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Adoption and policy implications of Japan's new corporate governance practices after the reform

Masao Nakamura

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Abstract In this paper we explain the process and policy implications of Japanese firms' adoption of recently reformed corporate governance practices. We use a selective adaptation framework in doing so. We present some qualitative predictions about the possible outcome of their adoption process. One advantage of our approach is that we can describe various aspects of the evolutionary process of Japan's corporate governance reform as a system in a consistent manner, rather than as independent pieces. Our predictions provide policy implications and are empirically testable. Japan's post-bubble corporate governance reform has been extensive and involves the enactment and revisions of many relevant laws and affected institutions. Japan's aim has been to install US-like practices (the *de facto* global standard), with these practices replacing the now tarnished bank-centered practices, and to facilitate Japanese industry in regaining global competitiveness. However, we show that Japanese businesses' adoption of US practices has been selective and efficiency and other policy implications of such behavior are potentially dysfunctional.

Keywords Corporate governance reform · Japan · Selective adaptation · Efficiency · *Keiretsu*

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M. Nakamura (✉)
Sauder School of Business, University of British Columbia, 2053 Main Mall, Vancouver, BC, Canada V6T 1Z2
e-mail: masao.nakamura@sauder.ubc.ca

Following its prolonged post-bubble recession that was kicked off by the burst of the bubble, Japan undertook a major institutional reform in its corporate governance and related mechanisms. A number of previous studies consider how Japan's new corporate governance behavior might become more like the US situation as a consequence of the new reform initiatives.

Milhaupt (2006) and Yoshikawa and McGuire (2008), for example, consider which of Japan's corporate governance practices might best be retained. Considering corporate governance as part of a nation's institutional framework, Yoshikawa and McGuire (2008) emphasize the importance of unique institutional arrangements that affect corporate governance practices and discuss issues of continuity and change for these sorts of institutional features of a nation. We agree with their views about the importance of the impacts on the corporate governance system of each nation's unique institutions.

In this paper we model Japan's reform process, which features the adoption of US-based corporate governance mechanisms, as a dynamic evolutionary process based on selective adaptation.[1] In this set-up, Japan is viewed as selectively choosing certain US practices while rejecting others that were introduced in the reform process. We show that such a selection process is often systematic and is in large measure predictable.

Advantages of our selective adaptation method include the following: (1) the method can explain various aspects of corporate governance behavior in a consistent manner; (2) the method distinguishes between the adopted legal settings and the local acceptance (implementation) of them based on the local norms that underlie these sorts of laws; and (3) the method provides a natural framework within which to analyze many issues raised in the previous empirical studies including those cited above. We present below our approach to describing Japan's reform as a dynamic and evolutionary process of adoption of US practices in a selective manner.

Selective adaptation approach

In our selective adaptation framework we explain Japan's changes in corporate governance practices and institutions as a dynamic evolutionary process. 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 select to implement (or enforce) various parts of the Anglo-American corporate governance practices.[2] We note that certain phenomena that are associated with Japan-specific factors (norms) cannot be easily explained using economic theory.[3]

[1] We consider the US corporate governance system, or more broadly, the Anglo-American system as the *de facto* global standard corporate governance system (e.g., Nakamura, 2006).

[2] Stiles (2006) discusses the dissemination of liberal norms.

[3] For example, econometric specifications in most studies of Japanese corporate governance include *keiretsu* dummies as explanatory variables. But the origin of such dummies is unknown, still capturing large amounts of statistically significant unobservable effects.

Selective adaptation: Japan's corporate governance practices before and after the corporate governance reform

We apply a selective adaptation framework to analyze Japan's reactions towards US-style corporate governance practices. For most practical purposes, it is reasonable to think that all legal and institutional settings required by Japanese corporations for adopting US-type corporate governance practices have been included in the Japanese government reform measures. Nevertheless, how fully proposed US practices were implemented and enforced in the end by Japanese corporations depends on the selective adaptation behavior of Japan's businesses, government, courts, and the public.

State variables for describing Japan's corporate governance

We focus on several major Japanese corporate governance issues that must be faced as Japan attempts to adapt to the Anglo-American system which embodies Western liberal norms. These norms are reflected in US practices including: legal protection of shareholders' rights, especially including the rights of minority shareholders; issues associated with large shareholders (i.e., concentrated ownership); and the agency costs (to all shareholders) that arise because firms' managers do not implement policies to maximize shareholder value.

We propose to use the following state variables to measure the change in the functioning of corporate governance mechanisms, before and after the reform, in the areas of our interest. These state variables can have effects that are not necessarily mutually independent or exclusive. For example, the factors that increase state variable S1 below, representing the degree to which shareholder value is maximized, will also benefit all shareholders, including minority shareholders S5. However, we define below protection of minority shareholders as a separate state variable (denoted by S5) because increased S1 may benefit large shareholders more than minority shareholders. Often large shareholders have power over the firm management and hence can influence it to their advantage, unlike minority shareholders. We view these state variables as one way to capture essential aspects of Japan's corporate governance mechanisms.[4]

The state variables we define are:

(S1) The degree to which shareholder value maximization is achieved.
(S2) The degree to which outside independent directors are involved in the decisions of boards of directors.
(S3) The degree of competition in the market for corporate control (i.e., activities associated with M&As).
(S4) The degree of transparency and information disclosure in accounting, financial, and other reporting to investors.
(S5) The degree of the protection of minority shareholders.

[4] Highly developed economies, compared to developing economies, tend to have high levels of achievements in these state variables (e.g., La Porta, Lopez-de-Silanes, & Shleifer, 1999; Shleifer & Vishny, 1997).

The first of our state variables (S1) describes the degree to which the management is faithful to shareholders' objective to maximize the firm's share value. Prior to the reform, Japanese firm management was able to pursue their own objectives which were often significantly at variance with shareholder value maximization. Agency costs of this sort were a significant source of economic inefficiency. One of the cornerstones of Japan's corporate governance reform is the formal acknowledgement by the Japanese government of shareholder value maximization as the primary objective of corporations' in their decision-making. Japan's new company law and other related laws focus on this point. Legal terms for the protection of shareholders' rights have been clearly set out, as in the United States.

The second of our state variables (S2) measures the degree to which the board of directors of a company functions as a governance body. If the board is controlled by insiders, which was often the case before the reform, it might be difficult to reduce the agency costs of the sort noted in our discussion of S1.

The third of our state variables (S3) measures how active the market for corporate control is. While Japanese banks played some role as a substitute for the market for corporate control before the reform, they were not able to replicate the benefits of a more competitive market for corporate control.[5] Inability to replace a firm's bad management team with a more competent one in a timely manner has been a major source of agency cost, of the sort noted in the discussion of S1, and a source of significant economic inefficiency. We are interested in how the reform impacts the degree of competition in the market for corporate control.

The fourth of our state variables (S4) measures the fair and transparent availability of firm information that is relevant to all investors concerned. Information disclosure and transparency is the basic prerequisite for efficient functioning of the stock market, allowing investors to evaluate the shares they own. Efficient capital markets also give managers information about the cost of capital which is required for their investment decisions. Efficient stock markets are also essential for developing an active market for corporate control. Japanese bank-based corporate governance mechanisms were insider-oriented and often lacked transparency.

The fifth of our state variables (S5) describes the degree to which the individual rights of investors, and particularly those of minority investors, are protected. It is well known that under the old bank-based corporate governance system, up to 70% of most listed firms in Japan were owned by financial and other corporate shareholders who were sympathetic to the incumbent management. Hence firm management generally paid little attention to individual and other minority shareholders' rights.

