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

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Abstract

In business organizations with long-term employment and internal promotion of top managers, the interplay of incentives between different generations of managers creates internal pressure on the CEO to internalize the welfare of future generations. This pressure that turns even self-interested myopic CEOs into public-spirited value-builders for future generation is called internal governance (Achariya et al. (2011)). In post-war Japan, internal governance has been developed so strongly that it can be called “company community”, and still is the essential element of Japanese corporate governance. External governance is discipline exerted on CEOs by equity holders and plays a role in complementing internal governance and to improving the efficient building-up of value. This complementary relationship would break down if external governance were excessive. In post-war Japan, external governance has been restricted by the practice of cross-shareholding.

Such Japanese corporate governance looked like it was working during the economic growth stage where internal governance is generally effective. After the Japanese economic bubble of the mid-80’s, when the conflicting interests between human capital providers and shareholders regarding free cash-flow became pronounced, the system began to malfunction. Since the mid-90’s, cross-shareholding has been declining and shareholder activism has been rising. Now an increasing number of executives are ready for open dialogue with institutional investors. Japanese style external governance will, however, be neither American-style institutional activism, nor British-style engagement. Japanese-style engagement will be even less confrontational than the British “behind-closed-doors” nature of engagement, and institutional investors will play the role of an internal catalyst that induces management’s initiative from within.

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I. Introduction

Many Western observers, especially investors, have expressed their uneasiness about the way Japanese public companies are governed. These observers are perplexed by the weak position of shareholders and the lack of outsiders on the board of directors. For them, shareholders are the company's owners. From their point of view, Japanese public companies are heretical because they do not appear to be run for their shareholders, but for their managers and employees. The chronically-low level of return on equity is taken as evidence for the scant concern that management has for shareholders' interest. Consequently, the Western observers call for reforms[1]. However, there is a puzzle to solve before we hastily take any definitive action. We need to first ask ourselves why Japanese public companies are run differently from the Western standard. Since many Japanese public companies have existed over half a century and have been successful, it is not rational to assume that they have been wrong since their inception. Considering their success, there simply must be some valid reasons why Japanese public companies are governed the way they are. Indeed, until the 1980's, the Japanese corporate governance seems to have worked well. What went wrong after the 1990's? Will we need a complete scrap and build? Where is Japanese corporate governance headed? Can we keep the essential elements of Japanese corporate governance while fixing other parts to strengthen it? These are the questions that lead our discussion in this article. Our short answer to the last question is that, yes, we can keep the essential elements intact while Japanese corporate governance evolves over the coming years.

There are two broad themes that are discussed in this chapter. The first theme is the nature of the internal organization of Japanese public companies in the post-1945 era. The concept of internal governance is introduced to develop insights into the ways in which corporate governance works in Japan today. The key point is that internal governance aligns the incentives of the constituents of the internal organization and drives the process that builds the company's value. The second theme is the evolution of management-shareholder relations in post-war Japan. As the practice of cross-shareholding wanes, a search is on to identify a new pattern of management-shareholder relations. Because the ownership structure of Japanese

[1] The American Chamber of Commerce in Japan (2013) is even more pessimistic when it states that "many domestic and foreign institutional investors have lost hope that standards for corporate governance in Japan will improve in the near future."

public companies is dispersed and institutional in nature, we believe that engagement by institutional investors will play a pivotal role in shaping the new pattern. Although engagement might recall a British model, our claim is that the style of engagement will be different from the British model and distinctly Japanese in practice.

The composition of this chapter is as follows. Part II discusses internal governance. The introductory section that defines the concept is followed by an exposition that elaborates on Japanese companies' organizational capacity for internal governance. The interplay of internal and external governance is then analyzed, and their complementary relationship is explained. Part III traces the evolution of management-shareholder relations in Japan. An analysis of the structure of cross-shareholding relationships is followed by a brief account of their historical evolution. The recent rise of institutional activism is then discussed, and some of recent examples of collaborative work between management and institutional investors are given. Part IV develops a theory of Japanese-style engagement. The notion of institutional investors as catalysts is introduced, and the gap-filling role of the activist investor is highlighted. Part V concludes.

II. Internal Governance and the Role of Shareholders

In this Part, we discuss what we consider to be the cornerstone element of Japanese corporate governance. It is termed *internal governance* because it is about control that is asserted on the top manager by the subordinate managers (Acharya *et al*. 2011). It is contrasted with internal control because internal control is hierarchically exerted top-down by the top manager. Internal governance is an economic concept. It applies not only to Japanese companies but also to companies elsewhere. A company's organization has the capacity for internal governance if it meets certain conditions. Internal governance develops in Japan because the organization of Japanese companies has certain qualities that match these conditions.

These qualities of Japanese organizations have been typically discussed in relation to the concept of "company community." In fact, there is precedence to discuss Japanese corporate governance from such a perspective (for instance, Shishido 2000 and more recently Buchanan *et al.* 2012). However, the argument here does not require that companies be a community. In fact, while the qualities that match the conditions for internal governance often give companies a community-like appearance, the companies

with these qualities do not need to be a community. In another words, being a community is not necessary for a company's organization to possess the capacity for internal governance. We start our discussion in this Part by defining what internal governance is.

