UCLA
UCLA Pacific Basin Law Journal

Title
The Olympus Scandal and Corporate Governance Reform: Can Japan Find a Middle Ground between the Board Monitoring Model and Management Model

Permalink
https://escholarship.org/uc/item/9v5803kw

Journal
UCLA Pacific Basin Law Journal, 30(1)

Author
Aronson, Bruce E.

Publication Date
2012

DOI
10.5070/P8301022242

Copyright Information
Copyright 2012 by the author(s). All rights reserved unless otherwise indicated. Contact the author(s) for any necessary permissions. Learn more at https://escholarship.org/terms

Peer reviewed

eScholarship.org Powered by the California Digital Library
University of California

THE OLYMPUS SCANDAL AND CORPORATE GOVERNANCE REFORM: CAN JAPAN FIND A MIDDLE GROUND BETWEEN THE BOARD MONITORING MODEL AND MANAGEMENT MODEL?

By Bruce E. Aronson*

TABLE OF CONTENTS

I. Introduction 95

II. The Olympus Scandal and Corporate Governance Issues 106
   - A. Background of the Olympus Case 106
   - B. Monitoring of Management under Japan's Corporate Governance System 115

III. Back to Basics: Revisiting Theoretical and Structural Issues 120
   - A. Purpose of Corporate Governance Reform 120
   - B. Monitoring Function of the Board of Directors 125

IV. Practical Issues: Achieving "Truly Effective" Corporate Governance Reform 129
   - A. Information 130
      1. Internal Sharing of Information 130
      2. Public Information Disclosure 132

---

* Senior Fulbright Research Scholar, Waseda University; Professor of Law, Creighton University School of Law.

I thank Mr. Sumitaka Fujita, Professor Yumiko Miwa, and Mr. Naoaki Okabe for acting as a panel of commentators following my presentation on this research at the Meiji Institute for Global Affairs Inaugural Symposium, Tokyo, Japan (Feb. 21, 2012), and participants in presentations at Nagoya University (April 20, 2012), AIMA Japan Hedge Fund Forum 2012, Tokyo Stock Exchange (June 4, 2012), 2012 International Conference on Law & Society, Law & Society Association, Honolulu (June 5, 2012), and Business Research Institute, Tokyo (Aug. 3, 2012) for comments.

I also thank members of two study groups on corporate governance in which I am currently participating: the Corporate Governance Research Forum, Business Research Institute and the Corporate Governance Research Group, Meiji Institute for Global Affairs, for fruitful discussion on many topics contained herein.

I conducted a substantial number of interviews, and would like to thank the interviewees for their cooperation in this research.

B. Enforcement 133
1. Public Enforcement 133
2. Private Enforcement 134
C. Gatekeeper Functioning 136
V. Towards a Mixed Model? Considering The Effective Monitoring of Management under the Japanese Corporate Governance System 140
VI. Conclusion 147

ABSTRACT

Since the 1990s global institutional investors have strongly advocated the widespread use of independent directors in accordance with the U.S.-derived board monitoring model. Japan may be the country that has displayed the greatest resistance to this prescription for reform.

The fallout from the scandal over financial reporting at Olympus Corporation provides a new opportunity to reconsider both theoretical and practical issues related to Japanese corporate governance reform. This Article proposes that the deadlocked debate in Japan over director independence be expanded in three ways to produce more effective reform.

The first aim is a "back to basics" re-examination of the fundamental goal of corporate governance and functioning of the board of directors in Japan. The goals of corporate governance should include addressing conflicts of interests and risk management rather than focusing primarily on improving business performance. These additional goals demonstrate the need for more effective monitoring of management.

Second, the debate in Japan should also focus on improving the operating environment for independent monitors to make any potential monitor of management more effective. In the American system, such an operating environment includes good information disclosure, strong enforcement, particularly through private litigation, and an active role for gatekeepers such as external audit firms. Achieving more effective monitoring in Japan will depend on the ability to create such a similarly robust operating environment for monitors within the framework of Japan's corporate governance system.

The third aim is to pay closer attention to current proposals and to the ongoing experimentation at a number of leading Japanese companies. Their goal is to develop a mixed governance system that seeks a "middle ground" between Japan's traditional management board model and the monitoring model. Proposals should also consider means to spread such best practices more broadly among Japanese companies.

Although current proposals and experimentation in Japan have the potential to achieve significant corporate governance reform, it is too early to judge whether the post-Olympus ferment will, in fact, lead to the incorporation of an effective management monitoring function into the traditional Japanese corporate structure.

I. INTRODUCTION

Japan has been in a corporate governance dilemma for the past 15 years. The country has been open to the idea of corporate governance reform following the collapse of its economic bubble in the early 1990s and has looked to the U.S. for inspiration. However, Japan has been caught between its traditional model of a board of directors that actively manages the corporation (the "management model") and the American model of a board that focuses on the monitoring and supervision of management (the "monitoring model").

The specific issue that has become the greatest bone of contention is whether to require listed Japanese companies to have outside/independent directors.[1] International institutional investors strongly advocate for the introduction of independent directors to monitor management and to protect shareholder interests.[2] To date, business organizations in Japan have successfully opposed any legal requirement for outside directors.[3] As a

1. In this Article, an "outside director" refers simply to directors who are not executives or employees of the corporation. "Independent directors" refer to outside directors who additionally have no material relationship with the corporation as measured by the relevant independence standard. Such standards typically exclude individuals in certain categories. The standard of the Tokyo Stock Exchange ("TSE") enumerates five categories of individuals who would generally not be independent, such as business managers, individuals from major clients, outside professionals whose organizations are major clients, major shareholders, and close relatives. *See* TOKYO STOCK EXCHANGE, INC., ENFORCEMENT RULES FOR SECURITIES LISTING REGULATIONS, Rule No. 211 of 2012, art. 4, ¶ 5.

For a discussion of the function of independent directors from a comparative perspective, *see, e.g.*, Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73 (2007).

2. *See generally White Paper On Corporate Governance In Japan*, ASIAN CORPORATE GOVERNANCE ASSOCIATION (2008) [hereinafter *ACGA White Paper*], *available at* http://www.acga-asia.org/public/files/Japan%20WP_%20May2008.pdf.

3. At present there is a TSE listing requirement that one director or company auditor in a listed company must meet the TSE's definition of independence, but there is no requirement that listed companies must have any outside directors. For the listing rule requiring one independent director or company auditor, *see infra* note 93. For the business viewpoint on current corporate governance issues, including any requirement for outside directors, *see* NIPPON KEIDANREN, TOWARDS BETTER CORPORATE GOVERNANCE (April 14, 2009) [hereinafter "KEIDANREN CORPORATE GOVERNANCE"] (Interim Discussion Paper on Key Issues), *available at* http://www.keidanren.or.jp/english/policy/2009/038.pdf.

result, Japan remains a clear outlier among industrialized nations in that it lacks any requirement for even one outside director for listed companies.[4]

Japanese corporations have overwhelmingly preferred to continue their traditional system of board management.[5] The monitoring function in this system is largely performed by internal corporate auditors (*kansayaku* or "company auditor")[6] who emphasize compliance with law by all employees rather than by independent directors who monitor the performance of the CEO and top corporate management.[7] It is not surprising that Japan has chosen to gradually reform corporate governance based on its existing management model rather than to suddenly transform to an American-style monitoring model.[8] However, the Olympus scandal highlights the dire consequences that can result from the lack of an effective system to monitor top management.

Accordingly, Japan faces two pressing challenges relating to the monitoring of management: finding an effective means of monitoring management within Japan's corporate governance system to limit risk, and continuing to attract foreign investment from international institutional investors who are accustomed to investing in companies that have independent directors to safeguard their interests. Responding to these challenges is complicated by big business' fear, shared by other actors, that merely adding a formal requirement to appoint one or more outside directors may result only in additional cost and inconvenience and not make a substantial contribution to actual improvements in

4. *See ACGA White Paper*, *supra* note 2, at 20 (noting that Japan is the only major market in Asia that does not require a minimum number of independent directors and an audit committee).

5. When offered an option under Japanese corporate law to change to an "American-style" board committee system, only 2.2 percent of listed Japanese companies chose that option. *See infra* note 146 and accompanying text.

6. There is no universally accepted English translation of *kansayaku*. Letter from Takeshi Yoshii, Chairperson, Japan Corporate Auditors Association, to Johnathan G. Katz, Secretary, U.S. Securities & Exchange Commission (*last visited* Mar. 9, 2013) (*available at http://www.sec.gov/rules/proposed/s70203/tyoshii1*.htm). This Article uses "company auditor" since that is the term used in a translation of Japan's Companies Act, sponsored by the Ministry of Justice. English translations of rules and reports on the TSE use the term "statutory auditor," and the industry association of *kansayaku* uses "corporate auditor." *Id.* No English term fully or accurately describes their function without further explanation. *Id.*

7. The emphasis in Japanese companies is generally on this compliance function rather than on independent monitoring of management by the board as in the United States. Both compliance and monitoring may be necessary for good corporate governance, but they are different functions. *See* discussion *infra* note 202.

