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**Abstract**

In 2014-15 Japan implemented a series of reforms to its corporate governance regime. The principal measures adopted were the country's first Corporate Governance Code, revisions to its Companies Law, and a Stewardship Code, together with a report (the Itō Review) on corporate competitiveness and incentives for growth. In this paper we analyse the objectives of these reforms and make an assessment of their likely success, drawing on interviews with key actors in Japanese government, finance and industry. We firstly frame our analysis by a consideration of what institutional theory has to say about the relationship between formal and informal norms and practices, and about the feasibility of using regulatory mechanisms of different types to alter embedded routines. We then consider the historical evolution of Japanese corporate governance since the early 20th Century and explore the causes of its current embeddedness and apparent resistance to change, noting pressures in the past which in some cases have changed it greatly while in others have had little effect. We then examine the manner in which the current reforms were devised and implemented, their content, and the influences that shaped them. We then discuss the methods used to conduct our primary interview research, which was carried out in 2016-17 with policy makers, corporate managers, investors, and other interested parties. We use our interviews to identify how the reforms were formulated and how they have been received. We then present our assessment. We suggest that despite a pattern of embedded institutions resisting regulatory pressures for change in recent years, Japanese corporate governance may now have reached one of its historical turning points. The introduction into Japan of the 'comply or explain' approach, the major innovation that distinguishes this reform exercise, is a significant moment. The existence of a corporate 'compliance machine' of administrative officers below board level, whose role is to interpret regulation and present it in executable form to their boards of directors, improves the Code's chances of implementation at large, listed companies. The Stewardship Code, meanwhile, has the potential to co-opt institutional investors' interests to the economic reform agenda of the political class. These politicians have shown an unusual degree of commitment to the reform process and continue to give it their strong support. At the same time, there are potential obstacles to unqualified adoption of the Corporate Governance Code, especially for smaller companies that lack administrative resources, and the 2018 revision of the Code has introduced some doctrinaire elements which seem at odds with the realities of governance in most Japanese companies. Moreover, some doubt remains regarding the ability of corporate governance reforms to deliver the kind of economic revival that politicians are seeking, at least in the short to medium term. Thus the question of whether the Corporate Governance Code will bring about lasting change in Japanese corporate practice remains an open one. The Code has clear advantages over previous attempts at reform but we compare this process to

the proverbial 'taking a horse to water', because no amount of formal exhortation will succeed if the horse chooses not to drink.

**JEL Codes**: G34, G38, K22

**Keywords**: corporate governance code, stewardship code, comply and explain, Japan

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## 1. Introduction

In May 2015 a revision to Japan's Companies Law came into force which, among other changes, introduced an optional new corporate structure, tightened the qualifications for external directors ('outside directors'), and required companies that lacked external directors to explain publicly why they considered them unnecessary.[1] This was followed closely in June 2015 by implementation through the Tōkyō Stock Exchange (TSE) of the Corporate Governance Code, which had been drafted by the Financial Services Agency (FSA) advised by a Council of Experts.[2] Prior to these developments, a Stewardship Code for investors had been developed by the FSA, advised by a separate Council of Experts, and published in February 2014,[3] and the Itō Review,[4] produced by the Ministry of Economy, Trade and Industry (METI), advised by its own Council of Experts, had been published in August 2014 to examine 'competitiveness and incentives for sustainable growth, building favorable relationships between companies and investors'[5]

The Corporate Governance Code, the Companies Law amendments which underpin it, and the Stewardship Code which complements and reinforces it have been presented by the various agencies responsible for producing them as a coordinated attempt to re-focus Japanese corporate governance. Their stated aim is to increase medium and long term corporate value for the benefit of the whole economy by encouraging boards to emphasise supervisory over executive responsibilities, by pressing for greater external supervision, by increasing transparency, by promoting equitable treatment of portfolio shareholders, and by emphasising to both companies and investors the need for constructive dialogue, simultaneously introducing the concept of 'comply or explain' in place of prescriptive regulation.

As we shall see, there are reasons to doubt whether formal regulation of this kind, however it is framed and implemented, can change an embedded and institutionalised set of practices such as corporate governance exactly as intended, and the experience of earlier attempts to do so in Japan is not encouraging. Nevertheless, there are new elements present here, both in the background and in the structure of this initiative, which may improve its chances of success.

Irrespective of whether a transformation of Japanese corporate governance will really produce economic benefits, the immediate question is whether the reforms will bring about their goal of changing the way in which Japanese companies are governed and managed. To address this question we analyse the mechanisms of the new Corporate Governance Code, together with the package of moves that accompany it, using empirical evidence from interviews with a range of actors involved or interested in the current reform initiative.

In section 2 we look at the theory of institutional change and specifically at the relationship between formal regulatory initiatives and socially embedded norms and practices. In section 3 we consider the historical background to corporate governance in Japan since the early 20$^{th}$ century, seeking to put the latest changes into historical context. In section 4 we present our empirical case study, which is based on interviews conducted in Japan in 2016 and 2017 with investors, managers, politicians, civil servants and corporate governance experts. We firstly look at the substance of the Corporate Governance Code itself and reactions to it, and then focus on five aspects from the current exercise that appear to distinguish it from earlier attempts at reform: the introduction of the concept of 'comply or explain', which has not been employed in Japan before; the importance of what we call the 'compliance machine' whereby the Corporate Governance Code has effectively interlocked with the administrative machinery of large Japanese companies to insert itself into management awareness to an extent not achieved before; the accompanying call for constructive investor involvement in the form of the Stewardship Code; the unusual degree of political pressure that generated these reforms; and the formal process for periodic review of the Corporate Governance and Stewardship Codes which produced the first revision of the Corporate Governance Code in June 2018. Section 5 concludes.

## 2. The theory of institutional change: formal and informal norms

As defined by North, 'Institutions are the rules of the game in a society or, more formally, are the humanly devised restraints that shape human interaction'. They contribute to efficiency and fulfil an important social function because they 'reduce uncertainty by providing a structure to everyday life'.[6] Economic activity in a market economy is shaped and structured not just by formal laws and regulations but also by social norms and practices that may mediate the impacts of formal rules or even subvert them. Many of the norms and practices which make up 'corporate governance', in its broad meaning of the governance and management of legally constituted business firms, operate beyond the scope of the formal rules contained in company law statutes and codes of practice. Because the situations facing economic actors are too varied and nuanced to be captured entirely by formal norms, the practice of corporate governance depends greatly on the exercise of personal judgement by directors and managers who are influenced by shared understandings of the 'rules of the game'. These preconceptions and values, tacitly embedded within the companies and their management, will tend to determine the fate of formal initiatives for legal and regulatory change, and, through a process of feedback, will affect the way in which more formal institutions evolve:

'Institutions change incrementally rather than in discontinuous fashion. How and why they change incrementally and why even discontinuous changes (such as

revolution and conquest) are never completely discontinuous are a result of the embeddedness of informal constraints in societies. Although formal rules may change overnight as the result of political or judicial decisions, informal constraints embodied in customs, traditions, and codes of conduct are much more impervious to deliberate policies.'[7].

Thus formal and informal elements combine to produce institutional evolution. Targeted intervention through formal measures, normally instigated by agents who are able to dictate to the market, is one driver of change: 'Only when it is in the interest of those with sufficient bargaining strength to alter the formal rules will there be major changes in the formal institutional framework'[8]. However, these formal changes then have to contend with the inertia of the informal institutional environment. Igarashi links the effectiveness of formal corporate governance reform to its ability to address latent demand from companies,[9] and Shishido observes this phenomenon as dual forces of 'policy push' from reformers and 'demand pull' from companies.[10] The second driver is therefore the degree of latent tendency towards incremental change, as institutional practices adapt themselves to changing circumstances. This process can be triggered by what Teubner, in the context of legal evolution, calls 'irritants' that attach themselves to agents' awareness and can eventually trigger a process of mutual adaption between old and new practices.[11] This is essentially an informal process that is not consciously planned and its progress may often pass unnoticed by actors at a higher level. Aoki describes a similar mechanism of gradual institutional change in terms of game theory and the search for an equilibrium based on a focal point around which agents can coordinate their expectations and behaviour. He sees pressure for change generated by a general weakening of an existing equilibrium, not necessarily driven initially by the wielders of power, but as a general perception among a sufficient number of agents who no longer see outcomes as legitimate. Typically, such a development is preceded by a 'general cognitive disequilibrium' (which can happen for various exogenous reasons as well as from cumulative endogenous reasons), triggering a search for redefinition. One reaction may be to look to other domains' apparently successful structures, or there may be intervention by politicians, until finally a new equilibrium is reached where agents feel that their system of beliefs is consistent with the perceived state of the domain, outcomes of actions yield no surprises, and the new set of choices receives general consent.[12]