Local business norms and instruments for Japan's selective adaptation

Japanese business norms Certain norms characterize behavior in Japan's business sector, and society in general.[6] Some of these norms are particularly important for

[5] Morck and Nakamura (1999).

[6] Examples of these norms include: group behavior, consensus, long-term relationships, vertical *keiretsu* relationships among corporations, importance of group-oriented values, trust and networks, and male-female behavior (e.g., Nakamura, 2009; Reischauer, 1988; Tiessen, 1997). These societal norms and business norms are often intermingled and are not generally separable. See also Fang (2010).

shaping Japan's acceptance or rejection of new US-style practices of corporate governance. We list three business norms that we regard underlie Japanese business behavior:

(N1) Norms associated with corporate groups (*keiretsu*). Group-oriented behavior reflecting economic efficiency effects may underlie Japanese *keiretsu* behavior, particularly for some vertical production *keiretsu* groups. Economic efficiency gains have not been verified for horizontal *keiretsu*.[7] *Keiretsu* groupings have proven to be highly potent poison pills and have functioned as such since the early 1950s. Japan's *keiretsu* behavior has been extensively documented (e.g., Lincoln, 2006; Lincoln & Gerlach, 2004). McGuire and Dow (2009: 346) emphasize the difficulty of defining *keiretsu* by stating that: "there has been a growing recognition that economic rationality and efficiency may be insufficient to understand the role of *keiretsu* in the Japanese economy." Our choice of *keiretsu* as a determinant of business norms is consistent with the observations of McGuire and Dow (2009).[8]

(N2) Consensus, and avoidance of open confrontations. This kind of value system might encourage out-of-court settlements and impede transparency and full acceptance of new corporate governance laws by individual business firms and shareholders.[9]

(N3) Stakeholder-oriented value maximization as the objective for corporate decision making. Many authors suggest that Japanese corporations have pursued firms' stakeholder-oriented value maximization (e.g., Aoki, 1988; Araki, 2005; Jacoby, 2005; Yoshikawa & Phan, 2001) and value-added maximization (Tsurumi & Tsurumi, 1991). These sorts of objective functions put much weight on the welfare of firms' employees as well as the welfare of suppliers, customers, and creditors.[10,11]

Instruments that facilitate adoption of new institutional settings and practices If firms and investors readily see the immediate or potential benefits of new laws, the laws may be implemented promptly and with full force. The reasons for full

[7] For example, Hadley (1970: 291) and Miwa and Ramseyer (2001). However, Nakatani (1984) and others also show the risk sharing function conducted by the horizontal *keiretsu* groups. In economics risk sharing is often thought to be efficiency increasing.

[8] Despite our focus on *keiretsu*-affiliated firms here, there are many non-*keiretsu*-affiliated firms in Japan. For example, Japanese METI (1999) reports that less than 10% of all Japanese firms have subsidiaries, which are essential components of vertical *keiretsu* groups. We develop our predictions to be discussed below taking into account the presence of such non-*keiretsu* firms. We are indebted to one of the referees for pointing this out.

[9] For some court cases, out-of-court settlements may mimic the court decisions as they are likely predictable. But it is unclear that the same can be said of out-of-court settlements for corporate governance litigations, which often allow the parties involved to withhold information which may be important for general shareholders to know.

[10] The Japanese economy's prolonged post-bubble under-performance suggests significant efficiency loss under the bank-based corporate governance system.

[11] It is possible that our business norms, (N1–N3), do not adequately characterize some Japanese business practices. One such example might be the Japanese preference for long-term employment and other business relationships.

acceptance are, in most cases, believed to be economic, though humanitarian considerations can be seen sometimes to be important. Also, there may be little reason for businesses to reject new rules if, all else equal, they perceive those rules are obviously better suited for modern economic activity compared to the old rules. Such an element of perception and legitimacy may be needed for having new rules be accepted by economic agents.

Selective adaptation of foreign legal and institutional practices is a dynamic process driven by interactions of local and foreign norms and cultures, among other factors. We postulate here that the outcome of such interactions depends primarily on the following three factors: (I1) perception, (I2) complementarity, and (I3) legitimacy.[12] As Etzioni (1961) and Unger (1975) 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.

Another reason that may facilitate acceptance of new laws is when they complement the existing old rules in some ways. When complementarity exists between two sets of apparently competing or contradictory institutions and practices, the two sets can be combined in such a way that the combined set functions in an effective and powerful way while allowing preservation of the original characteristics of each of the component sets. The degree of complementarity determines the degree of mutual sustainability in a nation of both local and nonlocal rules and the associated institutions and practices.

Legitimacy must accompany any successful adoption of new rules and regimes (e.g., Scharpf, 2000; Weber, 1978). 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 may vary depending on the contexts of the foreign laws and institutions and their underlying norms. But the effectiveness of the foreign laws, institutions, and practices adopted in a selective adaptation process is determined to a significant degree by the level of legitimacy of the selective adaptation process.

If legitimacy or complementarity in the new laws are not obviously present and yet the new laws are adopted by the government, investors and businesses alike may not seriously implement the new laws and may instead look for loopholes.

In circumstances where new laws and institutions proposing new corporate governance practices have elements of legitimacy and/or complementarity as discussed above, these new practices will likely be accepted. Their acceptance will further be facilitated if the practitioners concerned and the general public perceive that the new laws are consistent with their personal beliefs.

In the following we call perception, legitimacy, and complementarity the instruments for selective adaptation. In the following discussion, we argue that adoption of new practices is likely if at least some of the instruments that favor acceptance of the new practices can be found to exist *a priori*.

[12] Potter (2003, 2004) proposed using perception, legitimacy, and complementarity for explaining how selective adaptation proceeds in a foreign culture.

Relationship to Japan's adaptation behavior in the modern Japanese history

There is well-established evidence presented in the Japanese studies literature that shows that Japan successfully adapted to new Western methods introduced to the country since the Meiji Restoration in 1868. Western methods were introduced, for example, in technology, management, and political and legal institutions. Saxonhouse (1977: 195) stresses that "development economists have shown special interest in Japan's adaptation of foreign industrial and agricultural technology to her own needs." Saxonhouse and Ranis (1985) point out that, in the late 18th century, Japanese industry was successful in adapting technology, work organization, and product mix to a local setting with abundance in labor.

In describing Japan's design of its Tokyo police force in the 18th century, Westney (1987) points out Japan's choice of the French model which represents a close fit between French traditions of centralization and political surveillance and Meiji leaders' objectives. Westney further explains about how Japan historically chose among various organizational forms for its institutions as follows. Japan has chosen its institutions' organizational forms based on the following mix: some forms were directly reproduced from the main Western model; some were adapted from competing foreign models and grafted onto the system being designed; some were taken from other emerging organizations of the Meiji government; some retained the pre-Meiji features of relevant indigenous institutions; and finally, some organizational characteristics reflected Japan's innovative responses to the problems facing the new organizations.

Discussing Japan's technological development in the early to mid 1900s, Yamamura (1986) also emphasizes Japanese firms' and government's adaptive decisions in adopting Western technologies and development of domestic technological competence. Although our focus is on studying the contemporary evolutionary change in Japan's corporate governance practices using a selective adaptation framework, the above discussion suggests that our approach to study the evolutionary change in corporate governance practices seems well grounded in the historical evidence presented above. These studies also emphasize Japan's adaptive behavior which tends to find a mix of Western and locally available or locally developed methods.