8. *See, e.g.*, Luke R. Nottage et al., *Introduction: Japan's Gradual Transformation in Corporate Governance*, *in* CORPORATE GOVERNANCE IN THE 21ST CENTURY: JAPAN'S GRADUAL TRANSFORMATION 1 (Luke Nottage et al. eds., 2008).

corporate governance practices.[9] Accordingly, efforts must also be made, in the words of the TSE, to "create an environment to facilitate the fulfillment of the role of" independent monitors to enhance the monitoring function.[10]

This Article argues that it should be possible for Japan to find a middle ground between the management model and the monitoring model, which would incorporate a greater element of management monitoring into Japan's traditional corporate structure. The aftermath of the Olympus scandal provides an opportunity to make substantial progress towards that goal. This Article contributes to the comparative corporate governance literature by providing a case study that goes beyond the binary analysis of management board versus monitoring board.[11] I analyze a number of elements, both theoretical and practical, that are needed to address basic corporate governance issues high-

9. *See* KEIDANREN CORPORATE GOVERNANCE, *supra* note 3, at 2, 5 (emphasizing the importance of substance over form and the undertaking of corporate governance reforms that are "truly effective"). Although institutional investors strongly advocate for a requirement for independent directors, they also emphasize that the function and value of independent directors would need to be improved. *See ACGA White Paper*, *supra* note 2, at 18-19 (criticizing the current function of nominally external directors in Japan as lacking independence and an understanding of their fiduciary duties).

10. *See* TOKYO STOCK EXCHANGE, INC., REVISIONS TO LISTING RULES REGARDING CORPORATE GOVERNANCE TO RESTORE CONFIDENCE IN THE SECURITIES MARKET 3, Feb. 28, 2012, *available at* http://www.tse.or.jp/english/news/09/b7gje600 0000wkw4-att/20120302_a.pdf.

11. The typical approach has been to classify corporate governance systems as shareholder systems (e.g., the United States, through monitoring boards) or stakeholder systems (e.g., Japan, through management boards). *See, e.g.*, Marc Goergen et al., *Recent Developments in German Corporate Governance*, 28 INT'L REV. L. & ECON. 175 (2008). Evaluation of corporate governance reform has generally been based on assumptions that these differing systems would either converge due to globalization (which has usually meant that other systems would become more like the United States) or continue their own ways due to path dependence. *Compare* Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) (advocating convergence) *with* Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (advocating path dependence).

Influenced by convergence theory, commentators often looked for significant, systemic change in Japan based on a new emphasis on the maximization of shareholder wealth. Failing to find such transformational change, they often concluded that corporate governance reform in Japan was not significant. For citations and a discussion of the problems involved with using such a transformational standard to measure the significance of corporate governance reform measures in Japan, *see* Bruce E. Aronson, *Changes in the Role of Lawyers and Corporate Governance in Japan—How Do We Measure Whether Legal Reform Leads to Real Change?* 8 WASH U. GLOBAL STUD. L. REV. 223, 234-40 (2009).

This Article goes beyond the above binary assumptions of much of the comparative corporate governance literature on shareholder versus stakeholder systems and convergence versus path dependence. It looks at gradual reform efforts in Japan and provides a case study that explores in both theoretical and practical terms an example of a "hybrid" model that could be the end result of such reform.

lighted by the Olympus case and to achieve enhanced monitoring in Japan's corporate governance system.

Specifically, this Article argues that to help achieve this middle ground and provide effective monitoring of management, the current corporate governance debate in Japan should be expanded beyond the issue of board structure and a requirement for outside/independent directors. First, the debate should broaden to include a reexamination of board functions to enhance monitoring, with a greater emphasis on the goal of managing conflicts of interest and greater separation of the board's dual roles of management and supervision. Next, reformers should consider a range of significant practical measures to improve the operating environment for independent monitors and enable any would-be monitor of management to be more effective. Such measures should focus on greater information to strengthen monitoring processes, greater public and private enforcement to provide an incentive to engage in monitoring, and a more significant monitoring role for other external gatekeepers who provide professional services. Finally, reformers should increase efforts to develop and spread among Japanese listed companies a new "mixed" or "hybrid" model that incorporates a greater element of management supervision into Japan's traditional corporate structure, based on current proposals and experimentation at Japanese companies.

Much of the corporate governance debate in Japan has centered on the merits of adapting various aspects of the American monitoring model. The American monitoring model emphasizes the role of independent directors as a means to manage potential conflicts of interests and to better represent shareholder interests.[12] Despite some questions concerning the effectiveness of monitoring by independent directors in the United States and the suitability of the American model for Japan,[13] reformers in Japan

12. *See* discussion *infra* notes 111-15 and accompanying text.

13. Strong voices have also always challenged both whether this model is desirable and whether it accurately describes the reality of corporate governance practices at U.S. corporations. *See infra* note 113. In addition, the 2008 financial crisis raised new concerns about the effectiveness of independent directors in important areas such as risk management at financial institutions. Such failures led to increasing emphasis in the corporate governance literature on alternative approaches to the monitoring model for improving corporate governance. *See, e.g.*, Nicola Faith Sharpe, *Process over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261 (2012) (arguing that the process by which the board monitors management is more important than board composition or director independence); Renee M. Jones & Michelle Welsh, *Toward a Public Enforcement Model of Directors' Duty of Oversight*, 45 VAND. J. TRANSNAT'L L. 343 (2012) (arguing that private litigation is ineffective to enforce directors' duty of oversight and that public enforcement options, such as Australia's model of public enforcement by its securities regulator, should be considered). The post-2008 financial crisis

have looked consistently to the United States for inspiration on corporate governance reform.[14]

There has also been considerable outside pressure on the Japanese for American-style reform, as for the past two decades influential institutional investors based primarily in the United States and the United Kingdom have advocated the use of independent directors throughout the world, including in Japan.[15] In

---

concerns were also noted in Japan. *See, e.g., Introduction* to TOKYO STOCK EXCHANGE, INC., TSE-LISTED COMPANIES WHITE PAPER ON CORPORATE GOVERNANCE 2011 (March 2011) [hereinafter "TSE WHITE PAPER"], *available at* http://www.tse.or.jp/rules/cg/white-paper/b7gje60000005ob1-att/b7gje6000001m8gl.pdf. (noting that "corporate governance has changed dramatically worldwide" following the 2008 financial crisis and warning that the "Anglo-Saxon model of corporate governance" will disappoint shareholders and investors if it becomes a mere "formality").

14. One reason is the overall influence of American law in Japan. Japanese scholars often cite the importance of law in American society, the large legal academy in the United States, and the resulting breadth and depth of American legal scholarship. Interview with Noboru Kashiwagi, former General Manager of the Legal Department, Mitsubishi Corporation, and Professor of Law, University of Tokyo and Chuo University, Tokyo (Oct. 22, 2012). According to this popular view, new legal issues being discussed in the United States may well become topics in Japan "five years later." *Id.*

For a relatively recent example of the Japanese consciously adopting an American law approach over competing English and German models in a new and significant area of law, *see*, Curtis J. Milhaupt, *In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan*, 105 COLUM. L. REV. 2171, 2196-97 (2005) (discussing Japan's adoption of Delaware takeover jurisprudence over competing English, German, and European Union models). Milhaupt notes the greater familiarity with American law by Japanese scholars and other experts who serve on ministry deliberation councils and also the recognition of a business opportunity for lawyers and financial advisers involved in the policy formulation process. *Id.* at 2206-07. The persuasive power in Japan of American law leads to the citation of American law in many contexts, including in debates over corporate law amendments. For an example where both sides inaccurately cited American law as justification for their positions in a debate over a 2001 amendment to the Commercial Code that provided a new limitation on the liability of corporate directors, *see* Bruce E. Aronson, *Reconsidering the Importance of Law in Japanese Corporate Governance: Evidence from the Daiwa Bank Shareholder Derivative Case*, 36 CORNELL INT'L L. J. 11, 48 nn. 151 & 154 and accompanying text (2003).

15. Organizations such as the Council of Institutional Investors state that in principle their policies on corporate governance, formulated with respect to U.S. companies, should apply internationally. *See* COUNCIL OF INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE POLICIES, *available at* http://www.ecgi.org/codes/documents/cii_corp_gov_pol.pdf, and Questionnaire Response from the Council of Institutional Investors to the Tokyo Stock Exchange (recommending that two-thirds of board directors at listed Japanese companies be independent), *available at* http://www.cii.org/UserFiles/file/resource%20center/correspondence/2010/09-30-10%20Council%20Tokyo%20Exchange%20Feedback.pdf. By contrast, the Asian Corporate Governance Association, which focuses on improving corporate governance in Asia, has more modest numerical goals, specifically formulated for corporate boards in each major country in the region. For a summary *see* ASIAN CORPORATE GOVERNANCE ASS'N, RULES AND RECOMMENDATIONS ON THE NUMBER OF INDEPENDENT DIRECTORS IN ASIA (July 2010), *available at* http://www.acga-asia.org/public/

theory, the benefits of independent directors are not limited to shareholder-oriented systems, as a variety of corporate governance systems would benefit from effective monitoring of management.[16] And in practice institutional investors' goal of emphasizing a new role for independent directors has met with success in Asia: both China and Korea have adopted requirements for a minimal number of independent directors for listed companies.[17]

Japan is often criticized as the major outlier and holdout against this trend in favor of independent directors.[18] International institutional investors express frustration that Japan, a democracy with a mature, capitalist economy, well-established and liquid capital markets, and sophisticated corporate and legal systems, lacks what they view as basic protection for investors.[19] This continuing emphasis by institutional investors on the role of independent directors has led to counterintuitive results in some corporate governance rankings, such that by some measures Japanese corporate governance is rated very poorly, behind countries like China and Korea.[20] Japanese businessmen vehemently

---

files/Rules%20on%20Number%20of%20Independent%20Directors%20in%20Asia %20(ACGA%202010).pdf.

