

Japanese Corporate Governance Reform, Globalization and Selective Adaptation

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After the burst of a massive financial bubble in 1990, Japan undertook a corporate governance reform to cope with its significantly weakened economy. The aim of the reform was to establish a US-style transparent and market-oriented corporate governance system in Japan. Japan's new corporate governance system has now incorporated most US-style laws and practices. However, certain important aspects of the US system have not been adopted. In this exploratory study, we propose using a selective adaptation framework to explain the observed outcomes of the post-1990 corporate governance reform in Japan. Our selective adaptation framework gives predictions about the directions along which Japan's corporate governance practices might change. These predictions are mostly consistent with what has happened so far.

INTRODUCTION

Japan undertook a major corporate governance reform in the wake of the recession that followed the bubble of 1990. The reform was complemented by new financial deregulation and bank reform laws. The corporate governance reform continued throughout the 1990s and early 2000s, and is expected over time to change Japan's traditional bank-based corporate governance mechanisms.¹ However, the degree of the eventual decline in the banks' role in Japanese corporate governance still remains to be seen.

Many of the changes made to Japan's corporate governance practices so far are modeled after the corresponding US (or, more broadly, Anglo-American) practices. The Japanese government insisted on the establishment of (1) proper market-based mechanisms for corporate governance and (2) monitoring systems to ensure the smooth and transparent operation of these mechanisms. Within Japan, this is also seen as a process by which Japanese practices are harmonized with Western standards, which are seen as *de facto* global standards.

Japan's post-bubble corporate governance reform has been evolutionary and experimental in many ways. Hence, it is too early to predict the eventual patterns of corporate governance practices that will emerge from these changes in the longer run. Indeed, given that many aspects of the Japanese economy are

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closely tied to the global economy, it is likely that significant adoption of global practices by Japan will continue.

The Japanese government played an important role in the corporate governance reform, the aim of which was to help Japan regain its global competitiveness. The changes are wide-ranging and include new legal measures and institutional practices in such areas as: corporate governance; financial deregulation and monitoring; bank behavior; information disclosure and accounting; and the market for corporate control (M&As).

In Section 2 of this paper, we summarize the evolution of corporate governance practices in Japan in recent years. Section 3 explains the role of Japan's local norms in our selective adaptation framework. This theory explains how laws and institutions from the West are adopted in Japan and other countries where local norms conflict with the liberal norms underlying the laws and institutions being introduced. In Section 4, we first discuss Japanese norms. We then define certain state variables that describe Japan's corporate governance practices before and after the corporate governance reform. Finally, using our selective adaptation framework, we explain the changes in the interactions between Japanese business norms and Western liberal norms resulting from the corporate governance reform measures. In Section 5 we conclude the paper by noting that, despite the U.S.-style corporate governance laws and institutions that have come into effect in Japan, Japanese businesses' actual implementation of the new corporate governance practices so far has been quite selective and uneven. We explain this using our selective adaptation framework, which also provides us with some predictions about how Japan's new corporate governance system will evolve.

2. CORPORATE GOVERNANCE PRACTICES AND INSTITUTIONS IN TRANSITION

The changes in the institutional settings relevant to corporate governance practices in Japan took place mostly in the 1990s and the early 2000s, but some are expected to continue through 2010 and onwards. It is also important to pay attention to what has not changed. Japan is practicing selective adaptation in transplanting the US corporate governance model; therefore we will investigate why businesses have chosen not to adopt certain US corporate governance practices even where new Japanese laws expressly allow business them to do so.

For convenience, we describe Japan's corporate governance reform in the 1990s and early 2000s as a transition from Japan's traditional bank-based corporate governance system (Institution I) to a new US-style corporate governance system (Institution II).

Notable issues that must be dealt with in the transition

In achieving this transition, certain important issues must be dealt with by the government and by the affected organizations, including corporations. One such issue is clarification of the meaning of a corporation in relation to its owners' (shareholders') individual rights. Another is the treatment (protection) of minority shareholder rights, relative to the rights of majority shareholders. It is well known

that in the bank-based corporate governance system, which was in place at most Japanese corporations until the early 1990s, management had to pay attention only to the company's majority shareholders (i.e., banks and other financial institutions as well as industrial firm shareholders in companies that form *keiretsu* groups) and could safely ignore the company's individual and minority shareholders.

We regard the US practice of caring for minority shareholder rights as reflecting Western liberal norms. We also regard the US practice of protecting the rights of owners of private property as reflecting Western liberal norms. Consistency with these US practices is an important principle for corporate management to follow based on shareholder value maximization. However, shareholder value maximization is not consistent with traditional Japanese corporate operating procedure, which is based on stakeholder value maximization. As discussed below, the stakeholders of a firm include not only shareholders but also employees, creditors, suppliers and often major customers.

Pursuing shareholder value maximization generally requires that the market for corporate control must exist and must function well. For example, mergers and acquisitions (M&As), both friendly and hostile, must be allowed to take place freely so that management can focus on shareholder value maximization. Without such a well-functioning market for corporate control, firms may end up having to keep inefficient production units that contribute negatively to firm value. These inefficient production units might become productive if they were allowed to become subsidiaries of another firm. Such M&A transactions apply not only to production units but also to whole firms themselves in liberalized M&A markets. Under such a scenario, the shareholder value maximization principle continues to hold, since unprofitable firms will cease to exist.

In what we will refer to as Japan's Institution I, few of the practices associated with liberalized M&A markets and shareholder value maximization were present. This type of institutional paradigm was in place until the 1990s. We discuss in this paper how Japan has moved from Institution I to Institution II, another institutional paradigm that incorporates, at least partially, practices associated with liberalized M&A markets and the shareholder value maximization principle, as well as other US practices that reflect Western liberal norms.^{1,2}

Many academic researchers have examined the possible driving force and consequences of these institutional reforms for the Japanese economy. Representative studies include Methé (2004), Sohn (2008), Westney (2006) and Yoshikawa and Mcguire (2008). Like ours, these studies, consider how Japan might move towards US ways, at least in some areas, in response to such changes in the business environment as new legal institutions. For example, in this dynamic context, Methé and Westney focus on the mechanisms by which Japan as a system, in comparison to the US, decides which firms and industries, are to be retained and which ones allowed to go under. Yoshikawa and Mcguire consider which of Japan's practices in corporate governance might best be retained and which might not. The important role of *keiretsu* in Japan's change process, as discussed below, is also noted in some of these other studies. Based on

these and other previous works, this paper presents and discusses our selective adaptation approach to Japan's reform in corporate governance. To our knowledge, the formal application of this approach in this area is new.

Our approach

In the selective adaptation framework we use here, it is postulated that interactions between local (Japanese) norms and the Western liberal norms underlying the laws, institutions and practices associated with the Anglo-American corporate governance system will determine the manner in which Japan will choose to implement (or enforce) various parts of the Anglo-American corporate governance practices. Certain phenomena associated with Japan-specific factors (norms) cannot easily be explained using economic theory.³

3. NORMS UNDERLYING JAPANESE BUSINESS BEHAVIOR

Many studies have investigated various aspects of the normative nature of Japanese life. Even though there is no unique and agreed upon set of norms and values underlying all aspects of Japanese life, many researchers seem to agree that several cultural characteristics distinguish Japan from the United States.⁴ These norms span overlapping areas of Japanese business behavior, and hence are not exclusive.

Often-cited Japanese norms identified in Japanese business behavior

(1) *Group behavior*. E. O. Reischauer notes the "Japanese tendency to emphasize the group at the expense of the individual. ... Associations of business enterprises, from groups of petty retailers by street or ward to nationwide associations of great banks or steel producers, are more widespread and more important a feature in Japan than in America." (Reischauer 1988: 128, 133, 685). As noted below, this is consistent with the important role many types of corporate groups (referred to as *keiretsu*) continue to play in the Japanese business world.

(2) *Consensus*. "Consensus is the goal. ... To operate their group system successfully, the Japanese have found it advisable to avoid open confrontations" (Reischauer, 136).