We note also that one of our instruments, complementarity, often prompted Japan's decisions in the studies cited above to adopt Western methods in part, often combined with its own indigenous practices. In such cases decision makers in Japan clearly saw economic or other types of gain by adopting fully or partially new Western methods.[13]

Japan's corporate governance reform: Predictions based on a selective adaptation framework

In applying a selective adaptation framework to Japan's corporate governance reform, we consider how Japanese business norms (N1–N3) interact with Western

[13] We do not focus on this point in this paper but it is likely that the same can be said of Japan's adaptation to the corporate governance reform currently being undertaken. We are indebted to one of the referees for pointing out the relationship of this paper to the Japanese studies literature cited above.

liberal norms which work to enhance each of the state variables (S1–S5). In our selective adaptation analysis we use the three instruments (perception, legitimacy, and complementarity) instead of the liberal norms in directly calculating the relevant interactions. We proceed as follows. For each state variable and the associated US corporate governance practices which are thought to enhance the value of the state variable, we consider interactions between the instruments and the relevant Japanese norms. If the overall effects of the interactions are positive, we conclude that Japan accepts the relevant US practices by selective adaptation (and the underlying Japanese norms, in particular) and hence the relevant state variable(s) will increase in value as a result of the reform. Table 1 illustrates our framework of analysis for shareholder value maximization (S1).

Table 1 Japan's adaptation to US corporate governance practices: Implications of interactions between Japanese and Western business norms for corporate governance state variables (S1, S2,...,S5).

	Instruments of selective adaptation for Western liberal business norms		
	(I1) Perception	(I2) Legitimacy	(I3) Complementarity
Japanese corporate governance state variable: S1 (shareholder value maximization)			
Japanese business norms, (N1, N2, N3) below			
(N1) Corporate groups (*keiretsu*)	− (possible conflict between *keiretsu* and individual firms)	− (possible conflict between *keiretsu* and individual firms)[a]	+ (each supplier's shareholder value maximization reduces moral hazard and agency costs among vertical *keiretsu* firms)
(N2) Consensus as the goal, and avoidance of open confrontations	− (possible conflict between shareholders and other stakeholders)	− (possible conflict between shareholders and other stakeholders)	Δ
(N3) Stakeholder value, value added, and other group-oriented value maximization as the objective for corporate decision making	− (possible conflict between shareholders and other stakeholders)	− (possible conflict between shareholders and other stakeholders)	+ (paying serious attention to traditionally ignored shareholders' rights to some degree may even improve corporate governance)

Each cell represents possible impacts on the state variable in question (S1 in the present case) of the interaction between each of the Western business norms instruments and each of the Japanese business norms. (−), (+), and (Δ) mean, respectively negative, positive, and ambiguous impacts on the adoption of the state variable in question. For example, Japanese perception of shareholder value maximization in the context of corporate group (N1) is likely negative because of the possible conflict between *keiretsu* and individual firms. For the same reason legitimacy to promote shareholder value maximization (S1) will be negative. On the other hand, shareholder value maximization at each *keiretsu* member firm may improve that firm's governance by reducing *keiretsu*-related moral hazard and agency costs and hence the complementary role of shareholder value maximization may have a positive impact on strengthening the corporate group (N1). Overall, negative interactions between the Western and Japanese business norms are likely to dominate. Hence our selective adaptation analysis implies that shareholder value maximization is less likely to be adopted by Japanese firms.

[a] For example, crossholding and other types of intra-group shareholding are not compatible with each firm's shareholder value maximization.

State variables and the reform

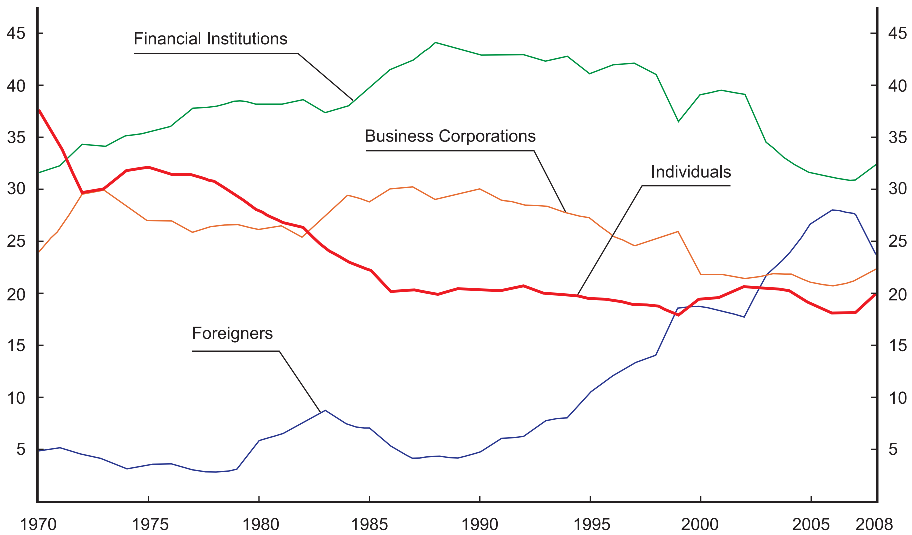
Shareholder value maximization (S1) There was general agreement in the post-bubble reform process that Japan's bank-based corporate governance system was too insider-oriented and that the US style market-based system, with the clear management objective of shareholder value maximization, needed to be implemented. In order to achieve this objective, many laws were revised. Japan's new company law, in particular, was set up to provide a new framework within which Japanese corporations can organize their business activities and corporate structures to be consistent with profit maximization. To secure investor confidence, Japan's new Financial Instruments and Exchange Law, enacted in June 2006, updates and consolidates all existing exchange laws, including the Securities and Exchange Law. It introduces the notion of flexibility in its mandate on regulating financial instruments.

However, Japan's initial acceptance of the notion of shareholder value maximization did not necessarily lead to straightforward acceptance of various business practices that are associated with the US-style shareholder value maximization. Investigation of interactions between Japanese business norms (N1–N3) and each of the three instruments (I1–I3) suggests the following. Since corporate policies based on firm value maximization often contradict with the objectives of *keiretsu* and other interfirm relationships (N1), they also disturb the harmony of consensus (N2) and stakeholder (N3) based policies, leading to negative perceptions and questions regarding the legitimacy of the new practices. Furthermore, even though policies based on firm value maximization clarify each *keiretsu* firm's own economic contributions and efficiency, which are sometimes ignored by policies based on (N1–N3), nevertheless focusing on a single firm's profit maximization is likely to conflict with (N1–N3). This suggests that there is little room for positive complementarity effects. These considerations are consistent with the following proposition based on selective adaptation:

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.

As implied by Proposition 1, the degree of firm value maximization (S1) has increased interactions between corporations and their individual and institutional shareholders. General decline in bank shareholding has been replaced by a substantial increase in shareholding by individuals and investment funds (Figure 1). As expected from Proposition 1 these new shareholders clearly view shareholder value maximization as an important objective to be pursued by the firm management. Japan's new laws acknowledge shareholders' ownership of their firms. However, if the majority of outstanding shares of a corporation are owned by friendly *keiretsu* firms as is seen from Tables 2 and 3 and Figure 1, the new laws telling corporations to follow shareholder value maximization will not provide legitimacy and the general perception may be that it also is not necessarily useful for individual shareholders.[14] We discuss

[14] In 2008, 54.8% of Japanese listed firms' outstanding shares was owned by financial institutions and business firms (Table 2). 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., Europe, Japan) than in countries where product market competition is strong (e.g., the US).