16. The monitoring model is generally associated with shareholder systems and the effort to reduce agency costs (i.e., protect all shareholders from self-interested actions by management). However, monitoring would, in theory, be equally important in other systems, such as a stakeholder system like Japan's, where the purpose would be the protection of minority shareholders from a controlling shareholder or shareholder group (including cross-shareholding by friendly corporate shareholders). *See, e.g.*, Goergen et al., *supra* note 11, especially Table 1 at 177.

17. The minimum for listed companies is one-third of the board in China (independent directors) and one-quarter of the board in Korea (outside directors). For a survey of Asian countries, *see* ASIAN CORPORATE GOVERNANCE ASS'N, *supra* note 15.

18. *See, e.g., ACGA White Paper, supra* note 2.

19. *See, e.g.*, ASIAN CORP. GOVERNANCE ASS'N & CLSA ASIA-PACIFIC MARKETS, 2012 CORPORATE GOVERNANCE WATCH SURVEY [hereinafter "2012 ASIAN CORP. GOVERNANCE SURVEY"] ("In short, even though Japan is one of the world's leading economies, it still lacks world-class [corporate governance] to match."), *quoted in Japan Downgraded in Corporate Governance Survey for Lack of Board Reform*, REUTERS, (Sept. 19, 2012), http://www.reuters.com/article/2012/09/19/us-japan-governance-idUSBRE88I0AY20120919. According to this survey, the "biggest disappointment" in Japanese corporate governance was the failure to include an earlier proposal for requiring at least one outside director in a recent draft amendment to Japan's corporate law. *Id.*

20. For example, in 2011, Governance Metrics International ("GMI") Ratings placed Japan 33rd out of 38 countries in terms of corporate governance, behind Korea, Russia, and Brazil. *See Olympian Depths; What the Olympus Saga says about Corporate Governance in Japan*, ECONOMIST, Oct. 22, 2011, http://www.economist.com/node/21533431. For additional information on GMI Ratings, see GMI's website, http://www3.gmiratings.com/. The Asian Corporate Governance Association's biannual survey of corporate governance in 11 Asian countries last rated Japan as tied for fourth place, ahead of Korea and China but trailing Singapore, Hong Kong,

object to the perception that Japan has poor corporate governance, as they believe that formal requirements for independent directors do not necessarily produce sound or effective corporate governance practices.[21]

However, Japan's ability to resist calls by global institutional investors to increase the role of independent directors may be weakening. Despite the substantial increase in foreign investment in Japan over the past two decades,[22] Japanese businesses have not been dependent on appealing to foreign investors to attract capital.[23] Circumstances began to change as a result of the financial crisis in 2008 and a report issued by the Asian Corporate Governance Association in the same year that strongly criticized Japanese corporate governance.[24] Government deliberation councils and other groups in Japan responded by taking a new look at the question of outside/independent directors and other possible improvements for Japanese corporate governance.[25] However, given continuing big business opposition, the pace was deliberate and progress remained modest.

---

and Thailand. *See* 2012 ASIAN CORP. GOVERNANCE SURVEY, summary *available at* http://www.acga-asia.org/public/files/CG_Watch_2012_ACGA_Market_Rankings.pdf.

21. *See* KEIDANREN CORPORATE GOVERNANCE, *supra* note 3, at 8-9 (emphasizing the independence of internal company auditors and arguing that since the value of outside directors depends on their individual qualifications, the introduction of outside directors should be decided voluntarily by individual companies and their shareholders). For quotes from leading Japanese politicians in support of their corporate governance system following the Olympus scandal, *see infra* note 26.

22. The share of the Japanese equity market held by foreign investors has increased from under 5% in 1990 to 26.3% in 2011. *See* TOKYO STOCK EXCHANGE, INC., 2011 SHAREOWNERSHIP SURVEY, *available at* http://www.tse.or.jp/english/market/data/shareownership/b7gje60000003t0u-att/e_bunpu2011.pdf.

23. Japan, as a large creditor nation with a capital surplus, has been in a position to "go its own way." This point is often raised in the context of national debt. Even though Japan's gross government debt is 220% of its gross domestic product, the highest ratio in the world, the nation has many strengths that compensate for this debt. *See, e.g.*, A. Gary Shilling, *Japan's Debt Sustains a Deflationary Depression*, BLOOMBERG (June 4, 2012), http://www.bloomberg.com/news/2012-06-04/japan-s-debt-sustains-a-deflationary-depression.html. One important reason why this large government debt load is sustainable is because, unlike the United States, Japanese government bonds are overwhelmingly owned by domestic investors and Japan is not subject to any substantial foreign pressure. For a comparative analysis, *see* Jochen R. Andritzky *Government Bonds and their Investors: What are the Facts and Do They Matter?* (Int'l Monetary Fund, Working Paper No. 12/158, 2012), *available at* http://www.imf.org/external/pubs/ft/wp/2012/wp12158.pdf.

24. *See ACGA White Paper*, *supra* note 2. For a discussion of how these changed circumstances result in less capital availability for investment worldwide and a need for Japan to demonstrate its commitment to good corporate governance, *see, e.g.*, Keisuke Nitta, *Will the Introduction of Independent Directors Make the Japanese Stock Market Attractive to Foreign Investors?*, RES. INST. OF ECONOMY, TRADE & INDUSTRY, column 14 (April 7, 2009), http://www.rieti.go.jp/en/projects/cgp/columns/14.html.

25. *See infra* notes 104-08 and accompanying text.

Against this background, the scandal over financial reporting at Olympus Corporation that unfolded in the fall of 2011 added new urgency to concerns over corporate governance issues generally, and particularly over the necessity of monitoring management. It has created both an opportunity to take action and public pressure to accelerate the pace of ongoing reform efforts. This case has prompted global institutional investors to vigorously renew their criticism concerning a lack of transparency and accountability in Japanese corporate governance.[26]

The Olympus case is particularly significant for a number of reasons. First, it follows on the heels of two tough years for Japanese corporate governance. In 2010, Toyota's slow response to car recall issues raised governance concerns about Japan's most highly-respected company.[27] The Great Eastern Earthquake of March 11, 2011 cast a harsh light on Tokyo Electric Power Company's (TEPCO's) preparedness and decision making, as the earthquake bankrupted what was formerly Japan's financially strongest company.[28] Furthermore, in late 2011, around the

---

26. The Asian Corporate Governance Association cited the Olympus scandal as one of the three factors that resulted in a lowering of Japan's corporate governance rating in its 2012 biannual survey. *See* 2012 ASIAN CORP. GOVERNANCE SURVEY, *supra* note 19. *See also* Takeyuki Ishida, Exec. Dir., Institutional Shareholder Services, K.K., Gaikokujin Tôshika kara Mita Nihon Kigyô no Kadai [Issues for Japanese Corporations as Seen By Foreign Investors], presentation at Business Research Institute, Tokyo, Japan, Aug. 31, 2012 (stating that the Olympus scandal was a huge issue for foreign investors, a source of additional distrust of investing in the Japanese stock market, and an additional reason for insistence upon a larger role for independent directors at Japanese corporations); William Pesek, *More Money Than Brains Leads to "Olympus Shock,"* BLOOMBERG (Oct. 22, 2011), http://www.bloomberg.com/news/2011-10-20/more-money-than-brains-leads-to-olympus-shock-commentary-by-william-pesek.html.

The renewed criticism following the Olympus case that Japan lagged behind other countries in corporate governance standards prompted Japan's top officials to defend Japanese practices. In an interview with the Financial Times, Prime Minister Yoshihiko Noda stated, "What worries me is that it will be a problem if people take the events at this one Japanese company and generalize from that to say Japan is a country that [does not follow] the rules of capitalism . . . Japanese society is not that kind of society." *See* Michiyo Nakamoto & Mure Dickie, *Japan PM Calls for Clarity on Olympus Scandal*, FIN. TIMES, Oct. 31, 2011, http://www.ft.com/intl/cms/s/0/1b7f24e2-031e-11e1-b7be-00144feabdc0.html#axzz28gIfF8nm.

Economy Minister, Yukio Edano, also reportedly stated at a press conference at the Foreign Correspondents' Club of Japan that although the Olympus case was "unfortunate," Japan's corporate governance was "at least at the same level as the U.S., or even better." *See* Malcolm Foster, *Minister: Japan Corp Governance on Par with U.S.*, YAHOO! FINANCE (Dec. 5, 2012), http://finance.yahoo.com/news/minister-japan-corp-governance-par-090648507.html.

27. *See, e.g.*, Bruce E. Aronson, *Learning from Toyota's Troubles: Board Oversight, Board Structure, and Corporate Scandals in Japan*, 30 J. JAPANESE L. 67 (2010).

28. A comprehensive investigation by the Japanese Diet (parliament) faulted the Tokyo Electric Power Company (TEPCO), regulators and the government for lax governance and collusion. For an executive summary of the report in English,

same time the Olympus scandal unfolded, a former chairman (and founding family member) at Daio Paper Company personally borrowed $140 million from company subsidiaries to pay off gambling debts.[29] And in 2012, Japan suffered its own version of a Bernie Madoff-type scandal, as disastrous investments and a Ponzi scheme at AIJ Investment Advisors, an asset management company, resulted in a nearly total loss of the $2.62 billion under management for its 123 corporate pension fund clients.[30]

Second, the Olympus case is reminiscent of the Enron scandal, not only because it occurred at a respected and innovative company, but also because it calls into question the functioning of fundamental aspects of Japan's corporate governance system.[31] Olympus had no obvious weakness in its business model or corporate governance structure. It had transformed from a declining camera maker to a highly successful global competitor in medical devices[32] that was presumably subject to product market discipline. And, in a country where only half of listed companies have any outside directors, three out of fifteen of Olympus' directors were outsiders.[33] Yet, like Enron, the presence of a relatively high number of outside directors compared to other com-

---

see generally THE NAT'L DIET OF JAPAN, THE OFFICIAL REPORT OF THE FUKUSHIMA NUCLEAR ACCIDENT INDEPENDENT INVESTIGATION COMMISSION, EXECUTIVE SUMMARY (2012), *available at* http://naiic.go.jp/wp-content/uploads/2012/07/NAIIC_report_lo_res2.pdf. One of the report's findings was that "TEPCO must undergo dramatic corporate reform, including governance and risk management and information disclosure—with safety as the sole priority." *Id.* at 23.