(3) *Long-term relationships*. Until the early 1990s, long-term employment was the norm for most regular workers in Japan (e.g. Abegglen 1958; Hashimoto 1990; Nakamura 1993; Sano 1995). After the massive restructuring that took place at many Japanese corporations since the 1990s, the size of the workforce of regular employees who enjoy long-term employment shrank at most companies. Despite this, many public opinion polls continue to suggest that the Japanese public prefers long-term employment security, a preference reflected in many company decisions (Lincoln and Nakata 1997).⁵

(4) *Vertical keiretsu relationships among corporations*. Japan's large manufacturers (e.g., Toyota, Toshiba, and Mitsubishi Heavy Industries) and their parts suppliers in the auto, electronics and other assembly-based manufacturing industries are typically organized in vertical production *keiretsu* groups (e.g., the Toyota Group). In these groups, the core assembler owns small pieces (e.g., 20-

30%) of their key (first-tier) suppliers who, in turn, own small pieces of the second-tier suppliers, and so on. Many Japanese firms believe that this form of industrial organization is more efficient than alternative forms that are fully vertically integrated. Ties between assemblers and their key suppliers have, in many cases, been in place for thirty years or more (Japan Fair Trade Commission 1993).⁶

(5) *The importance of group-oriented values.* Many authors have noted that Japanese businesses emphasize group-oriented values in their decision-making. For example, Bartlett and Ghoshal (1998, p.50) state: "In contrast to European family capitalism and American managerial capitalism, the Japanese cultural heritage has fostered a form of management that Chandler called 'group capitalism.' At a corporate level, as we have described in this paper, the group-oriented values were reflected in the *keiretsu* and other enterprise groups, which paternalistically watched over their affiliated companies. Lincoln et al. (1986, p. 343) also conclude that, in general, there is wide agreement that Japanese decision making is group and consensus oriented and involves little delegation of formal authority to positions held by individuals.

(6) *Trust and networks.* Lincoln (2006) describes Japanese customer-supplier relationships as follows: At a micro-level, "the trust, reciprocity, and stability typical of customer-supplier dyads in Japanese industrial goods markets have facilitated keiretsu firms to enjoy cooperation, synergy, and knowledge-sharing in product and process development." At a more macro level, webs of cross-shareholdings, director transfers, and preferential trade and lending flows have functioned both as information systems and as governance structures to disseminate, while conserving and protecting knowledge assets (Lincoln and Gerlach 2004).

(7) *Male/female behavior.* According to Reischauer, "The laws now give women full legal equality. But Japan is still definitely a 'man's world,' with women confined to a secondary position" (Reischauer 1988: 175, 183-184). Despite general acceptance of Western liberal norms and the great gains made by women in recent decades in Japan, social limitations and discrimination in employment remain. The massive post-WWII transfer of US managerial methods to Japan did not include US-style equal employment opportunity laws or the enforcement of them. Japan's behavior in this area seems consistent with selective adaptation.

Examples of Japanese policy decisions associated with norms

There is also empirical evidence that Japanese policy decisions were often influenced by local norms.

(1) Ogawa and Retherford find that "norms of filial care for elderly parents in Japan were fairly constant from 1963 until 1986, when a major weakening of norms began" (Ogawa and Retherford 1993)

(2) Miyashita (2007) argues that norms have shaped the foundations of Japan's post-war pacifism policies, but cautions that norms are often inseparable from material and structural forces.

(3) Chan-Tiberghien (2004, 2005), in examining the impact of global human rights norms on Japan, raises the question of why women's and children's rights saw dramatic discursive, political and legislative changes in Japan, while changes in minority rights remained minimal.

4. COMPARING JAPAN'S CORPORATE GOVERNANCE PRACTICES BEFORE AND AFTER THE CORPORATE GOVERNANCE REFORM: SELECTIVE ADAPTATION

Under certain circumstances, Japan, consistent with the selective adaptation theory, only partially accepted certain US practices (e.g., equal employment opportunity laws, and global human rights norms). Here we apply a selective adaptation framework to analyze Japan's reactions towards US-style corporate governance practices. For the most part, Japan's reform has instituted all the legal and institutional settings required by firms to adopt US-type corporate governance practices. Nevertheless, the extent to which proposed US practices ultimately are implemented and enforced by Japanese corporations depends on the selective adaptation behavior of businesses, government, courts and the public in Japan.

4.1 State Variables for Describing Japan's Corporate Governance

We focus on three groups of major issues in corporate governance. They are: (1) the legal protection of shareholders' rights, especially including those of minority shareholders; (2) issues associated with large shareholders (i.e., concentrated ownership); and (3) agency costs (to all shareholders) that arise because firm managers do not implement policies to maximize shareholder value.

We use state variables to measure changes in the functioning of the above and other aspects of corporate governance mechanisms before and after the reform. These state variables are not mutually independent or exclusive. If some factors affect one state variable, it seems likely that the same factors also affect other state variables.⁷ The following state variables are believed to capture essential aspects of Japan's corporate governance mechanisms:⁸

- (s1) The degree to which shareholder value maximization is achieved;
- (s2) The degree to which outside independent directors are involved in boards of directors' decisions;
- (s3) The degree of competition in the market for corporate control (i.e., activities associated with mergers and acquisitions);
- (s4) The degree of transparency and information disclosure in accounting, financial and other reporting to investors; and
- (s5) The degree of protection of minority shareholders.

State variable (s1) describes the degree to which the management is faithful to the shareholders' objective of maximizing the share values of firms. Prior to the reform, Japanese firm management was able to pursue its own objectives, which were significantly at variance with shareholder value

maximization. Agency costs of this sort were a significant source of economic inefficiency.

State variable (s2) measures the degree to which the board of directors functions effectively. It is often suggested, for example, that insider-controlled boards do not function effectively, with this impeding firms in achieving share value maximization (s1).

State variable (s3) measures how active the market is for corporate control. While Japanese banks acted as a substitute for the market for corporate control prior to the reform, they did not succeed in replicating the benefits of a more competitive market for corporate control.⁹ The inability to replace in a timely manner a poorly performing management team with a more competent one is believed to have been a major source of agency cost of the sort associated with state variable (s1), and a source of significant economic inefficiency. We are interested in how the reform affected the degree of competition in the market for corporate control.

State variable (s4) measures the fair and transparent availability of firm information relevant to all investors. Information disclosure and transparency is the prerequisite for efficient functioning of the stock market, allowing investors to evaluate properly the shares they own. Efficient stock markets also give managers information about the cost of capital for their investment projects. In addition, efficient stock markets are essential for developing an active market for corporate control. Japanese bank-based corporate governance mechanisms were insider-oriented and often lacked transparency.

State variable (s5) describes the degree to which the individual rights of investors, and particularly those of minority shareholders, are protected. Under the old bank-based system, up to 70% of most listed firms in Japan were owned by financial and other friendly corporate shareholders. Hence, firm management had little need to pay attention to individual and other minority shareholder rights.

4.2 Japanese Business Norms and Instruments that Affect the Degree of Acceptance of New Institutional Settings and Practices in Corporate Governance

Japanese business norms

We discussed above some of the norms and related issues that characterize Japanese behavior in business and in society in general. The following three groups of these norms are particularly important for shaping Japan's acceptance of new US-style practices of corporate governance.

(N1) Corporate groups. Group-oriented norms underlie Japanese keiretsu behavior (e.g., vertical production keiretsu).

(N2) Consensus. The norms of consensus as the goal, including the avoidance of open confrontations, encourage out-of-court settlements and impede transparency

and full acceptance of US style business practice laws by business firms and shareholders.

(N3) Group-oriented value maximization by firms. The norms of group-oriented value maximization encourage shareholding by friendly company shareholders, which are shareholders that allow company managers to ignore the rights of individual shareholders while pursuing other objectives, such as stakeholder value maximization (e.g. Aoki (1988), Araki (2005), Jacoby (2005)) and value-added maximization (Tsurumi and Tsurumi (1991)).