Source: Tokyo Stock Exchange. 2010. *2008 shareownership survey*. Tokyo.

Figure 1 Long-term trends in the ownership strcture of Japanese listed firms

some evidence supporting Proposition 1 and also related public policy issues in the next section.

Outside independent directors' involvement in board decisions (S2) Under Japan's new company law, corporations now have options to choose between the traditional Japanese style corporate board system and a US style executive committee system. In the latter system, majority members of each of the three executive committees (appointment, compensation, and auditing committees) must be from outside. New government policies generally encourage more extensive use of outside (independent) directors for corporate boards. Outside directors, however, play different roles depending on which system a company chooses to adopt. Broadly speaking, new government policies on corporate board structures may (1) encourage the use of outside directors and (2) allow each firm to choose between the traditional Japanese style corporate board and a US style executive committee-based board.[15]

Using a selective adaptation framework similar to the one shown in Table 1 for S1, we can show that directors who are strictly outsiders to firms' operations are less likely to be acceptable to firms as members of their boards. First, because of many Japanese firms' complex interfirm relationships (for example, driven by business norms [N1]) and firm-specific management practices (e.g., N2 and N3), many Japanese businesses do not believe that outside directors (S2) can provide solid oversight on firms' governance. Such outsiders are not likely to generate enough confidence in the company managers either. Outside directors are not likely to

[15] Firms adopting this system have some flexibility in designing how these three committees (appointment, compensation, and auditing) relate to the board of directors. For example, Sony adopted the US style system but Canon and Panasonic did not.

generate enough confidence because few insiders think outside directors can understand the complex relationship-based business issues that are often important for firms' operations and decision-making. This does not provide legitimacy to S2. However, outside directors can potentially bring in skills that insiders do not possess, and hence it is likely that despite possibly negative perceptions and legitimacy associated with outside directors, progressive firms may be able to take advantage of complementarity which will increase firms' efficiency. Regarding firms' choice between the Japanese style vs. US style committee system, we particularly note that the latter requires delegating all important management functions such as those involving appointment, compensation, and other personnel management to outsiders. These personnel management functions are among the most important key management functions in many Japanese firms (e.g., Aoki, 1988) and are closely tied to the business norms reflecting the importance of management focusing on *keiretsu*, consensus, and stakeholders (N1–N3). Delegating these functions to outsiders will raise negative perceptions on legitimacy and complementarity fronts. Hence we conclude with the following implications:

Proposition 2 Outside directors are more acceptable for progressive ("non-*keiretsu*") firms[16] which can take advantage of outside directors' complementary skills. Doing so will make firms more efficient. Adopting the new executive committee-based board system not only requires more outside directors but also requires the delegation to outside directors by firm management of certain key managerial decisions including executive appointments and compensation decisions. Such an organizational change interferes with the firm-specific operations reflected in business norms (N1–N3) and is less likely to be acceptable to the firms.

The above proposition suggests that the use of outside directors will continue to be limited in Japan. This is consistent with the fact that the majority of Japanese corporations do not have outside directors (Table 4). The proposition also implies that there is room for change in this regard as more progressive firms begin to increase their dependence on outside directors. We see from Table 5 that there is such a trend, though this seems to be only taking place at the margin.

Another implication of our proposition above is that firms will require special competencies to be able to take advantage of executive committee-based board structures. This is consistent with the fact that only a small number of listed firms have chosen this form of board structure in Japan, and, not surprisingly, their firm performance is not necessarily better than other firms with Japanese style board structures (Table 6).

Competition in the market for corporate control (S3) One of the fundamental issues raised by the reform about the Japanese business system has to do with the fact that, under the bank-based corporate governance system, it was difficult to cut inefficient parts of the company in order to grow more promising areas of a business. An active market for corporate control allows firms to exchange component parts in order to

[16] We sometimes use this nomenclature for convenience but it does not imply that all *keiretsu* firms are non-progressive.

Table 2 Changing patterns of stable shareholding: Japanese listed firms, 1970–2008.

Survey year	Govt. & local govt.	Financial institutions	City & regional banks	Trust banks	Investment trusts	Annuity trusts	Life insurance cos.	Non-life insurance cos.	Other fin. institutions	Securities companies	Business corps.	Foreigners	Individuals
1970	0.6	31.6	15.8	–	2.1	–	10.0	3.7	2.1	1.3	23.9	4.9	37.7
1975	0.4	35.5	19.0	–	2.2	–	10.2	4.4	2.0	1.4	27.0	3.6	32.1
1980	0.4	38.2	19.9	–	1.9	0.4	11.5	4.6	2.3	1.5	26.2	5.8	27.9
1985	0.3	39.8	20.9	–	1.7	0.8	12.3	4.1	2.4	1.9	28.8	7.0	22.3
1986	0.9	41.5	14.9	7.3	1.9	1.0	12.8	4.0	2.5	2.1	30.1	5.3	20.1
1987	0.5	42.5	14.9	8.6	2.6	1.1	12.4	4.0	2.6	2.3	30.3	4.1	20.4
1988	0.4	44.1	15.7	9.8	3.1	1.0	12.6	4.1	2.0	2.3	29.0	4.3	19.9
1989	0.3	43.5	15.7	10.2	3.7	0.9	11.8	3.9	1.9	2.0	29.5	4.2	20.5
1990	0.3	43.0	15.7	9.8	3.7	0.9	12.0	3.9	1.6	1.7	30.1	4.7	20.4
1991	0.3	42.8	15.6	9.7	3.4	1.0	12.2	3.9	1.4	1.5	29.0	6.0	20.3
1992	0.3	42.9	15.6	9.9	3.2	1.2	12.4	3.8	1.2	1.2	28.5	6.3	20.7
1993	0.3	42.3	15.4	10.0	2.9	1.4	12.1	3.7	1.1	1.3	28.3	7.7	20.0
1994	0.3	42.8	15.4	10.6	2.6	1.6	12.0	3.7	1.1	1.2	27.7	8.1	19.9
1995	0.3	41.1	15.1	10.3	2.2	1.8	11.1	3.6	1.0	1.4	27.2	10.5	19.5
1996	0.2	41.9	15.1	11.2	2.0	2.4	11.1	3.6	0.9	1.0	25.6	11.9	19.4
1997	0.2	42.1	14.8	12.4	1.6	3.8	10.6	3.5	0.9	0.7	24.6	13.4	19.0
1998	0.2	41.0	13.7	13.5	1.4	4.7	9.9	3.2	0.8	0.6	25.2	14.1	18.9
1999	0.1	36.5	11.3	13.6	2.2	5.0	8.1	2.6	0.9	0.8	26.0	18.6	18.0
2000	0.2	39.1	10.1	17.4	2.8	5.5	8.2	2.7	0.7	0.7	21.8	18.8	19.4
2001	0.2	39.4	8.7	19.9	3.3	6.0	7.5	2.7	0.7	0.7	21.8	18.3	19.7
2002	0.2	39.1	7.7	21.4	4.0	5.8	6.7	2.6	0.7	0.9	21.5	17.7	20.6
2003	0.2	34.5	5.9	19.6	3.7	4.5	5.7	2.4	0.9	1.2	21.8	21.8	20.5

2004	0.2	32.7	5.3	18.8	3.9	4.0	5.4	2.2	1.0	1.2	21.9	23.7	20.3
2005	0.2	31.6	4.7	18.4	4.4	3.6	5.3	2.1	1.0	1.4	21.1	26.7	19.1
2006	0.3	31.1	4.6	17.9	4.7	3.5	5.4	2.2	1.0	1.8	20.7	28.0	18.1
2007	0.4	30.9	4.7	17.5	4.9	3.5	5.5	2.2	1.0	1.6	21.3	27.6	18.2
2008	0.4	32.4	4.9	19.0	5.1	3.6	5.4	2.1	1.0	1.0	22.4	23.6	20.1

Units: %.

