Corporate Governance in Japan: Government Regulations*

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1. Introduction

The purpose of this paper is to review and evaluate recent regulations and amendments adopted by the Japanese government that will affect corporate governance. The conclusion of this review is based on several interviews taken in Japan as well as from published Japanese sources. These amendments will be reflected from within the Japanese business environment and their impacts will show how companies react to these regulations. As the economy is still in recession since the implosion of the bubble economy 13 years ago, the Japanese government is well aware of the positive effects that any amendments or changes can have on the system of corporate governance. The law presupposes that shareholders will exercise their prerogatives as defined under corporate law tin order to keep a check on top management. However, in reality, the practice of employee sovereignty seems to avoid this legal definition, so there is in effect, no really effective mechanism for checking top management (Fujihara 2003/Itami 2001). Accompanying this discussion there is a growing M&A (Mergers&Acquisitions) Market for the whole Japanese economy (Muramatsu 2002). In 1999, the previous Ministry of Trade and Industry published a paper recommending improving foreign direct investments (Ministry of Trade and Industry 1999). The focus was directed towards such items as:

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* Renewing management and technical systems
* Increasing the number of workplaces
* Better satisfied consumers
* Establishment of stronger international economic relationships

Historically, Japanese companies defined corporate governance goals more widely than mere creation of shareholder wealth, as is the case in the USA. In Japan companies are viewed as enduring social organizations, concerned with its market share and the size of the company. Suppliers and major clients are often times linked to the firm through a system of cross-shareholding and other measures designed to keep stability within the company and its associated client base (Van de Berghe/De Ridder 1999). This led to corporate rigidity and a strict adherence to the status quo rather than adapting to changing market needs.

Therefore, in order to create a needed economic recovery, the government amended several laws that were designed to produce a more efficient corporate governance structure. One of the major intentions was to improve the poor performance of many Japanese companies and to prepare them to better compete in the home market and also in the world markets. Since 1997 several major legal changes concerning corporate governance have been implemented. The purpose of this paper is to examine and discuss the actual effects these amendments have had on corporate governance in Japan.

2. Problems in Business Environment

In the previous decade Japan faced several economic problems at the same time (Matsuba 2001). Apart from the banking crisis with its corporate debt and bad loans problems, other non-banking companies were regarded as inflexible entities because there had never been a functioning market for company control (Bouissou 2002). Japanese companies relied traditionally on keiretsu and the main bank within their business structures for securing finance. However this very structure led to a climate of corporate secrecy and a virtual policy of non disclosure or at best, limited financial disclosure. Whereas during the rapid growth era of Japan's economy, this type of corporate governance secured and maintained market share, but in a sustained downturn and shrinkage of the total market, these previously helpful institutional settings became responsible for the shortcomings in corporate financial disclosure (Teramoto/Sakai/Nishimura 1997; Saito 2000).

The keiretsu, especially the six largest groups, still play a major role in the Japanese economy in the 1990s (Kensy 2001). The companies within the keiretsu maintain close relationships through a series of cross-shareholdings (Breuer 2002). These shares are simply maintained as securities within the company's holdings and essentially become illiquid. Furthermore, there is a series of interlocking directorates as well as regular company presidents' meetings for coordinating the group as a whole (Menden 1999). Within this network, the flow of information is limited to within the group itself, and is not disclosed to anyone not connected to the keiretsu. This means that for investors, there is no incentive to invest money in this kind of company, as there is a distinct lack of full disclosure (Teramoto/Sakai/Nishimura 1997). An anomaly is that for the keiretsu companies themselves, their internal share prices paid to members are often higher than actual market prices.

Since Japanese companies historically relied more on debt rather than on equity as their primary financing source, financial information was sent to financial institutions and to related companies within the keiretsu only. Individual stockholders and potential investors did not receive this information. Even as late as the 1990s, to meet their financial needs Japanese companies still relied much more on borrowing money from banks—than through the equity market itself (Gordon 1999). The debt ratio for Japanese companies has been at around 40-60% of their total financing, a much higher ratio than that of equivalent companies in the USA, or even in Germany. Financing tool through issuing new shares accounted for less than 10% of financial raisings in Japan (Itami 2001).

Bad loan policies from financial institutions have attracted a lot of attention not only throughout Japan but also in the world. Traditionally many banks relied on company statements and tacit promises to pay without checking the company's ability to pay or secure their loans. That brought a financial crisis not only to banks as many of their credits turned out to be losses, but also to industrial companies as well. Technically many of these companies were insolvent yet still continued to trade, especially these of the horizontal keiretsu (Menden 1999). These companies sometimes were not able to obtain suitable credit yet could ignore this problem without any feeling of wrong doing.

