies. In these cases, the court and the administrator appointed a special advisor to seek new funding sources and were able to conclude the start of the reorganization procedure within two or three months.¹¹³

Second, the Japanese Bankruptcy Code reforms went into effect on April 1, 2000 and brought Japan's bankruptcy system closer to that of the United States. There are two key points to the new law: companies can apply for court protection before their liabilities surpass their assets, and this move needs the approval of half a company's creditors, down from the previous requirement of three-fourths.¹¹⁴ The new bankruptcy law is intended in part to facilitate the transfer of operations of a failed company to its buyer.¹¹⁵ To this end, it has opened the way for a new restructuring method that combines filing for court protection and revival through mergers and acquisitions. Indeed, the new bankruptcy law is one factor leading to the recent increase in buyout activity in Japan.¹¹⁶

2. Proposal: Reduce The Level of Cross-Shareholding

Tax and accounting measures increasing the number of individual investors may facilitate reduction in the level of cross-shareholding. Reforms and needed reforms are discussed below.

Market Value Accounting. While the Japanese economy was experiencing robust growth, appraising financial assets and stocks at the cost of acquisition was a conservative accounting practice. However, after growth rates slowed and the bubble ruptured, appraisal of assets at acquisition costs became a tool for hiding unrealized losses.¹¹⁷ The acquisition value accounting system shifted to a market value system after April 2000. Under the new system, Japanese companies are required to record their holdings of marketable property assets and securities at current market value, rather than at cost. Management can no longer buttress balance sheets with property assets valued at inflated bubble economy levels, or manipulate profits by unwinding unrealized gains.¹¹⁸ As a result, firms that have large quantities of financial assets on their balance sheets, for example as part of *keiretsu*, are seeing their profit streams more exposed to price volatility through movements in equity markets. Thus, market value accounting has added impetus to reducing cross-shareholdings.¹¹⁹

Tokkin Tax Rules. Under Japanese corporate income tax law, when a domestic company invests in another company's shares, the basis of each share of the same company must be adjusted and averaged for income tax purposes. An exception to ordinary Japanese corporate income

¹¹³ Naoki Eguchi, Yoshiaki Muto, and Jeremy Pitts, "Japan Offers Debtors and Creditors Great Options", *INTERNATIONAL FINANCIAL LAW REVIEW*, Apr. 1998, at <<http://www.legalmediagrO/default.asp?Page=1&c Index=1&SID=1860&M=4&Y=199>>.

¹¹⁴ "Bankruptcy Law Broadens Protection", *THE NIKKEI WEEKLY*, 10 April 2000, at <<http://www.nni.nikkei.co.jp/AC/TNW/Search/Nni20000410EE2KA111.htm>> [hereinafter TNW, *Bankruptcy*].

¹¹⁵ TNW, *Bankruptcy*.

¹¹⁶ Ehara.

¹¹⁷ Mitsuhiro Fukao, "Japanese Financial Instability and Weaknesses in the Corporate Governance Structure," speech at the Conference on Corporate Governance in Asia: A Comparative Perspective, for Organization of Economic Co-operation and Development in Seoul, South Korea (March 3-5, 1999) (transcript available at <<http://www.oecd.org/daf/corporate-affairs/governance/roundtables/in-Asia/1999/fukao.pdf>>) at 14.

¹¹⁸ Yoost & Kerley, *M&A*.

¹¹⁹ Yoost & Kerley, *M&A*; JETRO, 18.

tax law is the *Tokutei Kinsen Shintaku*, or *tokkin* rule which allows a company to separate the basis of the securities it holds itself and those held by the trust. Thus, a company may maintain, for example, a 100 yen basis for the first share it buys and keep a 200 yen basis for the second share purchased through the trust.¹²⁰ However, individual investors cannot take advantage of the *tokkin* rule.

Since the *tokkin* rule allows corporate investors to buy and sell a number of shares of the same firm simultaneously and thus recognize a capital gain or loss without changing the size of their stake in the issuing company, trading volume by large institutions in the Japanese stock market increased following the introduction of the *tokkin* rule without decreasing stable stockholding. It is thus plausible that the *tokkin* rule helped to increase *keiretsu* and stable institutional stockholding.¹²¹

If it were concluded that the *tokkin* rule encourages the *keiretsu* structure, then, in light of the goal to reduce cross-shareholding, it would be advisable to eliminate the *tokkin* rule for companies—or, at least, to apply it to individual investors as well.

