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Reforms of Corporate Governance in East Asia

December 2022

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Abstract.

At the heart of corporate governance reforms in East Asia is board re-composition legislation aiming to alleviate the prevalent agency conflicts. The principal-principal agency conflicts associated with controlling shareholders are prevalent in China, Korea and Taiwan while the managerial entrenchment along the declining role of (main) bank is a concern in Japan. Countries such as Korea have actively initiated reform in contrast to Japan, which has adopted a conservative approach. Taiwan and China take a more moderate approach that lies between active reform and conservatism. While the reforms have shifted the governance system from the traditional relationship-based insider model towards the outsider-model, empirical research evaluating the effectiveness of the reforms has been indecisive. The remaining challenges the region faces, regardless of the approach to board re-composition reforms, are ensuring effective implementation of these reforms to enable the independence of the board so that it may execute its monitoring function.

Keywords: Corporate governance; Regulatory reforms; Independent director; Principal-principal agency problem; East Asia

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Introduction

Since the onset of the Asian financial crisis in 1997, OECD discussions (OECD, 1996), and the enactment of the 2002 Sarbanes-Oxley Act in the United States, corporate governance reforms have become essential in East Asia. These events drew attention to the agency conflicts between controlling shareholders and minority shareholders, termed the principal-principal agency problem and the managerial entrenchment. This principal-principal issue has been particularly prevalent in East Asia including China, South Korea (Korea hereafter) and Taiwan largely due to the concentrated ownership combined with a dominant family-controlled nature of business groups in the region (Bebchuk et al., 2000; Johnson et al., 2000; Min, Chen and Tien, 2022; Morck and Yeung, 2003; Young et al., 2008). Japanese government has also initiated board recomposition at national level to alleviate the managerial entrenchment (Miyajima and Saito, 2021; Morikawa, 2020).

Civil laws adopted in the region are relatively oblivious to the protection of minority shareholders in comparison to common-law (La Porta et al., 1998; Aminadav and Papiounou, 2020). The role of banks vis-à-vis capital markets has also been important for financing, as these banks have provided a main source of finance in all the East Asian economies. Japanese banks have been taking on an even larger role than supplying capital as they also share risks with the borrowing companies (Horiuchi, Packer and Fukuda, 1988; Sheard, 1986). Drawing on the view of the political economy, Roe (2006) posits that the governance structure is skewed towards favouring political power in an economy where the role of the government is significant in permitting business operations, designing entry barriers, and allocating financial resources.

The onset of the Asian financial crisis rekindled the debate regarding corporate governance reforms at an international level (OECD, 1999) as although the crisis was witnessed through the massive in and outflows of capital in the region at macro level, a key cause of the crisis were the legacies from malfunctioning corporate governance at the micro-firm level (Mitton, 2002).

Legacies of the Agency Problem in East Asia

In contrast to Berle-Means' observation in Anglo-Saxon economies, ownership of firms in East Asia has been highly concentrated. In Korea and Taiwan, concentrated ownership is held largely by a family or its affiliates which belong to the same business group (Amsden, 1989; Claessens et al. 2000; Min, Chen and Tien, 2022). For example, more than 60 percent of the

listed firms are classified as family firms in Taiwan. This concentrated ownership form is also prevalent in China and Japan where the government, referred to as the state, and financial institutions such as banks, are majority shareholders. An example of this is seen in China where the state held 32 percent of the total shares of listed Chinese firms during 2001-2008 (Hou, Kuo and Lee, 2012), though this percentage could increase if we include indirect state ownership. In Japan financial institutions have been the largest shareholder of Japanese firms, maintaining between 30-45 percent shareholdings followed by business corporations with 25-30 percent over the period of 1970-2008 (Tokyo Stock Exchange, 2010). Using Bureau van Dijk's ORBIS database in 2012 combined with the threshold levels of 20 percent of the voting rights for corporate controlling and 5 percent for a equity block, Aminadav and Papaionnou (2020) reported that 47.3 percent of 1,452 Japanese firms was identifies as controlled firms and 43.5 percent were as widely held with (a) blockholder(s). This portion of controlled firm (47.3 percent) is lower than that of China (72.2 percent) but higher than that of Korea (35.6 percent). The portion of widely held with (a) blockholder(s) (43.5 percent) in Japan was higher than China (21.3 percent) but lower than Korea (49.9 percent) and the world average (44.7 percent). However, concentration of banks' ownership in Japan has been substantially declined during the period of 1997 to 2003 due largely to the Japanese Anti-Monopoly Law's prohibition of banks holding more than 5 percent of other corporations' share. Miyajima (2022) reported that the shares held by insiders including banks, insurance companies, other corporations declined from 60 percent in 1995 to 30 percent in 2015.