There are many academic initiatives that illustrate the relationship between good Corporate Governance practices and company performance. It is believed that both belong together. For example the Japan Corporate Governance Index Research Group (JCGR) established an Index of recommendations of how to act best for a company. A questionnaire was sent to about 1.500 Japanese companies listed on the stock exchange. The answers from this questionnaire showed that companies following good Corporate Governance practices are in a better economical position than those who did not follow such practices (Wakasugi/Ahmadjian).

Most economists agree that cross shareholding has seriously weakened the effectiveness of Japanese corporate governance. Therefore, as stable shareholding weakened in 1990s, institutional investors were becoming more important. Within Japanese companies corporate governance is handled in many unique ways. The Boards of Directors usually consist of a very large number of people. Sometimes there are more than 40 directors who have been promoted internally as part of an institutional promotional process. With operational business company executives or executives of financial institutions often keep close and friendly relationships to other institutions. There is a lack of efficient control because of a lack of a sufficient number of outside directors.

Virtually, there are no non-executive directors among the board members as well as there being no independent auditor among the auditors (Muramatsu 2001). The problems stemming from this arrangement is that often these auditors or board members are financially dependent on the company or else were previously employed by the company they now have been elected to control. These factors make it difficult for outside directors to work independently in dealing with an old boy network of fellow board members. Thus, this lack of corporate governance has been identified as a major negative feature of Japanese management (Ohtsu/Imanari 2002). These problems of corporate governance finally led the Japanese government to enact and amend several laws. These laws will be discussed in the following section.

3. Amendments and Revisions by the Japanese Government

3. 1. Amendment of holding company law.

In 1997 the Anti-trust Law was amended so that holding companies could be established again (Muramatsu 2002). This system of corporate governance had been prohibited by the United States Occupation forces after World War II because of the fear that Japanese companies concentrated too much power into a minor group of a few very big players and limited the scope of competition and ability to raise finance of other companies that had no connection to these groups. To give a basic understanding of this practice: In contrast to investment companies and investment trusts, the intention of a holding company is to hold control over a group of distinct companies. The directors of the holding company normally form the board of director members from within the boards of the controlled companies.

Under the revised law, independent companies can be formed again into holding companies and subsidiaries can easily be switched to other companies. So it is possible to integrate companies into one organizational structure, but even more important for many companies today, is that they are now able to divest into separate companies. There is a strong belief by the government that the introduction of the new holding company system can accelerate the speed of M&A in Japan. The number of holding companies had increased from 12 in 2000 to 27 in 2001 (MARR 2002). It is estimated that holding companies will also increase as a consolidated tax regime has started on August 1st, 2002. This means Holding companies may pay a consolidated national tax, only local tax has to be paid separately by each member (Arai/Ponting 2002). This means a considerable savings in company taxes but more importantly, a considerable smoothing of corporate governance because instead of each member company being treated as a separate tax identity, the group as a whole is treated as one holding company.

3. 2. Introduction of stock swap system

In August, 1999 the Commercial Code concerning the stock swap system was amended. This amendment cleared the way to accelerate the forming of holding companies. Since a deal within a holding company does not have to be paid for entirely in cash, this shift has profound ramifications for shareholders of both sides, the side doing the acquisition as well as the side being acquired. In a cash deal both parties are easy to distinguish because there is the exchange of money for stock. That deal completes a simple transfer of ownership. In a stock-swap it is more difficult to distinguish, who is the actual seller and who is the actual buyer. It can happen that the shareholders of the acquired company end up owning the majority ownership from the company who was actually the buyer. The difference between a cash deal and a stock swap is not only in the flow of money. In a cash deal the buyer's side carries all the risk. On the other hand, in a stock swap, that risk is shared equally with both the selling shareholders side (Muramatsu 2002).

The Stock swap system clearly has its advantages for the Japanese economy. Many Japanese companies lacking sufficient capital or appropriate access to the market for raising capital, a stock swap means a new way for participating in other companies. Within itself, a company can profit extremely well if their market share is at high price. However, the complexity of the stock swap system is not always to be recommended. It needs to be examined on case by case basis. If the swapped stocks held by the company decline in market value, the company does not always value these shocks accordingly but carries them at the value they were nominally swapped at.

Since the new system has been introduced, stock swaps have increased from 20 cases in 1999 to 46 in 2000 and to 53 in 2001. From January 2002 until March already 22 cases were reported (MARR 2002).