Stock Investment Trust Tax Rules. Stock investment trusts are similar to U.S. mutual funds. However, the Japanese tax aspects of stock investment trusts are disadvantageous to individual investors. When a personal investor cashes out of an open-ended investment trust, the investor pays both the securities trading tax and a 20% withholding tax on any income. If share prices rise so that the fund has unrealized profits, and then a new investor is added but quickly cancels their account, the investor will be taxed on the unrealized profits in the fund even though they personally have not made any money.¹²² This tax deterrent combined with the tax incentive

for companies to use the *tokkin* system promotes the continued *keiretsu* structure. The Tax Code should enable personal investors to invest in trust funds under the same conditions as they invest in individual stocks.

3. Proposal: Adding Independent Directors and Revising the Role of *Kansayaku*

Accounting standard requirements that accurately reflect the financial health of a company are needed to help investors determine whether directors and *kansayaku* are making poor business decisions or misleading representations to investors.

Accounting Standard-Setting Authority. Accounting rules should be written, not by a ministry, but by a rule-writing institution with the competence, independence, and incentives to write good accounting rules.¹²³ In July 2000, the statutory authority of corporate accounting standard setting was transferred from the Business Accounting Deliberation Council (an advisory body to the Finance Minister) to a newly established Financial Agency, the FSA.¹²⁴

In April of 2001, the FSA was privatized and is now similar to the Financial Accounting Standards Board in the United States.¹²⁵ The hopes are that a private agency will be able to resist pressure from politicians who want such things as postponement of fair-market valuation of banks' long-term securities holding (discussed below).¹²⁶

International Accounting Standards. Beginning in fiscal year 1999, a new accounting standard based on International Accounting Standards (IAS) was systematically applied to publicly traded companies. These standards have had a major impact not merely on the way accounts are

¹²⁰ JETRO, 18.

¹²¹ JETRO, 396-397.

¹²² Fukao, 14.

¹²³ Bernard S. Black, "The Core Institutions that Support Strong Securities Markets," at <http://papers.ssrn.com/paper.taf?abstract_id=231120>, at 8-9 [hereinafter Black, *Core Institutions*].

¹²⁴ "Proposal for Reform of Accounting Standards Setting Body of Japan: A preliminary draft", SUB-COMMITTEE ON CORPORATE ACCOUNTING FINANCIAL RESEARCH COMMITTEE OF THE LIBERAL DEMOCRATIC PARTY, Dec. 21, 1999, at <http://www.y-shiozaki.or.jp/yasuhisa/special_e.html>.

¹²⁵ Yasuhisa Shiozaki, "Sense of Mission: Outlook for U.S.-Japan Economic and Business Relations," *THE JOURNAL*, June 2001, at 23 [hereinafter Shiozaki, *U.S.-Japan*].

¹²⁶ Shiozaki, *U.S.-Japan*.

tabulated, but on the way companies are organized and managed.¹²⁷ Internationally unified standards on corporate governance are necessary to ensure the integrity of audits and prevent improper actions by company management.¹²⁸ In addition, the IAS-like standards have also served as one element driving corporate restructuring in Japan.¹²⁹

Consolidated Accounting Standards Reform For Non-Tax Purposes. Historically, consolidated accounting played a relatively minor role in corporate disclosure because the Commercial Code allowed major accounting standards to be built around an individual company basis. As a result, managers disclosed only the details of the parent company, not those of the subsidiaries owned by larger companies. This enabled the concealment of loss-making deals and activities from the investment community by simply transferring them to subsidiary undertakings.¹³⁰

From reporting periods after April 1999, corporate information has been reported principally on a consolidated basis.¹³¹ Companies are no longer able to “cover up” losses, non-performing assets, and debt-ridden subsidiaries by excluding them from the consolidated assets statement.¹³² Instead, managers have begun to view their companies’ operations as a portfolio of businesses. As a result, there is pressure to create value at the corporate group— not just parent company level— and to restructure via, in part, divestment of sub-performing assets and companies.¹³³

B. Necessary Changes in Culture and Institutions

1. Proposal: Adding Independent Directors and Revising the Role of *Kansayaku*

To be effective, independent directors will need accurate information and the support of investors

to push for financially-sound business decisions. In addition, *kansayaku* will need accurate information, support from management, and pressure from investors to make the shift from an auditing culture of passive-endorsement to one of active review of company financial statements. Thus, the Commercial Code corporate governance reforms require more than changes in law—they require changes in institutional and individual behavior. This section provides a cursory description of the need for a culture of disclosure and activist institutional shareholders.