Watanabe (2010) reported that in 2007 the ownership concentration in a listed state-owned enterprise (SOE) in China was 38 percent, placing this at 8 percent higher than that of privately-owned firms. The author also demonstrated that between 60 and 80 percent of ownership rights were held by the state and state-owned firms, and that the ratio of cash flow rights to voting rights of the SOE was 90 percent compared to 70 percent for private firms. Therefore, the gap between cashflow rights and voting rights for the SOEs and private firms were 10 percent and 30 percent respectively. These figures are much lower than those from the top 30 Korean business groups (termed chaebols) which were reported to be approximately 75 percent for the upper ten groups and 48 percent for the lower ten groups in 2005 (Kim, 2005).

Claessens et al. (2000) find that over two-thirds of firms in East Asia are family firms. This prevalence of family-controlled business groups has created complicated agency conflicts in East Asia. These agency conflicts are witnessed in the family-controlled business groups across the region although they are named differently: *chaebol* in Korea, *Jituan Gongsi* (holding companies) in China, and *Jituan Qiye* in Taiwan. The characteristics of *Jituan Gongsi*

and *Jituan Qiye* are like the pyramidal structure of *zaibatu* in Japan, while chaebols are similar to the cross-ownership structure of *keiretsu* in Japan (McGuire and Dow, 2009). Reasons for the appearance of these business groups may be the institutional void which causes high transaction costs given market imperfections (Khanna & Palepu, 2000) or the transformation of traditional SOE's into modern joint-stock organisations in a short period due to industrialization policy (Lee, 2006).

Concentrated ownership combined with family business groups in East Asia including China, Korea, and Taiwan may oblivate traditional agency conflicts between owners and managers, which are referred to as the Type I agency problem. However, concentrated ownership has exacerbated the conflicts between controlling shareholders and minority shareholders, with the controlling shareholder's selfish behaviours occurring at the expense of minority shareholders which is signified by tunnelling (Johnson et al. 2000). This is the principal-principal agency problem or Type II agency problem (Bebchuk et al., 2000; Morck and Yeung, 2003; Young et al., 2008), which is typically more pronounced in family-controlled firms (Claessens et al., 2000; Morck, Nakamura and Shivdasani, 2000). In Japan the controlling shareholders are not so prevalent as in other East Asian economies. However, the existing managerial entrenchment or Type I agency problem has become more important. The main bank system seemed to be beneficial to mitigate the managerial entrenchment (Aoki, 1990; Aoki and Patrick, 1995) at least until the onset of the asset bubble in the 1990s. However, the sluggish Japanese economy over the last three decades triggered revaluation of the Japanese main bank and the corporate governance system. While the ownership and the role of (main) bank in Japan has been declined, Japanese firms have become more vulnerable to managerial entrenchments.

Monitoring of the company from the board of directors is therefore critical to alleviate these principal-principal agency conflicts in China, Korea and Taiwan and the managerial entrenchment in Japan. However, prior to the governance reforms of the region the board's monitoring function had failed with the board merely becoming a rubber stamp rather than exercising truly independent review. The failure of board monitoring of the firm was closely related with undesirable board composition, which comprised of internally promoted directors. This lack of a board that was independent of controlling shareholders and top managers was a key contributor to the board's monitoring failures (Bae, Cheon and Kang, 2008; Chen, Jian and Xu, 2009; Kim and Lee, 2015; Miyajima, 2022). The reciprocal-, circular-type and/or pyramidal- structure of ownerships among affiliates enabled controlling shareholders to wield managerial powers (voting rights) that extended beyond what their legal ownership (cash flow

rights) should have allowed. Claessens et al. (2000) report that the largest ultimate controlling shareholder in East Asian firms on average owns approximately 16 percent of the shares but has voting control almost 20 percent. In Japan, the declining ownership and managerial involvements of main banks while an alternative optimal governance model has yet to be developed also increased the agency conflicts between managers and shareholders. Given the prevalent principal-principal agency conflicts and the managerial entrenchments, the board's monitoring function in East Asian economies was more important than in Anglo-Saxon economies but the absence of board independence from controlling shareholders and top management led to a monitoring failure.