A. Internal Governance Defined

The view that bargaining plays an important part in corporate governance is congenial with contemporary economic theory. For instance, relying on the insight of the contract theory, Zingales (1998) defines corporate governance in reference to "the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by the firm." While we share a similar view emphasizing the role of bargaining, our concept is more broadly constructed as the "incentive bargain" that sets the incentives of capital providers (Shishido, forthcoming). Two layers of allocation are associated with the bargain. The first layer is the allocation of powers, or the assignment of decision rights; the second layer is the allocation of surplus value created by the company. In this framework, what is traditionally viewed as an issue of corporate governance relates to the bargain between management and shareholders. It thus pertains to the balance of power as well as the share of the surplus value between these two parties[2].

While such a traditional view focusing on the bargain between management and shareholders is important in understanding corporate governance in the public company, equally important, especially in the context of large public companies in post-war Japan, is the perspective focusing on the bargain between different generations of managers. Not only is the public company an entity in which managers and shareholders interact as insiders and investors, but it is also an internally managed organization in which top and subordinate managers interact with each other. We think it important that we analyze the structure of incentives that work within the company's internal organization in order to better understand how corporate governance works in Japan.

Interestingly, financial economists recently came up with an economic model that uncovers the incentive dynamics that work between the top and subordinate managers within a business organization possessing certain qualities (Acharya *et al.*2011). These

[2] See Eguchi (forthcoming) for a comparison of four patterns of management-shareholder relations that strike a balance between shareholders' ownership rights and management's authority.

qualities are summarized as two conditions of the model: First, the constituents of the company's organization are immobile. That is, the junior manager pursues a long-term career within the organization, and the top manager is selected from those junior managers. Second, the junior manager expects to be rewarded over the long run. That is, he expects to be rewarded for the abilities he develops over the long run by building a career within the organization, rather than seeking immediate returns for his effort. In an organization meeting these conditions, the interplay of incentives of different generations of managers creates an internal pressure on the top manager to internalize the welfare of future generations. This bottom-up pressure that makes the top manager a value-builder for future generations is called *internal governance*. It is contrasted with *external governance* that is exerted on the top manager by outsiders of the company such as shareholders and bankers.

The foundational logic of internal governance is simple: The leader will need to give a reason for subordinates to follow her direction; otherwise the performance of the organization deteriorates. In fact, this logic applies to any hierarchical organization. In business organizations in which constituents have long-run interests in the company's prospects because they expect to be rewarded over the long run, the subordinates follow the leader on the premise that the leader builds the future for her successors[3].

A useful way to think of the model's two conditions, i.e., (i) immobile constituents and (ii) incentives based on long-run career prospects is to regard them as factors that determine the company's organizational capacity for internal governance. If a business organization satisfies these conditions well, it has the capacity for internal governance. An element that counts positively on this score are firm-specific skills and knowledge that the junior manager learns as he pursues a career within the organization (Acharya *et al.* 2011). Since he cannot take these skills and knowledge to other organizations and be adequately compensated, the more he learns the less likely he will leave the company. Moreover, because the abilities developed through these skills and knowledge are necessary to lead the company, the top manager tends to be groomed internally.

[3] The rough sketch of the model of internal governance is as follows. The junior manager has a stake in the future of the company, but the incumbent top manager may not because she will be retired. Consequently, the junior manager watches his boss' actions to check whether she has made moves to build the company's future. Knowing this, and realizing that he is a major contributor to company's performance, the top manager will try to motivate her junior manager by investing in the company's long-run future. The junior manager cooperates with his boss because, by doing so, he acquires the abilities to perform as top manager.

B. Internal Organizations of Japanese Companies

While companies' organizations can be quite different depending on the nature of technology or the company's growth stage, they exhibit significant congruence within a country so that we can meaningfully speak of the organizational features that are specific to a country. The organizational features that determined the character of large Japanese public companies in the post-1945 period are twofold. First, the constituents pursue a long-term career within the organization, and mid-career job changes are rare. These are the pronounced features of Japanese organizations as opposed to the US, and to a smaller degree the UK, where the average tenure of workers is much shorter, and job mobility significantly higher (Ono 2010). The stylized form of long-term employment in post-war Japan is often called "lifetime employment." In reality, it is best understood as employers' non-legally binding promise to provide stable and continuous employment to the core employees (typically consisting of male, regular employees with certain number of years of experience). It had initially started simply as a good corporate practice in leading companies in the heavy industrial sector, but it later spread to a wider set of companies, supported by social institutions, including case law (Moriguchi and Ono 2006).

Second, in Japanese organization, the top manager is groomed internally rather than appointed from outside. Mishina and Hino (2013) confirm on this point using a sample of fifty largest manufacturers in terms of sales. In this sample, over 70% of top executives joined the firm as new graduates just out of college, or joined the firm before they had turned 30 years old, and were since promoted internally. Most of the remainder are either members of the founding family or assignees from the parent company. This process of internal promotion is also a process of learning. The junior manager is expected to accumulate skills and knowledge as he steps up the managerial hierarchy. Yashiro (2013) gives a concise account of this process.

