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The Future of Japanese Corporate Governance: Internal Governance and the Development of Japanese-Style External Governance through Engagement*

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Many Western observers, especially investors, have expressed uneasiness about the way Japanese public companies are governed. For these observers, shareholders are the company's owners. Japanese public companies are heretical because they do not appear to be run for the interest of their shareholders, but rather for the interest of their managers and employees. The chronically low level of returns on equity in Japanese companies is taken as evidence for the scant concern that management has for shareholders' interests. Consequently, Western observers call for reform.[1] However, there is a puzzle to solve before we hastily take

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[1] The American Chamber of Commerce in Japan (ACCJ) is even more pessimistic when it states that "many domestic and foreign institutional investors have lost hope that standards for corporate governance in Japan will improve in the near future" (ACCJ 2014:6). Also, according to GovernanceMetrics International (2010), Japan ranks nearly at the bottom in the governance ranking covering 38 countries.

any definitive action. We need to first ask ourselves why Japanese public companies are run differently from the Western standard. Since many Japanese public companies have existed for half a century, or even longer, and have been successful, it is not be rational to assume that they have been wrong since their inception. Considering their success, there must be some valid reasons why Japanese public companies are governed the way they are. Indeed, until the mid-1980's—just before the period of the asset-inflation bubble—the Japanese corporate governance seems to have worked well. What went wrong after that? Will we need a complete revamping of the system? Where is Japanese corporate governance headed? Can we keep the essential elements of Japanese corporate governance while fixing other parts to strengthen it? These are the questions that are the focus of this chapter. Our short answer to the last question is that, yes, we can keep the essential elements intact while Japanese corporate governance evolves over the coming years.

There are two broad themes that are discussed in this chapter. The first theme is the nature of the internal organization of Japanese public companies in the post-1945 era. The concept of internal governance is introduced to develop insights into the ways in which corporate governance works in Japan today. The key points are twofold. That is, (1) the mechanism of checks and balances between the top manager and her subordinates plays a much larger role in the overall governance of public companies in Japan than the US or Britain, and (2) this preponderance of internal governance results in an internalist orientation of

organizational control in Japanese public companies. The second theme is the evolution of management-shareholder relations in post-war Japan. As the practice of cross-shareholding continues to wane, a search is on to identify a new pattern of management-shareholder relations. Because the ownership structure of Japanese public companies is dispersed and institutional in nature, we believe that engagement by institutional investors will play a pivotal role in shaping the new pattern. Although engagement might suggest a British model, our claim is that the style of engagement will be different from the British model because of the internalist orientation of organizational control within Japanese public companies.

The composition of this chapter is as follows. Part I discusses internal governance. The concept is elaborated in the context of an economic model, and its applicability to Japanese companies is expounded. Part II traces the history of management-shareholder relations in Japan. After an analysis of cross-shareholding relationships, the topic turns to the emergence of institutional activism. Part III looks into the future of management-shareholder relations. The notion of institutional investors as catalysts is introduced, and the gap-filling role of the activist investor is mentioned. Part IV concludes.

I. Internal Governance and the Role of Shareholders

In this Part, we discuss what we consider to be the cornerstone element of Japanese corporate governance. It is termed “internal governance” because it is about control that is asserted on the top manager by her subordinates (Acharya et al. 2011). Internal governance can

be distinguished from internal control because internal control is hierarchically exerted top-down by the top manager. Internal governance is an economic concept. It applies not only to Japanese companies but also to companies elsewhere.[2] A company's organization has the capacity for internal governance if it meets certain conditions. Internal governance has developed in Japan because the organization of Japanese companies has certain qualities that match these conditions.

These qualities of Japanese organizations have been typically discussed in relation to the concept of the "company community" (e.g., Shishido 2000, Buchanan et al. 2012). However, the argument here does not require that companies be a community. In fact, while the qualities that match the conditions for internal governance often give companies a community-like appearance, companies with these qualities do not need to be a community. We start our discussion in this Part by defining internal governance.

A. Internal Governance Defined

The view that bargaining plays an important part in corporate governance fits well

[2] Although the idea of internal governance is well suited to the case of Japanese companies, Acharya et al. (2011) do not discuss Japanese companies at all. Instead, they discuss the internal governance of partnership organizations such as law firms. For the internal governance of partnership organizations, see Morrison and Wilhelm (2004), Gilson and Mnookin (1985). Also, mechanisms of internal governance can take other forms than those discussed by Acharya et al. See Landier et al. (2013).

with contemporary economic theory. For instance, relying on the insights of contract theory, Zingales defines corporate governance in reference to "the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm" (Zingales 1998). While we share a similar view emphasizing the role of bargaining, our concept is more broadly constructed as the "incentive bargain" that sets the incentives of various providers of monetary and human capital to the company, which we generally classify into management, employees, shareholders and creditors (Shishido forthcoming). In this framework, what is traditionally viewed as an issue of corporate governance pertains to the bargain between two classes of capital providers (i.e. management and shareholders) over the allocation of powers as well as the value added of the company.

While this traditional view that focuses on the bargain between management and shareholders is important in understanding corporate governance in public companies, equally important, especially in the context of large public companies in post-war Japan, is a perspective that focuses on the bargain between different classes of managers. Not only is the public company an entity in which management and shareholders interact as insiders and investors,[3] but it is also an internally-managed organization in which top management and its subordinates interact with each other. We think it is important to analyze the structure of

[3] Eguchi (forthcoming) describes four different patterns of management-shareholder relations, focusing on the power allocation between the two parties.

incentives that work within the company's internal organization in order to better understand how corporate governance works in Japan.