Source: Tokyo Stock Exchange. 2010. *2008 shareownership survey*. Tokyo.

Table 3 Cross-holding (*mochiai*) patterns: Japanese listed firms, 1987–2008.

	No. of cases					Fractions (%)				
	A.no change	B.entry	C.exit	D.unknown	E.total	A1	B1	C1	D1	F
1987	16,063	5,371	1,919	386	23,739	67.7	22.6	8.1	1.6	14.5
1988	16,017	6,982	1,611	530	25,140	63.7	27.8	6.4	2.1	21.4
1989	16,546	7,736	2,035	677	26,994	61.3	28.7	7.5	2.5	21.1
1990	20,387	5,955	1,424	507	28,273	72.1	21.1	5.0	1.8	16.0
1991	23,384	3,892	1,375	528	29,179	80.1	13.3	4.7	1.8	8.6
1992	25,010	2,695	1,095	411	29,211	85.6	9.2	3.7	1.4	5.5
1993	24,671	1,903	1,637	606	28,817	85.6	6.6	5.7	2.1	0.9
1994	25,125	2,117	1,300	557	29,099	86.3	7.3	4.5	1.9	2.8
1995	25,770	2,041	1,434	359	29,604	87.0	6.9	4.8	1.2	2.1
1996	25,854	2,408	1,271	487	30,020	86.1	8.0	4.2	1.6	3.8
1997	25,379	2,581	1,785	756	30,501	83.2	8.5	5.9	2.5	2.6
1998	23,786	2,453	2,526	668	29,433	80.8	8.3	8.6	2.3	−0.2
1999	18,994	1,848	4,355	2,245	27,442	69.2	6.7	15.9	8.2	−9.1
2000	14,131	1,801	2,398	1,293	19,623	72.0	9.2	12.2	6.6	−3.0
2001	13,327	2,410	2,301	941	18,979	70.2	12.7	12.1	5.0	0.6
2002	11,796	2,586	2,924	1,092	18,398	64.1	14.1	15.9	5.9	−1.8
2003	12,173	1,165	3,193	1,251	17,782	68.5	6.6	18.0	7.0	−11.4
2004	13,003	1,357	2,034	791	17,185	75.7	7.9	11.8	4.6	−3.9
2005	12,742	2,281	1,580	816	17,419	73.2	13.1	9.1	4.7	4.0
2006	13,671	1,909	973	743	17,296	79.0	11.0	5.6	4.3	5.4
2007	12,958	2,393	792	966	17,109	75.7	14.0	4.6	5.6	9.4
2008	12,698	1,756	677	1,179	16,310	77.9	10.8	4.2	7.2	6.6

A1, B1, C1, and D1 are percentage figures for A, B, C, and D; F is given by: (B–C)/E×100.

We classify the above *mochiai* period as follows: *mochiai* strengthened (1987–1992); *mochiai* reduced (1998–2004); and *mochiai* revival (2005–2008).

Source: Nitta (2009: Table 2).

Table 4 Fractions of outside directors at Japanese corporations.

	2,012 listed firms	30 firms with executive comm. boards	1,122 firms with traditional boards
%outside	1.81	4.97	1.57
%bank-sent	1.09	1.83	1.04
%controlling firm-sent	1.28	1.37	1.24

Sample: Firms listed on the first and second sections of the Tokyo Stock Exchange in August 2005.

Source: Miyajima and Nitta (2006).

Table 5 Listed firms with increased presence in the proportions of outside directors.

Year	1997	1998	1999	2000	2001	2002	2003	2004
Firms with increased board presence of outside directors	7	20	33	60	73	92	114	128
Sample size	639	635	634	630	622	605	589	581

Sample: Firms (listed on the Tokyo Stock Exchange) are such that their board size exceeded 15 in 1996 and the fractions of outside directors in their boards were less than 30% in 1996.

Source: Miyajima and Nitta (2006).

form mutually more efficient corporations. With this process, more share value is generated. It is also the goal shared by Japan's reform involving revisions of its company law and commercial code, anti-monopoly laws, exchange laws, and other related institutions.

For these reasons it is likely that positive perceptions, legitimacy, and complementarity are generally shared by *keiretsu* firms (N1) and stakeholders (N3) for more competitive transactions involving corporate control which lead to more efficiency. However, positive perception and legitimacy associated with N1 and N3 may be weakened when corporate control transactions are of hostile nature, and the Japanese consensus norm (N2) will definitely have negative interactions with perceptions and legitimacy of S3.

We summarize that Japanese business norms (N1–N3) have positive interactions with perceptions, legitimacy, and complementarity consistent with friendly mergers, but are not consistent with hostile takeovers on the basis of the public perception and legitimacy. Thus we derive 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.

Thus, using our selective adaptation framework we conclude that Japan's acceptance of a competitive market for corporate control will be more prevalent for friendly takeovers and mergers. On the other hand, hostile takeovers are less likely to be acceptable to Japanese businesses and society in general, even though

Table 6 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	2,689.191 billion yen	3,431.376 billion yen (+27.6%)	9.2%	51.7%

Source: *Nikkei*, August 16, 2005.

hostile takeovers can play a positive complementary role in improving the quality of management for failing firms.

Transparency and information disclosure in accounting, financial, and other reporting to investors and to the public (S4) Transparency and information disclosure is essential for protection of all investors. It is particularly important for minority shareholders who may 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 protection of investors. The primary laws that are relevant here 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 the listed firms.

The Japanese public and business community appreciate the importance of transparency and information disclosure for sound business operations, and hence their business norms (N1–N3) imply positive perceptions about them. On the other hand, Japanese businesses' interfirm and stakeholder relationships (N1 and N3) interact negatively with the legitimacy of S4 because of a potential conflict of interest, at least for *keiretsu* group firms. For example, corporate majority shareholders may find it important to withhold certain information.

Complementarity exists to some extent because even firms with many interfirm relationships (N1) can take advantage of newly mandated transparency and information requirements. For example, when these *keiretsu* firms attempt to raise capital in external capital markets, transparency and disclosure are required. These requirements also help improve the assessment of the market value of related business units compared with the past situation. 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 degree of such improvements depends on the degree and nature of interfirm relationships (as described by N1 and N3) and also their managerial style at the group level (as described by N2).

Japan's new company law now requires corporations to use consolidated financial statements as their primary means of reporting. It also requires corporations to annually report the value of financial securities and unrealized losses and profits. Since Japanese firms conduct large amounts of transactions with their affiliated *keiretsu* firms of all kinds, individual (typically minority) shareholders would have difficulty figuring out corporations' overall soundness unless their consolidated statements are available. Japanese firms also own large amounts of securities, often including stocks of affiliated companies, as part of maintaining their *keiretsu* relationships. New rules require corporations to report their financial positions for these securities annually. In the past many firms used their affiliated firms to manipulate their financial positions. For example, parent firms always post significant amounts of profits while their unlisted subsidiaries post losses. Under the new rules on disclosure and reporting, these questionable reporting practices are expected to decline. This is a positive implication for public investors.