(a) A Culture of Disclosure

The corporate governance reforms require institutions and players who provide information and whose reputations, and corresponding success, rely upon providing accurate information. This section looks at shifts needed in the “information culture” of two groups, accountants and securities exchanges, to ensure reliable access to information for investors,¹³⁴ thus serving as a check on representations and decisions of the *kansayaku* and directors.

Accountants. Audit requirements and accounting rules are no better than the accountants who conduct the audits. Where the *kansayaku* sign off on falsified financial statements, investors have little confidence in the legitimacy of the financial statements disclosed.¹³⁵ By 1999, the internal auditing systems of Japanese companies had lost much of their credibility. In the bankruptcies of the *jusen* housing finance companies, large construction companies, and financial institutions, there were many cases where it could only be assumed that some of the accountants and auditors turned a blind eye to inaccuracies.¹³⁶

¹²⁷ JETRO, 15.

¹²⁸ “IFAC To Call For Global Corporate Governance Standards”, *NIHON KEIZAI SHIMBUN MORNING EDITION*, 15 May 2001, at <<http://www.nni.nikkei.co.jp/AC/TNKS/Search/Nni20010514D14JFF01.htm>> [hereinafter NKS, *Global Corporate Governance*].

¹²⁹ JETRO, 15.

¹³⁰ Yoost & Kerley, *M&A*.

¹³¹ Yoost & Kerley, *M&A*.

¹³² JETRO, 16.

¹³³ Yoost & Kerley, *M&A*.

¹³⁴ A more thorough discussion of information providers and reputation intermediaries looks at the press, securities analysts, accountants, securities exchanges, and investment banks; however, given the space limitations of this article, the discussion is limited to accountants and security exchanges.

¹³⁵ “Panel Drafts Accounting Reforms,” *THE NIKKEI WEEKLY*, 3 July 2000, at <<http://www.nni.nikkei.co.jp/AC/TNW/Search/Nni20000703MH407992.htm>>.

¹³⁶ Fukao, 15.

To alleviate this basic mistrust of accounting practices, the Commercial Code reform proposal regarding *kansayaku* is an important first step.¹³⁷ However, since accounting is a reputational intermediary often beyond the reach of laws, there must also be voluntary commitments by accountants to “codes of best practice” within each company and corresponding enforcement measures for those who do not adhere.¹³⁸

Furthermore, an important cultural shift is that as Japanese society becomes more litigious, it may also encourage greater adherence to accounting standards. Before the bubble ruptured it was rare for a listed Japanese company to go bankrupt, and, as a result, the risk of lawsuits was limited. However, that is no longer the case. Creditors of Japan Housing Finance, one of the failed *jusen*, sued its auditors for compensation after it failed. If these suits result in stiff penalties to auditors, then they will help restore the relationship of checks and balances between auditors and companies that is necessary for auditing to function properly.¹³⁹

Securities Exchanges. A stock exchange with meaningful listing standards, and the willingness to enforce them by fining or delisting companies that violate disclosure rules, is also an important reputational intermediary. Stock exchanges establish and enforce listing standards, including disclosure requirements, and investors use the listing as a proxy for company quality. Both investors and the exchange understand that false disclosure by a few companies will taint all listed companies and reduce the value of an exchange listing.¹⁴⁰

There are currently four main stock markets in Japan: the Tokyo Stock Exchange,

the Osaka Stock Exchange, Nasdaq Japan, and Mothers. While corporate governance has been improved in varying ways thanks to these exchanges, the adequate transparency still does not exist. Part of the problem is that the individual exchanges set the disclosure rules. The other part of the problem is that many Japanese businessmen consider revealing one’s financial information and growth strategies for everyone to see — including competitors and the *yakuza* — as foolish.¹⁴¹