Reforms of Corporate Governance and Board Restructuring

Reforms in Korea

As a crisis-ailing country, Korea undertook governance reforms most swiftly among the East Asian economies as part of its wide-ranging economic reforms following the 1997 financial crisis. The government initiated various reforms of governance structure both at the firm and business group level.

At the firm level, amendments to various Acts¹ made it mandatory for public firms, with the exclusion of the Korean Securities Dealers Automated Quotations (KOSDAQ) to appoint at least 25 percent of the board as outside and independent directors (Min, 2016). This obligation was further strengthened by requiring large, listed firms (defined as a firm with assets no less than 2 trillion won, or approximately \$2 billion) to appoint at least three and 50 percent of the board member as outside directors. These large firms were also required to establish audit committees, with two thirds or more of the members needing to be outside director appointments. The 1998 amended Korean Company Law also required controlling shareholders to be a registered board member to ensure legal responsibility for their decisions. This Korean Company Law was amended substantially in 2011 to ensure transparent corporate management and disclosure of accounting information in accordance with the global standard. Outside directors have the same power as other board members including voting rights at the board meeting, and monitoring the CEO and other upper epsilons, among others. The Korean Company Law 2011 also specifies qualification requirements of the outside directors to ensure

¹ These amendments were the 1998 amendment to the Listing Act (Stock Market Listing Regulations) and the 2001 and 2003 amendments to the Securities and Exchange Act, which was ultimately integrated into the Financial Investment Services and Capital Market Act in August 2007.

their independence and stipulates that during the shareholder's General Meeting, outside directors recommended by the Nomination Committee should be appointed. Furthermore, at least 50 percent of the Nomination Committee itself should be outside directors. Both the Audit Committee and Nomination Committee are mandatory committees for large firms (and all financial firms) in Korea while China and Taiwan only require an Audit Committee. Japan provides public firms with an option of three committees (Audit-, Nomination- and Remuneration-Committee). To prevent controlling shareholder's tunnelling, the amended Korean Company Law 2011 also stipulates that board approval is required for all transactions between the firm and controlling shareholders, and transactions between the firm and the controlling shareholder's spouse, direct family, spouse's direct family, and companies controlled by the controlling shareholders and their families. Amid the nation-wide reforms following the 1997 financial crisis, the Korean government also effectively removed all restrictions against foreign ownership of companies and allowed hostile M&As as tools to enhance external monitoring through corporate raiders and increased scrutiny.

The reforms at the business group level include implementing restrictions on cross-ownership among affiliates to eliminate the discrepancy between the cashflow rights and voting rights of controlling shareholders. Korea has permitted a holding company system since 1999 to simplify the complicated ownership of chaebols. A holding company is defined as a company established mainly to hold shares issued by other companies. The business group level reforms also included prohibitions of mutual debt guarantees among affiliates and strengthened the notification system by requiring combined financial statement disclosures at the group level. This was because the mutual debt guarantees falsely inflated mortgage values allowing higher borrowing, which in turn led to the dogma of 'too big to fall' and controlling shareholder's tunnelling. The amended Fair Trade Act (in effect from 2021) prohibits financial and insurance companies from casting their votes in respect of their shares in their Korean affiliates if they belong to a business group subject to restricted mutual investment.