29. The former chairman, Motohiko Ikawa, was the third member of the founding family to head the company, after his father and grandfather. Company officials immediately complied with his orders to company subsidiaries to send money to his personal account and to his account with casino operator Las Vegas Sands. The company is now trying to recover the loans. *See, e.g.*, Hiroko Tabuchi, *Another Scandal Unsettles Corporate Japan as Paper Maker Accuses Ex-Chairman*, N.Y. TIMES, Oct. 28, 2011, *available at* http://www.nytimes.com/2011/10/29/business/global/new-scandal-presses-corporate-japan.html.

30. *See, e.g.*, Hiroko Tabuchi, *Money Fund in Japan Told to Halt Operations*, N.Y. TIMES, Feb. 12, 2012, http://www.nytimes.com/2012/02/25/business/global/japan-orders-aij-investment-advisors-to-suspend-operations.html.

31. *See, e.g.* Interview by Atsushi Nakayama with Kirk Hanson, executive director of the Markkula Center for Applied Ethics, Santa Clara University (Mar. 5, 2002), *available at* http://www.scu.edu/ethics/publications/ethicalperspectives/enronlessons.html (discussing the effect of the Enron scandal on American corporate governance).

32. Olympus is the world leader in endoscopes, with a 70 percent share of the global market. *See* Takashi Amano & Mariko Yasu, *Sony to Buy Olympus Stake as Hirai Seeks Revival From Losses,* BLOOMBERG: BUSINESSWEEK (Sept. 28, 2012), http://www.businessweek.com/news/2012-09-28/olympus-s-directors-approve-sony-tie-up-plan-official-says.

33. *See, e.g., Olympian Depths,* ECONOMIST, Nov. 3, 2012, http://www.economist.com/news/leaders/21565626-want-invest-underperforming-companies-no-outside-directors-go-japan-olympian.

panies was ineffective in preventing extensive wrongdoing and severe financial consequences.[34]

As a result, the path to reform remains unclear. Although many useful corporate governance reforms have been pursued,[35] big business in Japan as a whole (as represented by the largest industry group, *Nippon Keidanren*) has never accepted an American-style monitoring role for the board of directors.[36] This has led to a contentious and inconclusive debate during the past 15 years over a legal requirement that listed Japanese companies have outside and/or independent directors.[37]

This Article argues that the ongoing discussion in Japan could be broadened in three ways to go beyond this formalistic deadlock over board structure and to produce more effective corporate governance reform. First, there should be a re-examination of the board's functioning to enhance monitoring. The board's goals should place greater emphasis on monitoring conflicts of interest and risk management rather than focusing primarily on directly managing the business to improve corporate performance. The managing and monitoring functions of the board should be more clearly separated, and reforms need to reconsider and address the practical authority of Japanese company presidents to appoint both their successor as president and directors to the board.

Second, reformers should place a stronger emphasis on a range of important practical measures to provide a better operating environment for independent monitors and enhance their

34. Deliberate fraud by management at Olympus led to some comments by industry representatives that the Olympus case represents an outlier with no general significance for Japanese corporate governance. A typical example is a quote from an official of the Japan Association of Corporate Executives (JACE) stating that "The Japanese economy will lose its international competitiveness if strict regulation is implemented as a result of generalizations based on a few bad apples." Anthony Fensom, *After Olympus, Can Japan Inc Reform?*, THE DIPLOMAT (July 5, 2012), http://thediplomat.com/2012/07/05/after-olympus-can-japan-inc-reform. In an interview with the Financial Times, Japan's Prime Minister similarly stated, "I would not like the rest of the world to lump Olympus together with Japanese companies in general." *See* Nakamoto & Dickie, *supra* note 26.

35. These include overhauls of both the corporate and securities laws in the mid-2000s. *See* Kaisha Hô [Companies Act], Law No. 86 of 2005 [hereinafter "Companies Act"]; Kinyû Shôhin Torihiki Hô [The Financial Instruments Exchange Law], Law No. 65 of 2006 (also referred to as "J-SOX" or "FIEL") [hereinafter "FIEL"].

36. *See, e.g.* KEIDANREN CORPORATE GOVERNANCE, *supra* note 3, at 8 (emphasizing the dual board functions of management and supervision and noting that company auditors and the board of directors represent "two monitoring structures" under the Japanese corporate governance model). For a discussion of the confusion between the functions of the board and company auditors with respect to monitoring management in Japan, *see infra* notes 201-02 and accompanying text.

37. For additional background of this debate, *see* Aronson *supra* note 27, at 75-81.

monitoring function to achieve improvements in corporate governance practices. To the extent that the U.S. corporate governance system can be used as a model,[38] I have argued in the past that the strongest features of the U.S. corporate governance system are not necessarily independent directors per se, but rather the way the American system provides the monitors of management the practical means and incentives to fulfill their function. This generally includes information (both internal information and reporting systems and external public disclosure), enforcement (particularly private enforcement) and complementary monitoring roles for outside professional service providers acting as gatekeepers.[39] Such practical measures could be used to enhance the effectiveness of any monitor of management, and their potential usefulness is not limited to independent directors.

Third, reformers should pay closer attention to reform proposals and ongoing experimentation at leading Japanese companies that attempt to develop a mixed or "hybrid" governance system. A hybrid system combines some of the traditional strengths of Japanese companies with a more robust monitoring component by linking the information access of insiders and the independence of a limited number of outsiders. The development and spread of such a model among Japanese companies could be accomplished through means such as the establishment of a corporate code of best practice combined with a "comply or explain" requirement for listed companies. Such spreading of best practices would represent a significant improvement in Japan's corporate governance system and could be achieved without focusing exclusively on the structural issue of building up the number of independent directors.

This Article considers both theoretical and practical issues related to such effective corporate governance reform in the aftermath of the Olympus case. Section II briefly summarizes the facts in the Olympic case and the monitoring of management in

---

38. One could certainly conceive of potentially useful models from other jurisdictions, such as the "comply or explain" technique that originated in the United Kingdom but has spread to other systems, such as the German stakeholder system, or separation of the roles of CEO and chairman of the board. *See* David Seidl, Paul Sanderson & John Roberts, *Applying 'Comply or Explain:' Conformance with Codes of Corporate Governance in the UK and Germany* 17 (Centre for Bus. Res., U. Cambridge, Working Paper No. 389, 2009), *available at* http://www.cbr.cam.ac.uk/pdf/WP389.pdf.

For the first use in Japan of a form of the "comply or explain" approach, *see infra* note 108 and accompanying text (recommended for use with respect to a proposed requirement that every listed company in Japan have at least one outside director).

39. *See* Bruce E. Aronson, *What Can We Learn from U.S. Corporate Governance? A Critical Analysis*, 2 U. TOKYO J. L. & POL. 41, 41 (2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920865.

Japanese corporate governance. Section III highlights the theoretical and structural issues that may need to be reconsidered to achieve fundamental reform. Section IV discusses what a more effective Japanese corporate governance system might look like, in terms of strengthening the operating environment for any potential monitor of management. Section V considers the current debate and examples of reform efforts in Japan to find a "mixed" or hybrid system that combines the traditional Japanese structure with new elements to achieve a more effective monitoring of management and other reforms. This Article concludes that the Olympus case highlights the need for incorporation of a stronger monitoring component into the traditional Japanese corporate structure, and that recent proposals and business practices demonstrate the potential for a "mixed" system to achieve a middle ground between board management and monitoring models.

II. THE OLYMPUS SCANDAL AND CORPORATE GOVERNANCE ISSUES

A. Background of the Olympus Case

The Olympus case is possibly the worst corporate governance debacle of modern Japan.[40] Top management at Olympus concealed losses amounting to more than $1.5 billion dollars for over 20 years through three company presidents, utilized complex schemes to avoid changes in accounting standards, filed inaccurate securities reports for five years, and failed to provide basic information to its own board of directors. The Olympus scandal highlights a host of serious issues in current Japanese corporate governance practices (see Table 1).

---

40. The Olympus scandal was particularly troubling because it occurred after two prior accounting scandals at Yamaichi Securities, *see infra* note 45 and accompanying text, and Kanebo Corporation and Livedoor Corporation, *see infra* notes 49 and 50 and accompanying text, that had resulted in substantial changes in the relevant law, accounting standards, and (presumably) corporate practices. In addition, as noted *supra* in the Introduction, Olympus was widely thought to be a successful company and an unlikely candidate for a corporate governance scandal.

The most comprehensive source of factual information on the problems and schemes at Olympus are the reports by independent third-party committees appointed by Olympus after the scandal became public. For an English translation of the most important of these reports, which is 243 pages including appendices, *see* Olympus Corporation Third Party Committee, Investigation Report, Dec. 6, 2011 [hereinafter "Investigation Report"], *available at* http://www.olympus-global.com/en/info/2011b/if111206corpe_2.pdf. For a convenient summary of this report, which is 33 pages including appendices, *see* Olympus Corporation Third Party Committee, Investigation Report Summary, Dec. 6, 2011 [hereinafter "Investigation Report Summary"], *available* at http://www.olympus-global.com/en/info/2011b/if111206corpe.pdf. Both of these reports are used extensively in this section. For other committee reports, *see infra* notes 54 and 73.