One of the cornerstones of Japan's corporate governance reform is the formal recognition by the Japanese government of shareholder value maximization as a corporation's primary objective. Legal terms for the protection of shareholder rights were clearly set out, as in the United States.

Instruments that facilitate selective adaptation of new practices and to new institutional settings

A general framework

Selective adaptation of foreign legal and institutional practices is a dynamic process driven, in part, by interactions of local and foreign norms and cultures. We postulate that these interactions have different outcomes depending primarily on the following three factors: perception, complementarities and legitimacy¹⁰. As Unger (1975) and Etzioni (2000) note, perception affects how people understand foreign and local norms and also the purposes, contexts and implications of the foreign and local institutions associated with them. This, in turn, affects the processes and results of selective adaptation.

When complementarities exist between two sets of apparently competing or contradictory institutions and practices, it is possible for the two sets to be combined so that the combined set functions in an effective and powerful way while allowing preservation of the original characteristics of each of the component sets.

For example, consider a nation recently granted membership in the World Trade Organization (WTO). The WTO membership means this nation must comply with WTO's international trade rules, many of which are foreign to the nation. If complementarities exist between the WTO trade practices to be imported and the corresponding local and traditional trade practices, the local communities will be able, to a considerable degree, to both satisfy the international compliance requirements and protect local needs. The degree of complementarity determines the sustainability for the nation of both the local and foreign rules and associated institutions and practices.

Legitimacy must accompany any successful adoption of new rules and regimes (e.g., Weber, 1978; Scharpf, 2000). In our context, legitimacy determines the degree to which the affected local communities support the purposes and consequences of selective adaptation. The forms and requirements of legitimacy can vary depending on the contexts of the foreign laws and institutions and their underlying norms. However, the effectiveness of the foreign laws, institutions and

practices adopted in a selective adaptation process will be determined, to a significant degree, by the level of legitimacy of that process.

The corporate governance context

Japan's current corporate governance reform affects not only business firms and investors, but the entire Japanese economy including its household sector. How these actors of the economy perceive the new US-style corporate governance practices in Japan is an important determinant of how the selective adaptations of new practices proceed. For example, favorable investor perceptions of the new laws promoting strict US-style information disclosure will facilitate selective adaptation of the laws. The public, of course, forms their perceptions based on their understanding of the functioning of the new rules and practices and the underlying Western liberal norms.

At the same time, if the Japanese government wants Japanese businesses to adopt new US-style rules and practices, it must establish their legitimacy in Japan, for example, by showing that the new rules will generate new business opportunities on a level playing field. Alternatively, if, under the new rules, minority shareholders get improved treatment in terms of fairness and justice, then this may also give the new rules legitimacy on humanitarian grounds.

In most cases, legitimacy for the acceptance of new rules and practices by local business communities and investors is established on either economic or humanitarian grounds. Some elements of positive perception and legitimacy are needed for the new rules and practices to be accepted by local economic agents.

Local acceptance of new corporate governance rules and practices is also facilitated when the new rules in some ways complement the old rules. Such complementarity may be found when traditional Japanese internal-market based practices can be enhanced by the introduction of new US-style market-oriented practices and rules. For example, non-corporate shareholders may benefit from efficiency gains if the Japanese firms that had been relying on traditional, non-transparent management of related firms are required by the new rules to implement more transparent reporting of transactions with related firms.

When neither legitimacy nor complementarity of new corporate governance laws are present, then even if the government tries to enforce the newly instituted rules, investors and businesses alike may fail to implement the rules seriously, and instead may focus on looking for loopholes.

We expect that new corporate governance practices implied by the new reform laws are more likely to be implemented if Japanese practitioners have favorable perceptions of them, and see legitimacy and complementarity in the new laws being adopted. In what follows, we designate perception, legitimacy and complementarity as the three instruments for selective adaptation.¹¹ We argue that implementation of new practices in terms of selective adaptation is likely, if some, if not all, of the three instruments favor acceptance.

4.3 State Variables Before and After Reform

In applying a selective adaptation framework to Japan's corporate governance reform, we consider how the interactions between Japanese business

norms (N1)–(N3) and Western liberal norms affect the state variables (s1)–(s5). However, in our analysis we use the three instruments of perception, legitimacy and complementarity, instead of directly using the liberal norms, to calculate the relevant interactions. We proceed as follows. For each state variable and the associated US corporate governance practices thought to enhance its value, we consider interactions between the instruments and the relevant Japanese norms. If the overall effects of the interactions are positive, we conclude that Japan will accept the relevant US practices by selective adaptation, and hence the state variable will increase its value as a result of the reform.¹² Table 1 illustrates how our analysis proceeds in general for (s1) as well as the other state variables.

After discussing each state variable, we present propositions summarizing our arguments and some recent relevant examples. The Japanese corporate behavior described in the examples illustrates our propositions based on selective adaptation. Some of the examples reflect behavior described by multiple state variables.

Table 1: A General Framework for Selective Adaptation Analysis: Japanese and Western Business Norms' Interactive Influence on Japanese Corporate Governance State Variables (s1), (s2)... (s5)

Japanese business norms (N1, N2, N3) below	Instruments of selective adaptation for Western liberal business norms		
	(1) Perception	(2) Legitimacy	(3) Complementarity
Japanese corporate governance state variable: s1 (shareholder value maximization) ^a			
(N1) Corporate groups (keiretsu)	(-), (+), or (Δ)	(-), (+), or (Δ)	(-), (+), or (Δ)
(N2) Consensus as the goal, and avoidance of open confrontations	(-), (+), or (Δ)	(-), (+), or (Δ)	(-), (+), or (Δ)
(N3) Stakeholder value, value added and other group-oriented value maximization as the objective for corporate decision making	(-), (+), or (Δ)	(-), (+), or (Δ)	(-), (+), or (Δ)

^a Each cell represents the possible impacts on the state variable in question (e.g. s1) of the interaction between each of the Western business norms' instruments and each of the Japanese business norms (N1, N2, N3). For each cell, (-), (+) and (Δ) mean, respectively, negative, positive and ambiguous impacts on state variable (s1) of adopting relevant US style corporate governance practices associated with state variable (s1). The procedure is repeated for each of state variables s1, s2, s3, s4 and s5. See the text for details.

Shareholder Value Maximization (s1)

In Japan, shareholder value maximization is generally understood as one of the alternative operational principles that firm managers can use in managing their firms. Japanese business communities have given little thought to the fact that, in the US corporate governance framework, the shareholder value maximization principle is the *only* legitimate objective of corporate management, since it is the only principle based on protection of shareholders' individual property rights that are rooted in the underlying Western liberal norms. For this reason, Japanese business leaders and company employees who value stakeholder welfare (e.g. norms N2 and N3) do not necessarily share positive perceptions or appreciation for shareholder value maximization. Keiretsu firms and others with multiple equity connections (N1) are not necessarily in a position to promote shareholder value maximization for any one firm within a corporate group

Although many Japanese firms have influential corporate shareholders, they also have non-corporate (individual) shareholders, including foreign ones. Individual shareholders usually see legitimacy in shareholder value maximization in their capacity as firm owners. On the other hand (N1) and (N3) may imply that keiretsu firms and stakeholder value maximizers do not see much legitimacy in (s1). Local business communities may find relatively little opportunity to take advantage of complementarities through combining the shareholder value maximization principle with more group-oriented welfare maximization principles for firm operations.¹³

We tentatively conclude with the following proposition on selective adaptation of (s1).

Proposition 1: Little support exists for shareholder value maximization for firms with strong keiretsu relationships. On the other hand, individual shareholders of keiretsu and other non-affiliated firms are likely to support (s1).