The amended Korean Company Law of 1998 strengthened minority shareholder's rights by reducing the minimum requirements of shareholdings necessary to raise a derivative suit, request director or internal auditor dismissal, requesting injunctions against directors' illegal actions, review accounting books, request cumulative voting and recommend outside directors (Judd and Lee, 2000). This Korean Company Law was further amended in 2020 to strengthen the power of minority shareholders by allowing them to bring multi-step derivative actions, which enables minority shareholders of parent firms to bring derivative lawsuits directly against directors of certain subsidiaries. In December 2016, the Principle on the

Stewardship Responsibilities of Institutional Investors was published by the Korea Stewardship Code Council to encourage institutional investors including the National Pension Service to promote improved corporate governance practices of their invested firms. This was done via Code compliance, which was on a comply or explain basis.

Reforms in Japan

The Japanese government initiated a series of institutional resets to improve their governance system over the last three decades. Though the Japanese governance system has deep ties to the bank-oriented insider model, the reforms were intended to incorporate elements of the Anglo-Saxon model (Aoki, 1990; Nakamura, 2006, 2011). In doing so, the Japanese government has initiated its reforms on a more conservative scale than the other three East Asian economies discussed in this paper.

The Japanese reforms on board recomposition have been implemented at national level in the early 2000s and under Shinzo Abe's leadership in the middle of 2010s. The 2002 amendment to Japanese Company Law provided companies with the option to appoint outside directors to the company board. The Law endorsed companies adopting a US style executive committee system to decide appointments of outside directors, compensation, and conduct audits, with the majority of committee members required to be outside directors. The Tokyo Stock Exchange introduced the Principles of Corporate Governance for Listed Companies in 2004 to improve governance practices. These Principles were further revised in 2009, with further minor changes made in 2015, 2018 and 2021 demonstrating the Tokyo Stock Exchange's dedication to improving corporate governance practices. The 2009 revision introduced an independent director and auditor system, required a listed company to secure at least one member to be among its outside directors and auditors and to notify the Exchange of the result. However, compliance with these Principles is not strictly mandated as listed companies are only required to respect these principles on a comply or explain approach.

The second phase of the reform was undertaken under Abe-cabinet launched in 2013 to strengthen the competitiveness of Japanese economy and discontinue the lost decades by emphasising independent board's monitoring through the appointment of outside director, dissolving cross shareholdings and performance-based reward system (Miyajima, 2022). The portion of shares held by international investors including hedge funds who leveraged governance problem for increasing their investment returns has also been increased. Consequently, this reform has shifted the gravity of the Japanese corporate governance model towards more the traditional Anglo-American shareholderism. To implement the reforms and

corporate compliance with the reform, Japanese government fortified the role of financial institutions but the reforms led to modest but discontinuous increase in the appointment of outside directors (Miyajima and Saito, 2021; Morikawa, 2021). The Japanese Financial Services Authority introduced the Stewardship Code in 2014 and the Corporate Governance Code in 2015 on a voluntary basis, further indicating how much of the reforms in Japan are conservative due to their lack of legally binding power. The Japanese Company Law of 2015 also requires companies to use consolidated financial statements as their primary means of reporting and include annual data on cross-shareholding among affiliates in these statements. This stipulation is alike to the requirements Korean chaebols face in terms of reporting their combined financial statements. To further aid the transparent disclosure of information and limit abuse to minority shareholders, listed firms are also subject to revised public accountant laws and rules from the Tokyo and other Stock Exchanges. The Tokyo Stock Exchange implemented the Principles of Corporate Governance 2021 (Principle 4.6), which stipulates that controlling shareholder should respect the common interests of the company and its shareholders, and should not treat minority shareholders unfairly.

Reforms in China

China's Company Law was amended in 2006 to protect lawful shareholders' rights and public interests by emphasising the legal obligations and responsibility of those in practical control of the company including directors, senior management, and supervisors (OECD, 2011). China's Company Law aims to protect minority shareholders and prohibits insider trading and/or related-party transactions of controlling shareholders. One example of this is that board members and key executives are required to disclose to the board if they have a material interest in any transaction or matter directly affecting the corporation.

China's Securities Law was also amended in 2006 to improve the supervision of public companies and increase the legal responsibilities and rules regarding the integrity obligations of controlling shareholders or those with de-facto in control (Phan, 2008). According to the Securities Law, a majority/controlling shareholder is a shareholder holding 5 percent or more of total shares. An actual controller is defined as anyone who is not a shareholder but is able to exercise actual control over company's acts by means of investment relations, agreements, or other methods according to the China's Company Law. Listed firms are required to disclose detailed information about both majority/controlling shareholders, and actual controllers.