Table 1. Summary of the Olympus Case and Corporate Governance Issues

Olympus Issue	*Corporate Governance Problem*
Loss of $1.5 billion Loss of over 50% of stock market value	Shareholder losses and lack of confidence in public securities markets
Losses concealed over 20 years through the terms of three company presidents	CEO's practical ability to select successor CEO and company directors
Utilization of complex schemes to evade new accounting standards	Role of financial advisers and their regulation
Filing of false securities reports Change of accountants when questionable transactions were challenged	Role of outside audit firms and their regulation; role of internal company auditors
No information to board of directors; no oversight by board	Board functioning and role of independent directors; internal sharing of information

The Olympus story begins with typical problems faced by Japanese manufacturers in the mid-1980s. These manufacturers, including Olympus, sought to combat a strengthening yen and to maintain their profits by more aggressive financial management of their assets.[41] This "financial engineering"[42] (*zaitech*) generally proved to be unsuccessful, and caused dramatic losses after the collapse of Japan's economic bubble in the early 1990s.

A few companies obtained compensation for their losses from the securities companies that handled their investments.[43] However, many other Japanese businesses simply delayed recognizing losses, often through window dressing of accounts (*tobashi* or "flying away")[44] so that bad assets were shuffled among entities without ever having to disclose losses. Such practices led to

41. *See, e.g.*, INVESTIGATION REPORT SUMMARY, *supra* note 40, at 6.

42. *Id.*

43. Compensation for losses was obtained by some preferred customers in the case of discretionary accounts. When this became a big issue in the early 1990s, the Ministry of Finance failed to crack down in cases where there was no contractual obligation and loss compensation was "voluntary." *See generally* Mitsuru Misawa, *Loss Compensation in the Japanese Securities Market: Causes, Significance, and Search for a Remedy,* 25 VAND J. TRANSNAT'L L. 37 (1992-1993). This government position, which was intended to avoid liability by securities companies, perversely acted to weaken them instead and loss compensation issues continued. *Id.*

44. This practice was known by a number of phrases in English, including "shuffling" of assets. *See Yamaichi Chief Gives Diet Testimony on Tobashi Trades*, JAPAN TIMES, Dec. 9, 1997, http://www.japantimes.co.jp/text/nn19971209a2.html. It often involved the "sale" of loss-carrying securities from one entity to another near the end of an accounting period so that it would not need to appear in the "seller's" financial statements. *Id.* It might be "resold" back to the original "seller" at the beginning of a new accounting period or held by an affiliated entity. In either case

the dramatic failure of Yamaichi Securities, one of the Big Four Japanese securities companies, in 1997.[45] This event helped trigger both a financial crisis and a significant change in accounting standards in 2000 to require the periodic valuation of assets at market value and disclosure of losses.[46]

Instead of disclosing its losses and strengthening its finances, Olympus' response to the new accounting standards was to devise and implement a complex scheme, with the help of outside financial advisers, to remove the bad assets from the balance sheet of Olympus without recognizing the losses. To accomplish this goal Olympus set up new entities under its control and sold the bad assets to these entities at inflated prices (the assets' original cost) to continue concealment of the losses.[47] Olympus also provided the money, either directly or indirectly, to enable the related entities to purchase the bad assets.[48] As a result, Olympus did not account for any loss on these "sales" and the bad assets no longer appeared in Olympus' financial statements.

However, a further change in accounting standards following scandals at Kanebo Corporation in 2005[49] and Livedoor Corporation in 2006[50] forced related entities to consolidate their financial statements beginning in 2007. Olympus responded by

---

unrecognized losses could continue to mount, as happened in the case of Olympus. *See* INVESTIGATION REPORT, *supra* note 40, at 11.

45. Although Yamaichi had sufficient capital to cover its concealed losses of some $1.38 billion, its main lender, Fuji Bank, refused to continue providing unsecured funds for its daily operations. This liquidity crunch resulted in the biggest bankruptcy in Japan to date. Stephanie Strom, *Big Japanese Securities Firm Falls, Putting the System on Trial,* N.Y. TIMES, Nov. 24, 1997, *available at* http://www.nytimes.com/1997/11/24/world/big-japanese-securities-firm-falls-putting-the-system-on-trial.html?pagewanted=all&src=pm. The use of such *tobashi* window dressing in the Olympus case caused a number of media comparisons to the prior failure of Yamaichi Securities. *See, e.g.,* Mariko Yasu & Naoko Fujimura, *Olympus Urged to Extend Executive Purge Over Hidden Losses,* BLOOMBERG: BUSINESSWEEK (Nov. 9, 2011), http://www.businessweek.com/news/2011-11-09/olympus-urged-to-extend-executive-purge-over-hidden-losses.html.

46. The accounting standard changed in 2000 from a historical cost basis standard to a "mark-to market" standard under which any and all losses would be recognized for certain types of assets at the end of each accounting period. *See, e.g.,* INVESTIGATION REPORT, *supra* note 40, at 13-14.

47. INVESTIGATION REPORT SUMMARY, *supra* note 40, at 7-8.

48. Olympus indirectly provided financing to the separate entities by arranging for bank loans that were collateralized by Olympus' holdings of Japanese government securities. It also directly provided investment funds to the related entities. *Id.* at 8-9.

49. For a discussion of the Kanebo case, *see generally* Shingo Numata & Fumiko Takeda, *Stock Market Reactions to Audit Failure in Japan: The Case of Kanebo and Chuoaoyama,* 45 INT'L J. OF ACCT. 175 (2009).

50. *See Livedoor: Melting Down: Arrests in the Livedoor Scandal,* ECONOMIST, Jan. 26, 2006, http://www.economist.com/node/5444987. For a longer treatment by a former director of Livedoor, *see* SHIRO YAMADA, LIVEDOOR AND A NEW WAVE IN JAPANESE CORPORATE GOVERNANCE (JUDGE BUSINESS SCHOOL, UNIVERSITY OF

initiating the second phase of its concealment scheme, which was again devised by outside financial advisers.[51] The company paid grossly inflated prices and advisers' fees in M&A transactions for three Japanese companies, and later for a British company, Gyrus plc., and the inflated portion flowed back to repay Olympus for previously-provided financing and to cover accumulated losses.[52] When Olympus' outside accountants objected to the domestic transactions,[53] Olympus replaced its outside accounting firm, KPMG AZSA LLC with a new one, Ernst & Young Shin-Nihon LLC.[54]

Throughout this period the main business of Olympus was quite profitable, having successfully switched from cameras to a new business utilizing its imaging technology in medical devices.[55] All of the accounting problems stemmed from a small office in Olympus' Finance Department that was responsible for

---

CAMBRIDGE, SEPT. 1, 2006), *available at* http://y-46.com/files/Livedoor_and_a_New_Wave_in_Japanese_Corporate_Governance.pdf.

51. *See* INVESTIGATION REPORT SUMMARY, *supra* note 40, at 11-12. The INVESTIGATION REPORT refers to the first phase of Olympus' scheme as the "loss separation scheme" and the second phase as the "loss disposition scheme."

52. In accounting terms, the inflated premium would be booked as goodwill, which could be written off gradually without any large reduction in assets or capital on Olympus' books. *See id.* at 11.

53. Olympus' outside accounting firm objected to the large amount of goodwill booked in relation to the price paid for the three domestic companies. As a result, a substantial portion of the goodwill was written off immediately as an impaired loss. The Gyrus transaction involved similar issues about the size of goodwill in relation to the purchase price. *See id.* at 13-14.

54. Both accounting firms reportedly complied with the formal requirements for a change of auditor. However, it is questionable whether the succeeding audit firm fully understood and appreciated the concerns of the previous audit firm. The successor accounting firm, Ernst & Young ShinNihon LLC, also commissioned its own independent panel in December 2011, following questions raised by the release of the INVESTIGATION REPORT (*supra* note 40) on December 6, 2011. The Ernst & Young panel found no legal liability but recommended that accounting firms should go beyond their legal obligations in order to detect fraud. *See* Kana Inagaki, *Panel Clears Ernst & Young in Olympus Probe*, WALL ST. J., March 29, 2012, http://online.wsj.com/article/SB10001424052702304177104577311121349992712.html. Olympus' subsequent independent panel on auditor liability discovered numerous problems but did not find liability for either of the outside accounting firms. *See* OLYMPUS CORPORATION NON-DIRECTOR MANAGEMENT LIABILITY COMMITTEE, INVESTIGATION REPORT SUMMARY (Jan. 20, 2012), at 20-26, *available at* http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120117_4.pdf. For the full report, *see* OLYMPUS CORPORATION NON-DIRECTOR MANAGEMENT LIABILITY COMMITTEE, INVESTIGATION REPORT, Jan. 16, 2012, *available at* http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120117_5.pdf.

However, Japan's Financial Services Agency ("FSA") subsequently issued a business improvement order to both accounting firms for failure to recognize the risks at Olympus and poor communication during the change of accountants. *See* Jiji Press, *2 Olympus Auditors Ordered to Improve*, THE DAILY YOMIURI, July 7, 2012, http://www.yomiuri.co.jp/dy/national/T120706004637.htm.