Discussion

There was a general perception in the 1990s that Japan's outdated bank-based corporate governance system was a major cause of the near collapse of the Japanese economy. There was agreement that Japan's bank-based corporate governance system was too insider-oriented, and that a US-style market-based system, with a clear management objective of shareholder value maximization, was needed.¹⁴ In order to achieve this objective, many laws were revised. A new company law was set up to provide a framework within which Japanese corporations could organize their businesses and corporate structures consistent with shareholder value maximization. To secure investor confidence, Japan's new Financial Instruments and Exchange Law of June 2006 was enacted. This law updates and consolidates all the existing exchange laws, including the Securities and Exchange Law.

Interestingly enough, Japan's initial acceptance of the newly instituted measures promoting shareholder value maximization did not necessarily lead to

the acceptance of various business mechanisms or strategies associated with shareholder value maximization.

Notable changes regarding shareholder value maximization (s1) have taken place in the interactions between corporations and their shareholders. A general decline in bank shareholding has been replaced by a substantial increase in shareholding by individuals and investment funds (Arikawa and Miyajima (2007)). These new individual shareholders clearly view shareholder value maximization as an important objective of firm management, which is consistent with Proposition 1.

Nevertheless, as discussed above, the standard Japanese business norms provide little support for (s1) in terms of perceptions and legitimacy. Japan's new laws acknowledge shareholder ownership of their firms. However, large fractions of the outstanding shares of many firms are still owned by friendly keiretsu and other corporate shareholders.¹⁵ It seems that the new laws telling the firms to follow shareholder value maximization lack legitimacy.

Initial reactions

Many domestic, foreign and investment fund shareholders began taking advantage of the new opportunities for questioning the managers and directors of the firms whose shares they owned. For example, many foreign fund managers began raising objections to Japanese firms' corporate governance policies, and often voted against the firm management teams on shareholder value maximization grounds.

Many legal suits were brought against firm managers and directors. For example, West (2001, Table 1) reports that the number of shareholder derivative suits filed against their corporations' directors and executives at the Tokyo District Court increased from eighteen in 1993 to thirty in 1999 and that the total number of pending cases at Japan's district and higher courts increased also from 84 in 1993 to 286 in 1999.¹⁶ The legal suits questioned the validity of managers' and directors' actions in light of the shareholder value maximization objective and management's mandated responsibility. Some Japanese firms responded by disclosing more internal information voluntarily than before.¹⁷

Initially, the Japanese courts agreed that shareholder value maximization must serve as the essential guide for managers and directors. Poison pills proposed by many firms to fight off potential hostile takeover attempts were rejected by their shareholders in their general meetings in 2006, the first year when Japan's new company law became operational.

These suits convinced many managers and board directors that they might personally face legal cases from their shareholders if their business decisions resulted in major losses to their companies and hence damage to their market value. It is for these reasons that Japanese managers began taking the time to listen to their investment fund shareholders, who had suggestions on how to improve firm profitability.

Reactions in later stages

As the initial transition period ended in the early 2000s, many Japanese managers concluded that Japanese corporations could not accept the US-style shareholder-driven corporate management system. Managers often used the stakeholder value maximization theory to rebut the policy objections made by shareholder value maximization-based fund managers, both foreign and domestic. Many Japanese managers revisited the strategic use of keiretsu relationships as a tool to protect incumbent management's rights to manage their corporations. Japan's equity-based keiretsu relations, and more broadly, networks of stable and friendly firm shareholders, traditionally protected management but also often contradicted multiple basic objectives of Japan's corporate governance reform. This is because the presence of networks of such friendly corporate shareholders often works against shareholder value maximization (s1), competitive markets for corporate control (s3), and protecting minority shareholder rights (s5). We discuss this issue further below. Regarding shareholder value maximization (s1), friendly corporate shareholders, such as keiretsu networks, can cause firm behavior that is consistent with the selective adaptation behavior described in Proposition 1, where individual shareholders (including foreign) support management practices based on (s1), while keiretsu shareholders are reluctant to adopt these management practices fully.¹⁸

Outside Independent Directors' Involvement in Board Decisions (s2)

Japanese business communities and investors have a perception that directors outside the firm will have difficulty in overseeing the governance of the firm because Japanese management is concerned with complex inter-firm relationships (N1, N3) and firm-specific methods for consensus building (N2). At the same time, they also see legitimacy in outside directors who may be able help correct potentially corrupt governance practices involving insiders, even though such legitimacy may be limited in scope where management emphasis is placed on keiretsu (N1), consensus (N2) and group decisions (N3). On the other hand, progressive firms do find complementarities between inside and outside directors because, at such firms, both insiders and outsiders can contribute in different ways to the governance of their firms, with outsiders often bringing more fresh ideas in the areas of (N1), (N2) and (N3).¹⁹

An issue related to outside directors that remains ambiguous is the organizational form of firm governance. Under Japan's new company law, corporations now have the option of choosing between a traditional Japanese-style corporate board system and a US-style executive committee-based board system. Compared to the traditional system, the executive committee model requires outside directors to play more dominant roles in overseeing the management.²⁰ Given interactions between (N1-N3) and the legitimacy and complementarity of outside directors, we expect Japanese firms to realize legitimacy and complementarity by simply increasing the number of outside directors while maintaining the traditional board system. We expect that, within the traditional system, many firms can satisfy both legitimacy and complementarity while employing outside directors as advisors with voting rights. We argue that

legitimacy is lost if firms choose the organizational form of their boards by forming an executive committee system in which outsiders must take up more firm-specific and high-level decisions including appointments and compensation. These considerations lead to the following proposition.

Proposition 2: Outside directors are more acceptable for progressive firms which can take advantage of outside directors' complementary skills. Doing so will make firms more efficient. Adopting the new executive-committee based board system requires not only more outside directors but also the delegation by firm management to outside directors of certain key managerial decisions including executive appointments and compensation decisions. Such an organizational change interferes with firm-specific operations reflected in business norms (N1-N3) and is less likely to be acceptable to firms.

Discussion

Proposition 2 states that, in the context of our selective adaptation framework, progressive Japanese firms are likely to use more outside directors to improve their firm performance. On the other hand, keiretsu firms with many inter-firm connections will find it difficult to abandon the traditional board system in favor of US-style boards, whose executive committees are dominated by outsiders and make decisions on key issues including management level appointments and compensation.²¹ Reported statistics and preliminary research findings are consistent with Proposition 2.

For example, we see from Table 2 that Japanese firms have been increasing the proportion of outside directors on their boards in recent years. Miyajima and Nitta (2006, pp.33-34) also report regression results, based on a sample of firms listed in the Tokyo Stock Exchange for the period 1997-2004, suggesting that increases in the ratio of outside directors tend to improve firm performance as measured by the return on assets. They also note that market performance, as measured by Tobin's q and the price-book ratio, is higher for firms with proportionally more outside directors on their boards. These findings are consistent with Proposition 2.

Table 2: Fraction of Outside Directors within the Boards of Directors at listed Japanese Corporations, 1993-2004

Year	Total listed firms in the sample	% outside directors within their boards	Number of firms with 30%+ outside directors
1993	1498	12.71	206
1994	1513	12.50	200
1995	1541	12.32	193
1996	1581	12.29	196
1997	1619	12.02	195
1998	1649	12.16	209
1999	1732	12.71	236
2000	1866	13.37	277
2001	1896	14.03	299
2002	1898	14.89	333
2003	1937	16.53	387
2004	1992	17.31	433

Source: compiled from Miyajima and Nitta (2006, p.11)

We also note that only a very small number of Japanese firms have implemented the new US-style executive committee system.²² This is also consistent with Proposition 2.²³ A recent survey of Japanese listed firms' performance shows that those who have adopted the US-style committee system lag behind their peers who continue to use the traditional Japanese system (Table 3). Miyajima and Nitta (2006, p.35) also show that 1122 Japanese listed firms with traditional board systems outperformed thirty listed firms with executive committee board systems in terms of return on equity and return on assets. Firm performance differences based on different board organizational forms are not directly explainable by Proposition 2, but may be in part explainable by the fact that executive committee-based boards cannot function well in Japan, given the lack of enough qualified outside directors. We note that so-called outside directors in Japan are not really outsiders to the firm in practice, as many come from related firms.²⁴ While executive committees in the new system require many outside directors, the supply of quality outside directors in Japan is very limited.

