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The security market and the changing government role in Japan

Corporate governance issues

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Abstract

Purpose – The purpose of this paper is to explain how current security market regulations in Japan have evolved following Japan's corporate governance reforms, which began in the 1990s after the bursting of a massive financial bubble. As part of the reform, Japan aimed to introduce US-style corporate governance mechanisms.

Design/methodology/approach – This paper first explains the process behind Japan's corporate governance reforms using the theory of selective adaptation. By doing so, the various changes that have taken place in the regulations of security markets are also explained. The paper concludes with a discussion of the limitations of transplanting US-style corporate governance mechanisms in Japan and the implications for the functioning of Japan's security markets.

Findings – While applying a selective adaptation framework to Japan's efforts to transplant US-style corporate governance mechanisms to its own markets, the author found that certain Japan-specific business practices, such as its heavy reliance on *keiretsu* corporate groupings, may interfere with the market-based business practices and free competition which characterize the US system. This in turn places limitations on the functioning of US-style security markets in Japan.

Originality/value – This paper explains the limitations of government regulation on security markets in Japan, which may be of interest to both public and private sector analysts. This paper focusses on Japan's experience of transplanting US-style corporate governance mechanisms to Japan. The author expect that Japan's experience will be of much interest to China, South Korea and other countries in East Asia, where pyramidal and other types of business groups play important roles in their economies.

Keywords Corporate governance reform in Japan, Government regulation, Security market

Paper type Research paper

Introduction

The bursting in 1990 of a financial bubble in Japan triggered a long recession in that country's economy. It lasted well into the early 2000s and affected both Japanese firms and households adversely. Many Japanese firms lost the global competitiveness that they had enjoyed in the 1980s. In response to this, Japanese firms began changing their traditional business practices which used to be taken for granted.

Japanese firms' corporate governance practices were not excepted from attention. Laws to reform Japan's corporate governance and other related areas were introduced in the late 1990s. These new laws prompted many industrial firms to establish new corporate governance practices. In addition, failing Japanese banks became the targets of government reforms. The new reform laws, some of which specifically addressed Japanese banks, were implemented to monitor banks' behaviors after they were bailed out by the government.

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Japanese banks traditionally shaped Japan's bank-based corporate governance mechanisms. However, the new financial deregulation laws and bank-reform laws that were implemented in the late 1990s had major impacts on Japanese banks' behaviors[1] and, in particular, prompted the roles of Japan's bank-based corporate governance mechanisms to be diminished.

Many of the changes in corporate governance practices that have been proposed or implemented since then were modeled after US (or more broadly Anglo-American) practices. The establishment of: proper market-based mechanisms for corporate governance; and monitoring mechanisms for ensuring the smooth and transparent operation of such activities were emphasized by the Japanese government. This was also characterized as a process by which Japanese practices were adapted to western standards (which had become *de facto* global standards). Since every aspect of today's Japanese economy is tied to the global economy in some way, it is likely that a significant adaptation of global practices by Japan will take place over time.

Japan's corporate governance reforms involved significant changes in the laws regulating Japan's securities markets as well. The government's financial market regulation changed its emphasis from the traditional direct oversight and guidance of the banking and securities industries to facilitating implementations of the newly introduced corporate governance practices. In particular, enforcing transparency and disclosure involving securities markets became an important objective of government regulation (Nakamura, 2006, 2011, 2012).

This paper focusses on Japan's experience of transplanting US-style corporate governance mechanisms. We expect that Japan's experience will be of much policy interest to China, South Korea and other countries in East Asia, where pyramidal, *keiretsu* and other types of business groups play important roles in their economies (Nakamura, 2008, 2015).

Implications of corporate governance reforms for Japan's legal system

The Japanese government initiated a number of reform measures which were wide-ranging[2] and included new legal measures and institutional practices in areas such as corporate governance, financial deregulation and monitoring; bank behavior, information disclosure and accounting. Regulation of the market also underwent change as the rules for corporate control (M&As) were reformed[3]. We discuss these measures briefly below.