However, as we see in the above proposition, given Japanese corporations' persistent reliance on transactions with their related firms, these new laws are not likely to eliminate fraudulent accounting practices involving affiliated firms. Third-party monitoring of these interfirm transactions between affiliated firms is difficult at best and firms are likely to continue conducting questionable or illegal transactions in these areas.[17]

Protection of minority shareholders (S5) Japanese business norms (N1–N3) do not generally support viewing minority shareholders' rights as an overwhelmingly important matter compared to the majority shareholders' rights. This is because *keiretsu* norm (N1) and stakeholder norm (N3) typically support majority owners with the most bargaining power; and hence imply negative perceptions and legitimacy for minority shareholders even though the consensus norm (N2) may be somewhat more inclusive and may imply positive perceptions and complementarity. For example, corporate majority shareholders operate according to their own efficiency criteria and leave little room for interventions by minority shareholders. But consensus norm (N2) foresees positive complementarity from cooperation between majority corporate owners and minority individual shareholders.

Although Japan's new laws allow minority shareholders a new voice in the general shareholders' meetings and hence recognize their complementarity role, the rights of majority shareholders might still prevail in many cases. We thus derive the following:

Proposition 5 New rules about protecting minority shareholders will have limited impacts on Japanese corporate governance practices, particularly on practices of *keiretsu* firms. The potential for public embarrassments, for example, due to legal suits by protesting minority shareholders may force some firms to practice these new rules more strictly.

Limitations of the selective adaptation approach

We have presented our application of selective adaptation theory to the analysis of the evolution of corporate governance practices in Japan in the post-bubble era. Five propositions which are potentially empirically testable have been obtained. The key ingredients of our approach are: three local norms (N1, N2, N3) and three instruments for selective adaptation (I1, I2, I3). Our proposition for each of the five state variables (s_k, k=1,2,..,5) is obtained by considering interactions between the local norms and the instruments denoted as: (A_{kji}, j=N1,N2,N3; I=I1,I2,I3), k=1,2,..,5.

In this most general form, our analysis requires us to distil our proposition out of (A_{kji}), for each state variable k. This could be done by theoretical analysis as in this paper. This process of implementing selective adaptation analysis suggests the following potential limitations: (1) the relevance of appropriate choice of the local business norms; and (2) the difficulty to distil appropriate propositions because of

[17] For example, recent scandals in illegal accounting (e.g., creating of non-existing sale between related firms) by Fujitsu's and NEC's related firms (*Nikkei*, 2007: July 3).

contradictory movements in the values of (A_{kji}). In the rest of this paper we assume that these limitations are not binding for our analysis.[18] However, our on-going research suggests that the above limitation (2) could be relaxed if it is possible to specialize the form of the A matrix (A_{kji}) for given k in certain ways (Nakamura, 2009). Also, if appropriate survey data became available, then we could empirically test propositions such as ours that are derived based on theoretical analysis of the values of (A_{kji}).

Selective adaptation analysis: Evidence and implications for business practices and public policy

We have presented theoretical implications of our selective adaptation approach to Japan's corporate governance reform. In this section we discuss certain empirical and anecdotal evidence supporting our propositions and related policy implications. In policy discussions we focus on efficiency implications for the Japanese economy.

Business practices and policy implications

Proposition 1—"shareholder value maximization"[19] Initial reactions to the shareholder value maximization principle were particularly positive, facilitating individual, institutional, and foreign shareholders to bring many court cases against some Japanese firms' non-profit maximizing behavior (e.g., West, 2001). However, many Japanese managers would not accept the US style shareholder-driven corporate management citing stakeholder-oriented value maximization as a basis of their argument. Also, the Japanese government recently explicitly endorsed stakeholder-oriented value maximization (see, for example, Japanese METI, 2005: 38, Fig. 2−4).

Firm management began to devise new poison pills to fight hostile takeovers.[20] Poison pills based on *keiretsu* relationships and cross shareholding began to emerge.[21] These developments are consistent with the predictions of our proposition.

Another area where shareholder value maximization is not always practiced is restructuring of firms in financial distress. There is empirical evidence suggesting that Japan's stakeholder-oriented value maximization based out of court settlements involving affiliated firms and banks typically do not lead to increases in the value of a firm under distress,[22] while third party based restructuring methods tend to achieve improvements in the market value of a distressed firm, at least over shorter time periods (e.g., Inoue, Kato, & Bremer, 2008, Peek & Rosengren, 2005).

[18] If one or both of these limitations were severe, no practically meaningful propositions could be obtained.

[19] To save space, we do not repeat the selective adaptation implications Propositions 1–5 in their entirety in this section.

[20] The shares of the outstanding shares owned by Japanese banks clearly decreased over the 1990s. Other types of corporate shareholding also declined somewhat, but the majority of vertical *keiretsu*-related shareholding remained.

[21] These are highly potent poison pills, as was proved in the post-World War II period.

[22] Another interpretation of this might be that this process maximizes banks' (creditors') firm value.

Proposition 2—"outside directors; executive committee-based board systems" There is empirical evidence suggesting that the presence of outside directors improves firm performance but that the US style executive committee-based board system may not. For example, in a regression analysis of firm performance using a 2003 sample of Japanese firms listed in the first section of the Tokyo Stock Exchange, Shimizu (2007) shows that while the outside director ratio is statistically significant and positive (as Proposition 2 predicts), the committee dummy is statistically significant and negative. Similarly, Miyajima and Nitta (2006), using data on firms listed on the Tokyo Stock Exchange over the period of 1997–2004, find that the outside director ratio increases returns on assets and that firms with executive committee-based boards are outperformed by other firms using the traditional Japanese board system. These results are consistent with survey findings on the performance of committee-based firms given in Table 6. Our prediction is also consistent with Gilson and Milhaupt (2004) who find that, as of March 2003, no members of bank-centered horizontal *keiretsu* groups had adopted the U-style executive committee-based board of directors system. Explaining this in economics terms is difficult.

These and other studies imply increased economic efficiency associated with outside directors but the same cannot be said of adopting US style executive committee-based board systems.[23] This inconsistent efficiency consequence is clearly undesirable and results from dysfunctional reform policy schemes. Unfortunately some firms will continue to experience these inefficiencies. Overall, we see that despite the difficulty in finding qualified and truly independent outside directors in Japan,[24] we expect them to make positive contributions to progressive firms. On the other hand, Japanese firms' highly firm-specific operations may make it difficult for outsider-controlled executive committees to function effectively.[25]

Proposition 3—"market for corporate control" Japanese avoidance of hostile takeovers has prompted firms' implementation of various poison pills, but the most Japanese-like one is the stable shareholding practice adopted by many friendly financial and industrial firms. Despite its considerable deterioration since the burst of Japan's financial bubble in 1990 (Tables 2 and 3, Figure 1), this practice recently regained momentum. The recent revival of crossholding practice is driven by industrial companies (Nitta, 2009).

[23] Our selective adaptation theory does not give explicit predictions regarding firms' choice of using US style executive committee-based boards. We also note that "the role of committees generally and their relation to the overall board specifically are not fully understood" even for US boards (Adams, Hermalin, & Weisbach, 2010: 101).

[24] Most outside directors on Japanese company boards are not really independent directors. Many are sent in by their banks and affiliated companies (e.g., parent firm, subsidiary firm, *keiretsu* firm). Adams et al. (2010) also point out some ambiguity about the nature of outside directors on the boards of US firms.