Table 3: Comparison of firm performance by the type of corporate governance (outside directors), Tokyo Stock Exchange, first section firms

	Market value (June 28, 2002)	Market value (June 30, 2005)	Growth in sales revenue, 2002–2004	Growth in ordinary profit, 2002– 2004
New committee system (31 firms)	166.948 billion yen	162.256 billion yen (- 2.8%)	7.1%	36.9%
Traditional system with auditors ^a	2689.191 billion yen	3431.376 billion yen (+27.6%)	9.2%	51.7%

Source: Nikkei (August 16, 2005)

^a Sample size: 1,495 and 1,066 firms were listed in 2002 and 2005, respectively, in the first section of the Tokyo Stock Exchange

Competition in the Market for Corporate Control (s3)

Japan's business culture (as represented by business norms N1-N3) favors the expansion of firm affiliations with other firms via keiretsu and other such cooperative arrangements, and hence facilitates an increased supply of business units as potential targets for mergers that come to the market as a result of more competition. Introduction of competition in the market for corporate control is thus received in a positive light, since it will allow more friendly negotiated arrangements that are of higher quality than before.

A significant degree of legitimacy exists, for example, for an efficient increase in various forms of mergers and acquisitions. Also, new combinations of related firms arranged in a more competitive market for corporate control can complement the existing keiretsu and other inter-firm relationships.

We also note that certain Japanese business norms (e.g. N2, N3) are consistent with friendly mergers but not with hostile takeovers, based on public perceptions of legitimacy. Thus, selective adaptation implies Japan's acceptance of a competitive market for corporate control of friendly takeovers and mergers. On the other hand, hostile takeovers are less likely to be accepted by Japanese businesses and society in general. This point was recently reiterated by the Japanese Ministry of Economy, Trade and Industry (METI)'s Advisory Committee on Firm Value report on M&A policies, which states that: "firm value is the sum of all the value that belongs to its stakeholders and hence shareholder value is not the same as firm value" (METI (2005, p. 35)). In this context, hostile takeover attempts focusing only on shareholder value are not regarded as legitimate in Japan. We then obtain the following proposition.

Proposition 3: The corporate governance reform will promote Japan's acceptance of a competitive market for corporate control, particularly for friendly takeovers and mergers. Hostile takeovers are less likely to be practiced.

Discussion

There is no question that Japan's M&A activities have heated up since the reform.²⁵ Under the old bank-based corporate governance system, it was difficult for firms to cut loose their inefficient parts in order to expand more promising parts of their businesses. An active market for corporate control allows firms to exchange component parts in order to form more efficient corporations. With this process, more share value is generated.

Proposition 3 singles out hostile takeovers as unlikely events in Japan. In this regard, one notable trend in recent years is that many Japanese firms have begun to implement various forms of poison pills to fight off hostile takeovers. These poison pills proposed by the management, are often supported by Japan's shareholding patterns, with large fractions of Japanese corporations' outstanding shares still owned by friendly corporate shareholders such as keiretsu firms and other related corporations.²⁶

As of May 15, 2007, 14% of Japanese firms listed in the first sections of the Tokyo, Osaka and Nagoya stock exchanges and 8% of all 316 listed firms, had already implemented or were planning to implement anti-takeover defense schemes (Yomiuri Newspaper (May 17, 2007)). This is despite the argument by Warren Lichtenstein, chairman and chief executive of Steel Partners (and many other investors from the US) that "companies with poison pills in the United States typically have demonstrated poorer returns on invested capital, resulting in many of them being redeemed."²⁷

Another noteworthy event is that poison pills based on keiretsu relationships and cross shareholding themselves are becoming prevalent.²⁸ With this type of poison pill, friendly corporate shareholders (stable shareholders) do not sell off their shares in an opportunistic manner in potentially hostile takeover attempts. With stable shareholding, this type of poison pill is unlikely to contribute to shareholder gains or improvements in firms' operational efficiency. Nevertheless, Japanese stable shareholding has proven highly effective as a poison pill since the early 1950s and protects the incumbent management. As expected, most hostile takeovers or unsolicited takeover bid attempts fail in Japan.²⁹

Steel Partners experience

Since the early 2000s, Steel Partners has been aggressively buying shares for takeover purposes of Japanese companies such as Bull-Dog Sauce (a maker of condiments), Yhiro Chemical Industry (a machinery lubricants maker), Myojo Foods (a noodle maker) and Sapporo Holdings (a brewery). However, Steel Partners has so far failed in all its attempts to take over the target companies, either because of the target company's anti-takeover measures or because of friendly tenders by other companies.

The threat of a hostile takeover is often effective for improving the quality of firm management. Under a hostile takeover, the incumbent managers can be replaced by more competent ones, which may improve economic efficiency and create more value in the process. Since we predict that Japan's reform will not bring many hostile mergers, we also expect less efficiency gain associated with such mergers or the threats of them.

Nevertheless, we should not underestimate the potential economic efficiency to be gained from this new state for (s3) involving one-sided developments in the M&A markets. Until the 1980s, there were virtually no large-scale friendly mergers, let alone hostile ones. The few large-scale mergers that took place were generally value-losing events. One main reason for such failures was the difficulty involved in integrating different Japanese firms with highly firm-specific management systems.³⁰ Japan's new company law allows more prompt reorganization of merged business units.

In the post-reform market for corporate control and M&As, we have observed that most domestic M&A activities are between affiliated firms. They are friendly mergers by definition.³¹ This type of behavior is consistent with what Proposition 3 predicts and reflects keiretsu shareholders' reluctance regarding hostile take-overs.

Transparency and Information Disclosure in Accounting, Financial and Other Reporting to Investors and the Public (s4)

Japanese businesses and investors appreciate transparency and information disclosure, because these notions underlie the sound operations that support Japanese business norms (N1-N3). In practice, however, local business community support for legitimacy may not be fully present because of potential conflicts of interest, at least for keiretsu group firms, between the individual shareholders of firms and corporate investors such as keiretsu group member firms (N1 and N3). Complementarity exists to some extent because even private inter-firm relationships can take advantage of newly mandated transparency and disclosure requirements. For example, when these keiretsu firms attempt to raise capital in external capital markets, transparency and disclosure are required. These requirements also help assess the market values of the related business units more accurately than before. We obtain the following proposition.

Proposition 4: The new stricter transparency and information disclosure requirements will improve, to some degree, the transparency (and hence efficiency) associated with external market transactions for public investors and the firms involved. However, the extent of such improvements depends on the degree and nature of inter-firm relationships (as described by N1 and N2) and also their managerial styles at the group level (as described by N2).

Discussion

Transparency and information disclosure are essential for protection of all investors. It is particularly important for minority shareholders who do not have legal access to company books and other sources of information. Japan's corporate governance reform resulted in significantly increased requirements for transparency and information disclosure for corporate activities and the protection of investors. This is consistent with Proposition 4. The most relevant laws, in this regard, are the new company law, the new financial instruments and exchange law, and the revised certified public accountants' law. In addition, Tokyo and other Stock Exchanges impose their own disclosure rules on their listed firms.

Japan's new company law requires corporations to use consolidated financial statements as their primary means of reporting. It also requires corporations to report the value of financial securities and unrealized losses and profits annually.³² Since Japanese firms conduct large amounts of transactions with their affiliated keiretsu and other related firms, individual (typically minority) shareholders would have difficulty figuring out corporations' overall soundness without access to their consolidated statements. Japanese firms also own large amounts of securities, often including stocks of affiliated companies, as part of maintaining their business network relationships. The new rules require corporations to report these sorts of financial positions annually. In the past, many firms used their affiliated firms to manipulate their reported financial positions. For example, parent firms often posted significant amounts of profits while their unlisted subsidiaries posted losses. Under the new rules on disclosure and reporting, these questionable reporting practices are expected to decline. This is a positive change from the perspective of public investors.