A significant number of new regulations and corporate governance laws were proposed and implemented throughout the 1990s and the early 2000s. Many of these changes will have a major impact on the corporate governance practices of many Japanese firms for years to come. For this reason it is noteworthy that these changes in the legal frameworks for Japanese corporate governance took place so promptly. It is generally agreed that the reason for this prompt acceptance of the proposed changes in corporate governance practices and related areas was that the bank-based corporate governance mechanisms prevailing in Japan were among the major causes for the demise of many Japanese corporations(e.g. Morck and Nakamura, 1999, 2000). Even those who defended the benefits of the traditional bank-based corporate governance system conceded that the time for such a system had passed. They also argued that a more market-based corporate governance system, with proper incentive-based practices and disclosure clauses, based particularly on those found in the Anglo-American system, should replace the old practices that had dominated across Japanese businesses since the end of Second World War. In order to achieve this goal, the Japanese government promptly introduced laws that brought transparency and market-based practices to corporate governance mechanisms, capital markets and bank behaviors (e.g. financial deregulation and monitoring), securities exchange and other areas related to corporate-governance.

Capital market liberalization

Facing this circumstance and the near-collapse of many of the major banks and industrial firms[4], the Japanese government implemented several capital market liberalization measures which were intended to facilitate firms' access to public capital markets. For example, under these reforming laws, firms could issue straight corporate bonds without collaterals. Until the early 1990s firms were free to issue unsecured bonds that had the nature of equity (e.g. convertible and warrant bonds) as well as secured bonds with collaterals, but they could not issue (unsecured) straight corporate bonds. In order to force corporations to disclose relevant information for their investors, many aspects of the commercial code, the securities exchange law and other laws were revised. The primary objectives of these changes were to introduce western standards of accounting transparency and protection for investors.

Accounting transparency

Japanese corporations are now required to file quarterly consolidated financial statements with the Ministry of Finance, reporting the activities of the parent as well as related firms. (Previously reporting was required mostly for stand-alone firms only.) Under these new reporting rules many, if not all, of the transactions between parent and subsidiary firms, which used to be hidden from the public, have to be reflected in the reported accounting numbers[5].

Under the new rules the value of the financial securities (and also golf club memberships) that a firm owns and their unrealized losses must be reported at market value under most circumstances. (Previously no market value had to be reported so long as the securities were kept unsold.) The new requirement implies that banks must disclose the state of their financial assets and loans at their market value. This is expected to add transparency where it was previously non-existent. This measure, combined with a new law limiting banks' equity ownership to the level of their own capital, has already had a major impact on Japanese banks (Nakamura, 2011, 2012).

Another change took place in regard to how R&D expenditures are reported. R&D expenditures must now be treated as current expenses. (Previously R&D expenses could be treated as either expenses or as an item to be capitalized)[6].

Corporate governance practices

In addition to the above measures to increase information disclosure and transparency, a number of others have been implemented to improve the performance and value of firms by revising practices pertaining to corporate governance and market transactions (i.e. M&As)[7]. These include: options to use executive committees for management purposes; optional (but subsequently (in 2015) required) use of outside directors; legalizing holding companies[8]; legalizing treasury stocks and warrants to new stocks; and legalizing the issuance of various classes of stocks previously not allowed (e.g. tracking stocks (see Nakamura, 2012). In addition, purchasing firms by the exchange of stocks became legal in 2006. While takeover bids (TOBs) have been allowed since 1971, their effective use for M&As began only recently when other relevant tools and legal settings for M&As (particularly hostile M&As) became available.

Selective adaptation theory, Japan's business culture and its adaptation to reforms

For our selective adaptation framework, we have explained changes to corporate governance practices and institutions in Japan as a dynamic evolutionary process (Nakamura, 2011, 2012). It is postulated in this theory 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 Anglo-American corporate governance practices[9]. We note that certain phenomena that are typically associated with Japan-specific factors (norms) cannot be explained easily using economic theory[10]. We are interested in how such Japan-specific norms have affected Japan's adoption of US-style corporate governance practices.

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

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

State variables for describing Japan's corporate governance

For its corporate governance reforms, Japan has attempted to adapt to the Anglo-American system which embodies western liberal norms. These norms are reflected in US practices that include: the legal protection of shareholders' rights, especially the rights of minority shareholders; issues associated with large shareholders (i.e. concentrated ownership); transparency and information disclosure to ensure fair competition; and the agency costs (to all shareholders) that arise because firms' managers do not implement policies to maximize shareholder value.