Interestingly, financial economists have recently developed an economic model that uncovers the mechanism of checks and balances that works within business organizations possessing certain qualities (Acharya et al. 2011). These qualities are summarized as three conditions of the model. First, constituents of the company's internal organization are immobile and pursue their careers within the organization. Second, the top manager, the decision-maker of the company, is internally promoted from lower-ranking levels of management. And lastly, the constituents are given incentives over the long run by the prospect of benefits and rewards afforded to them when they run the company.

In an organization meeting these conditions, the interplay of incentives creates an implicit pressure on the top manager to internalize the long-run value of the company. This implicit control effecting discipline on the top manager is called internal governance. It is contrasted with the external governance that is asserted by outsiders of the company such as shareholders and bankers. The logic of internal governance is straightforward: The leader needs to give the subordinate a reason to follow, otherwise the subordinate will not cooperate, and the performance of the organization deteriorates. To see how this plays out in the model, think of a setting where an old top manager works with a young subordinate. Under the three conditions above, the subordinate cares about his company's long-run prospect since he has a

considerable stake in its future. But the top manager may not because she will be retired. Nevertheless, even this myopic top manager will be implicitly pressured to think for her company's future because that motivates her subordinate and elicits his cooperation.

A useful way to think of the model's conditions is to regard them as factors that determine an organization's capacity for internal governance. For instance, if the constituents of a company's internal organization are relatively immobile, the organization is deemed to have a capacity for internal governance because these constituents will have a stake in the company's long-run future. Moreover, if the constituents also have the prospect of one day running their company themselves, then the organization is deemed to have even a greater capacity for internal governance because the constituents will care more about their company's future.

In this context, it is noted that what matters for an organization's capacity for internal governance is not only the extent to which the constituents care about their company's long-run future, but also the range of those who care. To understand why, think of a situation where the top manager is always appointed from a select group of fast trackers that have been groomed for the top position from the earliest stage of their careers. In this case, since only those fast trackers credibly hold the prospect of themselves running the company and are motivated by it, the range of the constituents who care about their company's future is limited to this small select group. On the other hand, if the promotion process is more broadly based, and a larger set

of the constituents credibly shares the prospect, the range of those who care is wider. Our assumption is that the more constituents care about their company's future, the more deeply rooted is the process of checks and balances between the top manager and her subordinates, and hence the greater capacity for internal governance.

One element affecting the model's conditions is the nature of human capital needed for value creation. Suppose that this capital is firm-specific and composed of skills and knowledge that the organization's constituents learn while pursuing a career in the organization. Because these skills and knowledge carry less value outside the company than within it, the more the constituents learn, the less likely they will leave, thus resulting in a long-term career within the company. Moreover, because the constituents would be unwilling to learn the firm-specific skills and knowledge if the prospect of promotion, and hence long-run rewards, were dim, the top manager is more likely to be appointed from lower-rank managers than from outside to keep the constituents' incentives (Acharya et al. 2011).

B. The Internal Organizations of Japanese Companies

The organizational features of large public companies in post-war Japan closely match the model's three conditions. First, in these companies, employees pursue long-term careers, and mid-career job changes are rare. This feature is in contrast with the US, and to a smaller degree Britain, where the average tenure of workers is much shorter, and job mobility significantly higher (Ono 2010). The stylized form of the post-war employment practice in

Japan is often referred to as "lifetime employment." In reality, it is best understood as employers' non-legally binding promise to provide stable and continuous employment to core employees (typically consisting of male, regular employees with a certain number of years of experience). It initially started as a good corporate practice in leading companies in the heavy industrial sector, but it later spread to a wider set of companies, garnering further support as a social institution through what is known as the "abusive dismissal doctrine" (Moriguchi and Ono 2006). This doctrine, which has had a significant deterrence effect on the dismissal of regular employees, was established by Japanese courts in the 1970's and later codified as Article 16 of the Labor Contract Act of 2007.

Second, the top manager is groomed internally rather than appointed from outside. Mishina and Hino empirically demonstrate this point by examining the fifty largest Japanese manufacturers (Mishina and Hino 2013). According to their study, over 70% of top executives joined their firm upon graduating from college or before they turned age 30, and were then promoted internally. Most of the remaining top executives were either members of the founding family or came from the parent company.

Lastly, the process of selecting senior management is based on a system of rank promotion. In this system, the linkage between position and rank is not rigid, and employees are promoted up the hierarchy of ranks based on the "abilities" that they acquire on the job by being rotated around the organization. Since the pace of selection is generally slow in this

system, the majority of core employees maintain the prospect of promotion to senior management until relatively late in their career (Yashiro 2013). For this reason, the range of the constituents involved in internal governance is wide in Japanese public companies. That is, it covers not only senior managers competing for the top position but also a large group of junior managers and core employees that aspire one day to be the leader of the company.

Japanese companies are often described as possessing the character of a community. Important aspects of this character derive from their organizational attributes. For instance, since the organization's constituents pursue a long-term career, and top managers are internally promoted, the responsibility of running the enterprise is passed on internally from one generation to the next. This succession of management fosters a sense of continuity across different generations of managers and gives a Japanese company a community-like appearance.