Another area of improvement in accounting disclosure due to complementarity has to do with how Japanese firms' subsidiaries and affiliates are defined. Previously, under the Japanese consolidation standards, subsidiaries were defined to be those firms for which parent firms held a majority of voting rights based on stockholding. Internationally, however, control criteria standards are used: subsidiaries are defined to be those effectively controlled by their parent firms, regardless of the status of stockholding patterns (e.g. Mizuno, 2004).

Similarly, in Japan, prior to the reforms, parent firms' affiliates for consolidation purposes were defined as those companies (other than subsidiaries) in which the parent firm and its subsidiaries had at least 20% of the voting rights; and could exert a significant amount of influence. Yet internationally, the 20% equity ownership rule is not needed to define a firm's affiliate; rather, an affiliated company is defined to be a parent firm's non-subsidiary firm, over which the parent firm exerts a significant amount of influence. Japan's new accounting rules have incorporated these international accounting standards on subsidiaries and affiliates for accounting consolidation purposes.³³

While these new laws significantly improve transparency and disclosure requirements, as predicted by Proposition 4, it should also be noted, however, that, given Japanese corporations' persistent reliance on transactions with related firms, these new laws are not likely to eliminate fraudulent accounting practices involving affiliated firms. This outcome is also consistent with Proposition 4.

Third party monitoring of these inter-firm transactions is difficult at best and firms are likely to continue conducting questionable or illegal inter-firm transactions.³⁴

Another implication of the consolidated financial statement-based reporting requirement is that detailed stand-alone financial statements for each of the business units under a holding company are no longer required. Yet, these business units are often the objects of M&As, and potential acquirers and their shareholders, as well as the shareholders of the potential target firms, may worry about the accuracy with which the segment information required for the transactions is being disclosed. Disclosure requirements in this regard would be essential for transparent M&As.³⁵ In this respect, (S4) receives modest support in terms of positive public perception, legitimacy and complementarity.³⁶

We expect that the new financial instruments and exchange law and revised CPA law will significantly improve corporate reporting transparency and the protection of both investors and creditors.

Protection of Minority Shareholders (s5)

There is some degree of support for protecting minority shareholders not only in the business community but also among the Japanese public in general. While keiretsu firms' perceptions are unclear, the consensus and stakeholder value norms (N2, N3) tend to support inclusive behavior, supporting positive perceptions about protecting minority shareholders. However, feelings of legitimacy for protecting minority shareholders may not be adequately present, at least for keiretsu firms (N1) and stakeholder managed firms (N3), since these follow the strategy of maximizing group welfare, which may not be aligned with the welfare of minority shareholders. Japanese businesses, on the other hand, may find complementarity in the area of consensus building (N2), because newly introduced rules that tell firms how to deal with their minority shareholders may actually help the firms in avoiding potential litigation and other types of conflicts which can be costly. This brings us to the following proposition.

Proposition 5: New rules about protecting minority shareholders will have limited impact on Japanese corporate governance practices, particularly including the practices of keiretsu firms. The potential for public embarrassment, for example, due to legal suits launched by protesting minority shareholders, may force some firms to adhere to these new rules more strictly.

Discussion

Proposition 5 above suggests that Japan's post-reform corporate governance practices will not be as effective as their US counterparts in protecting minority shareholders. Japanese business norms do not generally consider minority shareholders' rights as important relative to the majority shareholders' rights. Although Japan's new laws allow minority shareholders a voice in general shareholders' meetings and hence recognize their complementarity role, majority shareholders' rights will still prevail in most cases.

In particular, if keiretsu and other friendly corporate shareholders form the majority shareholders of a firm, minority shareholders' objections may not go anywhere. These minority shareholders include individual shareholders and foreign shareholders such as foreign investment funds.

A number of events are consistent with this implication of selective adaptation behavior described by Proposition 5. We discuss these below.

Example- Koito and T. Boone Pickens

This early example of a problem of minority shareholders' rights took place in the late 1980s and the early 1990s, before the current Japanese corporate governance reform began. By 1990, the American takeover entrepreneur, T. Boone Pickens, managed to gain ownership of 26.43% of the Japanese company Koito Manufacturing and became its largest shareholder. Despite this, he found himself in the position of Koito's minority shareholder and could not force the Koito management to give him a seat on the board as an outside director. The reason Pickens was a minority shareholder was that, nineteen Japanese firms, many of which are Toyota keiretsu companies, held as a group a majority of Koito's stock, and all supported the Koito management. Koito's Japanese managers saw neither legitimacy nor complementarity in recognizing the largest individual shareholder's rights. This example shows how problems of minority shareholders' rights (s5) can go together with firms' opposition to outside directors.

In many respects, Steel Partners' recent experience in Japan is similar to that of T. Boone Pickens in earlier years. Both these US investors found that stable share ownership, including crossholding in Japan was a potent barrier to implementing corporate governance decisions not supported by the incumbent management.

We should also note that, despite the real difficulties Japanese minority shareholders face, there have been some successful revolts in general shareholders' meetings, where important management proposals on corporate governance were rejected. As in the following example, such proposals can be rejected if more than one-third of a firm's shareholders oppose them.

Example- Tokyo Steel

An example of foreign shareholder-driven rejection of a management proposal occurred in late February, 2007, when the Tokyo Steel Industrial Co. had its general shareholders meeting to discuss a management proposal on an agreed-on acquisition of Tokyo Steel Industrial by Osaka Steel. Arguing that the proposed purchase price by Osaka Steel of Tokyo Steel Industrial's shares was too low, a Japanese investment fund, Ichigo Asset Management, asked other shareholders to oppose the management plan of the acquisition by Osaka Steel. The minority shareholders complained that the merger proposal presented by the management was highly disadvantageous for Tokyo Steel's minority shareholders who were individual shareholders and also investment funds such as the Ichigo Asset Fund. The outcome was that 42% of shareholders voted against the management and the proposal was rejected (Yomiuri Shinbun Newspaper, Tokyo, March 26, 2007).

4.4 A Schematic Diagram Representation of Our Model with a Structure

Our proposed process of Japan's selective adaptation-based corporate governance reform may be described as a causal model relating our instruments and Japanese business norms to the state variables which collectively describe certain key aspects of Japan's corporate governance system under reform. Table 1 shows the general process of analysis of selective adaptation.

Using terminology from modeling we can also describe this process as follows. Our six state variables (s1)-(s5) each define the dependent variables and each dependent variable is determined by our three instruments (Perception, Legitimacy and Complementarity, denoted as P, L and C below), each of which defines an independent variable. In addition, in the relationships between each of the dependent variables and the three independent variables, the latter are affected by the latent Japanese norms which we call moderating variables.

As we have argued in the previous section, the context of Japan's corporate governance practices often allows us to determine the nature of the surrogate impacts of the moderating variables on the independent variables. If such a structure is identifiable, then the general process of analysis of selective adaptation presented in Table 1 can be simplified and made more manageable for empirical implementation. This is shown below.

Suppose Japanese business norms N1, N2 and N3 collectively influence our independent variables (instruments) P, L and C in two extreme ways: strong influence (strong norms) and weak influence (weak norms).³⁷ Suppose also that we can assume this structure for each of the dependent variables and that we can assign relevant corporate governance contexts to each of the pair of strong and weak norms for each state variable. Our discussion in the previous section implies the following structure exists in the Japanese corporate governance context: strong and weak Japanese business norms correspond, respectively, to keiretsu and individual shareholders for (s1); traditional and progressive boards for (s2); friendly and hostile takeovers for (s3); transparency for minority shareholders and for M&A purposes for (s4); and minority and majority shareholder rights for (s5). Tables 4 and 5 show how this process might function in sequential causal relationships for state variables (s1) and (s5). Table 5 also shows in the last column the likely directions of the impacts of the independent variables on each of the five dependent (state) variables.