We used the following state variables to measure the change in the functioning of corporate governance mechanisms, before and after the reforms, in the areas of our interest (Nakamura, 2011, 2012)[11]. These state variables can represent effects that are not necessarily mutually independent or exclusive. We viewed these state variables as one way to capture essential aspects of Japan's corporate governance mechanisms[12].

The state variables we defined 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 protection afforded to minority shareholders.

The first of our state variables (*S*1) describes the degree to which the management is faithful to their shareholders' objectives to maximize the firm's share value[13]. Prior to the reform, Japanese firms' managements were able to pursue their own objectives, which were often significantly at variance with the principle of shareholder value maximization. Agency costs of this sort were a significant source of economic inefficiency. One of the cornerstones of Japan's corporate governance reforms has been the formal acknowledgment 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 USA.

The second of our state variables (*S*2) 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 *S*1 above.

The third of our state variables (*S*3) 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 (Morck and Nakamura, 1999). An 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 *S*1, 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 (*S*4) measures the fair and transparent availability of firm information that is relevant to all concerned investors. Information disclosure and transparency is the basic prerequisite for the efficient functioning of a stock market, allowing investors to evaluate the shares they own. Efficient capital markets also give managers information about the cost of the 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 (*S*5) 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 percent of listed firms in Japan were owned by financial and other corporate shareholders who were sympathetic to the incumbent management. Hence, firms' managements generally paid little attention to individual and other minority shareholders' rights.

Japanese (local) business norms and Japan's selective adaptation

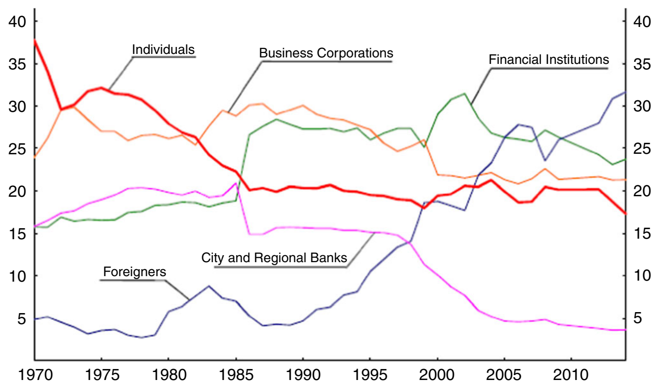
Certain norms characterize behavior in Japan's business sector, and society in general[14]. Some of these norms are particularly important for shaping Japan's acceptance or rejection of new US-style practices of corporate governance. We have listed three business norms that we regard as underlying Japanese business behavior:

- (N1) Norms associated with corporate groups (*keiretsu*). The belief that the effects of group-oriented behavior are reflected in the outward signs of economic efficiency may underlie Japanese *keiretsu* behavior, particularly for some vertical production *keiretsu* groups. Economic efficiency gains have not been verified for horizontal *keiretsu*[15]. *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 and Gerlach, 2004). Block shareholding, which characterizes various types of *keiretsu* groups, is shown by shareholding figures for "Business Corporations" and "Financial Institutions" in Figure 1. McGuire and Dow (2009, p. 346) have emphasized 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[16]. Korkie and Nakamura (1997) also showed that *keiretsu* groups have had significant impacts on how Japan's securities markets function.

- (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 businesses and shareholders[17].
- (N3) Stakeholder-oriented value maximization as the objective for corporate decision-making. Many authors have suggested that Japanese corporations have pursued stakeholder-oriented value maximization (e.g. Aoki, 1988; Araki, 2005; Jacoby, 2005; Yoshikawa and Phan, 2001) and value-added maximization (Tsurumi and Tsurumi, 1991). These sorts of objective functions put great emphasis on the welfare of firms' employees as well as the welfare of suppliers, customers and creditors[18].

Acceptance criteria (instruments) that facilitate the adoption of new institutional settings and practices

If firms and investors can readily see the immediate or potential benefits of new laws, the laws may be implemented promptly and with full force. The reasons for full acceptance are, in most cases, believed to be economic, though humanitarian



Notes: Survey has been conducted on a "Unit-of-Share" basis since 1985 survey. The market value of financial institutions excludes that of city and regional banks

Source: 2015 Shareownership Survey, Tokyo Stock Exchange (2015)

Figure 1. Long-term trend in the ownership structures of Japanese listed firms (%), 1970-2014

considerations can be seen to be important sometimes. Also, there may be little reason for businesses to reject new rules if, all else being equal, they perceive those rules to be obviously better suited for modern economic activity when compared with their predecessors. Such elements of perception and legitimacy may be needed for new rules to be accepted by economic agents.