As pointed out, these characteristics of Japanese companies are often embraced in the notion of "company community." A company community is a business organization with a communal identity that is strengthened by a set of norms and values as well as a sense of communal order. The two qualities of the organization that determine the capacity for internal governance often form the basis of company community. For instance, if the organization's constituents are immobile, the charge of running the enterprise is passed on internally from one generation to the next, thus fostering a sense

of continuity of generations. Such a sense of continuity is a factor that contributes to a community-like appearance of the business organization. Also, since the constituents expect to be rewarded in the long run, team effort and inter-generation mentoring are facilitated, thus helping nurture the sense of a social bond.

In Japan, long-term employment and internal promotion became the standard and norm among large public companies by the high-growth era of the 1960's. A system of progressively increasing remuneration reflecting level of skills and knowledge was also established around the same time and fixed the notion of long-run reward among the constituents of the company (Moriguchi and Ono 2006). During this high-growth era, large Japanese manufacturers made huge amounts of future-oriented capital investment in order to catch up with their rivals overseas. We believe that internal governance was an important ingredient of corporate governance that supported the drive to build value for those companies.

A question arises why Japanese corporate governance appears to have failed after the 1990's. If large Japanese public companies score strongly on the capacity for internal governance, why did it not stop the top manager from making wasteful decisions that would harm her successors? In short, the reason is growth bias. The incentive dynamics that support internal governance are not as effective in cutting back on investment as they are in creating a drive to invest. When the catch-up process was over, and returns on capital investment declined, further investment was not accompanied by a matching level of cash flows. But the top manager kept on pursuing the growth strategy since investing in company's long-run future was a technique for motivating her subordinates and for keeping the company going. It would take outside equity to force the top manager to divest what had been built up.

C. Interaction between Internal and External Governance

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

one hand, it fuels those dynamics by providing funding for investment. On the other hand, it functions as a brake by requiring dividend payments and thus restraining investment. Which effect is salient depends on the company's growth stage.

To understand this, note that equity holders would take back their claim on dividends and acquiesce to the top manager's decision to invest, so long as they can collect from future cash flows. So, when the current top manager decides to invest, she is essentially passing on her "liability" owed to equity holders to future generations. This passing-on will not break down as long as investment generates sufficient cash flows. But if the return on investment decreases, and investment no longer generates sufficient cash flows, it will falter because future generations will be squeezed out of those cash flows. Realizing this, the current top manager forgoes investment and pays out dividends. The top manager may have to even liquidate a part of existing capital (for instance, through asset sales) to pay out dividends if the return on existing capital is also expected to decline sharply.

Such discipline on capital investment, which works through equity holders' dividend claims, is an important aspect of external governance exerted by equity holders. In fact, discipline on capital investment can be exerted through other channels of external governance including direct intervention in managerial decision-making processes. The point here is that even such a crude form of external governance as the dividend claim substantially improves the efficiency of capital investment.

Nonetheless, it should be noted that external governance does not by itself create "efficiency." Unless there is an "engine" that stimulates incentives and provides propulsion, there is no investment to start with. The role of external governance is to complement the engine and to improve the efficiency of the process. Internal governance is such an engine. The relationship between internal and external governance is thus complementary in that together they bring about outcome that is not possible with only one of them in place (Acharya *et al.* 2011)[4].

Another important point to highlight is that the mechanism of internal governance will be impaired if external governance is excessive (Acharya *et al.* 2011). Recall that the

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

effectiveness of internal governance is premised on the prospect of long-run reward that the junior manager holds as he climbs up the corporate hierarchy. This reward comes from the surplus value the company creates. As briefly mentioned, management and shareholders compete over the allocation of surplus value created by the company. If external governance is excessive, and if the surplus afforded to the constituents of the company is squeezed too tightly, then there will be little reward the junior manager can expect in his pursuit of a long-term career within the company. In this case, the mechanism of internal governance will not work because the players' incentives are impaired. Myers (2013) points out the importance of managerial rents for a public company's overall efficiency. What is important, then, is to set the intensity of external governance at an appropriate level so that adequate managerial rents are preserved and to keep the mechanism of internal governance operational.

In the case of post-war Japan, the key factor that sets the intensity of external governance was the practice of cross-shareholding. Since this practice tilts the balance of power to the advantage of management, the intensity of external governance, which is conditioned on this balance, is set to be lax. The upside of this arrangement is that the company's organizational capacity for internal governance is preserved. But the downside is that the mechanism for curtailing wasteful investment is deficient when returns on capital investment decline. Before going further on discussing cross-holding, a few more remarks on internal governance are in order.

D. Final Remarks on Internal Governance

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

Kambayashi and Kato (2011b) use detailed micro-data that form the basis of the official statistics to study the stability of long-term employment and job security for "core employees" (age between 30 and 44, with at least five years of tenure accumulated) over the past twenty-five years. They find that the employment practices for this

group of employees has remained remarkably stable in Japan, while the pattern in the US has changed considerably, indicating a weakening of long-term commitment as well as loss of job security.