The China Securities Regulatory Commission introduced the Guidelines on Establishing an Independent Director System in Listed Companies in 2001. These Guidelines

require listed firms to appoint at least two independent directors to the board by June 2002 and by June 2003 at least one-third of the board should be independent directors (Clarke, 2006; Liu and Yang, 2008; Tan et al., 2007). This requirement is legally binding in China, alike to Korea and Taiwan. China also has a dual board system consisting of the board of directors and the supervisory board (under the General Shareholder's Meeting), alike to Taiwan. Both management and special committees are under the control of the board of directors.

Drawing on the OECD Principles of Corporate Governance, the government announced the Code of Corporate Governance of Listed Companies in 2002 that would be implemented jointly by the China Securities Regulatory Commission and the National Economic and Trade Commission (OECD, 2011). This Code provides the basic principles of corporate governance including means to achieve investor protection, alongside a basic code of conduct and professional ethics that directors, supervisors, managers and controlling shareholders need to follow. It also outlines information disclosure and transparency rules.

Reforms in Taiwan

Taiwan has undertaken its reforms somewhat gradually, similar to Japan. Applying the OECD Principles of Corporate Governance and the Cadbury Code of Best Practices, in 2002 Taiwan recommended that listed companies appoint independent directors and supervisors. The introduction of this shift was led by the Taiwan Securities and Futures Institute, Taiwan Stock Exchange, GreTai Securities Market, and Taiwan Corporate Governance Association. However, this recommendation became mandatory when the Securities and Exchange Act in 2006 required all listed firms to comply with regulations mandating a minimum of two independent directors and at least 20 percent of independent directors as a proportion of total directors (Solomon et al., 2003; Min, Chen and Tien, 2022).

Independent directors are elected by shareholders. The outside independent potential directors are recommended either by shareholders who own more than 1 percent of shares or by the board of directors. The Financial Supervisory Committee in 2006 requires all publicly listed financial firms and nonfinancial listed firms with an equity value (paid-in capital) of more than NT\$50 billion (US\$1.77 billion) to have at least two independent directors and at least a ratio of 20 percent independent directors to total directors. This requirement was expanded in 2011 to include all listed non-financial companies with paid-in capital valued at more than NT\$10 billion (US\$0.33 billion). Since 2014, all listed companies have been required to comply with these board regulations after the term of office of its existing directors

expires.² The Taiwanese government stipulated financial penalties for companies who fail to oblige with these requirements, although these fines are not considered to be a large sum as they range compared to their general business turnovers between NT\$240,000 (US\$8,000) and NT\$2.4 million (US\$80,000).

Evaluation of Reforms

Evaluation of the Korean Reforms

Korean listed firms began to appoint outside directors in 1999, with the proportion of listed firms with at least one outside director increasing from 34 percent in 1999 to 62.3 percent in 2000 to 94 percent in 2007 (Min and Bowman, 2015; Min, 2018). The most common number of outside directors per firm is two. The term of an outside director in Korea is usually 2-3 years, and an appointment can be renewed for a single additional term. Researchers report mixed results on the level of improvement in firm performance from instilling outside directors. Some researchers reported a positive impact from the outside director system on firm valuation/performance (Black and Kim, 2012; Choi, Park and Yoo, 2007; Min and Verhoeven 2013). They observe the improvement was driven by increased outside director's engagements and participations in the board meeting. However, some researchers do not support the effectiveness of this outside director system (Baek, Kang and Lee, 2006; Bae, Cheon and Kang, 2008). Although the Korean Company Law of 2011 aims to define outside directors to mitigate the influence of major shareholders of the company, outside directors still face pressure from the effective owner (CEO or called 'chongsoo') the company and the CEO still favours appointing ostensibly outside directors who they still have links to. These can be seen in the findings of Kim and Lee (2015) who conclude that outside directors who reject the CEO's proposals tended to be not re-elected while outsiders who graduated from the same high school or originated from the same hometown as the CEO tended to be re-elected (Kim and Lee, 2015).