The recent reforms to corporate governance in Japan are delivered through formal rules, even where they are presented as ostensibly voluntary 'comply or explain' requirements. They have been promulgated by powerful agents with 'sufficient bargaining strength to alter the formal rules' as North puts it, but their success is likely to be determined by the extent to which a majority of the agents concerned feel that these rules address shortcomings in an existing disequilibrium and also

hold out the prospect of an improvement. Unless that happens, compliance may occur only at a surface level, with actual practice continuing largely unmodified. Japanese history provides a good example from political governance of what happens when those in power impose formal change that does not coincide with the direction of informal institutional pressures. In 646, the Taika Reform, alongside its immediate objective of reasserting imperial power against a powerful nobility, sought to change the whole political fabric of Japan, from central government to land tenure to taxation, on the model of Tang China. But in the event:

> 'When the Japanese adopted Chinese administrative methods, which by the time of the Tang rulers had developed to a high pitch of efficiency, they borrowed the forms and the terminology, but not the underlying principles. The constitution of society in Japan was now perhaps even more aristocratic than it had ever been, for the creation of new offices merely gave to the privileged classes new powers and more prestige. It is hardly too much to say that the new system merely perpetuated under other names, and often emphasised, the abuses of the old'.[13]

This is what happened in 7th century Japan when its rulers sought to impose an alien political structure on a society with deeply embedded institutionalised practices. The question now is whether the recent corporate governance reforms have committed the same mistake or whether they are sufficiently aligned with the direction of informal institutional change to permit them to be adopted wholeheartedly and to function, at least approximately, as they were intended. Japan's recent history gives indications of the ways in which corporate governance can genuinely change, as well as some examples more reminiscent of the Taika Reform.

## 3. Historical background: the evolution of Japanese corporate governance

Japanese corporate governance is not static. As predicted by the institutional patterns described above, it responds to the stimuli of its environment by shifting emphasis so that even though many of its practices may seem unchanging, there is a constant undercurrent of change. In a study of Japanese capitalism during roughly 30 years from the 1980s, Tiberghien observes that a process of change has been in progress throughout that period: 'the model that results from this process is less coherent than in 1980, partly modified, partly resilient'.[14] But, in spite of this situation of constant change, it is possible to identify five approximate periods[15] when certain characteristics predominated:

1) the early 20th century, until the late 1930s, when shareholder value was prioritised;
2) the wartime command economy, when shareholders were excluded from governance;
3) the post-War consensus, driven by the need for economic reconstruction, that emerged in the late 1940s until it was undermined finally by the bursting of the equity and real estate Bubble that accumulated throughout the 1980s and began to unravel from late 1989;
4) the post-Bubble period from the 1990s into the first decade of the 21st century, when the existing orthodoxy was questioned and some reforms were attempted; and
5) the current period from 2014-15 where new rules have been imposed, mostly in the form of ostensibly voluntary practices.

Examination of these periods, and of the shifts between them, provides evidence of how the focus of Japanese corporate governance has changed in the past and implies likely outcomes for the current reforms.

Early 20th century corporate governance in Japan was characterised by strong shareholder influence and a high level of distributions. Large companies drew finance from the capital markets rather than from banks, and shareholdings were widely distributed.[16] It had much in common with current practice in the USA or the UK. This situation was disrupted by the onset of the Sino-Japanese War in 1937 and the progression into the Second World War in 1941 as the country's need for munitions and basic supplies led to the creation of a command economy. As the strictures of the wartime situation tightened, insecurity and lack of funds reduced investors' appetite for capital fundraising and official pressure began to be applied to reduce shareholder distributions, which were seen as siphoning resources from the war effort.[17] From 1943, at companies that were considered to be important to munitions production, dividends were capped, and shareholders were excluded from decisions on distributions, appointments and financing.[18] In institutional terms, the shift from shareholder capitalism to a command economy has every appearance of an externally imposed reform successfully cutting across a swathe of embedded practices. However, in this case, the war itself created a temporary disequilibrium that no one could ignore. The same shift from established corporate governance patterns to a command economy in wartime happened elsewhere and is not unique to Japan. In the USA, Alfred P. Sloan described the situation at General Motors during the early 1940s: 'For the next two or three years the War Administration Committee practically ran the organization. This was because our wartime policy was set and nearly all the corporation's work was war production'. However, by 1945, General Motors' Policy Committee was developing its plans for post-War operations; there was a

clear assumption that the end of the war would bring a reversion to established practices.[19]

In Japan, the end of hostilities did not bring a reversion to pre-War practices. Japan's situation was very different from that of the USA, where companies like General Motors could envisage a smooth transition back to normality. Japan's command economy had built up momentum over at least eight years since 1937 and its bureaucrats tended to favour this model; there was an urgent need to restore industrial infrastructure, using whatever means was seen to work; and a unique exogenous factor was introduced in the form of the General Headquarters of the Occupation Authorities (GHQ) which was in practice the military government of the US occupying forces, able to pressure the Japanese civil government to enact legislation. GHQ was determined to promote demilitarisation and democratisation and used revisions to commercial and financial laws and regulations to break up the *zaibatsu* family-controlled corporate groupings, to penalise the former capitalist class in general, and to try to tilt Japanese practice towards dispersed share ownership and democratic corporate governance.[20]

The intentions of the GHQ were implemented from a position of great power, and with clear objectives. Just like the Taika Reform, approximately 1,300 years before, their outcomes were quite different. Although the revised Commercial Code enacted in 1950, mostly drafted by GHQ, gave shareholders strong rights at listed companies, other developments contrived to make these irrelevant. From 1947, shares seized from *zaibatsu* families or taken as payment of the post-War wealth tax had been sold off to the public, with precedence given to employees of the companies concerned, so that by 1949 it is estimated that about 70% of the Tōkyō stock market was held by individuals. But in the same year, the fiscal reforms known as the 'Dodge Plan', named after the GHQ's financial adviser, Joseph Dodge, cut off the cheap official credit that had sustained chronic over-employment and price inflation, putting an end to the stock market boom and reversing the growth of equity investment by the general public. The subsequent Japanese economic recovery was structured around corporate management and employees and largely financed by banks. Banks and other financial institutions were encouraged to buy up the shares the public no longer wanted and became important shareholders, alongside other commercial stakeholder interests, while private portfolio shareholders and their interests were largely ignored. This situation, which was in keeping with the command economy's preference for minimal shareholder interference and funding from banks, which were easier to control than the capital markets, developed into the post-War consensus that is often seen nowadays as 'traditional' Japanese corporate governance.[21] The entire focus of Japanese corporate governance had been altered profoundly since the 1930s by a mixture of exogenous shock and informal change generated by

changing circumstances. Subsequently GHQ had provided a demonstration that control of formal change does not guarantee control over its outcomes.

The dominant features of this system, in its heyday of the 1950s and 1960s, were its focus on the corporate entity and everything that supported it as the essential drivers of the economy, indirect funding from banks, deference to bureaucratic influence, and widespread indifference to portfolio shareholders.[22] Many of these features have blurred or fallen way since then, but important influences remain. Crucially, a new element has appeared in the form of non-resident and mostly institutional shareholders, who were not a force in the market until the 1990s, but now hold about 30% of the total listed market.[23] On balance, the surviving key characteristic from this situation that distinguishes Japanese corporate governance today is its strong internal focus, perpetuated by internally promoted boards and typically sustained in emergency by reduced but persisting cross-holdings with like-minded companies and banks which tend to see themselves as stakeholders in the company's unmodified survival. From the viewpoint of board members, the company is an important social construct. It needs to be profitable in order to sustain itself and to support all the stakeholders who form its social burden, but only in absolute terms: more refined concepts which analyse the company as an investment commodity, such as investors' ability to derive a desired return on their capital investment (return on equity or 'ROE'), are alien to this view. Japanese board members tend to see themselves as custodians of their company and not primarily as facilitators of shareholders' investment returns: this is the organisation described variously as the 'employee-favouring firm', [24] as the 'community firm' [25] and as 'stakeholder-oriented value maximization'.[26] The post-War consensus achieved an equilibrium which for many years delivered excellent economic outcomes and rebuilt the economy; even portfolio shareholders who were not stakeholders through business connections tended to be sufficiently satisfied by consistent capital gains during the years of post-War economic expansion not to query the lack of consideration shown to them.

