Recent Japanese Corporate Governance Reform & Its Challenges

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Introduction

Today the Japanese government is making a serious effort at corporate governance reform modeled on highly developed Western systems in order to attract inward investment from foreign investors. However, the ownership structure of Japanese corporations has been transformed since the economic bubble burst in the early 1990s, and the process of shareholder meetings has also changed accordingly. These changes indicate that institution-based monitoring systems in Japanese corporate governance have already begun to work much better than before.

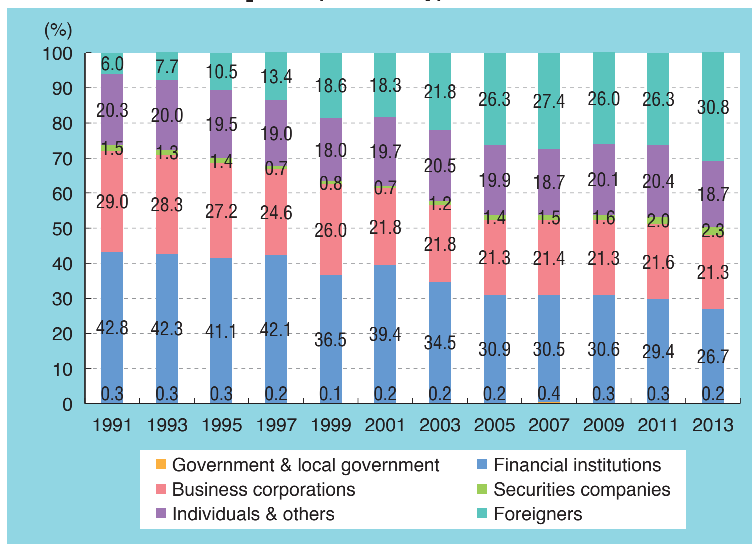
Function of Market-based Monitoring Systems in Japanese Corporate Governance

Since the 1990s the Japanese corporate governance system has been reformed in a way that has fostered the functioning of market discipline. Cross-shareholding is one of the main features of traditional Japanese corporate governance, and this stability in shareholding has hampered the function of market-based monitoring systems in Japan. However, since the collapse of the economic bubble, and with the progress of regulatory reforms of the banking system, banks and corporations have progressively sold the shares that they used to hold mutually. These shares have been bought mostly by foreign investors ("Institutional Investors and Reform of Corporate Governance" by Nobuo Sakuma, *Soka Keiei Ronshu*, Soka University, 2009 (Japanese)).

The *Chart* shows the transition of ownership structure among Japanese listed corporations for the last 20 years. Financial institutions and business corporations held over 70% of the shares of all Japanese listed corporations in 1991, but the ratio has fallen to 48% as of 2013. On the other hand, the shareholding percentage held by foreign investors including both institutional and individual investors has increased up to five-fold — by 30.8% — during the same time span.

CHART

Transition of shareholding ratio by type of investor in Japan (Biennially)



Source: Compiled by author using data from the Tokyo Stock Exchange, Nagoya Stock Exchange, Fukuoka Stock Exchange, & Sapporo Securities Exchange.

With this change of ownership structure, the presence of institutional investors in the Japanese corporate governance system has increased. The number of companies adopting anti-takeover measures has rapidly increased since the late 2000s in a reflection of the changing market environment, such as the lifting of the embargo on forward triangular mergers and the rise of foreign institutional investors. However, foreign shareholders are becoming more powerful, and it is harder for the Japanese corporations to wave aside their opinions. Although many corporations still adopt anti-takeover measures, some corporations have started

TABLE

Transition of reality of shareholder meetings in Japan (Biennially)

Year	91	93	95	97	99	01	03	05	07	09	11	13
Average time (minutes)	29	29	28	29	33	39	43	48	55	54	54	52
Shareholder meetings over two hours (number)	18	24	24	22	28	44	65	92	117	106	99	77
Companies trying to set meetings on the same date as other companies' meetings (%)	44.1	41.5	60.1	50.8	34.9	29.5	25.9	19.3	10.6	10.3	10.0	9.4
Meetings without statements by shareholders (%) *	87.5	85.0	86.7	81.0	72.9	61.2	55.6	48.2	39.7	37.4	34.6	33.4
Meetings without questions by shareholders (%)	93.5	91.2	90.7	87.5	81.1	75.5	72.6	69.3	63.4	65.5	61.0	65.4
Meetings without constraints on statements by shareholders (%)	9.8	12.4	11.8	18.2	25.3	35.6	39.6	47.2	53.8	56.1	60.6	89.3
Companies receiving negative statements such as "No" from foreign institutional or major shareholders (%) **	N.A.	5.3	12.1	11.5	19.2	22.9	43.7	55.7	59.3	58.8	58.5	62.7

** Excluding simple statements such as "Iginashi" (Agreed) and "Sansei" (Yeah)*
*** Including domestic institutional shareholders after 2003*
Source: Compiled by author using data in Shoji-Homu Kenkyukai (Japan Institute of Business Law), White Paper on Shareholder Meetings [Kabunushi Soukai Hakusho]

to demolish such measures autonomously to deal with foreigners' growing influence.