Selective adaptation of foreign legal and institutional practices is a dynamic process driven by interactions between local and foreign norms and cultures, among other factors. We postulate here that the outcome of such interactions depends primarily on satisfying the following three factors: (I1) perception, (I2) complementarity and (I3) legitimacy (see Nakamura, 2011, 2012; Potter, 2003, 2004). We call these three factors the acceptance criteria (or instruments) for the adoption of liberal-norm-based western practices. As Etzioni (1961) and Unger (1975) noted, 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 factor that may facilitate acceptance of new laws is if they complement the existing old rules in some way. 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 the preservation of the original characteristics of each of the component sets. The degree of complementarity determines the degree of mutual sustainability of both local and non-local rules and the associated institutions and practices in a nation. Figure 2 illustrates the dynamic process of selective adaptation we have discussed here[19].

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. However, 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.

In the following discussion we have also used the acceptance criteria of perception, legitimacy and complementarity as the instruments for selective adaptation (Nakamura, 2011, 2012). We have argued 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.

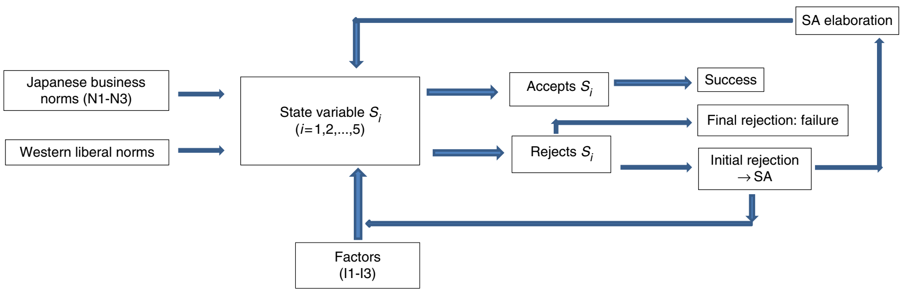


Figure 2.
Dynamic process for the determination of corporate governance reform policies based on selective adaptation (SA)

Implications for security market

Predictions based on a selective adaptation framework

When applying a selective adaptation framework to Japan's corporate governance reforms, we considered how Japanese business norms (N1-N3) interact with western liberal norms to enhance each of the state variables (*S*1-*S*5). For our selective adaptation analysis, we assumed that Japan will accept the new corporate governance practices proposed in the reforms, provided that the new practices satisfy the three acceptance criteria for selective adaptation explained above. From this analysis we obtained the predictions that are discussed below. The detailed derivation of these predictions can be found in Nakamura (2011, p. 194, Table I).

Shareholder value maximization (S1)

Little support exists for shareholder value maximization at firms with strong *keiretsu* relationships. On the other hand, individual shareholders of *keiretsu* and other non-affiliated firms are likely to support *S*1.

Outside independent directors' involvement in board' decisions (S2)

Outside directors are more acceptable at progressive ("non-*keiretsu*") firms[20], 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 delegation of certain key managerial decisions to outside directors by a firm's management, 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 *keiretsu* firms will be required to develop special competencies to be able to take advantage of executive-committee-based board structures. This is consistent with the fact that a relatively small number of listed firms have chosen this form of board structure in Japan, and, not surprisingly, their performance is not necessarily better than other firms with Japanese-style board structures (Table I).

Competition in the market for corporate control (S3)

Corporate governance reform is intended to promote Japan's acceptance of a competitive market for corporate control, particularly for friendly takeovers and mergers. Hostile takeovers are less likely to be experienced.

	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	2689.191 billion yen	3431.376 billion yen (+27.6%)	9.2	51.7

Source: Nikkei (2005)

Table I. Comparison of firm performance by the type of corporate governance (outside directors), Tokyo stock exchange, first section firms

Using our selective adaptation framework, we concluded that Japan's acceptance of a competitive market for corporate control would be more probable 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 hostile takeovers can play a positive complementary role in improving the quality of management at failing firms.