Scandals draw attention to corporate governance and stimulate calls for reform. In Japan, the apparently endless succession of frauds, other misdemeanours, and bankruptcies throughout the 1990s and beyond, which began to emerge soon after the collapse of the equity and real estate Bubble, undermined public faith in the state of the country's corporate governance. Practices that had been venerated as the underpinnings of the post-War economic revival were now considered suspect and the economic success of the USA throughout the 1990s was seen as proof by observers, including many Japanese bureaucrats and academics, that American corporate governance was needed to restore Japan's fortunes.[27] The Japan Corporate Governance Forum was established in 1994 and issued its Corporate Governance Principles in final form in 1998 calling for improved accountability

to shareholders, transparency, differentiation of decision-making and execution, and a majority of external directors on boards. CalPERS, the American pension fund, which was a major investor in the Japanese market, attracted attention with its public criticism of Japanese corporate governance practices, frequently reported in the Japanese press, roughly from 1996 until 2002. Even the Keidanren,[28] generally seen as a defender of established practices, called for changes in a 1997 paper entitled 'Urgent recommendations concerning corporate governance' although it preferred strengthening the position of in-house corporate auditors (*kansayaku*) to more radical measures.[29]

During this 'post-Bubble period' unease continued to grow. An upturn in the economy might have reassured observers that this was merely an isolated series of mishaps in an otherwise sound system but no economic improvement was evident while scandals and bankruptcies continued to emerge as companies, including financial institutions, found themselves often overexposed to poorly evaluated projects undertaken during the Bubble years and unable to cope with higher interest rates and constraints on bank lending. The 1990s in Japan have been described as a 'lost decade' when economic progress seemed to stop.[30] The reaction came as two distinct initiatives, implemented in 2002 and 2003, which gave the impression of disagreement between politicians and bureaucrats. The first approach was promulgated by a private member's bill rather than a ministerial initiative. The person credited with driving this reform is Ōta Seiichi, formerly a professor of economics at Fukuoka University, and at that time head of the Administrative Reform Task Force at the Liberal Democratic Party ('LDP'), who is thought to have been concerned for some years by weaknesses in corporate supervision. The main force of this reform, implemented in 2002 through an amendment to the Commercial Code, was to strengthen the position of *kansayaku*, extending their terms of office and requiring that 'large companies' [31] should have at least three, of whom half must be external. Strengthening this aspect of Japanese corporate governance gave the impression of a defensive move by traditionalists opposed to the enthusiasm for foreign governance ideas. The second reform was implemented in 2003, through another amendment to the Commercial Code. It was driven by the bureaucracy, advised by the experts of the Legislative Council (*Hōseishingikai*) at the Ministry of Justice (MOJ), and introduced an optional new corporate structure without *kansayaku*, where three empowered board committees handled audit, nomination and remuneration independently of the main board, all of which comprised at least three directors, of whom a majority had to be external and non-executive (although the same external directors could sit on all the committees, effectively making two the minimum requirement). This scheme sought to increase external supervision and also to split the supervisory and strategic planning role from day-to day running of the business by recognising a new class of executive officers (*shikkōyaku*), just below board level. In this, the reform drew on Sony's internal

reform of 1997 which had created the same effective structure within the existing legal framework. Because of strong opposition from the Keidanren to mandatory external directors,[32] the new structure was optional and was only adopted initially by 36 companies. The press described it as "American corporate governance" which probably made it less attractive in the light of the scandals at Enron and other companies that had emerged in the USA from late 2001.[33]

These two corporate structures of companies with *kansayaku* and companies with committees co-existed thereafter. Companies with *kansayaku* were always more numerous, although a few created internal committees whose functions were reminiscent of the companies with committees. Companies with committees reached a peak of 111 companies in September 2009, of which 73 were listed. These 73 listed companies, of which only 57 were from the mainstream first and second sections of the stock exchanges, amounted only to about 3% of all listed companies.[34] If the new structure were intended to lead a majority of Japanese companies towards a less introspective form of governance, it had clearly failed. The decisions of Toyota and Canon, two of Japan's most successful and prestigious companies, not to adopt the new system inevitably reduced its appeal and comments by Mitarai Fujio, president of Canon, that this system was unsuited to Japan carried great weight because he had lived in the USA for many years and was credited with the successful development of Canon's operations there.[35] More specifically, the creation of the three empowered committees was seen as a threat to the autonomy of the board because it distanced the executive members from important levers of power. As the executive head of an association expressed it in 2004: 'If they lose these three powers over auditing, nomination and compensation decisions, then what else can they do?'. Doubts regarding the usefulness of external directors were widely expressed. Senior members of management at some companies welcomed the idea of bringing external viewpoints into their board discussions but many dismissed external directors as (in the words of a CEO who had worked in the USA, speaking in 2004) 'all "yes-men"…the CEO's friends who were hired by him'. The success of the Keidanren in restricting the new corporate structure to an option rather than an obligation clearly contributed to its lack of penetration but the instincts of the Keidanren appear to have been accurate: this was a reform that was at variance with the underlying practices of Japanese corporate governance, which were still considered to represent a satisfactory equilibrium by a majority of corporate officers in Japan.

Although this situation persisted for over a decade it was always an uneasy compromise because it had not solved the economic pressures that had emerged throughout the 1990s. Japanese industry continued to lose ground to foreign competitors in global markets, as illustrated by the decline in the Japanese electrical machinery sector's share of world total exports from 12.2% in 2000 to

4.4% in 2014, while the shares of Korea and China both increased.[36] Between 2000 and roughly 2007, a series of activist hedge funds aggressively targeted companies where they alleged that cash holdings were excessive or that strategies were inadequate; this process was begun by funds operated by Yoshiaki Murakami (popularly known as the 'Murakami Fund') but was subsequently dominated by foreign-owned funds such as Steel Partners and TCI, who sought public attention to support their arguments.[37] Japanese companies reacted by introducing anti-takeover provisions, reaching a peak in 2010, when 24.1% of first section listed companies had such measures in place and subsequently declining as the threat from aggressive funds was felt to recede.[38] Meanwhile, pressure had been growing on Japanese companies to increase the number of their non-executive external directors. In 2004 the OECD's Corporate Governance Principles[39] had implied that all companies should appoint them and feeling was growing in Japan that they were both acceptable and necessary, although the Keidanren still opposed the concept of making them mandatory in a published opinion in 2006.[40] By 2007-8, committees at METI, the FSA and the TSE were all debating wider adoption.[41] The results of this gradual pressure can be seen in statistics published in the TSE's White Books which show that by 2006 40.8% of all listed companies with *kansayaku* had one or more external directors and that by 2014, when the tenor of the proposed legal reforms was clear, this had risen to 63.8%.[42] As these developments show, there was a background of discontent with the performance of corporate Japan which generated pressure for governance reform without achieving a consensus satisfactory to all concerned, so that initiatives appeared to surge and recede while most companies' styles of governance remained basically unchanged.

This period of uncertainty appeared to end with the enactment of the amendments to the Companies Law (which had replaced the Commercial Code from 2006 regarding corporate matters) in June 2014 and their implementation in May 2015. Among other things, these amendments created a new optional corporate format, the company with audit committee, which was essentially the company with committees minus the nomination and remuneration committees which had been found to be contentious because, as discussed above, they constrained the ability of senior management to select its preferred internal candidates and offer them appropriate reward; a tightening of qualifications for external directors which disqualified parent company executives and relatives of executives; and an obligation for listed companies which lacked external directors to explain formally why they considered them to be inappropriate – essentially a comply or explain rule enshrined in law. Although the Companies Law only pressed companies to have two or more external directors, the Corporate Governance Code went further and specified in its Principle 4.8 that companies should appoint 'at least two independent directors'. Together with these reforms came the Stewardship Code, which had been published in advance of the legal changes, in

February 2014, and the Corporate Governance Code itself, published definitively in June 2015 after announcement of the final proposal in March 2015. Japan now had a code of practice to guide institutional investors in their interaction with companies and a code of practice to guide companies in their governance. Both were presented as soft law, using the comply or explain model developed in the UK and adopted by the EU and the OECD, while the revised Companies Law of 2015 now provided a clear backing for this model and for the new Corporate Governance Code's emphasis on supervision by external directors. In the interim, between the publication of these codes, METI published the Itō Review in August 2014. This document can be seen as a distraction from the codes or as an elegant addition to them; in practice attention was drawn mostly to its perceived emphasis on ROE as a measure of successful corporate governance.

Since the 1930s Japanese corporate governance has shifted from shareholder primacy to a command economy and then to a corporate-focused system, passed through a period of relative anarchy and now largely been redirected towards shareholder primacy in the belief that this can assist economic recovery. The latest developments could be dismissed as yet another well-intentioned formal attempt to change embedded practices within Japanese companies that is doomed to fail. Japan has a long tradition of attempts by bureaucrats and their expert advisers, often from academic or legal backgrounds, to impose concepts inspired by foreign practices exogenously on a corporate sector that feels that it knows best how to operate successful companies. Politicians' interest in corporate governance is notoriously fickle: it wins few votes and seldom delivers fast results for the economy.[43] Japan has never had voluntary codes underpinned by the concept of comply or explain before; corporate governance in Japan has hitherto been mandated by hard law or left to institutionalised practice. The idea of stewardship by investors, in particular, which was effectively imported from the UK, is a totally new concept for Japan, and the UK Stewardship Code's lack of radical impact in its own market to date is not encouraging. Many features of the current reforms, such as their emphasis on external supervision, seem at variance with the internal focus of Japanese corporate governance since the 1940s. Yet there are reasons to believe that this initiative may succeed better than earlier attempts, despite these negative factors. A more detailed examination of what is happening, set against the context outlined above of Japanese corporate governance's evolution hitherto, suggests that factors have emerged that were not present before, which could substantially bridge the gap between intentions and outcomes.