[25] It is likely that there is more firm specificity in operations for vertical than horizontal *keiretsu* group firms, and hence our Proposition 2 may be more appropriate for arguments involving vertical *keiretsu* groups. We should also note that Proposition 2 does not explicitly discuss the conditions under which firms improve their performance by simply reducing their board size. This could occur, for example, if a firm, rejecting new board mechanisms, decides to improve their contribution to its stakeholders by reducing the number of their directors. We thank an anonymous referee for pointing out these issues to us.

The primary purpose of many recent incidents of stable shareholding is to guard the incumbent management against hostile takeovers. Stable shareholding proved to be highly effective as a poison pill.[26] If up to 70% of a firm's outstanding shares are owned in pieces by many friendly corporate shareholders, no outsiders can succeed in their hostile takeover bids.

A decade ago poison pills were virtually unheard of in Japan. There is also some empirical evidence suggesting that companies with poison pills have shown poorer returns on invested capital.[27] But a recent survey reports that, as of May 15, 2007, 14% of Japanese firms listed on the first sections of the Tokyo, Osaka, and Nagoya Stock Exchanges, and 8% of all listed firms (316 listed firms), have already implemented or are planning to implement anti-takeover defense schemes.[28]

As expected, because of stable shareholding and other types of poison pills, most hostile takeovers or unsolicited TOB attempts failed in Japan.[29]

The (possibly incompetent) incumbent management typically uses stakeholder-oriented value maximization to defend against hostile takeover attempts. The managers argue that the hostile buyer of their firm will focus on maximizing the returns to shareholders at the expense of other stakeholders such as employees, customers, suppliers, banks, and the like.

We have noted that Japanese firms' *keiretsu*-based industrial organization is not really compatible with hostile takeovers and that the Japanese government in practice endorses company policies which are more consistent with stakeholder-oriented value maximization (Japanese METI, 2005). This observation is consistent with Japanese courts' recent rulings, rejecting the legal suits brought to them by individual investors against the management regarding their allegedly unfaithful behavior towards shareholder value maximization.

Until the 1980s, there were virtually no large-scale friendly mergers, let alone hostile mergers. The few large-scale mergers that took place generally were value-losing events. One main reason for such failures was the difficulty for different Japanese firms of integrating two highly firm-specific management systems, particularly with respect to personnel management practices. Japan's new laws allow more prompt reorganization of merged business units. Whether the new regime under the reform will generate economic efficiency gains remains to be seen, as noted above.

These policies and business practices in the market for corporate control generate potential economic efficiencies as well as inefficiencies. Friendly mergers, which often take place between related firms, may or may not increase efficiency. It is quite possible that some of these friendly mergers are part of incumbent managers' schemes for building their own empires, which may not be consistent with generating economic efficiency. Under the US system, the threat of hostile takeovers

[26] Such stable shareholding prevented hostile takeovers of listed firms in Japan since the early 1950s.

[27] See, for example, Bebchuk and Cohen (2005), Gompers, Ishii, and Metrick (2003), and Hermalin and Weisbach (2003). Arikawa and Mitsusada (2008) show that Japanese firms experience negative abnormal returns right after announcing introductions of new poison pills.

[28] *Yomiuri Shinbun*, 2007: May 17.

[29] These include Oji Paper's attempt to absorb Hokuetsu Paper, Rakuten's attempt to takeover Tokyo Broadcasting System, and Livedoor's attempt to takeover Nippon Broadcasting System, as well as Steel Partners' takeover attempts of some target firms.

against an incompetent incumbent management team may lead to its replacement by a new competent management team, which would generate economic efficiency. As we discussed above, such efficiency gains may not be expected in Japan's reformed regime. The expected efficiency implications of *keiretsu* as a scheme of takeover defense are also unclear.

Using a sample of over 50,000 cases of mergers and takeovers by Japanese listed firms between 1980 and 2004, DBJ (2007) estimates the impacts of these events on the acquiring firms' performance as measured by returns on assets (ROA) and other criteria. The acquirers' ROA most often benefits from mergers when the acquired firm is an affiliated listed group firm. Furthermore the acquirers' ROA is highest when the target firm is (1) in the group and listed, followed by the case of (2) in the group and unlisted. No improvement in ROA is found when the target firm is (3) an outside listed firm. Considering that a large fraction of their sample observations happened during the 1990s or later, higher returns to mergers with listed than unlisted group firms may imply the effects of the new transparency and disclosure requirements in the reform. However, the fact that higher returns are available to group-based friendly mergers is consistent with our Proposition 3. Similarly Fukao, Ito, Kwon, and Takizawa (2006) estimated effects of mergers on the target firms for the period 1994–2002 and found that there was no improvement in their profitability after the merger but there was some improvement in total factor productivity for mergers between firms from the same corporate group (but not for mergers between unrelated firms). This is also consistent with Proposition 3 that friendly mergers are generally preferred in Japan.[30]

Contrary to the evidence from the US and European countries, there is considerable empirical evidence that suggests that the unconditional expected net wealth created from mergers and acquisitions in the post-bubble period (as well as periods prior to it) is negative.[31] This is despite the fact that, for certain subsets of these mergers such as the above case where both bidders and targets are from the same corporate group, returns for the bidder are positive (DBJ, 2007). This is consistent with predictions of Proposition 3 and may be explained by the fact that Japan is missing potentially significant efficiency gains that might come from the presence of hostile takeovers.

We conclude that selective adaptation theory implies that Japan's M&A markets after the reform, unlike those found in the United States, will not be well balanced, in that most active transactions will still be friendly M&As. Relatively few hostile takeovers are expected. Consistent with this prediction, Japan's M&A activities became much more active after the reform.[32] This is particularly so for post-reform

[30] In this paper we do not discuss Japanese firms' decisions on divestiture (i.e., which units to divest while which units to retain in their restructuring efforts to refocus). But we expect the Japanese market for corporate control to treat divested units in the manner described by Proposition 3. See also Choe and Roehl (2007) for a detailed analysis of this issue for South Korean *chaebols*. See also Chang (2003). We are indebted to one of the referees for pointing this out.

[31] See, for example, Kang, Shivdasani, and Yamada (2000), Komoto (2002), Lin, Michayluk, Oppenheimer, and Reid (2008), and Yeh and Hoshino (2002).

[32] For example, 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 as follows: US (1,372.7); UK (632.3); Spain (217.6); Italy (208.5); Canada (185.4); France (159.9); Germany (155.1); Australia (110.4); and Japan (81.3).

M&As, and most domestic M&A activities are between affiliated firms and they are friendly mergers by definition.[33] These mergers have also benefitted from Japan's new, much relaxed holding company law, which allows industrial firms to reorganize their divisional structures and ownership within and between firms. We have argued that these new merger transactions do not necessarily increase Japan's economic efficiency.

Proposition 4—"transparency and disclosure" The reform has improved Japan's level of transparency and disclosure. For example, new laws require firms' capital positions be reported at market value. Japanese banks and industrial firms alike now report such positions quarterly. Quarterly reporting of firms' consolidated financial statements is an important reform measure. Singleton and Globerman's (2002) findings that Japanese firms increased their performance in information disclosure over the 1990s are consistent with our predictions.