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

The fact that typical Japanese companies still retain the organizational capacity for internal governance does not imply that internal governance is indeed effective in these organizations. For instance, if the company is not a value creator, there is little surplus value to be allocated in the form of managerial rents, and internal governance is not likely to develop. Moreover, even if the company is indeed a value creator, it can be trapped in what might be called the "still-life equilibrium." This is when the incentive dynamics are settled merely on the bare survival of the company because the constituents opt for a "still life" rather than a life of constant change. If the company is trapped in this pitfall, internal governance is degraded to the maintenance of status quo, and it will likely take outside equity to set the company on the path of innovation and growth.

Thus, we do not claim that internal governance is effective in all Japanese companies. Our claim is more modest. That is, typical Japanese companies have a greater capacity for internal governance, as compared with companies in other industrialized countries, especially the US and the UK. And the top managers of well-run Japanese companies seem to spend quite a large amount of energy and effort knowing their subordinates and eliciting their participation, implying effective internal governance.

The empirical research described in Jackson and Miyajima (2007) confirms on this point, though indirectly. According to the study, public companies in Japan are grouped into three categories. The companies that belong to the core category (called

Hybrid firms) include no more than a quarter of the total sample, but employ two thirds of the total workforce. These companies make extensive use of the capital markets for meeting their financing needs, and maintain a high level of information disclosure. They are also proactive in governance reforms. Nonetheless, regarding internal organization, they firmly retain the norm of long-term employment.

III. Japanese Corporate Governance in Transition

The practice of cross-shareholding produced a distinctive pattern of management-shareholder relations in post-war Japan. Like poison pills in the US, this practice is a technique used to shield management from the influence of outside shareholders. This practice started losing its ground in the deep downturn of the market since the 1990's. As it wanes, a search is on to identify a new pattern of management-shareholder relations. In this Part, we review the historical evolution of management-shareholder relations since the end of the war and project their future by examining recent cases of collaborative work between management and institutional investors.

A. Rise and Decline of Cross-Shareholding Practices

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

In Japan, shareholders are also legally empowered, but unlike major jurisdictions in Continental Europe, a dispersed ownership structure prevails especially among large public companies[5]. Under these circumstances, the scheme of horizontal

[5] For a comparison of shareholders' governance rights, please refer to Enriques *et al*. (2009). In

cross-shareholding develops as a technique to create a virtual reference shareholder that shields management from the influence of legally empowered shareholders. The scheme is contrasted with vertical cross-holding as practiced in many countries of Continental Europe and Asia, where a minority blockholder effectively controls the whole group of companies using various ownership schemes including cross-shareholding. The method of horizontal cross-shareholding is intricate: Companies hold each other's shares on the implicit agreement that they will support each other's management as shareholders. These cross-holding arrangements can be made simply on a bilateral basis (e.g., Companies A and B holding each other's shares) or more complicatedly on a multilateral basis (e.g., Companies A, B and C each holding shares of other two). They could even be made on a cyclical basis (for instance, with the ownership chain extending from Company A to Company B to Company C and then back to Company A). The end result of these intricate ownership relations is a structure where the company virtually controls a substantive block of votes and plays the role of a reference shareholder for itself. It shuts management off from any interference that might be made by other outside shareholders.

The structure of ownership was totally different in pre-war Japan. In that period, even the largest public companies were owned by a small group of legally empowered reference shareholders[6]. This concentrated ownership regime was overturned by the two factors that shaped the political economy of Japan in the 1930's and 1940's. The first factor was wartime policy. In their effort to mobilize resource for the war, the government and military bureaucrats took determined positions against the influence of profit-motivated shareholders on corporate decision-making (Okazaki 1994a). Another factor was the occupation policy of the General Headquarters (GHQ) serving the Supreme Commander of Allied Powers. As part of its general policy to democratize Japan, GHQ aimed to remove the influence of the Zaibatsu and other capitalist families from all major companies[7].

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the late 1990's, financial economists vigorously conducted comparative studies of the ownership structures of both developed and developing markets. A representative work in this area is La Porta *et al.* (1999) that compared the ownership structure of the twenty largest companies by capitalization in twenty-seven different countries. According to this study, Japan is only behind Britain in the degree of dispersion of equity ownership.

[6] In 1935, the ten largest shareholders held 40% of the equity of the twenty largest companies. In the Zaibatsu (defined to include Mitsubishi, Mitsui and Sumitomo), the group holding company (headquarters) owned around 40% of its group companies. In the other conglomerates, the founders and their families as well as their asset management companies owned around 20% of the group companies. Okazaki (1994b); also see Okazaki (1994a) for an account in English.

[7] To eliminate the influence of capitalist ownership, GHQ dissolved Zaibatsu holding companies

Thus, by the end of the 1940's, the ownership of large public companies was no longer in the hands of large reference shareholders, but was generally dispersed among individuals[8]. Using such circumstances for their benefit, several legendary greenmail artists led the high-profile share buy-ups in the mid-1950's (Kawakita 1995). It is in this context of shareholder hostility that companies, especially former Zaibatsu members, presumably in search of a proxy for reference shareholders, started re-huddling around their banks by holding each other's shares. Cross-holding networks developed further as the ownership of public companies shifted from individuals to banks and other business corporations[9].