The recent announcement of Japan's Stewardship Code by the Financial Services Agency will further encourage market discipline to work more properly in the Japanese corporate governance system. This code adopts a "comply or explain" approach, and requires institutional investors to take responsible actions, such as disclosure of policies and results of voting activities.
(http://www.fsa.go.jp/en/news/2014/20140610-1.html)

Resolution of the Issue of Shareholder Meetings in Japan

There has been substantive progress in the democratization of shareholder meetings as the necessity for Japanese corporations to consider the interests of new shareholders, namely foreigners and other individuals, has increased since 1990s. The undemocratic process of shareholder meetings, such as huge constraints on statements made by shareholders themselves, the concentration of meeting dates, and the short length of the meetings, had been a serious problem in Japanese corporate governance. Among the companies listed on the Tokyo Stock Exchange, the percentage of companies having shareholder meetings on the same day has now decreased from 95.5% in 1996 to 38.7% in 2014 (Tokyo Stock Exchange, *Chart of the Transition of Concentration of the Dates of Shareholders Meetings [Kabunushi Soukai Syuchuuritsu Suii Graph]*, 2014).

The *Table* shows the transition of the reality of shareholder meetings among Japanese listed corporations biennially since 1991. As of the late 2000s, the average time of meetings has increased to about 50 minutes, about twice as long as the 29 minutes in 1991. The number of companies spending more than two hours for shareholder meetings began to increase rapidly after 2000, and exceeded over 110 in 2007.

Although the length of shareholder meetings hit a ceiling in the late 2000s, intensifying discussions at meetings still continue today. The number of companies whose shareholders neither ask questions nor make statements at the meetings has decreased since the 1990s. In particular, the percentage of meetings without statements being made by shareholders has fallen considerably from about 87.5% in 1991 to 33.4% in 2013.

Japanese corporations began to be aware of the growing necessity for democratization of shareholder meetings against the backdrop of the changes in ownership structure. The number of companies trying to schedule meetings on the same date as other companies has decreased from 44.1% in 1991 to 9.4% in 2013. The percentage of corporations not restricting the right of shareholders to make statements at meetings has also increased from 9.8% to 89.3% during the same period. Thus the reality of shareholder meetings has been ameliorated over the last 20 years.

Delayed Reform of Corporate Boards of Directors in Japan

The board of directors is an essential corporate

governance body for monitoring management, just as important as shareholder meetings. It is independence that is necessary for the board to monitor management objectively. However, the level of independence of boards in Japan falls woefully short of the advanced standards in Western countries. As of 2013, there are two types of corporate structures in large Japanese corporations — companies with audit and supervisory board members (*kansayaku secchigaisha*) and those with three committees (*iinkai secchigaisha*).

Most Japanese corporations have audit and supervisory board members, but companies adopting this structure do not need to take in outside directors at all. Among companies with audit and supervisory board members, the percentage of corporate boards without outside directors has decreased from 55.9% in 2008 to 46.3% in 2012 (*TSE-Listed Companies White Paper on Corporate Governance 2013*, p. 24). However, in the United States and many European countries, listed corporations are generally required to realize a majority of independent directors on their boards.

On the other hand, companies with three committees modeled on the US corporate structure were introduced in the early 2000s, being required to employ at least two outside directors. Companies adopting this structure must set up audit, nomination, and remuneration committees, and the majority of the members of each committee consist of outside directors. However, it is a fact that only about 2% of companies listed on the TSE have adopted this type of corporate structure (*TSE-Listed Companies White Paper on Corporate Governance 2013*, p. 16). Furthermore, although the percentage of outside directors in each main committee is about 70-80% in Japan (*TSE-Listed Companies White Paper on Corporate Governance 2013*, p. 47), the three committees in US-listed corporations generally consist of only independent directors due to listing rules.

Foreign institutional investors and proxy advisors tend to require Japanese corporations to increase the independence of their boards in the same manner as other countries. The more foreign investors hold shares, the more the number of outside directors. In 2012, as foreign investors held less than 10% of shares, the percentage of corporations in which outside directors accounted for the majority of the board was 0.9%. However, in cases where the percentage of shares held by foreign investors is equal to or higher than 30%, the percentage of the majority of the board consisting of outside directors increases up to 9.6% (*TSE-Listed Companies White Paper on Corporate Governance 2013*, p. 26).

With the amendment of the Companies Act in 2014, the independence of Japanese corporate boards will be reinforced at least partially and become closer to Western standards. Large and public companies with audit and supervisory board members not selecting outside directors at all must disclose their reasons for not doing so. Also, corporations will be able to choose companies with audit and supervisory committees (*kansatou-iinkai secchigaisha*) as a third kind of corporate structure. This type of company must establish an audit and supervisory committee in which outside directors make up the majority. In addition, executives of parent companies and second-degree relatives cannot become outside directors anymore (*Comparison between New and Old Letters of Law for Partial Amendments to Companies Act [Kaishahou no Ichibu wo Kaiseisuru Houritsu Sinkyuu Taisyou Joubun]*.
(http://www.moj.go.jp/content/000124654.pdf)

However, there is no rule requiring corporations to have independent directors occupy the majority of the board, either by hard or soft law. If we bear in mind that companies with three committees are few, it is doubtful that companies with audit and supervisory committees will become widespread in Japan. It is the next main challenge for Japanese corporate governance reform to increase the percentage of independent outside directors.

Finally, although reform of the independence of corporate boards is less advanced in Germany as in Japan, the German supervisory board is one of the most democratized corporate boards in the world. The German Corporate Governance Code does not require corporations to have independent directors occupy the majority but just an adequate number on the board, in a highly developed co-determination system. However, half of board members there consist of employee representatives, and about one third of them are representatives of powerful trade unions.

Conclusion

There is a growing presence of foreign and institutional investors in the Japanese corporate governance system with the change in ownership structure. This change has been reflected in the democratization of shareholder meetings. However, reform of the boards of directors in Japan is less advanced in terms of either democratization or independence compared to other countries, and this is the future challenge for the Japanese corporate governance system. JS

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