Transparency and information disclosure in accounting, financial and other reporting to investors and to the public (S4)

The new stricter transparency and information disclosure requirements will improve the transparency (and hence efficiency) associated with external market transactions for public investors and the firms involved to some degree. However, the scale of such improvements will also depend on the nature and extent of inter-firm 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 report the value of their financial securities and unrealized losses and profits annually. Since Japanese firms conduct large amounts of transactions of all kinds with their affiliated *keiretsu* firms, individual (typically minority) shareholders would have difficulty figuring out corporations' overall soundness unless their consolidated statements were available. As part of maintaining their *keiretsu* relationships, Japanese firms also own large amounts of securities, that often include the stocks of affiliated companies. New rules require corporations to report their financial positions with respect to these securities annually. In the past many firms used their positions *vis-à-vis* affiliated firms to manipulate their financial positions. For example, under the old accounting regime, parent firms posted significant amounts of profits while their unlisted subsidiaries would be posting losses. Under the new rules on disclosure and reporting, these questionable reporting practices are expected to decline. This has positive implications 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 transactions between affiliated firms is difficult, at best, and firms are likely to continue to conduct questionable or illegal transactions in these areas[21].

Protection of minority shareholders (S5)

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

Evidence and implications for business practices, securities markets and public policy

We have presented the theoretical implications of Japan's corporate governance reforms for securities markets and for corporate governance practices in general. In this section we will discuss certain empirical and anecdotal evidence that supports our propositions and the related policy implications created by these. In our policy discussions we have focussed on the efficiency implications for the Japanese economy.

Corporate governance, securities markets and policy implications

P1. "Shareholder value maximization."

Initial reactions to the shareholder value maximization principle were particularly positive, enabling individual, institutional and foreign shareholders to bring many court cases acting 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 model citing stakeholder-oriented value maximization as a basis of their argument. Also, the Japanese government recently explicitly endorsed stakeholder-oriented value maximization (see e.g. Japanese METI, 2005, p. 38, Figure 2-4). Firms' managements have begun to devise new poison pills to fight hostile takeovers[22]. Poison pills based on *keiretsu* relationships and cross shareholding have recently begun to emerge[23]. These developments are consistent with the predictions of our proposition.

Another area where shareholder value maximization is not always practiced is during the restructuring of firms in financial distress. There is empirical evidence suggesting that Japan's stakeholder-oriented value maximization, which is based on out-of-court settlements involving affiliated firms and banks, does not typically lead to increases in the value of a firm under distress[24]. On the other hand, third-party-based restructuring methods tend to achieve improvements in the market value of distressed firms, at least over shorter time periods (e.g. Inoue *et al.*, 2008; Peek and Rosengren, 2005):

P2. "Outside directors; executive-committee-based board systems."

There is empirical evidence suggesting that the presence of outside directors improves a firm's performance but that the US-style executive-committee-based board system may not do so (see Table I; also Shimizu, 2007; Miyajima and Nitta, 2006). Explaining this in economic terms is difficult. Our prediction is also consistent with the fact that, as at June 2015, only 60 listed Japanese firms then used the US-style executive-committee-based board system (Japan Association of Corporate Directors (JACD), 2015; also Gilson and Milhaupt, 2004).

These and other studies imply that there is increased economic efficiency associated with outside directors, but the same cannot be said of adopting the US-style executive-committee-based board system[25]. For example, in July 2015, Toshiba was accused of not practicing transparency and disclosure because the company had been using accounting methods that enabled it to report of unjustifiably low accounting cost figures that inflated its perceived profits (Inagaki, 2015; Reuters, 2015). Toshiba operates a US-style executive committee system, which clearly did not function adequately in this case.

This inconsistent efficiency is clearly undesirable and results from Japan's dysfunctional reform policy schemes. Unfortunately, some firms will continue to experience these inefficiencies. Overall, we have seen that despite the difficulty in finding qualified and truly independent outside directors in Japan[26], we would 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[27]:

P3. "Market for corporate control."

Japan's avoidance of hostile takeovers has prompted firms to implement various poison pill policies, but the most Japanese one is the stable shareholding practice adopted by many friendly financial and industrial firms. Despite its considerable deterioration since the bursting of Japan's financial bubble in 1990, this practice has recently regained momentum (see "Business Corporations" and "Financial Institutions" in Figure 1; also Nitta, 2009 and Nikkei Business, 2015).