Table 4: Examples of the Impact of the Moderating Variables on the Independent Variables

	Moderating (latent) variables (norms)	Independent variables (instruments)	Dependent (state) variables (possible values)
(s1) strong norms (keiretsu shareholders)	(N1, N2, N3) strong	→ (P, L, C) →	s1 (impacted by "keiretsu")
(s1) weak norms (individual shareholders)	(N1, N2, N3) weak	→ (P, L, C) →	s'1 (impacted by "individual")
(s5) strong norms (majority shareholder rights)	(N1, N2, N3) strong	→ (P, L, C) →	s1 (impacted by "majority rights")
(s5) weak norms (minority shareholder rights)	(N1, N2, N3) weak	→ (P, L, C) →	s'1 (impacted by "minority rights")

Table 5: Model Relationships

Dependent variables (state variables: s1 - s5)	Moderating variables (Japanese business norms: N1, N2, N3)^a	Independent variables (instruments: P, L, C)^b
s1 (shareholder value maximization)	(i)N1, N2, N3 ("keiretsu") (ii)N1, N2, N3 ("individual")	→ P(+), L(-), C(Δ) → P(+), L(+), C(Δ)
s2 (outside directors)	(i)N1, N2, N3 ("traditional board") (ii)N1, N2, N3 ("progressive board")	→ P(-), L(-), C(Δ) → P(-), L(+), C(Δ)
s3 (market for corporate control)	(i)N1, N2, N3 ("friendly takeover") (ii)N1, N2, N3 ("hostile takeover")	→ P(+), L(+), C(+) → P(-), L(-), C(-)
s4 (transparency)	(i)N1, N2, N3 ("transparency for minority") (ii)N1, N2, N3 ("transparency for M&A")	→ P(+), L(0), C(Δ) → P(+), L(+), C(-)
s5 (protection of minority shareholders)	(i)N1, N2, N3 ("minority rights") (ii)N1, N2, N3 ("majority rights")	→ P(+), L(-), C(+) → P(-), L(-), C(+)

In this Table, for each state variable, cases (i) and (ii) for the moderating variables correspond, respectively, to strong and weak local business norms.

^b (-), (+) and (Δ) after each of the independent variables (P, L, C) mean, respectively, negative, positive and ambiguous impacts on the state variable.

5. CONCLUDING REMARKS

We have applied a selective adaptation framework to analyze Japan's corporate governance reform, which started in the 1990s. The reform was undertaken with a conviction that Japan's discredited post-World War II bank-based corporate governance system must be replaced by a US-style corporate governance system. The US corporate governance system was chosen as Japan's model because of the apparently robust economic performance of the US economy. Japan's reform has introduced new laws that emphasize shareholders' rights and shareholder value maximization, minority shareholders' rights, competition in the market for corporate control, and transparency and information disclosure. With strong public support, the Japanese parliament promptly passed these new laws, which all reflected Western liberal norms.

We have argued that, despite the US-style corporate governance laws and institutions that have come into effect in Japan, Japanese businesses' actual implementation of the new corporate governance practices so far has been quite selective and uneven.³⁸

Our predictions, summarized as Propositions 1-5, are based on the application of our selective adaptation framework. They are mostly consistent with the level of implementation observed in Japan so far for various aspects of US corporate governance practices (i.e., state variables (s1)-(s5)). Table 6 summarizes the propositions and our tentative conclusions about their predictive capacity based on our analysis of the cases as well as available anecdotal and empirical evidence.³⁹

We tentatively conclude that Japan's corporate governance reform will result in increased competitive activities in the market for friendly M&As and also in significantly improved practices of disclosure and transparency. We predict that the Japanese public will feel a sense of legitimacy and will have positive perceptions towards US corporate governance practices in these areas. On the other hand, we expect that corporate governance practices reflecting shareholder value maximization, executive committee-based boards and hostile M&As will receive less support because of a lack of positive perceptions and legitimacy towards these practices among the public, even though these US practices might complement Japan's existing practices under certain circumstances.

Finally we note that our selective adaptation framework provides a framework that can be used for empirically testing implications of our Propositions, as data become available.

Table 6: Propositions and Empirical Support

State variable	Proposition	Empirical confirmation ^a
(s1)	Proposition 1. Little support exists for shareholder value maximization for firms with strong keiretsu relationships. On the other hand, individual shareholders of keiretsu and other non-affiliated firms are likely to support (s1).	Mostly supported
(s2)	Proposition 2. Outside directors are more acceptable for progressive firms which can take advantage of outside directors' complementary skills. Doing so will make firms more efficient. Adopting the new executive-committee based board system requires not only more outside directors but also the delegation by firm management to outside directors of certain key managerial decisions including executive appointments and compensation decisions. Such an organizational change interferes with firm-specific operations reflected in business norms (N1-N3) and is less likely to be acceptable to firms.	Mostly supported
(s3)	Proposition 3. The corporate governance reform will promote Japan's acceptance of a competitive market for corporate control, particularly for friendly takeovers and mergers. Hostile takeovers are less likely to be practiced.	Supported
(s4)	Proposition 4. The new stricter transparency and information disclosure requirements will improve, to some degree, the transparency (and hence efficiency) associated with external market transactions for public investors and the firms involved. However, the extent of such improvements depends on the degree and nature of inter-firm relationships (as described by N1 and N2) and also their managerial styles at the group level (as described by N2).	Mostly supported
(s5)	Proposition 5. New rules about protecting minority shareholders will have limited impact on Japanese corporate governance practices, particularly including the practices of keiretsu firms. The potential for public embarrassments, for example, due to legal suits launched by protesting minority shareholders, may force some firms to adhere to these new rules more strictly.	Mostly supported

^a Empirical confirmation is tentative and based on our discussion in the text.

NOTES

¹ Western liberal norms and the business practices associated with them (e.g. individual rights, competition, and transparency) are well accepted in Japan. However, these liberal norms are not consistently applied in prevailing business policies. Selective adaptation views the incorporation of both Japanese and Western liberal norms as forms of compromising behavior.

² Different authors give different predictions. For example, Hoshi and Kashyap (2001) predict that Japan's new corporate governance system will become like the U.S. one and also like pre-WWII Japanese system, where bank roles are much diminished, capital markets are driven by institutional investors, and corporate managers are disciplined by active markets for corporate control.

³ For example, Gilson and Milhaupt (2004) find that, as of March 2003, no members of bank-centered horizontal keiretsu groups had adopted the U.S.-style executive committee based board of directors system. Explaining this in economic terms is difficult.

⁴ These items on the list are neither exclusive nor exhaustive.

⁵ Kiyokawa and Yamane (2004) report that 65% of managers and 71% of workers in Japan believe lifetime employment is desirable.

⁶ Westney notes that vertical keiretsu and some other features of the Japanese business system are variety constraining, explaining Japanese firms' relatively slow adaptation to the changed domestic economic conditions under which they had to operate in the 1990s (Westney, 2006:181).

⁷ E.g., some factors which increase share value (s_1) below will also benefit all shareholders, including minority shareholders (s_5). We define protection of minority shareholders as a separate state variable, (s_5), because increased (s_1) may benefit large shareholders more than minority shareholders. This is because large shareholders have the power over the firm management and hence can influence it to their advantage, unlike minority shareholders.

⁸ These state variables were originally introduced by Nakamura (2008, 2011). Highly developed economies, compared with developing economies, tend to have high levels of achievement with respect to these state variables (e.g. Shleifer and Vishny (1997), Porta et al. (1999)).

⁹ Morck and Nakamura (1999).

¹¹ Potter (2003, 2004) suggested these factors.

¹² Perception, complementarity and legitimacy are the three conditions that affect the dynamic of selective adaptation of foreign laws in a local context (Potter (2003, 2004)). We use the term “instruments” in this paper to emphasize the positive role that these three conditions have in a country’s selective adaptation of foreign corporate governance practices.