## 4. Empirical case study

### 4.1 Methods and data

Our empirical research was conducted using information on the processes and final formats of the Stewardship Code, the Companies Law revision, the Itō Review, and the Corporate Governance Code, published by the government agencies concerned and the TSE, as our main secondary sources, supplemented by published commentaries on these developments from other sources. We also consulted press reports. Our primary data are drawn from interviews with representatives of 24 separate entities, some of whom were also members of the various Councils of Experts. Between April 2016 and October 2017 we contacted eight institutional investors or institutions related to them, seven companies (five of them at a joint meeting), one politician, two ministries, and six other persons and institutions closely linked to corporate governance matters. During this process we met five members of the Stewardship Code Council of Experts, three members of the Corporate Governance Code Council of Experts and nine members of the Itō Review Council of Experts. These meetings were conducted on a non-attributable basis (but permitting attribution with subsequent permission) and lasted, on average, about one hour. Most of them were recorded and transcribed; all were subsequently coded by topic using Atlas.ti. Approximately half of the meetings were in Japanese, with the rest in English. The interview format was semi-structured in that we offered specific topics for discussion, and ensured that most were addressed, but allowed the conversation to be directed by the interviewees where they wished to emphasise areas that they considered important.

### 4.2 The contents of the Corporate Governance Code

Japan's Corporate Governance Code is a new document, created specifically for the Japanese market rather than being amended from a foreign code, as is the case with the Stewardship Code. However, it shows the influence of the OECD's Principles of Corporate Governance (OECD, 2015). The officer in charge of drafting the Corporate Governance Code at the FSA had previously spent several years on secondment to the OECD and Mats Isaksson, Head of the Corporate Affairs division at the OECD, was an adviser to the Corporate Governance Code Council of Experts.

The Corporate Governance Code defines corporate governance as 'a structure for transparent, fair, timely and decisive decision-making by companies, with due attention to the needs and perspectives of shareholders and also customers, employees and local communities'. It has five General Principles, covering (1) rights and equal treatment of shareholders; (2) cooperation with other

stakeholders; (3) appropriate disclosure and transparency; (4) board responsibilities; and (5) dialogue with shareholders. These are expanded into 30 Principles and 38 Supplementary Principles. The first four General Principles cover similar topics to numbers II, IV, V, and VI of the OECD's Principles. The fifth General Principle has something in common with number III of the OECD Principles but appears to be structured more as a specific complement to the Japanese Stewardship Code, essentially priming companies on how to respond to stewardship initiatives. The OECD's Principal I has no equivalent here, since its content is more of a guide for regulators than for the regulated. One interesting feature, mentioned above, is that whereas the Companies Law presses companies only to appoint external directors, the Code goes further and calls for independent directors. The Corporate Governance Code frames its mission in terms of generating economic success for all concerned, in a sustainable manner. It has an Appendix which gives the immediate background to the creation of the Code, starting with the Japan Revitalization Strategy (discussed below), describes the objectives of the Code and the concept of 'comply or explain', outlines the intended scope and implementation of the Code, and notes that it will be reviewed periodically henceforth. It is clear that an effort is being made to persuade companies that adherence to the Code is both in their best interests and those of the economy as a whole: this is not presented simply as a new rulebook that must now be followed without question. As an investor observed to us in 2016: 'five years ago, people talked about corporate governance in terms of compliance so after the Olympus corporate scandal came out, people talked about corporate governance being important to prevent a recurrence of corporate scandals or accounting fraud. But the Abe administration is totally taking a different approach and saying that corporate governance is important for future growth of companies.'

### 4.3 Reactions to the Corporate Governance Code in a time of 'disequilibrium'

One motive for choosing to address corporate governance issues through a code can therefore be attributed to the influence of the OECD and the spread of such codes worldwide. An obvious call for action was provided by events such as the Olympus scandal, although the first deliberations preceded this by several years. But an investor interviewed in 2016 suggested that the underlying reason was much deeper, in the form of a widespread acceptance that the current system was no longer delivering satisfactory results, precisely as described by Aoki's idea of 'disequilibrium': 'Japan has realised it has reached a point where the old system is not producing the goods in terms of economic growth, jobs and so on…there has been a mindset change in Japan among companies, and investors, and government officials'. Moreover, as another investor noted, the ability of traditionally conservative institutions, such as the Keidanren, to resist reform had been constrained by the recent scandals: 'The Olympus case was the big one. So

I think the Keidanren couldn't push back much because of the scandal'. But, rather than simply being constrained, the Keidanren itself appears to have changed its stance. Although the Keidanren was reported to be considering the formulation of its own, separate corporate governance guidance as late as April 2014 [44], an investor who was a member of two Councils of Experts commented on the influence of Toray, both through its former chairman's position as chairman of the Keidanren and provision of officers from Toray to represent the organisation: 'Hitherto it was [an allegedly conservative company which provided an earlier chairman] and companies like that, so it was hard going but it just happened to be Toray and that was a good development'. An officer of the FSA told us in 2017: 'the Keidanren knew, perhaps, that this time, this opportunity – I mean the Abe administration and Abenomics – was the last chance for Japanese companies and for the Japanese economy to revive its power'. Comments from a discussion with representatives of the Keidanren itself in late 2016 reinforce the impression of a general awareness that change was needed: 'Medium and long term increase to corporate value is very important and the question is how to achieve that. Currently Japan's economy is stagnating and corporate profits are just not increasing'. The Keidanren appears to see the medium to long term focus in the Corporate Governance and Stewardship Codes as a formula to draw investors into a cooperative stance rather than as a goad to Japanese industry. At the same interview we were told: 'Unless we build a society where this medium to long term idea takes shape, the very existence of the institutional shareholders will disappear…this is the point where there is no alternative but that we all understand that we need to construct a format whereby society as a whole operates smoothly through dialogue'.

In our interviews, reactions to the provisions of the Corporate Governance Code were generally favourable, although there is concern that its penetration may be less than optimal at smaller companies. The chairman of a listed company commented: 'When we looked at all this Corporate Governance Code business, basically our company was doing a good bit of it already'. Although this person felt that the Code was in one sense a constraint on his company, he conceded that it was worthwhile: 'There certainly are some really irresponsible people around, so I think that perhaps something is needed…perhaps this is an opportunity to have a look at our own corporate governance and have a new think about it'. An investor who had served on the Corporate Governance Code Council of Experts made a similar comment: 'If people understand and see why it has a meaning for them, formally and also as a discussion with real meaning, then that's what we need'. However, the people who comment on the Corporate Governance Code tend to be those involved in its drafting and implementation or officers of large companies. Eisai's chief financial officer, Ryōhei Yanagi, who is a visiting lecturer at Waseda University, as well as a member of the Itō Review's council of experts, told us in 2017: 'In talking to some of the representatives [from

companies] who join my seminars a lot, I have mixed feelings. To be honest, the majority of them still lag behind…they are just paying lip-service'. The investor quoted above also commented on the varied effects of the Corporate Governance Code to date: 'Standards are going up across boards but a gap is opening. Among the top companies there is an increasing number which are implementing things and seeking to improve, and then, of course, there are companies that are always stagnating. The gap is widening. If you take the average, things are just a little better'. Another aspect of the reactions to the Corporate Governance Code appears in the first data on corporate responses to the 'comply and explain' regime received by the TSE, which are discussed below.

The Corporate Governance Code is a new phenomenon in Japan and its wholehearted adoption by all concerned is by no means certain. However, it has arrived at a point where existing practices have lost much of their former legitimacy as reliable drivers of economic prosperity. There is an appetite for change if only the new Code can gain acceptance as a viable solution.

### 4.4 Comply or explain

The adoption of a soft law approach through the obligation to 'comply or explain', rather than simply the announcement of mandatory rules, distinguishes the new codes from previous initiatives. It also appears in the amended Companies Law's requirement either to appoint at least one external director or explain why such an appointment is inappropriate. The lack of success of the optional Company with Committees system from 2003 could have led politicians and bureaucrats to conclude that more, not less, compulsion was required. As an investor described the hitherto accepted wisdom, 'for years everyone said to us in Japan "You need to change hard law. Soft law doesn't really work. Comply or explain won't work"'. Nevertheless, a system has now been implemented without any overt compulsion to comply.

It is not clear precisely where the enthusiasm for this approach was first generated and several influences appear to have combined. One element seems to have been awareness of the spread of 'comply or explain' in other regimes. As Masahiko Shibayama, an LDP politician closely involved in the political process behind these reforms (to whom we refer in more detail below) explained the situation to us: 'We studied these sorts of things and analysed examples from various foreign countries and we shared our information to some extent with ministries…there were probably opinions from some ministries that this was not a Japanese way to do it but, basically, I think it is obvious that business rules should adhere to global standards…so the idea that this 'comply or explain' way of thinking was appropriate…was, I think, understood by the ministries too at the time of the revision of the Companies Law in 2013'. Certainly, by that time, 'comply or

explain' had already become a standard approach across the EU. The European Commission Recommendation of 9 April 2014 on the quality of corporate governance reporting states: 'The "comply or explain" principle laid down in Article 20 of Directive 2013/34/EU is a key feature of European corporate governance. According to this principle, companies that depart from the relevant corporate governance code are required to explain in their corporate governance statement which parts of the code they depart from and the reasons for doing so'.[45] Another attraction of this approach may have been the need to mollify the Keidanren. An officer of a market regulator told us in 2016, describing the negotiations leading to the Corporate Governance Code: 'The Keidanren was totally opposed from the very start to any blanket obligations so if we had not had this approach…well, in this instance I think that the fact that we approached the governance code in this way was a major contribution'.