3. 3. Amendment of spin-offs

In June 2000 the Diet passed a bill for revising the Commercial Code in the field of spin-offs. As a company spin-off is the opposite of a company consolidation, it should become easier for companies to streamline their activities. Under the revised code, unprofitable divisions or divisions no longer belonging to core fields can be more easily transferred or sold to other companies or investors. Spin-off activities were introduced in 1997, so that means, in contrast to the holding company law and the stock swap system, it is not really a new development but rather a further development of recent steps taken by the government.

As a company spin-off needs to be approved by the Board of Directors, this decision needs to be approved at a general shareholders' meeting (Bebenroth 2003).

Two types of corporate breakups are covered under this amendment. In the first type of break-up, when a division is spun-off to a new company, a special plan needs to be established. The second type is the takeover of a division by an already existing company. In this second case the transaction will be formalized by a written contract.

Previously, before the amendment of the Commercial Code in the field of spin offs, the assessment had to be done by a court appointed lawyer (Bebenroth 2003). That always took a very long time from six months to one year, to achieve. However, if the spin-off division needed to stop this operation during that time, then, the process became extremely complex. So this amendment makes it far more economical and less complicated to spin off unprofitable or unwanted divisions.

3. 4. Market based Accounting

Japanese accounting traditionally focused on asset valuation at cost rather than on market value. The internationalization of capital markets and accounting standards as well as the rapid innovation in financial markets played a major role for developing new accounting standards. Already Prime Minister Hashimoto announced major financial systems reforms in November 1996 for "free, fair and global" markets and to counteract a decline in financial markets accountability (Gordon 1999).

In March 2001 the market based accounting system was introduced for companies listed on the Japanese stock exchange required to report at the beginning of March 2002. The new consolidated accounting system promotes transparency and it will be harder for Japanese companies to hide losses in subsidiary firms. It can be argued that internationally oriented companies may benefit from international standards of market based accounting, however, others might become more vulnerable to balance sheet volatility.

For foreign investors market based accounting has advantages because the balance sheet of the targeted Japanese company now gives far more valuable information than before. Now companies can be checked as to where they make losses and also where the companies make money. Also, whether or not the company has bad loans or other liabilities can be readily ascertained under this new system.

3. 5. Amendments in Stock Options

Since April 2002 the Japanese Commercial Code introduced new amendments in stock options. However, the system of Stock Option is not really a new model for Japan. Empirical evidence of shareholder value is unsolved so far (Winter 2001). According to this reform the board of directors can provide stock options to shareholders and to employees.

By means of these holders receiving the right of obtaining future stocks which are tradable on their own as "Naked Warrants", as has been the case in the USA for many years. An investor is now able to acquire a company through Naked Warrants without getting a majority holding from the very beginning. In some reported cases, the first step is for investors to buy 34.4% of the shares to get de facto control over the company. The advantage for the investor is that he does not have to consolidate all of the debts from the 34.4% acquired company at the beginning of the transaction. After the performance and the figures of the acquired company have improved, a full consolidation of the target company is therefore possible.

Through the introduction of stock options investors receive the right of easily acquiring more shares at a later date. From a juristic point of view, it is a very easy way to affect a company transfer. In April 2002 new amendments were introduced, especially to foster the venture capital business (Musahl/Witty 2002). A venture capitalist now is able to receive the rights over the target company without a real transaction having taken place.

The new guidelines are as follow:

* Previously only the board of directors was allowed to receive stock options (Art. 280-19, jap. CC, old version). Furthermore, in order to transfer stock options, an adequate reason was necessary. From April 2002 both restrictions were eliminated.
* Previously the name of a new recipient of Stock Options had to be announced at the Shareholder assembly (Art. 280-19-2, jap. CC, old version). Now, the board of directors can directly announce the name of the person.
* Previously the stock option was limited in time (Art. 280-19-4 jap CC, old version). So the option of receiving shares was limited to 12 months and the time horizon of buying shares with that option was limited to 10 years. Both limitations have been dropped.
* Previously, the amount of purchase of stock option was limited to 10% of outstanding Shares (Art. 280-19-3 jap. CC old version). This limitation is no longer valid anymore.

4. Impact on Companies

The Japanese economy has always been full of contrast. Historically, the economic situation of today is quite unique. There has never been such an interesting fiscal year for Japanese companies as the one ending in March 2002. While Toyota and NTT DoCoMo were the first Japanese companies to be able to report an operative profit of over one thousand billion Yen, traditional companies like NEC and Osaka's Matsushita faced the highest losses in their history. NEC finished the fiscal year with a loss of 56 billion Yen and Matsushita reported a loss of 212 billion Yen. In spite of that dream result of daughter company DoCoMo, NTT faced a consolidated operative loss of 812 billion Yen (Waldenberger 2002).