As a consequence of the Korean Company Law amendments, controlling shareholders of business groups (chaebols) are now registered board members. This is expected to constrain controlling shareholders' misbehaviours by imposing legal responsibility for abuse of their powers in business decision makings. Furthermore, the development of political democracy has meant that social activists and the media in Korea have become increasingly vocal and

² In Taiwan, the term of outsider directors are usually three years with the possibility of re-election.

taken actions to monitor chaebols' illegal businesses. The foreign investors have increasingly sued the chaebols under the notion of recovering their losses caused by the principal-principal agency problem and they have also contributed to improving the governance practices of chaebols and rectifying controlling shareholder misbehaviour. Permitting a holding company for chaebols has also largely simplified ownership structures from a crossholding to vertical pyramidal structure which supports increased transparency. This vertical structural has been increasingly accepted by chaebols since 1999, and in 2015, 48 percent out of 50 chaebols had adopted this holding company system (Kim, 2016).

Chang and Hong (2002) posit that chaebols played a positive role in circumventing market inefficiencies during Korea's initial economic development stage. Examining the affiliates of the top 30 chaebols, Jin and Park (2015) also reported that the separation between controlling shareholder's cash flow and voting rights positively impacted firm accounting performance but not their market performance. To add further complexity to the opinions of whether outside directors are effective, it is noteworthy that despite these reforms international investors still consider the governance of chaebols' as a risk and this, combined with their low dividend rate and low corporate growth rate, has been one of the main causes of the Korea discount (Ducret and Isakov, 2020).

Evaluation of the Chinese Reforms

The corporate governance framework in China has developed and adapted alongside the country's economic transformation. In contrast with other East Asian economies, the Chinese economy is predominantly under the control of the Chinese Communist Party with restrictions in the capital market. In 1999 the Party stipulated that the state must maintain absolute control over strategically important industries or enterprises, such as public utilities and metallurgy. Unlike other East Asian economies, China only allows shareholder voting by proxy and does not permit mail, e-mail/electronics, and telephone/videoconferencing in regular shareholder meetings.

Evaluation of the reforms in China has been divisive. Using meta-analysis, Mutla et al. (2018) reported that the Chinese governance principles advocating for board independence and managerial incentives were associated with improved firm performance. Clarke (2006), however, points out that boards have a high proportion of scholars, which may suggest that Chinese firms recruit their independent directors primarily to satisfy the China Securities Regulatory Committee and for their academic reputations, rather than for business know-how or genuine accountability. It has been found that controlling shareholders of Chinese listed

firms engage in many related-party transactions to expropriate minority shareholders (Chen, Jean, and Xu, 2009). North (2005) claimed that formal institutions could only play a secondary role in China as personal relationship (Guanxi) dominates the economy. The lack of clear identification of the owners of SOEs also undermines corporate governance because the state is both the ultimate owner and the regulator and it also leaves open the issue of who should monitor the managers (Broadman, 1999). Reviewing the existing laws and regulations related to corporate governance in China, OECD (2011, p.4) also noted “As market discipline is still evolving...the rules and laws on paper must be *effectively implemented* in order to make a difference...For China, priority areas for attention may include: curbing abusive related party transactions, enhancing the quality of boards, improving shareholder protection and curbing market abuse. It may also be useful to devote special attention to the all-important issue of how to improve implementation and enforcement of these laws.” (emphasis added by author)

Evaluation of the Taiwanese Reforms

Taiwan’s Listing Rules in 2002 encouraged listed firms to appoint independent directors. The portion of independent directors in boards has increased and is now 9.3 percent on average for newly listed firms (Liu and Yang, 2008). Consequently, in 2005 the portion of outsider directors for all listed firms was 72.9 percent and 76.3 percent for newly listed firms. Compared to other economies in the region, the Taiwanese economy has been dominated by smaller-sized family firms and business groups (Claessens et al., 2000). In contrast with Korea where large business groups and firms are dominant, in Taiwan more than 80 per cent of firms are small and medium-sized enterprises whose shares are concentrated in the hands of a few shareholders.

