9.5 STRATEGY SPOTLIGHT

ETHICS

JAPANESE GOVERNMENT PUSHES FOR GOVERNANCE REFORM

Corporate governance structures in Japan look very different than those found in the United States. Few members of boards of directors are independent of the firm. Instead, most are also firm managers, meaning they are unlikely to recommend the firm radically change its strategy even if such change may be warranted. Even though many Japanese firms have extensive global operations, only 274 of the approximately 40,000 director positions at Japanese firms were held by foreigners in 2015. Firms within business groups have cross-shareholding, where supplier firms own part of their customer firms and vice versa. Also, banks often own shares in the companies they lend to and, as a result, do not put strong public pressure on client firms to improve their operations or balance sheets. Government regulations do not require that accounting firms that serve as external auditors are independent of the firm. As a result, many firms use closely affiliated "outside" auditors, reducing the pressure the firm faces to accurately report earnings and file financial statements. Finally, top manager compensation is low compared to other countries and not closely tied to firm performance, reducing the incentive for management to take bold actions. These cozy governance systems fit the longstanding Japanese desire for economic stability and lifetime employment.

However, two decades of economic malaise has led Prime Minister Shinzo Abe and his government to push for governance reform. These cozy governance arrangements have resulted in firms that are slow to restructure, not very competitively aggressive, and unable to fully understand the different needs of the global markets in which they compete. One measure of the conservatism of firm management is that, in 2015, Japanese companies were hoarding $1.9 trillion in cash, an amount nearly half the size of the Japanese economy. This is cash firms could use to expand, develop new technologies, or acquire other firms, but these firms were choosing to sit on it instead. Abe and his government are trying to change things with a new corporate governance code. Rather than working up hard and fast rules, Abe's code lays out general principles and relies on social pressure to get firms to change. Companies are advised to improve communication with shareholders, to respond to large shareholder concerns, to focus more on increasing shareholder value, to remove anti-takeover provisions, to increase diversity and the promotion of women, and to use an independent auditor.

There is some evidence these social pressures are working. In 2016, firms distributed a record amount of cash to their stockholders. An increasing number of firms are introducing shareholder friendly measures, such as return on equity targets and regular earnings reports. Corporate boards are also becoming a bit more independent with the average number of outsiders on the boards of large Japanese firms rising from less than one to three members since 2012. Big banks have announced they will reduce their shareholding in customer firms by about 25 percent in the next five years. Cross-shareholdings between firms have reduced to 11 percent of market capitalization in 2016, compared to 34 percent in 1990. Finally, some major firms, such as Hitachi, are divesting unrelated and unprofitable business units and focusing on core, growing business operations.

Japan has no interest in fully incorporating American corporate governance practices. It sees the United States as too short term and shareholder focused. Instead, Abe wants to alter governance practices to push firms to be more aggressive and responsive while also maintaining a degree of stability and a longer term focus.

Sources: Anonymous. 2015. Meet Shinzo Abe, shareholder activist. *economist.com*. June 6: np; Smith, N. 2015. Japan flirts with governance reform. *bloomberg.com*. January 9: np; de Swaan, J. 2016. Abe must double down on Japan's corporate sector reforms. *ft.com*. September 28: np; and, Lewis, L. 2016. Abe's corporate governance reforms show signs of progress. *ft.com*. December 20: np.

All public corporations are required to disclose a substantial amount of financial information by bodies such as the Securities and Exchange Commission. These include quarterly and annual filings of financial performance, stock trading by insiders, and details of executive compensation packages. There are two primary reasons behind such requirements. First, markets can operate efficiently only when the investing public has faith in the market system. In the absence of disclosure requirements, the average investor suffers from a lack of reliable information and therefore may completely stay away from the capital market. This will negatively impact an economy's ability to grow. Second, disclosure of information such as insider trading protects the small investor to some extent from the negative consequences of information asymmetry. The insiders and large investors typically have more information than the small investor and can therefore use that information to buy or sell before the information becomes public knowledge.

Government pressures to improve corporate governance is not only found in the United States. Strategy Spotlight 9.5 discusses how Japanese regulators are pushing for governance reform in a country that has long resisted changes that would lead firms to focus more on shareholders.