In Japan, long-term employment and internal promotion had become the standard and norm among large public companies by the 1960's. The practice of rank promotion was also established around the same time and formed an important part of the Japanese employment system (Moriguchi and Ono 2006). Throughout the 1960's, large Japanese manufacturers made large amounts of future-oriented capital investment in order to catch up with their rivals overseas. We believe that the mechanism of internal governance in place during that period created and supported the drive that built long-run value for those companies.

The question then becomes: Why did Japanese corporate governance fail in the latter half of the 1980's, causing excessive capital investment? If large Japanese public companies score strongly on the capacity for internal governance, why did it not stop top managers from making wasteful decisions that would harm their successors? In short, the reason is the bias towards growth. This bias exists because the mechanisms of internal governance are not as effective in cutting back on capital investment as they are in creating a drive towards investment. When returns on capital investment decline, a matching level of increases in cash flow will not accompany further investment. However, top managers may continue to pursue growth strategies since, under the logic of internal governance, investing in the long-run future of their companies is needed to motivate their subordinates. It will therefore require additional discipline exerted on the top managers by outside equity to effect a cutback on capital investment.

C. The Interaction between Internal and External Governance

Outside equity refers to the equity holding by outsiders. Outsiders are contrasted with insiders in that the latter include the constituents of the company's internal organization as well as large shareholders, such as a company's founders, that exert effective control over management. Trading partners and the partners of cross-holding relations are considered outsiders, though they often behave like insiders vis-à-vis other types of outsiders such as genuine investors. Outside equity interacts with the growth dynamics of internally-governed

organizations in seemingly contradictory ways. On one hand, it accelerates growth by providing funding for capital investment. On the other hand, it acts as a braking mechanism by requiring dividend payments and thus restraining capital investment. Which effect is more pronounced depends on the company's growth stage.

To understand this seemingly paradoxical interaction, note that equity holders would take back their claim on dividends and acquiesce to the top manager's decision to invest, so long as they could collect from future cash flows. So, when the current top manager decides to invest, she is essentially passing on her "liability" owed to equity holders to the future generations. This mechanism will not break down as long as investment generates sufficient cash flows. But if the return on capital investment decreases, and investment no longer generates sufficient cash flows, it will falter because the future generation will need to meet the "passed-on liability" with the decreased cash flows. Realizing this, the current top manager forgoes investment and pays out dividends.

Such discipline on capital investment, which works through the dividend claims of equity holders, is an important aspect of external governance exerted by equity holders. As explained, the role for the mechanism of internal governance in the process of long-run value creation is that of an "engine" that generates propulsion for the process. The role for the mechanism of external governance, on the other hand, is that of the controlling device that improves the efficiency of the process. The relationship between internal and external

governance is thus complementary in that together they bring about an outcome that is not possible with only one of them in place (Acharya et al. 2011).[4]

Another important point to highlight is that the mechanism of internal governance will be impaired if external governance is excessive (Id.). Recall that one of the conditions for effective internal governance is the prospect of benefits and rewards that will be afforded to the organization's constituents when they run the company. These benefits and rewards include not only extra bonuses and perks, but also pet projects and any other slack investments that can be considered private benefits. Since these managerial rents come out of the surplus value the company creates, shareholders and managers have conflicting interests over its allotment. Suppose that external governance is excessive and the surplus value afforded to constituents is squeezed too tightly. In this case, the mechanism of internal governance will not work well because the lubricant for the "engine" is lacking. Myers points out the importance of managerial rents for a public company's overall efficiency (Myers 2013). From this perspective, the goal for the governance architecture is not to maximize external governance, but to set its intensity at an appropriate level, so that the mechanism of internal governance remains functional.

[4] Also, Hirota and Kawamura (2007) analyze an internal governance mechanism similar to what is discussed in this chapter. But their focus is on the incentive structure between management and employees, and also on the substitutability, rather than the complementarity, of internal and external governance.

In the case of post-war Japan, the key factor that set the intensity of external governance was the practice of cross-shareholding. Since this practice had the effect of isolating management from the influence of shareholders, the intensity of external governance, which correlates with the degree of their influence, tended to become lax. Filling in the void and supplying supplementary governance was the system of main bank monitoring that developed in the 1960's (Okuno-Fujiwara 1999). In this system, a bank that had a long-term continuous business relationship with, and in many cases an equity stake in, the company would extend the largest share of loans and was thus called the "main bank." Effectively it acted as a delegated monitor for other lenders (Aoki et al. 1994). We will discuss more about cross-shareholdings in the next Part, but before moving on, a few additional remarks on internal governance are in order.

D. The Scope of Japanese Internal Governance Today

As mentioned, the immobility of the organization's constituents, which is a condition for effective internal governance, had become a feature of Japanese companies by the high-growth era of the 1960's. Since that time, however, the Japanese economy has undergone several recessions involving wage and employment adjustments. During this period, the media has repeatedly reported the eclipse of the Japanese employment system. Therefore, we must examine whether the assumption of immobility is still reasonably valid. As we discuss below, the answer seems to be "yes."

Kambayashi and Kato use detailed micro-data to study the stability of long-term employment and job security for “core employees” (in their definition, employees between the ages of 30 and 44, with at least five years of tenure accumulated) over the past twenty-five years (Kambayashi and Kato 2011b). They find that the employment practices for this group of employees have remained remarkably stable in Japan, while the pattern in the US has changed considerably, indicating a weakening of long-term commitment as well as a loss of job security.