¹³ In considering the interactions above, specific Western liberal norms underlying particular U.S. practices are not explicitly enumerated. Instead the designated three instruments are utilized. This way of proceeding allows us to make practical inferences about Japan’s selective adaptation behavior. This will facilitate more formal statistical testing of our hypotheses once appropriate data become available.

¹⁴ Our conclusion is consistent with Roe (2001), who suggests that shareholder value maximization is, empirically, less likely to be accepted in countries where product market competition is weak (e.g. European markets) than in countries where product market competition is strong (e.g. the U.S.). This is because a high level of competition is generally regarded as one of the qualities implied by Western liberal norms.

¹⁵ The mass media have often pointed out the problems caused by Japan’s insider-oriented corporate boards (e.g. Hanai (2000)).

¹⁶ Statistics on the shareholder patterns of all Japanese listed firms show that Japanese business corporations and financial institutions (both known to be friendly shareholders) continue to own significant amounts of Japanese firms’ outstanding shares (about 25% each) in 2007 (Tokyo Stock Exchange (2009)).

¹⁷ Derivative suits are lawsuits that were brought by shareholders of Japanese corporations on behalf of the corporations against their directors and executives. As part of Japan’s earlier liberalization attempt of its corporate governance mechanisms, the 1993 revision of the Japanese commercial code significantly reduced the cost associated with these derivative lawsuits by shareholders.

¹⁸ For example, *The Economist* (2007) states: “Mitsubishi Heavy Industries reported on its own collusive practices after a revision to Japanese anti-monopoly law was made in January 2006 which reduced or exempted companies reporting their own infringements from punishment.” Commenting on this incident, an article in *The Economist* (2007) asks: “Why would a big company like Mitsubishi Heavy Industries report something like that? Because it had become clear to them that if executives collude knowingly they will be punished heavily, and become embroiled in shareholder suits,” says Mr. Kubo, a director at Tohmatsu Enterprise Risk Research Institute. ‘It was not like this before. It’s because of the new corporate codes. Recent court cases do emphasize executive culpability. In the old

days, only the person in charge was arrested, after which he would apologize and escape... like a lizard dropping his tail.”

¹⁹ Nevertheless, we caution that, since shareholder value maximization is obviously attractive to stockholders of all types, it is possible that proposals legitimately based on this principle in the general stockholders' meetings may get support from the majority of the shareholders against firm management opposition. Such votes of dissent were observed at the general stockholders' meetings of Tokyo Steel (February 2007) and Aderans (May 2009). We are indebted to an anonymous referee of this journal for bringing the Aderans case to our attention. The Tokyo Steel case is discussed in this paper below. In the Aderans case Steel Partners, the largest shareholder of Japan's largest wigmaker, was able to elect eight directors it supports to Aderans' board, against the slate of candidates supported by the company management and its entrusted private investment fund, Unison Capital (Harding (2009)). These cases involved the friendly merger agreements between Tokyo Steel (purchaser) and Osaka Steel (purchaser) and between Aderans (purchaser) and Unison Capital (purchaser). The point of contention in both cases was the tender offer prices which appeared to be unjustly low for the shareholders unrelated to the management. In both cases management lost.

²⁰ We thank an anonymous referee for pointing out the possible role of complementarity here.

²¹ While the Japanese government encourages the use of outside directors in both traditional and new systems, the use of outside directors is more strictly mandated in the new system. In the new executive committee based system, the majority of members of each of the three executive committees which reside within the board of directors must be from outside. For example, Sony has adopted a US-style system but Canon and Panasonic have not.

²² These implications of Proposition 2 are potentially empirically testable.

²³ As of March 2009, only 54 out of about 2000 firms listed in the first section of the Tokyo Stock Exchange adopted the committee system. Of these 54 firms, 15 firms are Hitachi group companies (Japan Auditors' Association, 2009). Firms adopting the committee system have some flexibility in designing how these three committees (appointment, compensation and auditing committees) relate to their boards of directors.

²⁴ Proposition 2 implies keiretsu firms' reluctance for adopting executive committee based boards. This explains Gilson and Milhaupt's (2004) findings that, as of March 2003, no members of bank-centered horizontal keiretsu groups had adopted the executive committee based board of directors system.

²⁵ An amendment of the Commercial Code in 2002 established the first Japanese definition of an 'outside director' as a person who has not previously been a director, officer or employee of the same company or its subsidiaries. Furthermore, this person does not have an executive role in the business of the company. However, the independence of an outside director is not clearly specified (Seki, 2005). In the Japanese case, this has so far been difficult, as many outside directors are, in fact, not thought to be independent (particularly not the CEO), as they come from the government, other banks or from other companies with which the company for which they will be a director had a long-standing relationship. Hermalin and Weisbach (2003) call these outside directors 'affiliated' or 'gray' directors. Japan is clearly considered to have insider dominated boards (Charkham, 1994).

²⁶ E.g. Arikawa and Miyajima (2007). However, the volume of M&As involving Japanese firms is still small by international comparison. The amounts (in billion dollars) of M&As reported for different countries for the first 6 months of 2007 are: U.S. (1,372.7); U.K. (632.3); Spain (217.6); Italy (208.5); Canada (185.4); France (159.9); Germany (155.1); Australia (110.4); and Japan (81.3).

²⁷ Japanese banks' shareholding clearly declined over the 1990s. Other types of corporate shareholding also declined somewhat, but the majority of vertical keiretsu-related shareholding remained.

²⁸ E.g., Bebchuk and Cohen (2005), Gompers et al. (2003) and Hermalin and Weisbach (2003).

²⁹ These are potent as poison pills; their effectiveness was proven during most of the post-World War II period (e.g., Morck and Nakamura (1999)).

²⁹ These include Oji Paper's attempt to absorb Hokuetsu Paper, Rakuten's attempt to take over Tokyo Broadcasting System, and Livedoor's attempt to take over Nippon Broadcasting System.

³⁰ For example, the merger between the Kangyo Bank and the Daiichi Bank, two of Japan's largest banks, kept two separate personnel management systems under the new merged bank (Daiichi-Kangyo Bank), with all promotions conducted within the respective former systems, for more than 10 years. Their performance badly lagged their industry peers during this period.

³¹ In 2005, there were 3,734 reported transactions of M&As in Japan. Of these, 2,725 (73%) were between group (affiliated) firms, while the remaining 1,009 (27%) involved non-group firms. Furthermore, the fraction of in-group M&As has been increasing since the early 1990s (Development Bank of Japan (2007)).

³² Prior to the reform, only stand-alone financial statements were required. Firms did not report unrealized gains or losses of the securities they owned.

³³ For example, the European Union (EU) recently accepted Japan's new accounting standards. See, for example, "EU allows US, Japan firms to keep accounting standards," Reuters, Tue Apr 22, 2008 9:59am EDT; and Commission of the European Communities (2008).

³⁴ An example is the recent scandals regarding illegal accounting (e.g. creating non-existing sales between related firms) by Fujitsu's and NEC's related firms (Nikkei (July 3, 2007)).

³⁵ E.g., in the case of Mitsubishi Motor Corporation selling itself to Daimler Chrysler, it was subsequently disclosed that MMC hid its record on recallable manufacturing defects. As a consequence, Daimler Chrysler sold back all the shares of MMC to MMC and also was awarded compensation for the lack of disclosure of MMC's manufacturing defects.

³⁶ Nevertheless, we expect the level of disclosure and transparency in Japan to be lower than it is in the West for activities involving intra-keiretsu group transactions.

³⁷ We thank a referee for suggesting this way of specializing our general model.

³⁸ This observation is consistent with some other researchers' For example, in discussing Japanese firms' slow adjustments to new business circumstances Methé (2004, p.6) concludes that "... Many of the laws and regulations that have been introduced are based on US models. However, these new laws and regulations are being interpreted and implemented by incumbent agents in ways that constrain the momentum for change in the overall system and that may channel this momentum into maintaining the status quo and supporting heterostatic change."

³⁹ Further empirical research and theoretical foundations are warranted.

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