55. *See supra* note 32.

investments,[56] and the three successive presidents who oversaw the concealment of losses all came from that office rather than from the company's main business. No information on the losses was ever disclosed to the board of directors, and management generally discouraged employees from providing information on questionable company practices.[57]

Having apparently completed its scheme and now freed of its long-concealed losses, Olympus felt safe enough to tap an outsider, in fact a foreigner, as president in April, 2011. It chose a 30-year employee from England, Michael Woodford.[58] Prior management remained, and the incumbent Japanese chairman continued as the company's CEO.[59]

However, in August and again in October of 2011 a small, independent magazine called Facta published embarrassing arti-

---

56. *See* INVESTIGATION REPORT, *supra* note 40, at 8-11.

57. Japanese companies and other organizations generally have an internal disclosure system (naibu tsuhô seido) or company hotline for employees to provide information on questionable activities. This is based on Japan's Whistleblower Protection Act (Law No. 122 of 2004), an English version of which is *available at* http://www.cas.go.jp/jp/seisaku/hourei/data/WPA.pdf. The law generally protects workers who report unlawful conduct including unfair or discriminatory treatment. It also encourages reporting such matters to in-house complaint departments by requiring sufficient cause to report to outside parties. For an introduction to this law, *see* Leon Wolff, *New Whistleblower Protection Laws for Japan,* 17 J. JAPANESE L. 209 (2004), *available at* http://sydney.edu.au/law/anjel/documents/ZJapanR/ZJapanR_17_19_Wolff.pdf.

An Olympus employee who utilized this system to report a questionable practice unrelated to the long-term concealment of company losses alleged that he was transferred three times thereafter in retaliation. On August 31, 2011 the Tokyo high court overturned a decision of the Tokyo district court and found in favor of the employee. *See* Editorial, *Protection Law Fails Whistleblowers,* JAPAN TIMES, Sept. 27, 2011, *available at* http://www.japantimes.co.jp/text/ed20110927a2.html.

In a confidential interview, a Tokyo attorney, whose firm did some work related to the Olympus scandal, told me, "If you want to know about the attitude of Olympus' management, read this court decision." Interview with Bruce E. Aronson (confidential), Tokyo (2011).

The INVESTIGATION REPORT also refers to Olympus' internal disclosure system (referring to it as an internal "Compliance Help Line") and criticizes it as having a "closed nature." *See* INVESTIGATION REPORT, *supra* note 40, at 128.

58. *See* Jonathan Soble, *Ex-Olympus Chief Questioned Payments,* FIN. TIMES, Oct. 14, 2011, http://www.ft.com/intl/cms/s/2/87cbfc42-f612-11e0-bcc2-00144feab49a.html#axzz1b4gzXJ8p. This article, based on an interview with Woodford, ascribes Woodford's hiring to Olympus' desire for a foreign president who would focus on undertaking painful restructuring measures with respect to the faltering cameras business without looking carefully at past "domestic" transactions that were questionable. *Id.*

59. Although Woodford was appointed president in April 2011, he was not immediately made CEO. Later, as problems began to arise and Woodford pushed for answers, he was made CEO at a board meeting on Sept. 30, 2011. *See* INVESTIGATION REPORT, *supra* note 40, at 177. However, he was fired two weeks later. *See infra* notes 63-64 and accompanying text.

cles on Olympus' large losses on its recent acquisitions.[60] Insiders at Olympus downplayed the story, but Woodford retained PricewaterhouseCoopers ("PwC") in London to examine adviser fees paid for the Gyrus acquisition in England. PwC's interim report concluded that there were significant defects in Olympus' governance on matters such as its due diligence and decision-making procedures.[61] On October 11, 2011 Woodford sent a 13-page letter demanding the resignation of the entire board, citing "serious governance concerns" and attaching the PwC report.[62] At a special meeting of the board on October 14, 2011, Woodford was fired as President for alleged problems with his "management style" in a meeting that lasted minutes.[63]

Woodford then broke the story to the Financial Times and contacted law enforcement authorities in the U.K. and the U.S.[64] A week later the story finally appeared in the mainstream Japanese press.[65] After initially denying all of Woodward's accusations, Olympus' top management admitted hiding losses and

---

60. *See* INVESTIGATION REPORT, *supra* note 40, at 176-78. Facta was able to act independently due to its reliance on subscribers rather than advertisers. The publisher, Shigeo Abe, regretted his past experience at Japan's leading business daily, where outside pressures had prevented early publication of an important scandal (*see supra* note 45 and accompanying text) involving Yamaichi Securities. *See* David McNeill, *Stop the Presses and Hold the Front Page*, JAPAN TIMES, Jan. 8, 2012, http://www.japantimes.co.jp/print/fl20120108x1.html. Not only was the Olympus story not picked up by the mainstream Japanese press, Facta's publisher was also worried that Olympus would sue his small magazine for defamation and possibly put him out of business. Remarks by Shigeo Abe, Publisher of Facta, at Kinkyû Tôron: Orinpasu Jiken, Nihon wa Nani wo Manabu beki ka? [Emergency Discussion: The Olympus Scandal, What Should Japan Learn?] Shagai Netto Seminâ [Outside Director Network Seminar], Tokyo, Dec. 20, 2011.

For an overview of events from Woodward's perspective *see* Karl Taro Greenfield, *The Story Behind the Olympus Scandal*, BLOOMBERG: BUSINESSWEEK, Feb. 16, 2012, http://www.businessweek.com/articles/2012-02-16/the-story-behind-the-olympus-scandal. Woodward has also written a book based on his experience. *See* MICHAEL WOODFORD, EXPOSURE: INSIDE THE OLYMPUS SCANDAL: HOW I WENT FROM CEO TO WHISTLEBLOWER (2012).

61. For a summary of Woodford's actions and issues raised in the PwC report, *see* Letter from Michael Woodford, President and CEO, Olympus Corporation, to Tsuyoshi Kikukawa, Chairman, Olympus Corporation (Oct. 11, 2011), *available at* http://www.offshorealert.com/GetDocument.aspx?id=4177.

62. *Id.*

63. See Greenfield, *supra* note 61; INVESTIGATION REPORT, *supra* note 40, at 177.

64. *See* Jonathan Soble, *Ex-Olympus Chief Questioned Payments*, FIN. TIMES, Oct. 14, 2011, http://www.ft.com/intl/cms/s/2/87cbfc42-f612-11e0-bcc2-00144feab49a.html#axzz1b4gzXJ8p.

65. Following Woodford's dismissal, the Japanese press initially echoed the viewpoint of Olympus' management about Woodford's supposedly problematic management style. However, within weeks the Japanese press began to cover allegations of wrongdoing at Olympus. *See, e.g.*, Jake Adelstein, *Japan's Olympus Scandal is Slowly Coming Into Focus*, GUARDIAN, Nov. 3, 2011, http://www.guardian.co.uk/commentisfree/2011/nov/03/japan-olympus-scandal.

resigned in November 2011.[66] Woodford initially spoke of trying to regain control of Olympus, but was discouraged by Japanese institutional investors' continuing support for the current management.[67]

Once the true story came to light, Olympus's stock value dropped by nearly 80%.[68] The company restated the last five years of financial statements and submitted them to the TSE on December 14, 2011, just in time to avoid being delisted.[69] Later, the TSE levied its maximum fine, a mere $100,000, on Olym-

---

66. *See, e.g.*, Phred Dvorak & Daisuke Wakabayashi, *Olympus Spurs More Questions than Answers*, WALL ST. J., Nov. 8, 2011; Hiroko Tabuchi, *3 Olympus Executives Resign Ahead of Crucial Meeting*, N.Y. TIMES, Nov. 24, 2011.

67. There was no immediate clean sweep of Olympus' management following the revelations of wrongdoing. After Woodward's resignation in November 2011, the new president of Olympus was Shuichi Takayama, a long-time executive and board member who claimed he knew nothing about the scandal. Even when Olympus initiated litigation against current and former board members and corporate auditors, *see infra* note 78, it allowed those same individuals, including Mr. Takayama, to continue to manage the corporation. *See* Hiroko Tabuchi, *Olympus Sues Executives Over Coverup, but Does Not Dismiss Them,* N.Y. TIMES, Jan. 10, 2012, http://www.nytimes.com/2012/01/11/business/global/olympus-sues-executives-over-cover-up.html. This provoked howls from foreign institutional investors that Olympus was being managed by a "discredited board". *Id.* The entire board was eventually replaced at a special shareholders' meeting in April 2012. *See infra* note 75.

Foreign shareholders shared Woodford's concerns and issued statements of support. *See* Kana Inagaki, *Foreign Shareholders Call for Return of Fired CEO*, WALL ST. J., Nov. 11, 2011. However, Japanese institutional shareholders continued to support Olympus' management, and Olympus' main bank, Sumitomo Mitsui Banking Corp. refused to meet with Woodward. *See Woodford Gives Up Fight to Head Olympus, Will Sue* (CNS NEWS), http://cnsnews.com/woodford-gives-fight-head-olympus-will-sue-1. At a press conference on January 6, 2012 at the Japan National Press Club in Tokyo, Woodford stated that "[d]espite one of the biggest scandals in history, Japanese institutional investors have not spoken one single word of criticism, in complete and utter contrast to overseas shareholders who are demanding accountability from directors." *Id.* A video excerpt of Woodford's press conference is *available at* http://www.youtube.com/watch?v=NXZA08x4HZA. Although Woodford gave up on his initial effort to resume control of Olympus due to a lack of support among Japanese institutional investors, these same investors sold shares in Olympus following the scandal. Ironically, it was foreign investors who lobbied with the TSE to avoid delisting of Olympus, arguing that delisting would be adverse to shareholders. *See, e.g.*, Letter from Asian Corp. Governance Assoc. to Tokyo Stock Exchange, Nov. 17, 2011, *available at* http://www.acga-asia.org/public/files/ACGA%20Letter%20to%20Tokyo%20Stock%20Exchange%20(November%2017%202011).pdf.