The Japanese employment system, which had been originally adopted for core employees of large companies, spread to other groups of employees, such as mid-career hires and female regular employees, as the economy boomed in the 1980’s (Moriguchi and Ono 2006). It was mostly these new members of the Japanese employment system that found promises of long-term employment reneged when economic hardship hit their companies in the 1990’s (Kambayashi and Kato 2011a). However, since the organization’s constituents involved in bottom-up governance are the members of the original core group, we believe that the assumption of immobility is still valid at least in the case of large companies.

The fact that typical Japanese companies still retain the organizational capacity for internal governance does not imply that internal governance is indeed effective in these organizations. For instance, if the company is not a value creator, there is little surplus value to be allocated in the form of managerial rents, and the mechanism of internal governance is unlikely to develop. Moreover, even if the company is indeed a value creator, it can be trapped

in what might be called the "quiet-life equilibrium." This is the pattern in which the constituents' incentive dynamics are not geared to the growth of corporate wealth but settled on the maintenance of the status quo because they opt for a "quiet life" rather than a life of risk and challenge. If a company falls into this trap, it will likely require outside equity to restore the company onto the path of innovation and growth.[5]

Thus, we do not claim that internal governance is effective in all Japanese companies. Our claim is more modest. That is, typical Japanese companies have a greater capacity for internal governance than companies in other industrialized countries, especially the US and Britain. And well-run Japanese companies use that capacity effectively to design their overall governance structures. The empirical research described in Jackson and Miyajima, and later updated by Miyajima, indirectly confirms this point (Jackson and Miyajima 2007, Miyajima 2011). According to these studies, public companies in Japan can be grouped into three categories. The companies that belong to the core category (called "Hybrid firms") include no more than a quarter of all companies, but employ two thirds of the total workforce. These companies make extensive use of the capital markets to meet their financing needs and are proactive in governance reforms. Nonetheless, with respect to internal organization, they firmly retain the norm of long-term employment. This suggests that these companies deem

[5] "Quiet life" is a term used in the economic literature to describe a pattern of managerial behavior in which a lack of external discipline causes managers to forgo opportunities for value creation to avoid effort and risk. For example, see Bertrand and Mullainathan (2003).

internal governance to be an important part of their governance architecture.

Opposite in many respects to this progressive type are the “traditional” companies (called “J-firms”) that exhibit the features of the Japanese companies in the 1960’s and 1970’s as is. That is, they not only maintain long-term employment as well as seniority-based wages, but they also depend predominantly on bank loans and retain extensive cross-holding relationships. These companies still include a quarter of all companies and employ 10% of the total workforce. Yet their profitability trails behind that of the Hybrid firms even after adjusting for the difference in the industrial composition.

When a change in environment takes place, it poses a challenge for companies to evolve. The contrast between the two categories of companies suggests that the Hybrid firms have met the challenge, but the J-firms have not. Indeed, Miyajima’s updated research reports that 16% of those classified as J-firms in 2002 had been subsequently delisted one way or another by 2008 (Miyajima 2011). While the J-firms still represent a non-negligible portion of public companies today, their economic importance is likely to diminish further over time.

III. Japanese Corporate Governance in Transition

The practice of cross-shareholding produced a distinctive pattern of management-shareholder relations in post-war Japan. Like poison pills in the US, this practice is a technique used to shield management from the influence of outside shareholders. It began to weaken during the deep downturn of the market starting in the 1990’s, and as it continues to

wane, both management and shareholders are struggling to identify a new pattern of relationship with each other.

A. The Rise and Decline of Cross-Shareholding Practices

From a functional perspective, the scheme of horizontal cross-shareholding as practiced in post-war Japan may be viewed as a device to create a virtual "reference shareholder" in a diversified ownership structure where control resides in the market, rather than in the hands of specific shareholders. "Reference shareholder" is a term used to describe ownership concentrations in Continental Europe and refers to a large blockholder who may not hold a majority of votes but nonetheless controls the votes necessary to effectively determine the outcome of a shareholder meeting (Cools 2005). In jurisdictions (such as those in Continental Europe) where corporate law generally empowers shareholders with substantive statutory rights, having a reference shareholder in support of management stabilizes management as it limits the influence of other shareholders (Id.).

In Japan, shareholders are also legally empowered, but in contrast with major jurisdictions in Continental Europe, a dispersed ownership structure prevails especially among large public companies.[6] Under these structures, the scheme of horizontal cross-shareholding

[6] For a comparison of shareholders' governance rights, see Enriques et al. (2009). In the late 1990's, financial economists vigorously conducted comparative studies of the ownership structures of both developed and developing markets. A representative work in this area is La Porta et al. (1999) that compared the ownership structure of the twenty largest companies by

develops as a technique to create a virtual reference shareholder that shields management from the influence of legally empowered shareholders. This scheme is contrasted with vertical cross-shareholding as practiced in many countries of Continental Europe and Asia, where a minority blockholder effectively controls the whole group of companies using various ownership schemes including cross-shareholding. The method of horizontal cross-shareholding is intricate—companies hold each other's shares on the implicit agreement that they will support each other's management as shareholders. These cross-holding arrangements can be made on a simple, bilateral basis or a more complex, multilateral basis. Their end result is a structure where the company virtually controls a substantive block of votes and thus functions as a virtual reference shareholder for itself.

The structure of ownership was very different in pre-war Japan. During that period, even the largest public companies were controlled by a small group of legally empowered reference shareholders.[7] Two major policy moves that shaped the political economy of Japan in

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capitalization in twenty-seven different countries. According to this study, Japan is only behind Britain in the degree of dispersion of equity ownership.