The practice of cross-shareholding persisted throughout the stock market boom of the 1980's. But it started losing ground in the down-turn of the market in the 1990's. As stock prices plunged, capital losses on stock positions hit the bottom line of companies that held other companies' shares. These companies started unwinding their cross-holding positions in the mid-1990's, and the unwinding trend has generally persisted up to the present[10]. Miyajima and Kuroki (2007) give a detailed analysis of the process of massive unwinding that took place around the banking crisis in the latter half of the 1990's.

After the burst of the equity bubble in 1990, real estate prices kept on declining as the Japanese economy went into a prolonged recession. Such secular decline in real estate prices caused heavy losses on banks' loan portfolios. Reflecting the erosion of their balance sheet, banks' share prices started plummeting in the mid-1990's, triggered by such events as the failures of several regional banks and housing loan companies.

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and placed the shares held by the families and holding companies under public ownership. Moreover, GHQ purged Zaibatsu family members and their designees from the corporate boards. As a result, the post-war boards of large public companies were mostly composed of former employees and contained no representatives of shareholders' interests (Okazaki 1994b).

[8] The government started selling the shares that had been temporarily placed under public ownership. Individuals including company employees took up these shares. By the end of FY1949, individuals owned 69.1% of listed companies. Tokyo Stock Exchange *et al.* (2013).

[9] In the universe of large listed companies, the percentage of equity held by banks and other business corporations increased from the low level of 16.0% in 1953 to 33.2% in 1962. The percentage rose further to 41.5% in 1974. Franks *et al.* (2009).

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

Anxiety regarding the banks' balance sheets heightened to a crisis level in the late 1990's when several major banks and one of the "big four" securities firms went bankrupt. Facing huge losses as well as imminent risk from holding bank shares, corporations were compelled to unload their holdings, though the patterns of their behavior were not uniform. On one hand, the corporations that had relatively easy access to the capital markets for financing and hence less dependence on bank loans took the lead in unwinding their cross-held positions. On the other hand, the corporations that depended on banks for financing tended to stick to their stock positions in spite of the risk it entailed (Miyajima and Kuroki 2007).

Banks and other financial institutions were also under pressure to unload their holdings of corporate shares. Three factors were in effect to produce this pressure, that is, (i) the need for the bank both to secure funds for disposal of non-performing loans, (ii) to comply with the capital requirements set by the Bank for International Settlements, and (iii)the introduction of current value accounting. Driven by these factors, banks started selling shares of corporations that had high valuations and easier access to the capital markets for financing. Banks were cautious about selling shares of corporations that had higher dependency on bank loans because the unwinding of the cross-holding relationship would send a signal to the market that the banks had given up on those corporations (Miyajima and Kuroki 2007).

Today, cross-shareholding is still a part of corporate practice, especially in strategic alliances between corporations. But the cross-shareholding arrangements between banks and corporations, which composed more than two thirds of all cross-holding relationships right after the bubble burst, now carry a very small weight in the ownership structure of public companies (Ito 2011). While cross-shareholding might still be a feature of Japanese corporate governance, it is by no means the dominant factor it used to be in determining the intensity of external governance.

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

As the unwinding continued, two major developments attracted the public's attention and heralded a change in management-shareholder relations. One was the wave of confrontational activism that began with M&A Consulting's hostile bid against Shoei, a Tokyo Stock Exchange First Section company, in 2000. Following this high-profile

takeover attempt in which the activist fund put forth shareholder value to legitimate their claim, a number of listed companies were targeted by both domestic and overseas activist funds that also used financial arguments and confrontational techniques to put pressure on management. While these events caused turmoil in several targeted companies, by the end of the 2000's, this adversarial form of activism waned without much success, as the strategy of activist funds shifted to a pattern involving a much lesser degree of hostility and public exposure. Buchanan *et al.* (2012) analyze the strategy and claims of activist funds during this period as well as management's response.

Another development that heralded a change in management-shareholder relations is the rise of institutional activism. Learning from the practice of overseas counterparts, pension funds and their money managers started actively exercising their voting rights at shareholder meetings. Under the strong leadership of their management at that time, the Pension Fund Association (PFA) and the Pension Fund Association for Local Government Officials spearheaded this nascent form of institutional activism. PFA is a public pension fund that functions as the umbrella fund for former members of corporate pension plans who left their plans before meeting the qualification for plan transfer. PFA caught the media's attention when it announced a comprehensive guideline for exercise of voting rights and voted against 40% of management proposals at the shareholder meetings held in June, 2003. In Japan, the peak month for shareholder meetings is June. A little over two thirds of all listed companies hold shareholder meetings in this month. For detailed analysis of PFA's version of shareholder activism, please refer to Aronson (2011) as well as Seki (2005).