68. *See* Tabuchi, *supra* note 67.

69. The third-party investigation committee found no evidence to support a report in the August 2011 Facta article (*see supra* note 60 and accompanying text) of Japanese organized crime involvement in the Olympus scandal. *See* INVESTIGATION REPORT SUMMARY, *supra* note 40, at 17 (finding "no involvement" of such "anti-social forces" in the loss disposition plan). The absence of evidence concerning any such link presumably permitted Olympus to remain listed.

pus.[70] Olympus commissioned a third-party investigation committee to examine the matter.[71] The committee released an extensive report in December, 2011 that discussed the schemes in detail and pronounced Olympus' management "rotten to the core."[72] The company then formed two additional third-party investigation committees to look at liability issues for directors and for auditors. These committees issued reports in January 2012.[73] Criminal investigations and civil lawsuits followed these disclosures (see Table 2).

Table 2. Olympus' Internal Investigations and Litigation[74]

Olympus Internal Investigations and Findings	Resulting External Investigations/Litigation
Third-party committee report, Dec. 6, 2011:	Criminal investigation
Accumulated losses due to management schemes; lack of corporate governance and internal control system	SESC securities investigation
Director liability investigation committee report, Jan. 10, 2012:	Tokyo stock exchange—no delisting
Lawsuit recommended against 19 former executives for $208 million	Shareholder litigation
Non-director management liability investigation committee report, Jan. 17, 2012:	Woodford employment litigation (settled by payment to Woodward)
No liability for outside auditors; lawsuit recommended against five past and present company auditors for $31 million	Olympus litigation against former directors and company auditors

70. *See, e.g.*, Kana Inagaki, *TSE Keeps Olympus Listed, Imposes Fine*, WALL ST. J., Jan. 20, 2012, http://online.wsj.com/article/SB10001424052970204616504577172171651245402.html. (describing the maximum 10 million yen fine imposed on Olympus as "a maximum, if largely symbolic, fine . . .").

71. Olympus announced it would appoint a third-party committee on October 21, 2011 and announced the appointment of the committee on November 1, 2011. *See* OLYMPUS CORP., NOTICE CONCERNING THE ESTABLISHMENT OF A THIRD PARTY COMMITTEE (Nov. 1, 2012), *available* at http://www.olympus-global.com/en/corc/ir/tes/pdf/nr111101.pdf.

72. *See* INVESTIGATION REPORT SUMMARY, *supra* note 40, at 23. The unofficial English translation on Olympus' website actually says, "The core of management was corrupted . . . ." However, many newspaper accounts used the more colorful (and equally accurate) phrase "rotten to the core." *See, e.g.*, Mariko Yasu, & Naoko Fujimura, *Olympus Report Clears Way for Clean Sweep of Board That Failed to Stop Rot*, BLOOMBERG (Dec. 6, 2011), http://www.bloomberg.com/news/2011-12-06/olympus-management-rotten-to-the-core-panel.html. For a discussion of the use and limitations of such third-party panels, *see infra* notes 188-92 and accompanying text.

73. *See* OLYMPUS CORPORATION DIRECTOR LIABILITY INVESTIGATION COMMITTEE, INVESTIGATION REPORT, Jan. 7, 2012, http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120110_2.pdf; OLYMPUS CORPORATION NON-DIRECTOR MANAGEMENT LIABILITY COMMITTEE, INVESTIGATION REPORT, *supra* note 54.

74. Sources include: English versions of the committee reports commissioned by Olympus, *supra* notes 40, 54, and 73; *infra* note 77 (government investigations); *supra* notes 67, 69-70 (Tokyo Stock Exchange) *infra* note 78 (shareholder litigation); Duncan Robinson, *Olympus Settles with Ex-chief Woodward*, FIN. TIMES, May 29,

Olympus' plan to reform its corporate governance was implemented at an Extraordinary General Meeting of Shareholders on April 11, 2012.[75] The number of board members was reduced from 15 to 11, outside directors were made a majority of the board, and the top management was replaced.[76] Meanwhile, various government investigations by prosecutors, police and Japanese regulators are proceeding as of the date of publication of this Article.[77] There are still ongoing private lawsuits filed by Olympus against former directors and company auditors, as well as suits filed by shareholders.[78] Olympus is also planning to rebuild its capital, which was diminished when Olympus finally acknowledged and wrote off its long-concealed losses, through a new capital and business alliance with Sony Corporation.[79]

2012 (discussing Woodford litigation); *infra* note 78 (Olympus litigation against former directors and company auditors).

75. *See* OLYMPUS CORP., NOTICE CONCERNING THE RESULTS OF THE EXTRAORDINARY MEETING OF SHAREHOLDERS (Apr. 20, 2012), *available* at http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120420.pdf.

76. *See id.* This reform plan was also criticized, as proxy adviser Institutional Shareholder Services recommended voting against the candidate for chairman and another candidate for director on the grounds that they had long careers as bank lenders to Olympus, and further recommended voting against the company's candidate for president due to his lack of high-level experience at the company. Olympus strongly objected to ISS' negative recommendations. *See* Michiyo Nakamoto, *Olympus Rejects ISS Criticism of Proposals,* FIN TIMES., April 11, 2012, http://www.ft.com/intl/cms/s/0/e4eab54a-83b5-11e1-82ca-00144feab49a.html#axzz28gIfF8nm.

77. Three former Olympus executives and the corporation have pleaded guilty to criminal charges. *See, e.g., Olympus and Ex-Executives Plead Guilty in Accounting Fraud,* N.Y. TIMES, Sept. 25, 2012, http://www.nytimes.com/2012/09/26/business/global/guilty-pleas-in-trial-over-olympus-scandal.html?_r=0.

78. Olympus filed lawsuits against 19 former and current directors and company auditors as recommended by the OLYMPUS CORPORATION DIRECTOR LIABILITY INVESTIGATION COMMITTEE, INVESTIGATION REPORT, *supra* note 73, and the OLYMPUS CORPORATION NON-DIRECTOR MANAGEMENT LIABILITY COMMITTEE, INVESTIGATION REPORT, *supra* note 54. For a description and the list of defendants, see OLYMPUS CORPORATION, NOTICE CONCERNING MEASURES OLYMPUS CORPORATION WILL IMPLEMENT IN LIGHT OF COMMENCEMENT OF LAWSUITS AGAINST DIRECTORS AND CORPORATE AUDITORS, Jan. 18, 2012, *available at* http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120118.pdf. *See also* Tabuchi, *supra* note 67. With respect to shareholder litigation in Japan against Olympus, *see, e.g.,* Harumi Ozawa, *Olympus Scandal Triggers Japan Shareholder Activism,* YAHOO! NEWS (Jan. 22, 2012), http://au.finance.yahoo.com/news/olympus-scandal-triggers-japan-shareholder-124237789.html.

79. Olympus is looking for a capital infusion of some 50 billion yen (roughly $640 million) before the end of the fiscal year in March 2013 to help make up its $1.5 billion concealed losses, low shareholder equity, and continuing losses in the camera business. *See, e.g.,* Juro Osawa & Kana Inagaki, *Olympus, Sony Tie Up,* WALL ST. J., Sept. 28, 2012, http://online.wsj.com/article/SB10000872396390444712904578023743949186694.html. Following implementation of the agreement with Sony, Sony will become Olympus' largest shareholder with 11.5 percent of voting shares. *Id. See also* Press Release, Olympus Corp. and Sony Corp., Announcement of Agreements Between Olympus and Sony to Form Business and Capital Alliance (Sept. 28, 2012), *available at* http://www.sony.net/SonyInfo/News/Press/201209/12-0928E/index.html.

B. MONITORING OF MANAGEMENT UNDER JAPAN'S CORPORATE GOVERNANCE SYSTEM

When initially examining Japan's tremendous economic success in the 1980s, commentators in both the U.S. and Japan developed a familiar, if now somewhat faded, model of Japanese corporate governance.[80] The model emphasized economic analysis over law, and key features included lifetime employment; large, insider-dominated boards that directly operated the business (i.e., no separation of directors and officers); close cooperation among businesses, including membership in an industrial group (*keiretsu*); and large shareholdings by main banks and other group companies.[81] In terms of monitoring management, this account paid little attention to the formal legal duties under corporate law of directors and company auditors, and instead emphasized the practical monitoring role of main banks,[82] as well as the monitoring roles of affiliated business partners and product markets.[83]

However, the collapse of Japan's economic bubble around 1990 undermined this traditional model. The subsequent financial crisis reduced the role of the main banks and other supporting features of the system.[84] Since 1996, an ongoing debate on corporate governance reform has spurred numerous amendments to Japanese corporate laws.[85] To some Japanese and many

80. *See, e.g.*, MASAHIKO AOKI, INFORMATION, CORPORATE GOVERNANCE, AND INSTITUTIONAL DIVERSITY: COMPETITIVENESS IN JAPAN, THE USA, AND THE TRANSITIONAL ECONOMIES (Stacy Jehlik trans., 2001).

81. *Id.* Although popular, this prevalent view of Japanese corporate governance was also challenged from a number of different perspectives: (1) a viewpoint that this model was primarily an idealized stereotype and was already in decline by the time it became popular in the 1980s, (2) an argument that many of its main features, such as *keiretsu* and main banks are, in fact, myths, and (3) criticism that the model of internal monitoring by banks (*see infra* note 82) does not correspond to the actual interests and performance of banks. For citations and a discussion of these criticisms, *see* Aronson, *supra* note 14, at n.22.