[7] In 1935, the ten largest shareholders held 40% of the equity of the twenty largest companies. Among the Zaibatsu (defined to include Mitsubishi, Mitsui and Sumitomo), the group holding company (headquarters) owned around 40% of its group companies. Among the other conglomerates, the founders and their families as well as their asset management companies owned around 20% of the group companies. See Okazaki (1994a, b). Nonetheless, it should be noted that, even with these major blockholdings, ownership in pre-war Japan was dispersed by

the 1930's and 1940's overturned this structure. The first move was wartime policy. To mobilize resource for the war, the government and military bureaucrats deliberately implemented specific policies to remove the influence of shareholders from the companies (Okazaki 1994a). The second move was the occupation policy, taken by the General Headquarters (GHQ) serving the Supreme Commander of Allied Power. As part of the general policy to democratize Japan, the GHQ dissolved Zaibatsu holding companies and placed the shares held by these companies and the capitalist families under public ownership (Okazaki 1994b).

Thus, by the end of the 1940's, the control of large public companies was no longer in the hands of large reference shareholders, but was generally dispersed among small individual investors that had purchased the shares when they were sold to public.[8] Taking advantage of this situation, several legendary greenmail artists led high-profile share buy-ups in the mid-1950's (Kawakita 1995). It is in this context of shareholder hostility that companies, especially former Zaibatsu members, presumably in search of a proxy for reference shareholders, started reorganizing around their banks by holding each other's shares. Cross-holding networks developed further in the 1960's, as well as during the first half of the1970's, as corporations sought to "stabilize their shareholders," not least in anticipation of a

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the standards of the time. See Franks et al. (forthcoming) for detailed analysis.

[8] By the end of FY1949, individuals owned 69.1% of listed companies (Tokyo Stock Exchange et al. 2014).

threat of foreign takeover following the complete liberalization of the capital markets.[9]

The practice of cross-shareholding persisted throughout the 1980's as the stock market boomed and brought in profits on the cross-holding positions. But companies started unwinding these positions after the burst of the equity price bubble, and the trend has generally continued up to the present.[10] A large factor accelerating the process of unwinding was the erosion of banks' balance sheets (Miyajima and Kuroki 2007). Throughout the first half of the 1990's, a persistent decline in real estate prices produced heavy losses on banks' loan portfolios. The resulting erosion of their balance sheets caused selling pressure on two fronts. For one, the banks were required to finance those losses by selling their holdings of corporate shares. Additionally, the corporations faced the risk of holding banks' shares as the prices of these shares started plummeting in the mid-1990's in the midst of the banking crisis.

[9] In the universe of large listed companies, the percentage of equity held by banks and other business corporations increased from the low level of 16.1% in 1953 to 33.2% in 1962. The percentage rose further to 42.7% in 1974 (Franks et al. forthcoming). For an account on the formation of cross-holding networks, see Miyajima and Kuroki (2007).

[10] Add banks' holdings of corporate shares and corporate holdings of bank and corporate shares, and define the sum as broadly defined cross-shareholdings. Their total value as a percentage of the value of all listed stocks declined from 34.61% in FY1991 to 12.75% in FY2009. Of these broadly defined cross-shareholdings, those confirmed to be part of cross-ownership arrangements fell from 24.69% to 5.70% as a percentage of the value of all listed stocks during the same period. See Ito (2011).

Placed under the pressure to sell, both banks and corporations started unwinding each other's cross-holding positions in the latter half of the 1990's. This process continued even on a more massive scale during the first half of the 2000's. Miyajima and Kuroki analyze the patterns of unwinding during these periods and point out that they were not uniform across the board (Miyajima and Kuroki 2007). On one hand, the corporations that had relatively easy access to the capital markets and less dependence on bank loans for financing were eager to dismantle their cross-holding relations, and the banks prioritized selling these high-valuation shares to maximize the proceeds. On the other hand, the corporations with a high dependency on bank loans held on to the cross-holding relations, and the banks on their part remained cautious about dissolving them because this would send a signal to the market that they had given up on those corporations.

Today, cross-shareholding is still a part of corporate practice, especially in strategic alliances between corporations. But the arrangements between banks and corporations, which composed more than two thirds of all cross-shareholdings right after the burst of the equity price bubble, now account for a small portion of the ownership structure of public companies (Ito 2011). Cross-shareholding might still be a feature of Japanese corporate governance, especially among the J-firms introduced at the end of Part II. But with respect to the Hybrid firms and other large-capitalization companies in which institutional money concentrates, it is no longer the dominant factor it used to be in determining the intensity of external governance.

B. The Rise of Institutional Activism and the Deepening of Dialogues between Management and Institutional Investors

As the dissolution of cross-holding relations continued, two major developments attracted the public's attention and heralded a change in management-shareholder relations. One was the wave of confrontational activism that began in 2000 with M&A Consulting's hostile bid against Shoei, a Tokyo Stock Exchange First Section company. Following this high-profile takeover attempt, in which an activist fund made appeals to shareholder value to legitimate its claim, a number of listed companies were targeted by both domestic and overseas activist funds that also used financial arguments and confrontational techniques to put pressure on management. While these events attracted widespread public attention, adversarial forms of activism waned by the end of the 2000's. The forms of activism that still remain are mostly of a different variety involving a much lesser degree of hostility and public exposure (Buchanan et al. 2012).