The primary purpose of many recent incidents of stable shareholding has been to guard the incumbent management against hostile takeovers. Stable shareholding proved to be highly effective as a poison pill[28]. If up to 70 percent of a firm's outstanding shares are owned in pieces by many friendly corporate shareholders, no outsiders can succeed in their hostile takeover bids (Nakamura, 2011, 2012).

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

In self-justification, 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 in practice the Japanese government endorses company policies which are more consistent with stakeholder-oriented value maximization (Japanese METI, 2005). This observation is consistent with Japanese courts' recent rulings that have rejected the legal suits brought to them by individual investors against managements that they have regarded to have behaved in bad faith toward the principle of 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 that different Japanese firms had trying to integrate 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 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 under Japan's reformed regime. The expected efficiency implications of *keiretsu* as a defensive scheme that wards off takeovers are also unclear. Considerable empirical evidence exists in the literature to support *P3* (e.g. Development Bank of Japan (DBJ), 2007; Fukao *et al.*, 2006; Nakamura, 2011).

Contrary to the received wisdom from the US and Europe, 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 in the periods prior to it) has been negative (see e.g. Kang *et al.*, 2000; Komoto, 2002; Lin *et al.*, 2008; Yeh and Hoshino, 2002). This is despite the fact that, for certain subsets of these mergers such as the above case where both bidders and targets were from the same corporate group, returns for the bidder have been positive (DBJ, 2007). This is consistent with the predictions of *P3* and may be explained by the fact that Japan is missing potentially significant efficiency gains that might come from hostile takeovers.

We have concluded that selective adaptation theory implies that Japan's M&A markets after the reform, unlike those found in the USA, will not be well-balanced, in that most active M&A transactions will still be friendly. Relatively few hostile takeovers are expected. Consistent with this prediction, Japan's M&A activities became much livelier after the reforms were enacted (e.g. Arikawa and Miyajima, 2007). In the post-reform era, most domestic M&A activities have been between affiliated firms and they are friendly mergers by definition[30]. These mergers have also benefitted from Japan's new, greatly 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:

P4. "Transparency and disclosure."

The reforms have improved Japan's level of transparency and disclosure. For example, new laws require firms' capital positions to be reported at their market values. Japanese banks and industrial firms alike now report such positions quarterly. Quarterly reporting of firms' consolidated financial statements is an important reform measure. Singleton's 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 ought to be essential, but the new laws require little disclosure about firms' segmentation information. We expect that *keiretsu* and other inter-firm relationships will constrain more complete disclosure of intra-group transactions by firms. Japan's new financial instruments and exchange law and revised certified public accountants (CPA) law will improve corporations' reporting transparency and protect both investors and creditors better, albeit with some limitations[31].

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 being made by firms and public investors, the incorrect rating of *keiretsu* firms by the rating agencies for capital markets, and an 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 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 (e.g. Morck and Nakamura, 1999; Morck *et al.*, 2000). Under the Anglo-American system, such dual roles cannot be practiced by banks, either by law or by the banks' choice[32]:

P5. "Minority shareholders."

One historical example of the importance of majority shareholding by affiliated firms in Japan comes from T. Boone Pickens's experience as a minority shareholder. In 1990, the American takeover entrepreneur, Pickens, owned 26.43 percent 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, 19 Japanese firms, many of which were Toyota *keiretsu* companies, owned a majority of Koito's stock, and all supported its management (see Nakamura, 2011, 2012 for further empirical examples).

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 shareholders' pursuits of their interests may lead to size-based agency costs and even potentially limit new managerial ideas and entrepreneurship. Western liberal norms see the existence of minority views as a source of diversity, adding to the economic vigor of a market and potential driver of efficiency gains. Japan's reform policies regarding the protection of minority shareholder rights have incorporated some of the mechanisms used in the US system without necessarily encompassing the western liberal principles that underlie the US system. The efficiency implications of Japanese policies in this area of reform remain to be seen.

Concluding remarks

Japan's corporate governance reforms were undertaken with a conviction that Japan's discredited bank-based corporate government system, a legacy of the era following the Second World War, should be replaced by a US-style corporate governance system. This was chosen as Japan's model because of the robust economic performance of the US economy. Japan's reforms have 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 reflected western liberal norms.