Many companies had changed from an internal control system to a market oriented corporate governance system. As one of the forerunners of this system, Sony, recently changed its company-structure. In the new Board of Directors there are now seven inside directors and three non-executive directors, one of them is a foreigner. But even more dramatically was the change of the number of board members, this number decreased from 38 to only 10 (Muramatsu 2001).

The M&A market also increased in the year 2002. Overall, the M&A market of 2002 increased for more than 25% to 2244 transactions, on the other side, about 2000 companies went bankrupt (Asahi Shinbun 2003).

The impact for Japanese companies differs markedly in regard to the big players and to the small and medium sized companies (SMC). While many big Japanese players are very profitable, small and medium sized companies often fight for survival (Teramoto/Harada 2001). While the big companies use the amendments to restructure and to become more competitive, SMC's often end up selling their entities because these companies are not listed on a stock exchange and traditionally got loans from banks. As banks themselves face economic problems and cannot provide credits, SMC's themselves in turn face a lack of liquidity because of the banks unwillingness to extend credit.

Another phenomenon is that in Japan, many SMC's are normally run by their founders. These founders do not intend to extend their businesses, but maintain what they have established. When these owners are ready to retire, they need to look for a successor (Muramatsu 2002). But as young people do not want to take the risks and pressures connected to these companies, many SMC's are ready to be sold. Some company transactions have been reported in the pharmaceutical and construction industries as well as in retailing and wholesaling.

The ownership of companies changed as banks began to unwind the cross-shareholdings (Brickley/Coles/Link 2001). Many companies have started to buy back their own shares. Also, many companies have aggressively been purchasing their own shares on the market so as to prevent a further decline in the share price. On March 31, 2002, 51% of the 1.842 listed companies had a decline of ownership by financial institutions compared to six months ago (Nikkei Weekly 2002).

There are many reasons for foreign companies to participate in Japanese firms through acquisition (Thomas 2002). Not only some Japanese firms but whole industries face economic difficulties. In any case, foreign investors are attracted by the huge Japanese market. It can be shown that direct investment by foreign companies in Japan increased rapidly in the last years from 1997 on (Bebenroth 2001). Before 1997, on average, 30 direct investments from outside investors were reported. By 1998, that number had increased to 85 and from 1999 on the number rose to 129 cases. In the years 2000 and 2001, 175 and 176 cases were reported respectively. In 2002, a further 129 acquisitions were made by foreign companies in Japan (MARR 2003).

There are several plausible reasons for this development. On the one hand it is thought many foreign investors wanted to enter the Japanese market but previously could not get a chance of acquiring a company because none were in such a bad shape to be sold. On the other hand, because of the government amendments, foreign investors could now feel safer in targeting companies, because the whole system became more transparent for foreign investors than it had been the case previously. In short, economics or financial difficulties meant that many Japanese companies are not able to survive without new investors. Therefore foreign companies can now participate in Japanese firms through acquisition or stock purchases.

5. Conclusion and future outlook

Through these amendments the Japanese government aims to revitalize the economy in the way it was before the bursting of the bubble economy. In recent years, remarkable amendments were implemented in corporate governance in Japan. The formation of holding companies has increased together with a sharp rise in stock swaps as well as spin-offs and stock options.

Japanese financial institutions were aware of bad debt problems within banks and companies and started to decrease ownership. They sold down stocks which were in turn bought back by the companies. The previous flexible contacts based on mutual trust changed into a market based best solutions. And top-management became aware of the need to pay attention to the public and to disclose performances and results of their companies. As an example, recently Japanese car makers have issued recall notices about certain products in contrast to a previous policy of absolute denial of responsibility.

Recently, there has been a visible increase in M&A activity. So, the aim of revitalizing the economy by means of amended corporate governance is being accomplished and company transactions can now be seen to be open and transparent. While the changes in corporate governance have some affect in revitalizing the economy, there are still many other interconnected problems that need to be vigorously addressed by the Japanese government. The problem of bad loans is perhaps the most outstanding. No matter how good the law is on corporate governance, if there is no provision for raising capital and attending to risk and bad loans, then these laws will not produce the changes that they are intended to accomplish.

Whenever Japan has been challenged from abroad, historically it has always ended up economically stronger and wealthier than ever before. That was the case in the Meiji-restoration, in the period after the end of World-War II and there might be now a similar situation caused by globalization. The changes in corporate governance laws enacted by the government do demonstrate that Japan and its economy are ready to compete at home as well as in the world.

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