Another development that heralded a change in management-shareholder relations is the rise of institutional activism. Learning from the practice of their overseas counterparts, pension funds and their investment managers started actively exercising their voting rights at shareholder meetings. Under the strong leadership of their management at the time, the Pension Fund Association (PFA) and the Pension Fund Association for Local Government Officials spearheaded this nascent form of institutional activism. PFA, an umbrella organization for corporate pension plans, manages a large pool of funds reserved for paying the vested benefits

to those who have prematurely left the plans. PFA caught the media's attention when it announced a comprehensive guideline for the exercise of voting rights and voted against 40% of management proposals at shareholder meetings held in June, 2003.[11]

While the activism by the public pensions was certainly unprecedented in terms of its social impact, it would be worth noting that these funds were not the first to vote actively. The California Public Employees' Retirement Pension System (CalPERS), which started applying a systematic voting policy for its Japanese shareholdings in 1990, was their forerunner (Jacoby 2007). Nonetheless, the actual impact of CalPERS' voting policy, and for that matter any foreign investors' voting policy, was limited in the 1990's because the size of their holdings as a percentage of all Japanese equities was still small.

More than a decade has passed since the two types of shareholder activism heralded a change in management-shareholder relations in Japanese public companies. Two developments that have since taken place are having further impacts on these relations. First, foreign investors have increased their presence as major holders of Japanese equities,[12] and they exert significant influence on the voting outcomes of their portfolio companies. Second,

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[11] For a detailed analysis of PFA's version of shareholder activism, see Aronson (2011), Seki (2005).

[12] In the universe of listed companies, the percentage of the equity held by foreigners increased from 7.7% in 1993 to 21.8% in FY2003 and to 30.8% in FY2013 (Tokyo Stock Exchange et al. 2014).

the domestic investors are less reserved in their exercise of voting rights. While active voting was considered ahead of its time a decade ago, it is no longer uncommon for domestic investment managers to cast a significant percentage of their votes against management if deemed appropriate.[13] Recognizing a change in the wind, an increasing number of company executives have begun to reconsider the existing pattern of their relationship with shareholders that depended on cross-holdings.

Paralleling this change in the posture of management is a move by institutional investors to activate their communication with management. Two types of activity are observed. The first concerns a more meaningful exercise of voting rights. Over the past decade, the institutions have developed elaborate guidelines for directing their votes. The upside is greater consistency of decisions, but the downside is the prevalence of the "one standard suits all" approach. Single-minded box ticking rather than careful investigations of individual cases tends to drive the voting process. This tendency is further exasperated by: (1) the heavy

[13] Even in a leading company like Canon, the percentage of votes cast against the reappointment of the top executive was as high as 28% at the shareholder meeting held in March, 2013. Unlike Toyota, which introduced outside directors to the board in that year, Canon did not appoint any outsiders to the board. The percentage of votes cast against management for other directors remained in the single digits. Canon eventually introduced two outside directors at the following year's shareholder meeting. (An Extraordinary Report disclosing the details of the voting outcomes at the shareholder meetings is mandatory under the Financial Instruments and Exchange Act.)

concentration of shareholder meetings in listed companies in a short period of a few weeks in June, and (2) insufficient disclosure of information beyond the level required by law. Dissatisfied with the situation, several investment managers have started working with the Investor Relation (IR) officers of their portfolio companies, asking the latter to supply more detailed information in a timely manner so that they can make at least more informed, if not case-by-case, voting decisions.

The second type of activity aims more directly at activating the communication between institutional investors and the management of their portfolio companies. An example is the Corporate Reporting Lab under the auspices of the Ministry of Economy, Trade and Industry. This forum of IR officers and corporate governance professionals was established in 2012, with the explicit purpose of promoting better communication between management and investors.[14]

Such collaboration between management and institutional shareholders may still be in an embryonic stage, but it indicates that both parties are actively considering a "post-cross-shareholding" form of relationship. Recent formulation of Japan's Stewardship Code ("the Code") will likely accelerate this move.[15] By introducing the notion of constructive dialogue, the Code sends a clear message to the public that active communication between

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[14] For more detail, see the Lab's website. http://www.meti.go.jp/english/policy/economy/corporate_accounting/index.html

[15] The Code is posted at http://www.fsa.go.jp/en/refer/councils/stewardship/20140407.html.

management and institutional investors needs to be promoted further.

IV. External Governance in Internally-Governed Organizations

Engagement generally refers to the dialogue between management and (relatively large) minority shareholders that takes place when the latter wish to exert influence on management. In Britain, such dialogue takes place regularly between institutional investors and the management of their portfolio companies and has long determined the nature of their relationships. Given the dispersed and institutional ownership structure of Japanese public companies,[16] we believe that engagement by institutional investors will play a pivotal role in shaping the future pattern of management-shareholder relations in Japan. Although this rising role of engagement in Japan might be interpreted as a convergence to the British model, Japanese organizations' higher capacity for internal governance will likely affect the ways in which engagement is undertaken and hence give engagement in Japan a different color.

A. Japanese-Style Engagement

To understand the features of engagement in Japan, a comparison with the British experience, especially during the 1980's and 1990's, is useful. The most salient feature of the

[16] Regarding ownership dispersion, see *supra* note 6. According to Tokyo Stock Exchange et al. (2014), the percentage of equity held by domestic institutional investors (i.e., trust banks, insurance companies and other financial institutions excluding banks and securities companies) is 23.1% in FY2013. The percentage held by foreigners is 30.8% in the same year. Our estimate for the total institutional holdings is thus roughly 54%.