The concept of 'comply or explain' seems to have caused initial confusion at some Japanese companies. An officer in the TSE's Listing Department told us in April 2016 that many companies had requested clarifications regarding their exact obligations under the new Corporate Governance Code: 'even though we held explanatory meetings about what was in practice expected, the people involved at companies – people such as legal department officers – persisted in asking us what was right and wrong or how to define certain things. I think they are not used to it yet'. This differs slightly from the experience of the EU's corporate governance regime, where companies seem happier to explain their non-compliance, though not always in a satisfactory manner. The EU Recommendation of April 2014, quoted above, commented: '…it appears that there are some shortcomings in the way the principle is applied in practice, in particular as regards the quality of explanations provided by companies when departing from corporate governance codes'.[46] The European problem appears to be less with rigidity of compliance than poor quality of explanation, but both situations illustrate the need for more than token cooperation if a 'comply or explain' system is to function effectively.

In Japan, the degree of compliance and the quality of explanations from those companies that do not comply are both still coalescing. In April 2016, the TSE was studying the first season of submissions from listed companies that had met the deadline of December 2015, following the introduction of the Corporate Governance Code in June of that year. Officers of the TSE's Listing Department told us that as of August 2015 about 60 companies had submitted, with about half being fully compliant. However, these tended to be the largest and best-prepared companies so the compliance ratio decreased as the December deadline approached. One possible reason is that the largest companies have the highest number of foreign shareholders, who may press for compliance, but a simpler explanation may be that larger companies have more administrative resources to

deal with requirements like this. Nearly two years later, the TSE's data as of July 2017 show a rise in full compliance to 31.6% among First Section companies, with only 7% being less than 90% compliant [47]. The Second Section, comprising mostly smaller companies, shows a similar tendency but at a much lower level, with 4% fully compliant and 27% less than 90% compliant. The TSE analysed 8,142 cases of explanations among First and Second Section companies as of 14 July 2017, putting them into five main categories: 'Will comply in future, with timeline' (1.5%); 'Will comply in future, without timeline' (8%); 'Considering whether to comply' (35.6%); No plan to comply because of specific circumstances (39.9%); and 'No plan to comply, because of alternative measures' (15%). The first three categories all show reductions against the situation in December 2016 but the last two have both increased, especially non-compliance because of specific circumstances (up from 31.2% to 39.9% of the respective samples) which suggests that some companies may be making a serious effort to assess the relevance of compliance to their particular businesses.

Despite this trend, there appears to be a general feeling that compliance is the ideal response to the Code, though sometimes this can degenerate into purely formal compliance. A senior executive at a major company told us in 2017: 'There is a variety of levels of compliance…when I look at other firms there are areas where one wonders whether that really constitutes compliance and even within our company there are areas where one wonders if we really are complying with certain clauses'. This tendency inevitably stifles informative explanation. An adviser to the Keidanren, who had been monitoring the situation, told us in 2016: 'the fact is that levels of compliance in corporate governance are high. You see, it's an extension of the rule based idea: "compliance is the regular response" is rather the way people think so explanations just don't seem to appear'. An investor put it more bluntly when we discussed this in 2016: 'It is quasi-hard law. So that is great tactics by the TSE and the FSA'. This tendency to favour compliance is not a uniquely Japanese phenomenon. In the UK, where 'comply or explain' has a longer history, Grant Thornton commented in their 2017 Corporate Governance Review of the FTSE 350 (the UK's principal listed companies): 'In the 16 years we have been reviewing corporate governance there has been a general trend towards compliance. That trend continues this year, with the number of companies declaring full compliance reaching a new high of 66%. Ninety-five percent (2016: 90%) comply with all but one or two of the 55 provisions of the Code.' [48] Following implementation of the revisions to the Companies Law in 2015, which underpins the Corporate Governance Code by requiring that listed companies should have at least one external director or explain why external directors are not appropriate, 95.8% of listed companies reported the appointment of external directors in 2016. [49] Few companies, it seems, had chosen to explain why external directors were inappropriate.

The obvious danger is that the appearance of compliance will become an obligation. Although executives at major companies interviewed in 2017 generally agreed that there was no obligation or logical reason to aim for 100% compliance, they were aware of pressures to comply. One observed: 'when [investors] are reviewing risk and estimating whether there is a downside risk or not, they may be looking to see whether compliance is 100% or not, so if they are investing in, say, 1,000 companies, they probably need to use a mechanised screening process. So what that means is that – effectively – in the sense of the forms we adopt, it benefits us in a general way to be 100% compliant. There is no incentive to interpret things especially seriously and drop to 90%'. This viewpoint is sustained by research on the UK's longer experience. MacNeil and Li find that explanations tend to be tolerated by investors, as demonstrated in the companies' share prices, mostly when companies' performance excels, pointing to the conclusion that compliance is the safest route. '"Comply or perform" appears to be a more appropriate description of the process…it appears that investors' tolerance of non-compliance is linked to some extent with superior financial performance (in terms of share price). This is not to say that outperformance causes non-compliance, but it does seem to be the case that investors do not value reasoned arguments for non-compliance and prefer to use financial performance as a proxy to determine when non-compliance can be excused'.[50] It remains to be seen whether Japan can create a regime of confident and informative explanation which is properly appraised by investors or whether it experiences the same problems as the UK. We comment further on the problem of purely formal compliance in the next section.

### 4.5 The compliance machine

Linked to the obligation to 'comply or explain' is one aspect of the Corporate Governance Code that has not attracted attention but which may add greatly to its impact. Because it is a detailed code and because its 'comply or explain' format automatically introduces nuances of implementation, it has effectively interlocked with the compliance organisations within Japanese companies whose work it is to interpret such things. When new regulatory obligations are imposed on companies, the regulations are normally studied in detail by whichever department is responsible for compliance, analysed to define them into specific areas for action, and then presented by the department concerned for discussion, possibly up to board level, and eventual implementation. This situation is not unique to Japan but Japanese companies generally take regulatory responsibilities seriously and implement them thoroughly. As an investor told us in 2016: 'Just when things are written down like this, in Japan people tend to look at the written word and tend to agree that it is a good thing'.

The nature of the impact of the Corporate Governance Code through this corporate 'compliance machine' is illustrated by comments from senior managers at several large companies. One told us in early 2017 that although separate departments had hitherto dealt individually with regulatory requirements specific to their own areas of responsibility, 'the Corporate Governance Code widened the scope a lot because it dealt with matters relating to shareholders, the nature of the board of directors, and also management in its widest sense, so the departments that were involved – for example the IR department, the planning department, or what is loosely called in Japan the general affairs department – all these departments who were involved came together and there was a concerted discussion about all sorts of things. Subsequently, the board became involved and we held various exhaustive discussions which involved the CEO as well'. This bottom-up process of analysis is crucial. The Code's contents were examined in depth by managers and their staff who are accustomed to reading long and tedious documents with a view to presenting their key elements for action to boards with much shorter attention spans. As the same officer told us, 'Probably, even if we had taken it straight to the board of directors, they would not have been quite sure how to debate the contents…We looked to see how each one of the topics was being handled at present and how it ought to be handled in future, and organised and extracted the detail, so, in that sense, I think it was fairly easy for the board members to understand things'.

The future effectiveness of the Corporate Governance Code seems likely to depend greatly on the ability and willingness of administrative departments to implement it conscientiously. A senior manager at a major company noted the temptation to cut corners: 'The Japanese Corporate Governance Code has 73 clauses but, actually, disclosure is covered by 11 of them so, as a first step, we could look at just those 11, improve our management and afterwards if we kept quiet about it and claimed full compliance, no one would know. If you really cornered the officers in charge regarding this point, I believe that there is an incentive to do this. Indeed I believe that there are many small companies where only one person is doing things…so…well…'. Others corroborated this: 'All you have to do is to write a few things for the current year into what you have already produced. So, when all is said and done, when you lack personnel, that is the way things go'. From these comments it is easy to see why the gap identified between enthusiastic adopters of the Code, who tend to be large companies, and those who seek to minimise the effort they exert, has opened up. Further evidence of initial weakness in the compliance process is provided in a report from the NLI Research Institute in October 2018 which notes that a survey of 1st and 2nd Section listed companies by METI published in February 2018 revealed that 28% of the 941 respondent companies had admitted that although they were formally in compliance with the requirements of the Code, their actual practices still differed.