Another implication of consolidated financial reporting is that detailed stand-alone financial statements for each of the business units of companies under a holding company are no longer required. Since public investors invest in listed holding companies, rather than in their individual business units, such stand-alone financial reporting for each business unit might not appear essential. Yet, these business units are often the objects of M&As, and in those cases, potential acquirers and their shareholders, as well as the shareholders of the potential target firms, could become concerned about the accuracy with which specific segment information related to the unit being transacted is disclosed. Disclosure requirements in this regard would be essential, but the new laws require little about firms' disclosure of their segment information. We expect that their *keiretsu* and other interfirm relationships will constrain more complete firm disclosure of intra-group transactions. Japan's new financial instruments and exchange law and revised CPA law will improve corporations' reporting transparency and the protection of both investors and creditors, albeit with some limitations.[34]

The lack of complete transparency and disclosure is potentially a serious source of economic inefficiency in the Japanese economy, since it could cause undesirable consequences such as incorrect investment decisions by firms and public investors, incorrect rating of *keiretsu* firms by the rating agencies for capital markets, and incorrect distribution of the financial risks across economic decision units. Dysfunctional policies as a result of selective adaptation are one cause of these inefficiencies. For example, some of Japan's reform laws clearly require high degrees of transparency and disclosure, but its new anti-monopoly laws continue to

[33] In 2005, there were 3,734 reported transactions of M&As in Japan. 2,725 (73%) of these 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 (DBJ, 2007).

[34] Niimi (2007) also raises some concerns about this. We expect that the level of disclosure and transparency in Japan will continue to be less than that in the West for activities involving intra-*keiretsu* group transactions. One factor that contributes to transparency is the revision of Japan's certified public accountants law, which has gone through a number of revisions since the 1990s. All revisions were intended to strengthen CPAs' monitoring capacity and improve quality of accounting auditing of Japanese listed and unlisted corporations. A number of scandals triggered these revisions. The most recent revision of 2007 requires accountants to audit and report fraudulent book keeping by firms with more stringency. It will also be accompanied by strengthening of the penalty terms for accountants who violate the rules.

allow firms to maintain certain types of *keiretsu* activities (e.g., banks' ownership of corporations for aggressive control purposes). Japanese banks' continuing dual role as investors and creditors regarding their client firms may continue to generate economic inefficiencies.[35] Under the Anglo-American system, such dual roles by banks cannot be practiced, either by law or by banks' choice.[36]

Proposition 5—"minority shareholders" One historical example of the importance of majority shareholding by affiliated firms in Japan is T. Boon Pickens' experience as a minority shareholder. In 1990, the American takeover entrepreneur Pickens owned 26.43% of the Japanese company Koito Manufacturing, and was its largest shareholder. Despite this, he could not force the Koito management to give him a seat on the board. Together, nineteen Japanese firms, many of which are Toyota *keiretsu* companies, owned a majority of Koito's stock, and all supported management.

We should note also 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. Such proposals can be rejected if more than one third of a firm's shareholders oppose. On the other hand, if majority shareholders are not *keiretsu* affiliated, minority shareholders' views against the management might be endorsed by firms' shareholders. In its general shareholders' meeting held in February, 2007, Tokyo Steel's management proposal to make Tokyo Steel become one of Osaka Steel's subsidiaries was rejected because about 42% of shareholders opposed the proposal. The minority shareholders argued that the management proposal would seriously disadvantage the company shareholders. It was thought that many of the shareholders who voted against the management are individual shareholders each owning less than 1% of Tokyo Steel shares. We note that this opposition to the management was originally organized by the Singapore-based Strawberry Asset Management which used the Internet extensively to achieve this result. Without this sort of a major effort by a skillful investment fund, the Tokyo Steel management would have won.[37]

We also note that Japanese courts sometimes side with minority shareholders, providing them potentially favorable methods of claiming their due rights. For example, in the MBO case involving Rex Holdings in 2007, the minority shareholders' claim that the TOB price the management offered them (230,000 yen per share) was unduly low was accepted by the Tokyo Higher Court and then subsequently by the Japanese Supreme Court in June 2009. The court-ordered TOB price (336,966 yen per share) was based on a 6-month average of the share price prior to the TOB announcement plus a 20% premium. Rex accepted this ruling.

[35] For example, Morck and Nakamura (1999) and Morck, Nakamura, and Shivdasani (2000).

[36] On balance, our empirical evidence seems to suggest somewhat less optimistic prospects for the value of transparency Japanese firms place than our theory implies.

[37] A more recent example which resembles the Tokyo Steel case discussed here is Steel Partners' gaining control of wigmaker Aderans. Steel Partners directly appealed to Aderans' general shareholders about Aderans management's failure to maximize share value (Hardin, 2009). See also Chen & Young (2010) for the infringements of minority shareholder rights in recent Chinese M&A.

The protection of minority shareholder rights reflects Western liberal norms and is important as well in its own right. But it also has implications for economic efficiency. Large majority shareholder pursuit of their interests may lead to size-based agency costs and even potential limitations of new managerial ideas and entrepreneurship. Western liberal norms view minority views to be a source of diversity, adding to economic vigor and possible efficiency gains. Japan's reform policies regarding the protection of minority shareholder rights incorporate some of the mechanisms used in the US system but do not necessarily encompass the Western liberal norm principles that underlie the US system. The efficiency implications of Japanese policies in this area under reform remain to be seen.

Concluding remarks

Our selective adaptation method can explain in a consistent manner various aspects of the evolutionary change in corporate governance behavior by distinguishing between the adopted legal settings and the local acceptance (implementation) of the settings based on the local norms that underlie adoption of such laws.

We have applied a selective adaptation framework to Japan's corporate governance reform. The reform was undertaken with a conviction that Japan's discredited post-World War II bank-based corporate government 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 robust economic performance of the US economy. Japan's reform has introduced new laws which 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 reflect Western liberal norms.

We have shown that, despite the enactment of US-style corporate governance laws and institutions facilitating new corporate governance practices, the actual implementation of them by Japanese businesses has been selective and uneven.

Anglo-American corporate governance practices based on Western liberal norms have a long tradition of robustness and are market driven. In addition their efficiency properties have been studied extensively in the economics literature. In the countries where Anglo-American practices are traditionally practiced, their laws, legal frameworks, and institutions are generally consistent with their practices. We have shown that this is not so in Japan.

We have pointed out that as Japan adopts US practices in a selective manner, certain economic inefficiencies may occur because piecemeal adoption of the original market driven US practices may lead to adoption of US practices combined with local norm driven Japanese practices, which turn out to be inconsistent with each other when it comes to the issue of achieving economic efficiency. Policies adopted in such an environment may become dysfunctional and may fail to achieve their original objectives. This is not desirable, since the original purpose of the Japanese reform was to help regain Japan's lost economic efficiency (and hence lost global competitiveness).

Our tentative conclusions are as follows: Japan's corporate governance reform will achieve increased competitive activities in the market for friendly M&As and should also significantly improve practices regarding disclosure and transparency; on the other hand, corporate governance practices reflecting shareholder value maximization, outside director driven executive committee-based boards, and hostile M&As will receive less support. We have argued that increased friendly merger activity is not necessarily accompanied by efficiency gains. We should also stress that our analytical predictions hold for a large number of ("old") Japanese firms but not necessarily for some other ("new") firms which do not share the same basic business norms. It is possible that these new firms might be able to take advantage of the new governance rules, organize their businesses most efficiently and grow.

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Masao Nakamura (PhD, The Johns Hopkins University) is professor and the Konwakai Japan Research Chair at the Sauder School of Business and the Institute of Asian Research of the University of British Columbia. His research interests include economic behavior of firms and households, Japanese and Asian economies, international business, and management of technology and environment. He has published books and also articles in academic journals. For details please see his home page: http://strategy.sauder.ubc.ca/nakamura/.