Although the institutional activism spearheaded by the public pensions was certainly unprecedented in terms of the degree of impact on other investors as well as on the business community in Japan, they were not the first to vote actively. The California Public Employees' Retirement Pension System, or CalPERS, was one of these forerunners. Already famous for its aggressive activism, CalPERS started applying systematic voting policy to Japanese stocks in 1990 with intent to promote changes in corporate governance practices (Jacoby 2007). Nonetheless, despite its intent, the actual impact of CalPERS' voting, and for that matter any foreign investors' voting, was limited in the 1990's because their holdings of Japanese equities were still small. More than two decades have passed since that time. Now foreign investors exert significant influence on the voting outcome of their portfolio companies as they have

substantially increased their presence as major owners of Japanese equities[11]. Another significant development during this period was a change in the stance of domestic investors. While active voting was considered ahead of time at the turn of the century, it is no longer uncommon for domestic investment managers to cast a significant percentage of their votes against management if deemed appropriate[12]. Recognizing a change in the wind, an increasing number of company executives have started revisiting the management-shareholder relations based on cross-shareholdings and are ready for open dialogues with institutional investors.

Paralleling the change of posture on the part of management is a move by institutional investors to activate their relationship with management. This move is partly motivated by the institutions' wish to make their exercise of voting rights a more fruitful undertaking. Over the past decade, the institutions have developed elaborate voting guidelines to direct their votes. The upside is the consistency of voting decisions, but the downside is the prevalence of the "one standard suits all" approach. Single-minded box ticking rather than careful investigations of individual cases tends to drive the voting process. The heavy concentration of shareholder meetings, of which roughly one third in the universe of listed companies take place in a single week in June, reinforces this tendency because the time-critical nature of the voting process prevents one from taking a time-intensive approach. Moreover, the lack of detailed information beyond the level required by law makes informed decision-making virtually infeasible. Being unhappy about the situation, several investment managers have started working with the Investor Relation (IR) officers of their portfolio companies to make at least more informed, if not case-by-case, voting decisions. For instance, in the case of director and statutory auditor appointments, investment managers might ask for the candidates' views regarding the role they would play if elected. If the company were to provide the requested information, both parties would be better off with more informed voting decisions as an outcome.

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[11] In the universe of listed companies, the percentage of the equity held by foreigners increased from 6.3% in 1992 to 17.7% in FY2002 and to 28.0% in FY2012 (Tokyo Stock Exchange *et al.* 2013).

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

In addition to these efforts to make shareholder voting a more meaningful exercise, a number of institutional investors, with support of managers of their investee companies, have started working more directly on activating dialogue between the two parties. An example of such work is the activity of the Corporate Reporting Lab under the auspices of the Ministry of Economy, Trade and Industry. This forum of IR officers and corporate governance professionals was established in 2012. Its style of activity is unique in that its participating members take the initiative of launching projects and METI sponsors them by providing secretariat services. The area of focus for the initial year was proactive disclosure and communication of governance-related information. Within this scope, several projects aimed at helping disclosures and promoting dialogue were launched[13].

These collaborative works between management and institutional shareholders may still be in a germinal stage. But they indicate that managers are looking ahead into the "post-cross-shareholding" relationship with investors, and that the institutions are actively seeking dialogue with management. Given these indications, a prognosis is that dialogue between management and institutional investors will play a pivotal role in shaping the pattern of management-shareholder relations in Japan. A recent policy move to formulate Japan's Stewardship Code ("the Code") backs up this prognosis. With the title of "Principles for Responsible Institutional Investors," the Code was published in March, 2014, as part of Prime Minister Abe's strategic plan, called the "Japan Revitalization Strategy." Approved by the Cabinet in June, 2013, the strategic plan includes as one of the near-term action items a review of corporate governance practices that secure sustainable growth of Japanese companies (Prime Minister 2013). A milestone set for this action item is the formulation of the Code, which consists of seven principles that institutional investors are expected to follow. The primary aim of the Code is to promote constructive dialogue between institutional investors and their portfolio companies (Council of Experts 2014). By sending a clear message to the public that such activity should be promoted, the Code gives strong support for initiatives that seek more active communication between management and shareholder.

IV. External Governance in Internally Governed Organizations

[13] Please visit the website cited below for more information about Corporate Reporting Lab, including an abstract of its progress report and some of its output.
http://www.meti.go.jp/english/policy/economy/corporate_accounting/index.html

Engagement generally refers to the dialogue between management and (relatively large) minority shareholders that takes place when the latter wish to exert influence on management. In Britain, such dialogue takes place regularly between institutional investors and the management of their portfolio companies and has long determined the nature of their relationships. Given the dispersed and institutional ownership structure of Japanese public companies[14], we believe that engagement by institutional investors will play a pivotal role in shaping the future pattern of management-shareholder relations in Japan. Although this rising role of engagement in Japan might be interpreted as convergence to the British model, Japanese organizations' higher capacity for internal governance will likely affect the ways engagement is undertaken and hence give engagement in Japan a different color.