As the author of the report observed, there are probably many more companies in the same position who have kept silent.[51]

The impact of this bottom-up process of implementation, at least at large companies with sufficient administrative resources, is demonstrated by the different reception that appears to have greeted the Itō Review. This was inspired by the Kay Review in the UK, which itself has not been universally well received,[52] and it lacks the traction of the Corporate Governance Code with the 'compliance machine' because it is not a code requiring compliance or explanation. Several investors and commentators to whom we spoke dismissed it as an attempt by METI to reassert its corporate governance credentials in the face of the central role given to the FSA and the TSE, although a civil servant at METI stressed that initial discussions surrounding the Itō Review in fact predated the two Code exercises and had informed their debates. A company chairman told us that he had not read the Itō Review in detail but felt that it contained little of relevance to his company. In our interviews we were told on several occasions that it was simply too long and complicated for most people to bother reading. Corporate officers told us that institutional investors did not mention it at shareholder meetings, although some retail investors apparently showed awareness of it. However, a member of the Itō Review Council of Experts defended the exercise robustly as being of lasting value 'because it had an explicit ROE hurdle in it, of 8%, which was high enough for it to bite. And the second [reason] is it did have a detailed assessment as to Japan's ROE being about margins, not being about leverage'. Another member of the Council regretted that the 8% ROE target had been interpreted so mechanically, pointing to the spate of 'CB-decap' issues that followed, where companies issued convertible bonds to fund share buy-backs, temporarily reducing their shareholders' capital and thereby artificially raising their ROE. The Keidanren conceded that the Itō Review was of value but challenged the significance attributed to the 8% ROE target: 'If you read the Itō Review properly, there is no reason why it should have any bad effects. However, that 8% business, especially with the mass media, has somehow taken on a life of its own'. Nevertheless, a greater awareness of ROE as one valid measure of corporate health and proof that Japanese companies have lower ROE than many companies in other jurisdictions not because of higher leverage but because of lower profitability do seem important achievements. The real contrast between the Itō Review and the Corporate Governance Code lies more in the fact that while the Corporate Governance Code appears to have succeeded in becoming part of the corporate environment, the Itō Review, despite its important messages, has remained largely unread and sometimes misinterpreted because it is a top-down exhortation which is addressed to Japan's whole corporate management class; there is no easy way to ensure implementation of its ideas because, unlike the Corporate Governance Code, no one has been designated either to implement it or to ensure compliance and

consequently no one can be held responsible for not paying it the attention it deserves. Similarly, no corporate officers or investors to whom we spoke in early 2017 showed much awareness of the March 2017 report by METI's Corporate Governance System Study Group (*CGS Kenkyūkai*), which contains a number of proposals concerning the quality of board debate, the need to broaden sources for external directors and the position of former senior directors as influential advisers, all of which are topics that appear to deserve serious consideration.[53] This kind of 'top-down' approach through exhortation may plant the seeds of future reform but in the short to medium term it tends to be ignored.

### 4.6 The Stewardship Code

More than a year before the implementation of the Corporate Governance Code, Japan's Stewardship Code was announced in February 2014. This is another innovative feature of the present reforms. Instead of attempting to influence corporate governance solely through regulation or admonition directed at companies, the FSA, directed by the LDP, seeks to co-opt institutional investors for the first time into the process of monitoring and improving corporate governance. The TSE describes the intended function of the Stewardship Code in the Appendix to the Corporate Governance Code in the following terms: '…the [Corporate Governance] Code and Japan's Stewardship Code are "the two wheels of a cart" and it is hoped that they will work appropriately and together so as to achieve effective corporate governance in Japan.'

No one seems to be certain how enthusiasm for a stewardship code began in Japan. Two investors whom we interviewed linked the first public mention of this concept to comments made at the Council for Industrial Competitiveness (*Sangyō Kyōsōryoku Kaigi*), a committee chaired by Prime Minister Abe which formed part of the LDP's economic revival initiative. This committee first met in January 2013, only seven months before the first meeting of the Stewardship Code Council of Experts in August of that year. This points to unusually rapid implementation so it is likely that some discussions preceded this; by 2013, enthusiasm for codes of this sort had already begun to spread globally, with codes of best practice for investors already in place in the UK, the Netherlands, Canada, South Africa, and Switzerland. Among them, the UK Stewardship Code probably attracted the greatest attention as the first code to be issued by a regulator.

The fact that the Stewardship Code preceded the Corporate Governance Code by more than a year gives the impression that it was accorded great importance. However, an officer of the FSA pointed out that the order of the two codes may have been determined by the need to finalise the amendments to the Companies Law in advance of the Corporate Governance Code, whereas the Stewardship Code could proceed independently and was therefore implemented first. In his

view, what began as simple expediency was subsequently revealed to be a subtle and effective approach but happened more by chance than intent: 'I gradually became aware of that; the strategy works very well'. Several investors commented to us on the effectiveness of implementing the Stewardship Code before the Corporate Governance Code. One told us: 'By starting with the Stewardship Code they are trying to shut down corporate complaint. Basically if the government goes and meets with the Keidanren or big companies and says, "We need to reform your corporate governance" then they would say that investors don't care…so it was actually quite clever and they actually knew what the Keidanren's counter-argument would be'. An investor who was a member of the Stewardship Code Council of Experts told us that corporate representatives on the council had taken the attitude that investor stewardship would not be a major issue for them. Moreover they were probably reassured by the Stewardship Code's framing as a means to raise corporate value. The same officer at the FSA confirmed this view: 'The code seeks "growth-oriented governance". This may be unique to Japan but it came from the advisers…This approach worked very well…to soften the objections from the company side'.

Although the Stewardship Code uses the same formula of 'comply or explain' as the Corporate Governance Code, the implied compulsion of the Corporate Governance Code is lacking. The Corporate Governance Code is imposed on listed companies through the listing regulations of the TSE, albeit with the option to explain divergence, but the Stewardship Code explains its status as follows: 'The Code is not a law or a legally binding regulation. The Council [of Experts] expects those institutional investors who support the Code and are prepared to accept it to publicly disclose their intention'. A press report in October 2016 noted concerns by Nicholas Benes, head of the Board Director Training Institute of Japan, that hardly any corporate pension funds had adopted the Stewardship Code. Although the FSA's data from April 2018 show that a total of 227 investors and fund managers have now announced adoption, only three of them (Eisai, Panasonic and Secom) are non-financial corporate pension funds, joined by a further eight pension funds for financial companies.[54]
It remains to be seen how effective Japan's Stewardship Code will prove in the hands of those entities which have adopted it. In the UK, for example, there are doubts as to the UK Stewardship Code's effectiveness. Wong observes in a 2015 review of the UK Code: 'In its 2014 report on corporate governance and stewardship developments in the UK, the Financial Reporting Council sounded an alarm that 'too many signatories fail to follow through on their commitment to the code'.[55] In a paper calling for an approach more focused on the real issues rather than just the outward forms of good practice, Reisberg concludes that it 'is a weak code, at the heart of which lies an amorphous concept - that of stewardship - which has no definite form and which means different things to different players'.[56] The Japan Stewardship Code is based closely on the UK Stewardship

Code, but differs in some respects: five of its seven principles are essentially the same as five of those of the UK's seven principles, apart from a specific reference to 'sustainable growth' in the Japanese Principle 3. But the UK's Principle 4 regarding guidelines for escalating activities and Principle 5 regarding collective action are replaced by the Japanese Stewardship Code's Principle 4 regarding the need for common understanding and constructive engagement with investee companies, and Principle 7 regarding the need for investors to have extensive knowledge of the investee companies and to engage positively with them; two potentially adversarial principles have been removed and replaced by admonitions for informed discussion and cooperation to promote the growth of investee companies. As noted above, the obligation for investors to promote corporate value, which was felt to reassure the Keidanren and corporate interests in general, is emphasised.

The Keidanren appears to have been satisfied by this approach, perhaps seeing the Stewardship Code as a means to bring institutional investors closer to longer-term corporate objectives. An adviser to the Keidanren analysed the importance of the Stewardship Code to us in the following terms: 'The underlying thinking of investors and shareholders is, after all, inevitably short term. They obviously tend to think in terms of quick returns, the desire to see a quick return and wanting to crystallise profits. They tend to be short term so the idea is to bring them towards the long term and establish a balance.' One institutional investor to whom we spoke also saw the Stewardship Code in a positive light, though from almost the opposite standpoint. According to this investor, the existence of the Code meant that probing questions could no longer be dismissed by companies as unwarranted interference: 'It's stewardship. I am here to comply with the Stewardship Code.' Other institutional investors, especially those that were foreign-owned, insisted that the Code changed very little in terms of their style of approach to companies; in their view they had been doing all that it requires already. However, some drew attention to the danger that domestic investors might now feel obliged by the Code to descend on all the companies in which they were investing to ask essentially the same questions with little regard for quality: 'So let's say, just hypothetically, that two hundred firms have invested in Toyota, so if two hundred institutional investors all go to Toyota, Toyota will be too busy to do any work.'