Applying a selective adaptation framework, 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 corporations 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, the properties of their efficiency 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 an adoption of US practices that are combined with local-norm-driven Japanese practices, and these might turn out to be inconsistent with each other when it comes to achieving economic efficiency. Policies adopted in such an environment may become dysfunctional and may fail to achieve their original objectives[33]. This is not desirable, since the original purpose of the Japanese reform was to help regain Japan's lost economic efficiency (and hence its lost global competitiveness).

Our tentative conclusions about Japan's securities markets and government oversight under the corporate governance reform are as follows. Unlike in the post-Second World War era, when there was direct government supervision of securities markets, the Japanese government's role under its corporate governance reforms is indirect and its primary role is to maintain transparency and ensure that there is a level playing field for all participants in the markets. Fair competition on a level playing field is a stated goal of Japan's new corporate governance system. Nevertheless, as we have argued, our predictions suggest rather an uneven evolution of securities and related market activities under the reformed regime.

While the reform measures will on the one hand increase 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 as a result.

Finally, we would like to add that while we have focussed on Japan's experience to transplant the US-style corporate governance mechanisms to oversee its business community, we expect that Japan's experience will be of much policy interest to China, South Korea and other countries in East Asia where pyramidal and other types of business groups play important roles in their economies, and which are in the process of undertaking their own corporate governance reforms (Nakamura, 2008, 2015).

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Notes

1. For example, the new laws discourage (but do not prohibit) banks from owning their client firms' equity shares. Such ownership of client firms' shares in significant quantities often allowed the banks to dictate the governance of their client firms.
2. Even though some aspects of the reforms (i.e. capital markets liberalization) began in the 1980s, most of the essential reform measures were taken up by the Japanese government after the bubble burst.
3. Another important reform undertaken by the Koizumi government was the privatization of Japan Post, a government corporation providing postal, financial and other services to the public (Nakamura, 2006).

4. Throughout the 1990s many banks suffered from massive bad loan ratios, while industrial firms struggled with excess capacity. Most of the industrial firms' excess capacity was financed by bank loans.

5. Many business researchers raised concern, however, that, consolidation of the financial statements of a parent firm and the related firms under its control masks subsidiary-specific information that used to be available to investors. For example, listed subsidiary firms used to be required to report their financial statements for their own operations. This is no longer required.

6. Unlike the Securities and Exchange Commission in the USA, the Tokyo Stock Exchange (TSE) has no disclosure requirement concerning the annual compensations of its listed firms' top five executives. Accordingly, few Japanese firms disclose their executives' compensation details. (Nikko Cordial Group, a securities firm, is an exception in this regard and publishes its top executives' total compensation figures.) Despite the important role executive compensation plays in firms' corporate governance, neither the Japanese government nor the TSE seems to be interested in instituting any disclosure requirement in this area.

7. Since these government and private-sector measures were introduced to increase activities in the market for corporate control, the number of M&As in Japan has increased substantially.

8. During the corporate governance reform negotiations in the mid-1990s, the Japanese government promptly accepted industrial firms' arguments that reorganizing their groups of divisions and firms under a holding company umbrella would allow these firms to improve their financial performance (due to consolidation of money-losing and money-making subsidiaries' financial statements).

9. Stiles (2006) discusses the dissemination of liberal norms.

10. For example, econometric specifications in most studies of Japanese corporate governance include *keiretsu* dummies as explanatory variables. However, the origin of such dummies is unknown and they capture large amounts of statistically significant unobservable effects.

11. These state variables are introduced here to describe the statuses of five important aspects ("states") of corporate governance of a corporation. For example, state variable S4 below has a high value when a corporation's performance in terms of transparency is of high quality.

12. Highly developed economies, compared to developing economies, tend to have high levels of achievement in these state variables (e.g. La Porta *et al.*, 1999; Shleifer and Vishny, 1997).

13. In this paper, "shareholder value maximization" is used to describe firms which try to increase their firm value by maximizing their daily profit. In economics, firm value is often used to describe the accumulation of firm profit over time. In this sense firm value maximization and profit maximization are often used in an interchangeable manner.