A. Japanese-Style Engagement

To understand the features of engagement in Japan, a comparison with the practice in Britain is useful. The most salient feature of British-style engagement is its collective nature. Since the 1980's, institutional investors have from time to time formed coalitions and engaged collectively with management. Historically, two conditions made such collective approach possible. The first condition is the ownership structure. During 1980's and 1990's, a small group of domestic institutional investors together held a major portion of the equity of large public companies and could collectively control the outcome of shareholder meetings held at these companies if they desired to do so[15]. Moreover, this small group of investors formed a close-knit community. Their affinities with each other made it easier to share common viewpoints and build consensus (Cheffins 2008).

The second condition is British law. Compared with other major jurisdictions in Europe and the United States, relevant regulations stand much less in the way of

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[14] Regarding ownership dispersion, please see note 6 above. We make use of the statistics published by the stock exchange to get an idea of the size of institutional holdings (Tokyo Stock Exchange *et al*. 2013). The percentage of the equity held by domestic institutional investors (i.e., trust banks, insurance companies and other financial institutions excluding banks and securities companies) is 24.2% in FY2012. Since the percentage of equity held by foreigners is 28.0% in FY2012, our estimate for the total institutional holdings is roughly 52%.

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

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

In Japan, the situation is very different. Not only is the ownership structure more dispersed, but the investor community lacks affinities and the coherence of views that characterized domestic institutional investors in Britain. Moreover, unlike Britain, both the rules of Large Shareholding Reports and the TOB rules under the Financial Instruments and Exchange Act (FIEA) do not distinguish corporate governance activism from other concerted activities[16]. The hurdles for forming a coalition will be substantially higher, if not insurmountable. The British model of collective engagement will not apply to Japan.

Another feature of British-style engagement is its private and non-confrontational nature. Although exceptions certainly exist, British institutions prefer negotiating "behind the closed door" with management and tend to avoid public confrontations

[16] Under the rules for Reports of Possession of Large Volume, the aggregate interests including those of joint holders will need to be reported if the stock ownership exceeds the 5 percent threshold (FIEA Art. 27-23(1)(3)(5)(6)). Those that are deemed as "Joint Holders" due to their motive (FIEA Art. 27-23(5)) include, among others, parties to voting agreements, written or verbal, and parties to joint shareholder proposals. The Financial Service Agency (FSA) has clarified the definition of such Joint Holder. See FSA, Q&A Regarding Reports of Possession of Large Volume (in Japanese), mimeo, especially Q20, 22 and 23 (Mar. 31, 2010).

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

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

(Black and Coffee 1994, Davies 2010, Solomon and Solomon 2004). This is in contrast with American-style institutional activism, as represented by CalPERS, that often employs "theatrical" techniques such as open-door media exposure. In the case of Japan, the nature of engagement will be even less confrontational than Britain. Indeed, in the British case, it is still true that engagement depends on the perceived credibility of the threat the institutions as a group can pose because of their collective voting power. In the case of Japan, however, the institutions cannot use the perception of a threat to strengthen their position because coalition formation is not considered realistic. Then a natural question arises: If Japanese institutions cannot resort to power, how can they ever be effective in influencing management? We think that, in order to be effective, the institutions will need to play the role of *catalysts* that induce change from within. That is, rather than placing external pressure to unilaterally assert their viewpoints as investor, they will need to proactively share views with management and induce its initiatives.

The reason why we think that institutional investors will need to play the role of catalyst stems from the recognition that the pattern of organizations' control is different between Japan, on one hand, and the UK and US (the UK/US for short), on the other hand. In Japan, the implicit bottom-up influence exerted on the top manager by the subordinate managers plays a larger role in organizations' control than in the UK/US, where control tends to be concentrated in the top manager. Moreover, reflecting the immobility of their constituents, control of Japanese companies has a more "internalist" orientation, with a shared belief that those with long-run commitment to the company's enterprise should have influence over the company's policy[17].

Because of these differences in the patterns of organizations' control, the ways in which outside shareholders can influence management most effectively should be different between the US/UK and Japan. In the UK/US, organizations' control is more concentrated and has a less internalist orientation. Thus, the strategy of placing outside pressure on the top manager by, for instance, using the threat of coalition formation or open-door media exposure is appropriate. However, in the case of Japan, organizations' control contains both top-down and bottom-up elements, and it has a more internalist orientation. The strategy of placing outside pressure should not be

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

effective, and a better approach would be to create pressure from within.

In any form of engagement, whether Japanese or not, the institutional investors' role is to bring in outsiders' perspective to management and exert influence. In order to be influential in the Japanese context, however, the institutions need the ability to think with management, though they are certainly not part of it. This quality, which implies congeniality to management, distinguishes engagement in Japan from the classic British style.

B. Activist Investor as Gap-Filler

In the last section, we characterized the role of institutional investors as catalysts that induce change from within. While the institutions in a catalyst role are capable of mitigating issues of corporate governance to a considerable extent, there is a limit to what they can do because of their primary function in the market being a diversified investor. Supplementing the catalyst role of institutional investors as a gap-filler is the activist investor that earns returns by serving as "governance intermediary" (Gilson and Gordon 2013).