### 4.7 Political pressure

A defining feature of the developments surrounding the Corporate Governance Code is the involvement and commitment of politicians. Some years before the reforms of 2014-15, politicians had already begun to show a greater interest in corporate governance. The Democratic Party of Japan ('DPJ') which took power in August 2009 expressed enthusiasm for corporate governance reform, particularly with regard to strengthening the independence of external directors, introducing employee participation into governance structures, and reviewing the responsibilities and liabilities of parent and subsidiary company groupings. At first there was expectation of radical change.[57] The MOJ's Legislative Council Corporate Law Subcommittee (*Hōseishingikai Kaishahōsei Bukai*) met 24 times between April 2010 and August 2012 to consider corporate governance and amendments to the Companies Law.[58] Ultimately, the DPJ failed to implement many of its planned agendas amid infighting and pressure from unforeseen events such as the Fukushima nuclear plant disaster in March 2011, but the process of amending the Companies Law continued after the fall of the DPJ government in 2012, though with a different emphasis.

Shortly after its return to power in December 2012, the LDP established its Japan Economic Revitalization Headquarters (*Nihon Keizai Saisei Honbu*), hereafter 'JERH', whose objectives were announced on 26 December 2012 as 'striving to reinvigorate the national economy, working with the Council on Economic and Fiscal Policy [of the Cabinet], by constructing the necessary economic policies as well as implementing a growth strategy in order to escape from the combined strong Yen and deflation, and restore the economy to strength…'.[59] Subsequently the 'Japan Revitalization Strategy (Japan is Back)' was published in June 2013.[60] Further annual publications followed outlining areas for reform, reviewing progress and proposing future action. Within this process, two aspects attract particular attention. The first is the decision by the prime minister, Shinzō Abe, explicitly to include corporate governance in his 'Abenomics' platform for national economic revival and the second is the leadership shown by energetic politicians within the JERH in driving the practicalities of the reform process. These aspects are considered in more detail below.

'Abenomics' is the collective name given to the economic revival policies developed by the LDP and promoted by the Abe government from 2012. It comprises the 'three arrows' of monetary easing, fiscal stimulus and structural reforms. The Companies Law amendments and the two codes announced in 2014-15 form an important element of the structural reforms. There are mixed views about the overall success of 'Abenomics'. A Bloomberg report in December 2017 conceded areas of progress but observed: 'Five years since Shinzō Abe came to power in Japan the economy is much stronger but falling short of the revolution

he pledged to deliver'. The IMF, in its July 2017 Country Report on Japan, expressed guarded enthusiasm for the success of Abenomics to date although it noted a lack of progress on structural reforms.[61]

Corporate governance reform was mentioned by Abe at G20 meetings and the two codes featured in a summary of the achievements of Abenomics to date published by the Japanese government in May 2017 under the subtitle 'Energise corporate activities'.[62] In a series of interviews with investors and parties involved in governance reform conducted in 2016, it was clear that most interviewees saw Abe's public enthusiasm for improved corporate governance as a major factor in the progress achieved hitherto. As one senior executive at a pension fund put it: 'I think the catalyst was purely our prime minister since December 2012'. Another investor commented: 'The driving force for the Stewardship Code, the Corporate Governance Code, in particular, very much [came from] Abe. Without the Abe government, I don't think you would have those two documents'. There were various opinions concerning the reasons for this enthusiasm. Some linked Abe's desire to strengthen the economy directly to plans for constitutional change in order to recognise the armed forces and authorise them to operate more freely: 'Prime Minister Abe needs popularity in order to achieve his goal of changing the constitution' and similar comments were made to us by a lawyer and several investors. Two investors, while supportive of the reforms, noted that corporate governance reform attracts good attention and comes cheaply: 'The politicians have sensed that corporate governance is well-received. Because this idea of "governance" – and Mr. Abe is on to this – is something that you can talk about and get a good reception. Then, now that they have grasped this, it's even more attractive for the Ministry of Finance: governance doesn't cost any money'. There was some doubt expressed that Abe may not even understand the dynamics of corporate governance. A person who had met him responded to the question of how well the prime minister grasped it with 'Not that well…This was all served up to him on a plate'. An investor agreed: 'I don't think Abe really understands this greatly – but there are people in the LDP who have thought a lot about it.'

This brings us to the second aspect of political involvement: the impetus provided by other politicians within the LDP. Two people whose names were mentioned to us frequently as drivers of the reforms were Yasuhisa Shiozaki, the acting head of the JERH during its first years, and Masahiko Shibayama, who worked closely with him on drafting and implementation of the reform schedule. Shiozaki formerly worked at the Bank of Japan and Shibayama is a commercial lawyer by training. Both have commented publicly on the reform agenda and its achievements. In the Japan Revitalization Strategy of June 2013, reviewing corporate governance was listed third out of eight topics in its key section on 'Unleashing the power of the private sector to the fullest extent'. Actions to

achieve this were defined as 'Amend the Companies Act and promote the installation of external directors who can supervise from an outsider's perspective without being bound to company constraints or interests' and 'Consider and compile principles (Japanese version of the Stewardship code) for institutional investors to fulfil their fiduciary responsibilities, such as promoting the mid- to long-term growth of companies through dialogues.' Both objectives, rather than being merely expressions of good intentions, were earmarked for rapid implementation.[63] What was effectively a working appendix, entitled 'Materials', was published in August that year to summarise events to date.[64] It recorded the actions approved by the Cabinet for implementation and gave details of the UK Stewardship Code, noting that the planned Japanese stewardship code would adopt the same 'comply or explain' model. In May 2014 this initiative was followed by the Japan Revival Vision which contained detailed proposals for a corporate governance code,[65] and the 2014 revision of the Japan Revitalization Strategy announced that a corporate governance code would be drafted. Further annual revisions continued and in 2017 the Future Investment Strategy 2017 (*Mirai Tōshi Senryaku 2017*) outlined future plans to review and develop both stewardship and corporate governance thereafter, described the follow-up committee to oversee this process, and listed outstanding items that required attention, such as the need to penetrate beyond purely formal compliance with the new codes by companies and investors, the need to promote discussion of key strategy at board meetings, and the ambiguous position of former senior executives as advisers exerting influence without legal responsibility.[66] With the exception of pressing banks to relinquish corporate shareholdings and reducing cross-shareholdings in general, which had formed a key element of the first LDP initiatives (for example, this featured prominently in the Japan Revival Vision of May 2014 and was discussed in press interviews by Shiozaki) a substantial amount of radical reform at a formal level had been implemented in an unusually short time.

The work behind this achievement was described to us by Shibayama. An important trigger of these reforms was the resurgence of corporate scandals such as those revealed at Daiō Paper Corporation and Olympus Corporation in 2011. Michael Woodford, the dismissed CEO of Olympus, met LDP politicians in 2011, as well as members of the then ruling DPJ, and, despite his fears to the contrary, his conversations appear to have created a stimulus for action.[67] As Shibayama explained it to us 'in fact the starting point for the corporate governance reform was the well-known issue of Olympus'. This comment was supported by a civil servant, who told us separately: 'The Olympus case and the other big Japanese cases for fraud were surely one of the starting points of the discussion.' However, Shibayama emphasised that the JERH envisaged more that damage prevention: 'This corporate governance reform is not just a retroactive sort of thing to prevent corporate scandals: not just a passive thing. Through it we aim to further revitalise

decision-making'. Shiozaki is credited by Shibayama with taking control of primary drafting into the LDP's own hands, despite the fact that 'usually the text tends to be put together from proposals from offices at each ministry', and the drafters continued to discuss and draft throughout public holidays. Arguments from ministries that a more sedate pace of implementation would give more time for reflection and consultation were rejected. Shibayama confirmed that it was decided to entrust production of the codes to the FSA, even though METI had a long record of involvement in the corporate governance debate: 'We came to the conclusion that METI has connections with all kinds of companies, whereas the FSA is, after all, the supervisor of the market'. None of the entities consulted or directly involved in this exercise appear to have shown initial enthusiasm: 'in the beginning [all concerned] were in fact not enthusiastic at all about this innovation represented by the Corporate Governance Code' and it appears that pressure had to be applied by the politicians to start the process.

The existence of similar codes in the UK and elsewhere is an obvious source of inspiration for the LDP. However, non-resident institutional investors and other commentators had been pressing for corporate governance reform for some years already. In 2009 the Asian Corporate Governance Association specifically called for a voluntary code in its 'Statement on corporate governance reform in Japan'.[68] Benes, meanwhile, had lobbied strongly for implementation of an FSA-led code using the 'comply or explain' format and robust disclosure requirements, viewpoints that he expressed directly to Shiozaki and his colleagues through detailed documents and explanations, as well as a presentation to the JERH.[69]

The importance of this political impetus raises the related question of whether the current reforms can survive if this enthusiasm cools or if there is a change of government. The general consensus among those whom we interviewed was that the process has created its own momentum and is no longer dependent on constant political support. One investor to whom we spoke in April 2016 felt that corporate governance reform in Japan had proved too useful to the political class to be abandoned easily and commented: 'You hear this a lot – you hear it from foreigners – they ask what will happen when Japan's government changes: surely this will all change, they say. But I don't think governance will change much'. Certainly the current structure of a Corporate Governance Code invigilated by the TSE and the FSA appears to be self-sustaining unless a future government actively seeks to dismantle it.