British-style engagement is its collective nature. Since the 1980's, institutional investors have from time to time formed coalitions and engaged collectively with management. Historically, two conditions made such a collective approach possible. The first condition was ownership structure. During the 1980's and 1990's, a small group of domestic institutional investors together held a major portion of the equity of large public companies and could collectively control the outcome of shareholder meetings at these companies if they intended to so.[17] Moreover, this small group of investors formed a close-knit community. Their close relations with each other made it easier to share common viewpoints and build consensus (Cheffins 2008). It should be mentioned in passing, however, that these market conditions that historically supported coalition formation are more precarious today than in the past. What happened is that foreign investors have largely replaced domestic institutional investors as the major owner of British equities. Reflecting this change, the investor community has become less uniform and more fragmented (Cheffins 2010).

The second condition, which unlike the first condition continues to hold today, is British law. Compared with other major jurisdictions in Europe and the United States, relevant

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[17] Cheffins (2008) describes this ownership structure using statistics and citations. According to a study cited, by the 1990's, the 20 top domestic investment managers managed just over one third of the equity of all listed corporations. Goegen and Renneboog (2001) estimate that, in 1992, the insurance companies and investment/pension funds that individually had more than 3% stakes together controlled roughly 20% of all voting rights of listed companies.

regulations have put much less of a restraining effect on coalition formation (e.g., Black and Coffee 1994, Cheffins 2008, Santella et al. 2009). The legal issue in this regard is whether such coalition formation activity is to be considered a case of "acting in concert," which is subject to regulation. On this issue, both the Takeover Panel and the Financial Services Authority (FSA) have explicitly indicated that standard acts of collective engagement such as joint conferences and voting together on a particular resolution would not constitute acting in concert for the purpose of the takeover regulations (FSA 2009, Prudential Regulation Authority 2013, Takeover Panel 2013, 2009). Moreover, FSA has clarified that the requirement of aggregate disclosure under the Disclosure and Transparency Rules does not typically apply to normal acts of collective engagement (FSA 2009).

In Japan, the situation is very different. First, not only is institutional ownership less concentrated, but the investor community lacks the affinities and cohesive views that characterized the domestic institutional investors in Britain. Second, both the rules of Large Shareholding Reports and the TOB rules under the Financial Instruments and Exchange Act (FIEA) do not distinguish corporate governance activism from other concerted activities.[18]

[18] Under the rules for Reports of Possession of Large Volume, the aggregate interests including those of Joint Holders will need to be reported if the stock ownership exceeds the 5 percent threshold (FIEA Art. 27-23(1)(3)(5)(6)). Those that are deemed as "Joint Holders" due to their motive (FIEA Art. 27-23(5)) include, among others, parties to voting agreements, written or verbal, and parties to joint shareholder proposals. The Financial Services Agency (FSA) has

Thus, compared with Britain, the hurdles for forming a coalition will be substantially higher, if not insurmountable.

Another feature of British-style engagement is its private and non-confrontational nature. Although exceptions certainly exist, British institutions prefer negotiating with management "behind closed doors" and tend to avoid public confrontations (Black and Coffee 1994, Davies 2010, Solomon and Solomon 2004). This is in contrast with American-style institutional activism, as represented by CalPERS, which often employs "theatrical" techniques such as open-door media exposure. In the case of Japan, the nature of engagement will be even less confrontational than Britain because, with coalition formation not considered a realistic possibility (at least in the near term), the institutions cannot use the perception of a

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clarified the definition of such Joint Holder (FSA 2010).

Institutional investors are only required to file a simplified report if their ownership does not exceed the 10 percent threshold. The additional condition for qualifying for this preferential status is that the motive of ownership is not for an "Act of Making Important Suggestion, etc." (FIEA Art. 27-26(1)). "Important Suggestion, etc." includes proposals, made at a shareholder meeting or to the corporate officials, regarding appointment and dismissal of representative directors and important changes in dividend policy (Ordinance for Enforcement of FIEA Art. 14-8-2).

Under the TOB rules, a tender offer will be required if the sum of voting rights held by all related parties exceeds the percentage threshold. The parties that are deemed to be in a "Special Relationship" with the Tender Offerer due to their motive essentially match with the Joint Holders explained above (FIEA Art. 27-2(7)).

threat to strengthen their position. Then the natural question becomes: If the Japanese institutions cannot resort to power, how can they ever be effective in influencing management? We think that, in order to be effective, the institutions will need to play the role of "catalyst" that induces change from within. That is, rather than placing external pressure to unilaterally assert their viewpoints as investors, they will need to proactively share their views with management and induce its initiatives.

The reason why we think that institutional investors will need to play the role of catalyst stems from the recognition that the relative importance of internal and external governance, as well as the nature of organizational control within the company, differ between Japan and the US and Britain (the US/UK for short). In Japan, the mechanism of internal governance based on checks and balances between the top manager and her subordinates plays a larger role in an organization's overall governance than in the US/UK, where this mechanism plays a more marginal role. Moreover, reflecting the larger role this mechanism plays, organizational control within Japanese companies has a more "internalist" orientation. That is, their constituents share a belief that those with long-run commitment to the company's enterprise should have influence over the company's policy.[19]

Because of these differences, the ways in which outside shareholders can most

[19] Buchanan (2007) also sees this internalist orientation as a defining characteristic of Japanese companies. Our argument, however, is less dependent on the characterization of Japanese companies being a community, which Buchanan emphasizes.

effectively influence management also differ between the US/UK and Japan. In the US/UK, the mechanism of internal governance plays a relatively marginal role, and organizational control within a company has a less internalist orientation. Thus, the strategy of placing external pressure on the top manager by, for instance, using the threat of coalition formation or open-door media exposure can be effective. In the case of Japan, however, this mechanism plays a primary role, and organizational control within a company has a more internalist orientation. The strategy of placing external pressure is not effective, and a better approach is to create pressure from within.