Given the aversion to revealing financial information and the choice of four exchanges, if one exchange’s disclosure requirements are too daunting, companies can flock to a competing market. Nasdaq Japan, recognizing this ingrained attitude, made some compromises when it began. For example, whereas the U.S. Nasdaq requires at least three independent outside directors on the board, Nasdaq Japan doesn’t require any. This problem should be addressed; the Securities and Exchange Surveillance Commission, for example, might be given more authority to produce a uniform set of standards to which all companies would have to adhere.¹⁴²

(b) *Activist Institutional Shareholders*

In addition to information providers and reputational intermediaries, activist shareholders are key actors needed to promote Commercial Code reforms. While institutional investors cannot directly control self-dealing, they can initiate derivative suits, exercise their voting rights in companies in which they have invested, increase disclosure of information about those companies, threaten to sell off shares, and raise corporate governance issues through shareholder proposals and informal dialogue.¹⁴³ In short, as cross-shareholdings unwind,¹⁴⁴ market pressure from institutional investors will increasingly be crucial in

¹³⁷ NKS, *Global Corporate Governance*.

¹³⁸ Fukao, 15.

¹³⁹ Fukao, 15.

¹⁴⁰ Black, *Core Institutions*, 13.

¹⁴¹ Steve Mollman, “Going Public in Japan: Warts and All”, *THE JAPAN INC NEWSLETTER*, 18 April 2001, at <<http://www.japaninc.net/newsletters/index.html?list=jin&issue=129>>.

¹⁴² Mollman.

¹⁴³ Black, “Core Institutions”, 32; “Why Corporate Governance Today?”, at <<http://www.thecorporatelibrary.coÖ/081495why%20corporate%20governance%today.htm>> [hereinafter *Why Corporate Governance*].

¹⁴⁴ “ANALYSIS: Pressures Build To Increase Shareholder Value”, *NIHON KEIZAI SHIMBUN MORNING EDITION*, 11 July 2001, at <<http://www.nni.nikkei.co.jp/AC/TNKS/Search/Nni20010710D10JFF05.htm>> [hereinafter NKS, *Shareholder Value*].

holding directors accountable for their decisions and *kansayaku* accountable for their representations. This section focuses on private pension plans and stock investment trusts as institutional shareholders.

Japanese Pension Fund Reforms. Pension funds in Japan have the potential of acting as institutional activist shareholders, particularly in light of two recent reforms.¹⁴⁵ In one set of reforms, funds are moving from being controlled by the MOF to private funds that are open to management by foreign asset managers.¹⁴⁶ Private managers will likely focus on investing for returns and, thus, assert pressure on companies to shift to more competitive structures that produce a higher return for their investments.

In a second set of reforms, employers may begin offering defined-contribution rather than defined-benefit plans to their employees.¹⁴⁷ It is likely that as employees contribute and invest their own pension money, large amounts of domestic pension fund money may move into the capital markets.¹⁴⁸ As employees focus on the return on their profit, then they will likely exert a stronger pressure on the pension funds handling their money, insisting on disclosure requirements of both asset management performance and its investment process.¹⁴⁹

Foreign Pension Funds. Pension plans in the United Kingdom, the Netherlands, Canada and the United States are becoming massive investors in the equity securities of foreign countries. The liberalization of

investment restrictions in Japan has conferred economic power on those countries having liquid investable funds.¹⁵⁰ In foreign markets, including Japan's, pension funds use indexed trading and many note that corporate governance is one of the few active mechanisms that may be used to enhance the indexed returns.¹⁵¹ Thus, in many instances, it is foreign institutional investors who are a vigorous force for change of the governance of domestic companies.¹⁵²

Japanese Stock Investment Trusts. Because corporate pension funds and life insurance companies will not be able to buy up all of the shares unwound from dissolution of the interlocking shareholding due to risks associated with asset investments, the individual sector may replace those larger investors. As a result, stock investment trust services will be of growing importance as individuals increasingly use them to diversify their investments.¹⁵³ A stock investment trust industry can perform as an activist institutional shareholder and demand strong disclosure.¹⁵⁴

Foreign Investment Funds. An increasing number of investors in Japan are foreign shareholders.¹⁵⁵ Whereas companies previously turned to their banks to explain earnings results after financial statements were prepared, now, after annual shareholder meetings are completed, the top management of many companies holds meetings with overseas institutional investors.¹⁵⁶ A growing number of firms discuss operating

¹⁴⁵ Nagamori.

