Choice as Regulatory Reform:
The Case of Japanese Corporate Governance

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The Project

- Examine a unique approach to corporate reform that emphasizes choice as opposed to blanket, mandatory reforms
- Identify characteristics/strategies of adopting firms
- Frame areas of future inquiry; provide roadmap for debate

A Decade of Corporate Reform

1993	Fixing fee of 8200 yen for shareholder derivative suits
	Introducing a board of statutory auditors [*kansayaku*]
	Reducing shareholding threshold to demand inspection of records
1994	Deregulating limitations on repurchase of shares (1)
1997	Introducing stock option system (Deregulating limitations on repurchase of shares (2))
	Simplifying merger procedures
1998	Deregulating limitations on repurchase of shares (3)
1999	Creating share exchange system
2000	Creating company spin off system
2001	Lifting ban on treasury stock
	Creating new stock acquisition right [*shin kabu yoyaku ken*] system
	Expanding the authority of statutory auditors
	Authorizing limitations on managers' liability
2002	Creating an option to form committees of the board of directors in lieu of the statutory auditor system

Political Dynamics of Reform

- Postwar-1980s: “Policy pushed” versus “demand pulled” legal reform (Shishido 2001)
- 1990s-2000s: Production of corporate law becomes competitive
- 2002 Reform: Anglo-American model refracted through domestic lens

Choice

- As of 4/03, “large” Japanese firms can retain statutory auditor system <u>or</u> adopt board committee system
- Mandatory committees: audit, nomination, and compensation
- Each committee must have a majority of “outside” directors

“Outside” v. Independent Directors

- Commercial Code art. 188: “director who is not involved in the management of the company, nor is currently or at any time has been an executive director, manager or employee of the firm or any of its subsidiaries.”
- Contrast NYSE listing standards and Delaware case law

Adopting Firms (overview)

- 71 firms (45/3000 listed firms)
  (Is that many, or few?)
- 36 group firms
- 35 firms not part of group

Adopting Firms (types)

- Global Market Players: Sony
- Foreign shareholders: Columbia Music Ent. (44%), Orix (40%)
- Distressed: Resona, Manulife
- Strategic: Vodaphone, Seiyu
- Groups: Hitachi, Nomura

  NB: Groups ≠ *Keiretsu* with MB

Foreign Cross Listings

- Only 4 of the adopting firms (Sony, Hitachi, Orix, Nomura Holdings) are cross-listed on U.S. exchanges.
- 4/19 NYSE; 0/14 NASDAQ
- Why so few?

  (i) Sarbanes-Oxley Act

  (ii) Level III ADRs

Adoption Strategies

- Simple story: Signaling/Bonding "good" corporate governance
- Endogeneity: (Demsetz & Lehn)
- Group control: Mutability of reform
- Indeterminacy: (Olson 1982)

Bifurcated Board Composition

- Group firms have "<u>outside</u>" directors.
- Non-Group firms have <u>independent</u> directors.

- **93% of Nomura group "outside" directors affiliated with parent; Hitachi group 78%. 32.5% are managers of parent; 83.3% have business or financial ties to firm (sample of 42).**
- **Non-group firms: Top professions of outside directors are manager of unaffiliated firm (36.2%) and lawyer (17.2%). 17.2% have business or financial ties to firm (sample of 42).**

Event Study (1)

- Test market reaction to public announcement of intent to adopt committee system (sample: 22 publicly traded firms, excluding public Hitachi affiliates)
- No significant stock price effects

Event Study (2)

- Divide into 2 sub-samples: "domestic" and "international" firms
- Again, no statistically significant stock price effects

Event Study (3)

- Check stock price effects of each individual firm's announcement
- Market reacted significantly to announcement by three firms: Ichiyoshi Securities (-), Toyama Chemical (-), Resona Holdings (+)

Directors, Complements, and Convergence

- Formal, not functional convergence
- Missing complementarity: judicial review
- Committee system + “outside” directors = stakeholder tunneling/ entrenchment technology

The Future

- U.S. and Japan moving in opposite directions on corporate governance reform?
- "Choice" does not imply convergence with U.S. model or emergence of a single new J-Form corporate governance in Japan.