14. Examples of these norms include group behavior, consensus, long-term relationships, vertical *keiretsu* relationships within corporations, the importance of group-oriented values, trust and networks, and male-female behavior (e.g. Reischauer, 1988; Tiessen, 1997). These societal norms and business norms are often intermingled and are not generally separable.

15. Nakatani (1984) and others have shown that there is a risk-sharing function that is conducted by the horizontal *keiretsu* groups. In economics, risk-sharing is thought to increase efficiency. We note that Japan's *keiretsu* groups are distinct from its pre-Second World War *zaibatsu* groups which were pyramidal business groups, after which model South Korea's *chaebols*, for example, were created. See Morck and Nakamura (2005, 2007) and Nakamura (2015).

16. Despite our focus on *keiretsu*-affiliated firms here, there are many non-*keiretsu*-affiliated firms in Japan. For example, the Japanese Ministry of Economy, Trade and Industry (METI) (1999) reported that less than 10 percent of all Japanese firms have subsidiaries, which are essential components of vertical *keiretsu* groups. We developed our predictions for discussion below taking into account the presence of such non-*keiretsu* firms.

17. For some court cases, out-of-court settlements may match the probable court decisions as they are likely to be predictable. However, it is unclear if 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.

18. 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 long-term business relationships.

19. We are indebted to an anonymous referee for suggesting this diagram.

20. Despite this nomenclature being used for convenience, some *keiretsu* firms are not "non-progressive".

21. For example, recent scandals in illegal accounting (e.g. the creation non-existent sales between associated firms) by Fujitsu's and NEC's related firms and, also more recently, by Toshiba's (Inagaki, 2015; Reuters, 2015).

22. The proportions 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 shareholdings remained as per Figure 1).

23. These are highly potent poison pills, as was proved in the period following Second World War.

24. Another interpretation of this might be that this process maximizes banks' (creditors') firm values.

25. Our selective adaptation theory does not give explicit predictions regarding firms' choices about using US-style executive-committee-based boards. We have also noted that "the role of committees generally and their relationships to their overall boards specifically are not fully understood" even by US boards.

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

27. It is likely that there is more firm-specificity in operations for vertical rather than for horizontal *keiretsu* group businesses, and hence our *P2* may be more appropriate for arguments involving vertical *keiretsu* groups. We should also note that *P2* does not explicitly discuss the conditions under which firms improve their performance by simply reducing their board sizes. This could occur, for example, if a firm, rejecting new board mechanisms, decides to improve their contributions to stakeholders by reducing the number of their directors. We thank an anonymous referee for pointing out these issues to us.

28. Such stable shareholding has prevented hostile takeovers of listed firms in Japan since the early 1950s.

29. These include Oji paper's attempt to absorb Hokuetsu Paper Mills, Rakuten's attempt to take over Tokyo Broadcasting System, and Livedoor's attempt to take over Nippon Broadcasting System, as well as Steel Partners' takeover attempts of several target firms.

30. In 2005, there were 3,734 reported M&A transactions in Japan. In all 2,725 (73 percent) of these were between group (affiliated) firms, while the remaining 1,009 (27 percent) involved non-group firms. Furthermore, the fraction of in-group M&As has been increasing since the early 1990s (DBJ, 2007).
31. 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 CPA law, which has undergone a number of revisions since the 1990s. All revisions were intended to strengthen CPAs' monitoring capacity and improve the quality of the 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 bookkeeping more stringently. It will also be accompanied by a strengthening of the penalty terms for accountants who violate the rules.
32. On balance, our empirical evidence seems to suggest somewhat less optimistic prospects for the value Japanese firms place on transparency than our theory implies.
33. We also note here, as an anonymous referee pointed out, that, in selective adaptation environments, many reasons other than those we have presented can generate dysfunctional policy consequences. For example, firms may take advantage of the flexibility that the reform policies allow in the form of the board auditing mechanism and design their board to limit transparency. Or the pursuit of friendly mergers encouraged by the reform may create a large holding company by which many previously disclosed intra-firm transactions need not be disclosed any longer, contradicting the two state variables: competition in the market for corporate control and transparency. Furthermore, such friendly mergers might be motivated by empire-building motives on the parts of firm executives. Unfortunately, the consequences caused by such dysfunctional policies result in substantial economic inefficiencies.

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