In any style of engagement, whether Japanese or not, the institutional investor's role is to bring in an outsider's perspective to management. However, because of the internalist nature of organizational control, institutions cannot exert influence in Japanese public companies unless they have built a constructive relationship with management and have won a certain level of its confidence. Such congeniality to management, which is necessary for the outside investor to act as an agent for change, distinguishes engagement in Japan from the classic British style. And it makes engagement in Japan more of a relational undertaking rather than an arm's length negotiation between parties with conflicting interests.

B. Activist Investors as Gap-Fillers

In the previous section, we characterized the role of institutional investors as catalysts inducing change from within. However, the business model of institutional investors as

investment managers places a limit on what they can do in their capacity as catalysts. Supplementing the catalyst role of institutional investors and playing the role of gap-filler is the activist investor that earns a return by serving as a "governance intermediary" (Gilson and Gordon 2013).

The effectiveness of the catalyst approach to engagement in dealing with general governance issues does not require further elaboration. As described in Part III, institutional investors in Japan have already begun a dialogue with management in this area. What is not clear is whether the catalyst approach can be equally effective in addressing company-specific problems, such as the company's financial performance. In fact, the long history of British-style engagement does not provide a clear answer on this point. While the British institutions broadly engaged on general governance issues, with respect to company-specific problems, their activity was more restricted with an emphasis placed on the worst performers and *ex-post* crisis situations in cases of scandals or self-dealing. In these extreme situations, their intervention often led to the turnover of top management (Black and Coffee 1994).

The form of external governance in which outside intervention takes place only in extreme situations is called "contingent governance." A typical example is the control exercised by the Japanese main bank during the high growth era. Since contingent governance does not interfere with internal governance (Shishido 2007), it was suited for the governance regime of the time, which focused on internal governance. But this regime was not adequate to

prevent wasteful investment in the latter half of the 1980's. As the management-shareholder relationship premised on cross-shareholdings shifts to a new pattern emphasizing engagement, a question arises as to the effectiveness of engagement as a means of exerting discipline on management, especially in the context of a possible interpretation that it is a form of contingent governance. On this point, the former Chief Investment Officer (CIO) of a major British insurer that often played a leadership role in collective engagement provides instructive commentary. Comparing British-style engagement with main bank intervention, the CIO remarks that the extent of intervention by British shareholders did not remotely approach the level exhibited by the banks in Germany and Japan (Cheffins 2008). The business model of institutional investment managers is to provide low-cost portfolio diversification and superior active returns relative to their peers. Because they follow this model, these institutional investors naturally lack in either expertise or incentive in supplying company-specific oversight.

If institutional activism is not up to the task of providing sufficient oversight on company-specific problems, there needs to be a supplementary mechanism that will fill in the gap. The activist investor can play this role by functioning as an intermediary that activates the interaction between management and investment managers regarding company-specific problems. To see how this might work, note that investment managers will certainly be responsive to the company-specific proposals made by activist investors, even if they might be

reluctant to make proposals themselves. Realizing this, the activists will try to win their support. But so will the company's management because otherwise it will lose the contest. Such competition between the activists and management will activate the interaction between management and investment managers and contribute to better oversight of company-specific problems.

V. Conclusion

This chapter discusses two themes that are related to the series of questions posed at the beginning. The first theme is internal governance. Internal governance is an implicit control that is asserted on the top manager by her subordinates. Its mechanism aligns the incentives of these human capital providers and supports the process that builds value for the company. The mechanism of internal governance is well developed in Japan because the internal organization of Japanese public companies possesses the qualities that make the mechanism particularly effective. The same qualities also give the Japanese company its community-like features.

The mechanism of internal governance works well when returns on the company's capital investment are high. But the bias towards growth that is inherent in the mechanism can cause wasteful investment when the returns diminish. In the case of Japan, the mechanism of external governance that should have complemented the mechanism of internal governance and imposed discipline on capital investment was ineffective because the practice of cross-shareholding weakened the influence of shareholders too much. What is important for

internally-governed companies is to set the intensity of external governance at an appropriate level.

The second theme of this chapter concerns the impact of the unwinding of cross-shareholdings and the emergence of institutional investors as key players in Japanese corporate governance. While the mechanism of internal governance based on checks and balances between the top manager and her subordinate will remain the cornerstone of the new governance regime, institutional investors will also play a pivotal role. Given the internalist orientation of organizational control in Japanese public companies, institutional investors can be more effective in their engagement with management if they play the role of catalyst from within rather than attempt to exert pressure from outside.

Nonetheless, the institutional investors' business model focusing on portfolio diversification and relative performance with respect to peers limits their capacity as purveyors of external governance. Supplementing the catalyst role of the institutional investor is the activist investor, who will activate the interaction between management and the institutional investment manager by playing the role of a "governance intermediary."

Engagement in Japan will develop as more and more institutional investors participate in active dialogue with management. However, an excessively cautious attitude stemming from fears of triggering the concerted action or insider trading regulations can be a major deterrent from achieving this goal. Learning from the British experience, Japanese regulators can play a

facilitating role in this regard by clarifying regulations, providing guidance, and considering revisions of relevant statutes if necessary, so that the fears of institutional investors are alleviated.

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