### 4.8 Follow-up

Instead of presenting the Corporate Governance Code as a final solution to all corporate governance issues, this initiative is intended to be a continuing process. The Corporate Governance Code, in its Appendix, makes clear that further action to review progress and introduce new measures is planned: '…while the Code establishes fundamental principles for effective corporate governance, these principles do not remain unchanged. Under rapidly changing economic and social circumstances, in order to ensure that the Code continues to achieve its objectives, the Council of Experts expects that the Code will be periodically reviewed for possible revisions'. Political will to drive this process appears to exist. Shibayama told us in 2017 'from now on we need to put some spirit into it, to see whether we can really make it work properly'.

Review of both the Corporate Governance Code and the Stewardship Code has been entrusted to a single committee at the FSA, the 'Council of Experts concerning the follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code', announced in August 2015. In 2016 a person close to this process told us, 'The Follow-up Council does not seem to have done much yet and its role appears to be to promote a gradual process of review to see how much the new codes are being implemented. The new council is distinct from the councils that advised on the two codes and, judging by the list of members, seems to lack their strength of representation from the business and investment communities. It is run by the FSA'. The list of the Council's members published in October 2017 certainly includes only two members from industry and three from the investment sector, from a total of 18. However, some members also served on the earlier Councils, suggesting a degree of continuity.

A revised Corporate Governance Code was announced in June 2018 [70]. The changes appear to be a mixture of one item of unfinished business, where a topic that had earlier been promoted strongly by the LDP was omitted from the 2015 Code but has now been inserted, and dissemination of new concepts which may not have immediate effect but could become important in the future, if they are actively promoted. The principal topic of unfinished business is new wording to intensify pressure on cross-shareholdings. Action on this had been signalled by the LDP before the first version of the Corporate Governance Code was issued, apparently with little effect. In an interview with Shūtarō Kataoka of Chizai-tank (*Chizai Tonya*) in August 2014, Shibayama was asked what had happened about the proposals in the Japan Revival Vision of May 2014 for establishment of a shareholding vehicle to facilitate dissolution of cross shareholdings. He commented, 'On this occasion, Mr. Shiozaki put a lot of effort into pursuing the issue of dissolution of cross-shareholdings with the ministries. There appears to have been strong resistance from industry associations for the financial sector,

board members of companies belonging to the Keidanren and so forth'.[71] In the revised Corporate Governance Code this topic has now been re-stated in much stronger terms, with the assumption made clear that reductions will take place, that outstanding holdings will be reviewed annually by boards, and that the issuers of cross-held shares must not hinder the process. There appears to be a real determination that cross-shareholdings must decrease.

The new and potentially radical concepts inserted in the revised Code are as follows: (1) the need to strengthen management of corporate pension plans and make them more effective investors; (2) the need for CEO succession planning; (3) tightening of remuneration policy; (4) encouragement to establish nomination and remuneration committees dominated by external directors; (5) the need for more diversity on boards, with specific mention of 'gender'; and (6) greater awareness of cost of capital. These six issues can probably be ignored safely by most companies for the short to medium term but, depending on the degree of pressure that the FSA and TSE choose to apply, they could all become critical in the future because they confront the internal focus of most Japanese companies and the style in which they are managed. More active and independent control of corporate pension schemes could introduce a hitherto absent pressure group for higher shareholder distributions; the concept of CEO succession planning confronts the established practice of CEOs choosing their successors and, by extension, possibly also the practice of CEOs proceeding to become chairmen; transparency and formalisation of remuneration policy threatens to restrict the ability of CEOs to control executive rewards; specific nomination and remuneration committees would accelerate this process further and tend to isolate senior management from their current levers of control; concerns regarding 'gender' may presage increased pressure to promote women within companies, which is already supported by the LDP; and a focus on cost of capital calls to mind the Itō Review and its emphasis on ROE.

## 5. Conclusions

In this paper we have considered whether the current efforts to reform Japanese corporate governance have the potential to succeed when measured against their institutional and historical background. Japanese corporate governance has certainly changed during the past 90 years. In the process, it has been influenced by exogenous forces such as the wartime command economy, the economic traumas that followed the war, the demands of GHQ, and the structural reforms of 2002-3, while at the same time adapting itself progressively over many years to changing market forces. Throughout this period it has demonstrated that it is capable of evolving to meet new circumstances but that formal institutional change is unlikely to deliver its expected results when it runs counter to the flow

of informal institutions that are embedded and considered legitimate by key actors.

The Corporate Governance Code and other reforms of 2014-15 are formal institutional changes which therefore run the risk of subversion by the informal institutional environment. In spirit they are close to the company with committees reform of 2003, which does not bode well for the achievement of their aims. However, this more recent initiative has introduced new factors: 'comply or explain' to bring flexibility and, perhaps unintentionally, to draw in the 'compliance machine' that exerts powerful influence at most large companies; stewardship to co-opt the investment industry; political will, demonstrated at a pitch not seen hitherto; and periodic review to monitor progress and amend the strategy flexibly. Moreover, the promotion of corporate governance reform has moved from being in the style of top-down admonition, producing worthy documents that have generally attracted little attention, to a regime overseen closely by regulators, in the form of the FSA and the TSE, who can apply powerful sanctions through regulations, within but distinct from general company and commercial law.

The politicians who have promoted the process of reform through the JERH appear to see it as a contributor to economic revival. Officially, Prime Minister Abe shares this view, although some consider his interest to be linked more to hopes of a short-term economic upturn to strengthen his political position. In fact it is not clear that better corporate governance does lead to stronger corporate performance. Love, in a paper written for the World Bank, summarised the situation: 'There is a vast body of literature devoted to evaluating the relationship between corporate governance and performance, measured by valuation, operating performance or stock returns. Despite the large number of papers, there is no consensus yet'.[72] Vogel makes a similar point with regard to the lack of definitive results from US studies. He observes that 'Japanese policy makers and corporate executives have enacted many reforms in the absence of clear evidence that these reforms actually do any good'[73]. From this perspective, corporate governance reform intended to revive the economy is an act of faith with little hard data to convince any doubters. However, at this early stage in the process of implementing the Japanese reforms, it is too soon to say whether the economic benefits of the changes will be realised. If, in due course, the expected economic benefits fail to materialise, the cause of reform could be to that extent discredited.

Underlying all of the factors driving reform, and perhaps even more important than any of them, is a perception widely shared among the people we interviewed that Japan faces a systemic economic crisis unless its economic model can be revived. Corporate governance has been identified as a major contributor to the continuing sense of crisis and there appears to be general acceptance that change

in this area is necessary. Ultimately, the success or failure of these reforms may depend on their ability to address this feeling of disquiet – in Aoki's terms a 'disequilibrium' – so that they are implemented with more than just the appearance of compliance. The strain that the Corporate Governance Code places on smaller companies which lack resources to respond to its requirements adequately has been noted as a problem already. Some companies, and not just the smaller ones, are likely to create a façade of compliance in the hope that they can continue to govern their businesses in familiar ways. Whether enough companies accept the reforms as beneficial and implement them sufficiently to create an enduring climate of reform will therefore be the key issue over the next few years. Because of the new factors described above, there is at least a possibility of this happening.

One weakness of the Corporate Governance Code is its emphasis on some elements that suggest a theoretical approach rather than one more informed by practical experience. An example is the pressure to appoint external directors applied by the revised Companies Law, amplified by the Code to a call for independent directors. The UK has already retreated slightly from over-emphasis on directors who lack internal experience of their companies' businesses and 'the empirical support for staffing boards with independent directors remains surprisingly shaky'.[74] At the same time, the Code seems to pay little attention to practices such as the tradition of unanimous decision-taking by boards, which makes it difficult for any kind of director to impede proposals which have already reached the boardroom.[75] While the 2015 Code mostly comprises a summary of best practice already widely accepted – if not always implemented – in Japan, the 2018 revision seems to veer further towards a doctrinaire approach by proposing changes that diverge from accepted practices, sometimes in ways that threaten the existence of those practices and the comfort of those who benefit from them. In comparing the 2015 and 2018 Codes, the 2018 revision generally implies less willingness by reformers to accept a hybrid system which integrates the traditional strengths of Japanese corporate governance – as suggested by Aronson [76] – and more determination to impose new elements which support their favoured theories. It therefore remains to be seen whether these new requirements will be accepted as readily as those of 2015 or whether they will clash with informally institutionalised practices and be implemented only at surface level. The TSE's data show a distinct fall in full compliance for all listed companies since the 2018 amendments to the Code.[77]

Japan's Corporate Governance Code enjoys the benefits of a receptive environment and an impressive delivery mechanism, sustained by political will, an intelligible focus on raising corporate value, and a commitment to sustained flexibility. It has the ability to succeed in its governance objectives - although the immediate economic improvements it seeks to generate may prove elusive -

provided that it can remain largely attuned to the demands of Japan's informal institutional environment. If it ceases to be sensitive to the tacit preferences of corporate management and seeks to impose practices simply because regulators see them as logically optimum, it may fall into the same trap as earlier reform attempts, despite the advantages it currently enjoys.

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