The effectiveness of the "catalyst" approach of engagement in dealing with general governance issues does not require further elaboration. As described in the previous section, institutional investors in Japan have already started having in-depth dialogues with management in this area. For instance, if the agenda is a lack of information about the company's governance regime, institutional investors will engage with management, explain why improvement is desirable, and urge management to initiate action plans for better information disclosure.

What is not clear is whether the catalyst approach can be equally effective in working on company-specific issues, such as the company's financial performance. In fact, this point is not clear even in the long history of the British-style engagement. While the British institutions broadly engaged on general governance issues, with respect to company-specific issues, their activity was more restricted with a focus placed on the worst performers and ex-post crisis situations such as the cases of scandals or self-dealing. In these extreme situations, their intervention often led to turnover of top management (Black & Coffee 1994).

The form of external governance in which the outside investor intervenes only in extreme situations is called "contingent governance." A typical example is the control exercised by the main bank in Japan in the high-growth era. Since contingent governance does not interfere with internal governance (Shishido 2007), it was suited for the governance regime at that time, which focused on internal governance. But this regime was not adequate to prevent the wasteful investment in the 1990's. As the management-shareholder relationship based on cross-shareholdings shifts to a new pattern emphasizing engagement, a question arises as to the sufficiency of external governance under this new regime. In this context, it should be noted that the CIO of a major British insurer, which often played a leadership role in collective engagement, once commented that the extent of intervention by British shareholders did not remotely approach the level the banks in Germany and Japan exhibited (Cheffins 2008). Since the Japanese-style engagement featuring the catalyst role of institutional investors will likely be no less "contingent" than the British-style collective engagement, one can seriously question whether such engagement alone can adequately provide the level of external governance required for efficient value creation.

Closely related to this issue is the point raised by the Walker Report regarding the British institutions' reluctance to involve themselves in the company-specific affairs (Walker 2009). Published in November, 2009, this report calls for the replacement of the widely-held view that engagement acquires importance only in crisis situations. What the report endorses is an alternative view that stresses communication in "normal" times, particularly on company-specific issues (Walker 2009). Although this argument by itself sounds quite reasonable, there is a difficulty. That is, the alternative view that stresses normal-time communication is at odds with the business model of mainstream investment managers. An important point is that these professional investors supply low-cost portfolio diversification and, as such, contribute to efficient risk transfer in the market. Being specialists in portfolio diversification, these managers naturally lack in both the incentive and expertise in supplying governance oversight on individual companies.

If institutional activism, whether British style or Japanese style, is not up to the task of providing a sufficient level of external governance, there needs to be a supplementary mechanism that will fill in the gap. Regarding this point, we share the view of Gilson and Gordon (2013) that the activist investor as "governance intermediary" can play the role of gap-filler. As the authors point out, although mainstream investors might not

create company-specific proposals by themselves, they will certainly respond to the proposals submitted by activist investors. Realizing this, the activist will try to win the support of mainstream investors. Management will also try to win their support because, otherwise, it will lose the contest. The mutual trust built through Japanese-style dialogues with investors will definitely help. Such competition between the activist and management will invigorate communications between management and mainstream investors. The company-specific dialogues that ensue will fill the gap in the catalyst approach and contribute to the leveling up of external governance.

V. Concluding Remarks

This article centers on two themes that are related to the series of questions posed at the beginning. The first theme is internal governance. Internal governance is an economic concept. It applies not only to Japanese companies but also to companies elsewhere. Internal governance develops in Japan because the organization of Japanese public companies has certain qualities that make this mechanism effective. These qualities also give the Japanese company its community-like features.

Internal governance aligns the incentives across different generations of managers. It provides propulsion necessary to build value for the company. This mechanism worked well during the catch-up phase of the Japanese economy until the 1980's. But once this process was over, the growth bias inherent in the mechanism caused wasteful investment because the practice of cross-shareholding reduced the intensity of external governance that should otherwise have imposed discipline on investment. What is important for internally governed companies is to set the intensity of external governance at an appropriate level.

The second theme of this article is the emergence of institutional investors as a key player in Japanese corporate governance. While the incentive dynamics between different generations of managers that exert internal governance will still be the cornerstone of the new governance regime, institutional investors will also play a pivotal role. Given the more dispersed and internalist nature of organizations' control in Japanese public companies, institutional investors can be more effective in their engagement with management if they play the role of catalyst rather than try to exert pressure from outside.

The institutional investor's capacity as purveyor of external governance is limited by its primary function in the market as a diversified investor. Supplementing the catalyst role of institutional investors is the activist investor, who will play a gap-filling role in the governance regime. The double-casted nature of external control that such complementarity entails is likely to be the feature that characterizes the future pattern of Japanese corporate governance.

Engagement in Japan would develop as more institutional investors recognize the importance of constructive dialogue with management. Clarifying regulations that might otherwise cause unnecessary fears of concerted action would facilitate active communications among institutional investors. Moreover, providing guidance for insider trading regulations would help alleviate concerns of both institutional investors and investee companies regarding in-depth dialogues. Since the excessive conservatism on the part of both institutional investors and investee companies is a major hurdle for lively activism, regulators will need to send a clear message to the public that active engagement is an activity that should be promoted rather than deterred.

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