¹⁴⁶ Yasuhisa Shiozaki, "The Politics of Reform and Japan's Pension Industry" Speech to Members of the House of Representatives, Japan Society, New York, Sept. 18, 2000, at <<http://www.y-shiozaki.or.jp/report/report3/00918s.html>> [hereinafter Shiozaki, *Japan's Pension Industry*].

¹⁴⁷ "Upper House Approves Bill To Reform Pension," THE JAPAN TIMES ONLINE, 9 June 2001, at <<http://www.japantimes.com/cgi-bin/getarticle.p15?nb20010609a1.htm>>.

¹⁴⁸ Leo C. O'Neill, President of Standard & Poor's, "How Good Corporate Governance Practices Can Lead The Reform of Japan's Business and Financial Systems," American Chamber of Commerce in Japan, Tokyo, June 13, 2001.

¹⁴⁹ Shiozaki, *Japan's Pension Industry*.

¹⁵⁰ "Corporate Governance and Pension Plans: If One Cannot Sell, One Must Care—Positioning Pensions for the Year 2000," 5 May 1995, at <<http://www.lens-library.com/info/whar5.html>> [hereinafter *Wharton Pension*].

¹⁵¹ *Why Corporate Governance*.

¹⁵² *Wharton Pension*.

¹⁵³ Fukao, 4.

¹⁵⁴ Black, *Core Institutions*, 18.

¹⁵⁵ Fukao, 12.

¹⁵⁶ NKS, *Shareholder Value*.

issues with these investors, bringing their proposals to the table at the internal company meetings. A fund manager at a foreign-affiliated asset management firm noted that some executives are using the “voice of overseas shareholders” as a way to push through internal reforms that would not succeed if advocated by the manager alone.¹⁵⁷

IV. CONVERGENCE TOWARDS AN ANGLO-AMERICAN SYSTEM OF CORPORATE GOVERNANCE?

The collapse of the bubble economy and intensifying globalization facilitating rapid capital flows have forced Japanese corporate governance and its surrounding environs to adapt to a deregulated world. Without this deregulation, Japanese companies face tough competition in the international markets. Japanese companies must now adapt to a more shareholder-centered system of corporate governance to raise funds and remain competitive by adapting to the rapid changes of an international market. The changes that ensued form the crux of this paper.

Is there convergence from a Japanese system of corporate governance to an Anglo-American system? According to Bebchuk and Roe, despite the growing power of

competition in international markets and globalization, rapid and complete convergence is not a given.¹⁵⁸ Local rules affect governance more than things like production technologies. They argue that these local rules are more stagnant and difficult to change. Some of the barriers to more rapid reform include some strongly embedded forces in Japanese society. As noted in Part I, the foundations of a stakeholder based Japanese system of corporate governance have been built over time, thereby creating tough barriers to reform. Indeed some scholars remain skeptical of convergence for these very reasons. Yet in Japan, we are seeing change in these very areas: local rules. Given the evidence, it is difficult to argue that the rigid nature of local rules combined with complementarities nurtured over time create stability, as there is much evidence of change in these local rules.

This leads to the question why - why these changes and why now? Perhaps the depth and length of Japan’s economic slump has finally forced changes of this magnitude. Unfortunately, answers to these questions are beyond the scope of this paper. But in terms of convergence, the direction of change is certainly towards and Anglo-American one. Whether or not there will be a complete convergence is uncertain, and perhaps doubtful in the near future.

MARK POE is a third year student in Stanford University's Law School. KAY SHIMIZU is a PhD student in the Department of Political Science at Stanford University. Her research interests include the political economy of Japan and Greater China. JEANNIE SIMPSON is a third year student in Stanford University's Law School. Upon graduation, she will join Morrison and For-ester in Tokyo.

¹⁵⁷ NKS, *Shareholder Value*.

¹⁵⁸ Lucian Bebchuk & Mark J. Roe, “A Theory of Path Dependence in Corporate Ownership and Governance”, in *CORPORATE GOVERNANCE TODAY 565* (The Sloan Project on Corporate Governance at Columbia Law School, 1998).