Filatotchev, Lien and Piesse (2005) found that board independence from the company’s founding family has a positive impact on performance. Min, Chen and Tien (2022) reported that influence from family logic and the controlling family has a negative impact on the level of proactiveness a firm has in following board regulations. On the other hand, shareholder-oriented logic conveyed by foreign investors has a positive impact on the degree of proactiveness a firm has in engaging with board regulations. Furthermore, results illustrate that the level of proactiveness a firm has improved a firm’s performance through the board’s strengthened monitoring. Like Korea and China, however, Liu and Yang (2008) claim that the effectiveness of outsiders has been constrained by the close association of newly appointed independent directors and supervisors with controlling shareholders.

Evaluation of the Japanese Reforms

Relative to other economies, Japanese firms have displayed higher reluctance to adopt the outsider corporate governance model. The amended Japanese Company Act 2002 and the Principles of Corporate Governance for Listed Companies in 2009 have not been effective in driving outside director appointments. The portion of outside directors among 2,012 listed firms in 2004 was approximately 2 percent (Miyajima and Nitta, 2006) though 36 percent of listed and over-the counter companies have introduced outside directors, as have more than half of companies with capital of more than 30 billion yen (Miyajima, 2007). Although some large multinational companies including Sony supported the board composition reforms,³ many Japanese firms instead support the deeply rooted bank-oriented insider model. Regardless of the Japanese firms' choice in organisation structure, suspicion has been cast on the effectiveness of independent monitoring due to the difficulty of appointing independent auditors and directors (Miyajima, 2007; Morikawa, 2021). Japanese firms consider that the roles of outside director clash with the traditional statutory auditor (*kansayaku*) role. This view combined with the possibility of optional choice to appoint outside director explains why the portion of outside directors among listed firms was such insignificant.

While the proportion of outside directors is not substantial in Japan, some research suggests that outside directors are associated with increased economic efficiency while adopting the US style of outsider-dominant executive committees (Miyajima and Nitta, 2006). This positive impact, however, is not always found as Miyajima (2007) later reported no significant relationship between outside board members and performance. This indecisive result was confirmed by Morikawa (2021). Financial institutions such as the National Pension Fund and commercial banks are crucial to ensuring the appointment of outside directors as these financial institutions have substantial ownership roles in Japanese firms and therefore should support Japanese firms' compliance with the Stewardship Code. The increasing role of international hedge funds has also influenced governance behaviors of Japanese firms (Miyajima, 2022). However, the dual role of Japanese banks' operating as investors and creditors for their client firms poses an ongoing risk of impairing the implementation of the Stewardship (Morck and Nakamura, 1999; Morck, Nakamura and Shivdasani, 2000). New rules to protect minority shareholders will have limited impacts on Japanese corporate governance practices as legal suits from minority shareholders are viewed as public

³ Sony supported these reforms by actively undertaking them and appointing 3-5 outside directors out of 10-20 total board members. Sony also established three committees, these being the Nomination, Audit and Remuneration Committees.

embarrassments rather than signals of company issues warranting concern and investigation (Nakamura, 2011). In summary, there is both change and continuity in Japanese corporate governance (Yoshikawa and McGuire, 2008; Nakamura, 2011).

Conclusion

Corporate governance reform has been an important issue for both policy makers and managers in East Asia where the principal-principal agency problems and the managerial entrenchment have been prevalent. To rectify these problems of the controlling shareholders' exploitation of minority shareholders and ensure the independence of the boards' monitoring function, Korea, Taiwan and China mandate the appointment of independent directors to the boards of public firms. In contrast, this appointment for mitigating the managerial entrenchment is an optional requirement for Japanese firms. Amended laws and regulations in the East Asian region also stipulate complementary measures to constrain controlling shareholders misbehaviours and alleviating managerial entrenchment.

Consequently, the traditional relationship-based insider governance model in the region has seemingly shifted towards the Anglo-American outsider model. Researchers report mixed results regarding the effectiveness of these reforms. Despite these mixed results, as the principal-principal problem and managerial entrenchment is so prevalent in the region, corporate governance reforms are still worthwhile even if the magnitude of the improvement on firm performance is unclear. Reaching an optimal governance system and its practice will require a dynamic evolutionary process and continuous adaptation to the changing business environment.

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