82. If a company's situation deteriorated to the point where a workout was required, the main bank would step in and assert significant financial control over the troubled company. *See* Masahiko Aoki et al., *The Japanese Main Bank System: An Introductory Overview*, in THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES 1 (Masahiko Aoki and Hugh Patrick eds., 1995); Masahiko Aoki, *Monitoring Characteristics of the Main Bank System: An Analytical and Developmental View*, *id.*, at 109.

83. *See* Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization,* 102 YALE L. J. 871 (1993) (arguing that cross-shareholding and cooperation in production by industrial companies in Japan created an effective system of mutual monitoring geared towards product market competition).

84. *See* Aronson, *supra* note 14, at 16-17. The clearest example is that from the mid-1990s, bank shareholdings were, to a large degree, replaced by foreign shareholders. *See* TOKYO STOCK EXCHANGE, INC., *supra* note 22.

85. *See* Aronson, *id.*

foreign commentators, the fundamental question is whether there should be at least a partial shift from an employee-dominated firm to one where a more independent board of directors and/or company auditors more actively monitor management on behalf of shareholders.[86]

In attempting to improve the monitoring function in Japanese corporate governance, amendments to Japan's corporate law have emphasized strengthening the role of company auditors rather than the role of directors. Under Japanese corporate law, directors have fiduciary duties generally similar to those mandated in the U.S.[87] Company auditors, who have no managerial duties, have the role of checking management performance of the directors.[88] Their role, which was loosely derived from the German Supervisory Board,[89] has expanded over time from financial auditing to include compliance and, arguably, monitoring of management.[90] Since 1993, large companies are required to have a board of audit[91] composed of company auditors; since 2001, at least half of their company auditors must be outsiders.[92] Beginning in 2010, at least one of the outside company auditors or outside directors must satisfy the definition of independence under TSE listing standards.[93] In addition, the term of office for

86. *See, e.g.*, Curtis J. Milhaupt, *A Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't, and Why,* in INSTITUTIONAL CHANGE IN JAPAN 97 (Magnus Blomstrom and Sumner La Croix, eds., 2006).

87. Directors have a duty of care (Companies Act, Art. 330; Civil Code, Art. 644) and duty of loyalty (Companies Act, Art. 355) and have the authority to audit the acts of the representative director and other directors (Companies Act, Art. 362, ¶ 2, Item 2). *See* Companies Act, *supra* note 35. For a summary, *see* Bruce E. Aronson, *Learning from Comparative Law in Teaching U.S. Corporate Law: Director's Liability in Japan and the U.S.,* 22 PENN ST. INT'L L. REV. 213, 219-22 (2003).

88. Companies Act, *supra* note 35, art. 381 ¶ 1.

89. Unlike a Supervisory Board in Germany's two-tier board structure, company auditors in Japan have no power to appoint directors. This has led to criticism not only in Japan, but also by corporate law scholars in Germany, as one German commentator has labeled the Japanese company auditor system as a "One and a half tier board." *See* Aronson, *supra* note 27, at n.58.

90. The "audit" or monitoring function of directors and company auditors involves both consideration of whether acts are in violation of the law (*tekihôsei*), and also whether they are in the best interest of the company (*datôsei*). *See* Companies Act, *supra* note 35, art. 362, ¶ 2; Item 2; Companies Act, Art. 381, ¶ 1.

91. Companies Act, *supra* note 35, art. 328, ¶ 1.

92. Companies Act, *supra* note 35, art. 335, ¶ 3. A board of auditors must contain a minimum of three auditors. *Id.*

93. The requirement for each listed company to have at least one independent director or auditor was promulgated on December 30, 2009 as an amendment to the TSE's listing regulations. The rule calls for each listed company to have one outside director or outside auditor (as defined in the Companies Act) "who is unlikely to have conflicts of interest with general investors." *See* TOKYO STOCK EXCHANGE INC., SECURITIES LISTING REGULATIONS 436-2 (as of August 31, 2011), English translation *available at* http://www.tse.or.jp/english/rules/regulations/b7gje600000044tu-att/listing_regulations.pdf.

company auditors has been gradually lengthened to four years in an effort to enhance their independence.[94]

Japanese corporate law also added an optional alternative to this traditional system in 2002.[95] This system allows Japanese companies to replace the traditional, German-inspired representative director and company auditor positions[96] with an American-inspired alternative: a representative executive officer and three board committees (audit, compensation, and nomination committees), with a majority of outside directors required for each committee.[97] However, only 2.2% of listed Japanese companies have given up their traditional company with auditors structure and adopted this new, American-inspired company with committees structure.[98]

It is widely recognized in Japan that the company auditor system is "difficult to explain" to global investors and that issues remain concerning its effectiveness.[99] Nevertheless, most Japanese businesses seem reluctant to abandon the company auditor system for a number of reasons, including its widespread use by the vast majority of Japanese companies and the decades-long effort to strengthen its effectiveness.[100]

---

94. *See* Companies Act, *supra* note 35, art. 336, ¶ 1.

95. A government-sponsored proposal in 2002 to require at least one outside director was defeated, but a new, optional "American-style" board committee system was passed and became available in 2003. *See generally* Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance,* 53 AM. J. COMP. L. 343 (2005).

96. This traditional structure is now called a "company with auditors" under the Companies Act. *See e.g.,* Companies Act, *supra* note 35, art. 327, ¶ 1 (requiring that both companies with auditors and companies with committees establish a board of directors).

97. This new structure is called a "company with committees" under the Companies Act. *Id.*

98. TSE WHITE PAPER, *supra* note 13, at 15.

99. This difficulty is admitted (and lamented) by the organization in Japan formally tasked with representing company auditors, the Nihon Kansayaku Kyôkai [Japan Company Auditors Association]. Not only do they have difficulty explaining the various roles of company auditors and how company auditors interact with other corporate players, but they are still considering, after decades, what is the best English translation of the Japanese term *kansayaku.* Interview with Four Officials of the Japan Company Auditors Assoc., Tokyo (June 12, 2010).

100. Advocates of retaining the familiar company auditor system for most Japanese companies interestingly include some Japanese businessmen whose companies have adopted, and are highly satisfied with, the "American-style" company with committees structure. Interview with Seiya Shimaoka, General Manager of the Legal Department, Toshiba Corporation, Tokyo (March 30, 2012). The reason is that these businessmen generally do not see a sharp division between companies with auditors and companies with committees, and instead see similarities in recent attempts by corporations with different structures to develop a "hybrid" approach. *Id.* *See* discussion *infra* Section V.

Over the last few years there has also been modest progress in increasing the role of independent directors. As noted above, the TSE added a new requirement at the end of 2009 that every listed corporation must have one independent (as opposed to outside) director or company auditor.[101] However, most listed companies have fulfilled this requirement by appointing an independent company auditor rather than an independent director.[102] At present, roughly half of Japanese listed companies still have no outside directors.[103]

There are currently three government advisory councils and a number of private study groups that are wrestling with proposals to improve Japanese corporate governance[104] as well as specific actions being contemplated by Japan's FSA in response to the Olympus case (see Table 3).[105] The most prominent governmental deliberative council is the relatively new Corporate Law Subcommittee of the Legislative Council within the Ministry of Justice, whose task is to propose changes to the Companies Act.[106] With respect to the most controversial issue of requiring at least one outside director for listed companies, the Subcommittee's preliminary report, issued in December, 2011, was unable to reach a conclusion and merely listed three options for amending the Companies Act with respect to outside direc-

101. *Supra* note 93.

102. As of 2010, 75.5 percent of listed companies appointed an independent company auditor to fulfill this requirement and 24.5 percent appointed an independent director. *See* TSE WHITE PAPER, *supra* note 13, at 40, 42.

103. As of 2010, 48.7 percent of all listed companies (and 47.6 percent of companies with auditors) had at least one outside director. *Id.* at 19.

104. In addition to the deliberative council that is examining changes to the Companies Act, (*see infra* notes 107, 108 and accompanying text), the FSA is examining securities law issues and the Audit Committee of its Business Accounting Council is looking specifically at auditor issues. A separate study group at the Ministry of Economy Trade and Industry (METI), headed by a well-known corporate law scholar, is also examining possible corporate governance reform. For topics being covered by METI's current group, koporeto gabanansu shisutemu no arikata ni kan suru kenkyûkai [Study Group on the Form of Corporate Governance System], *see* http://www.meti.go.jp/committee/kenkyukai/sansei/corporate_gov_sys/001_05_00.pdf. As of the date of writing this Article, this group has yet to release a report.

105. Remarks by Shozaburo Jimi, Minister of State for Financial Services, Dec. 16, 2011, *available at* http://www.fsa.go.jp/en/conference/minister/2011/20111216-1.html.

106. This new Subcommittee, formed in 2010, received a broad mandate to examine the proper form of corporate governance. The key issue remained the question of monitoring of management and the independence of outside directors and company auditors. *See* Kigyô Tôchi no arikata ni tsuite no saikin ni okeru omo na shiteki [Main Recent Comments on the Form of Corporate Governance], *available at* http://www.moj.go.jp/content/000046835.pdf. This reference material #1 to the first meeting of the new Subcommittee lists three main issues to be covered: (1) monitoring function of outside directors, (2) monitoring function of outside company auditors, and (3) independence of outside directors and outside company auditors. *Id.*

tors.[107] In its subsequent draft amendments issued in August, 2012, the Subcommittee adopted a form of a "comply or explain provision," which would require a reporting company without any outside directors to explain its reason for the lack of outside directors; in an additional supplementary resolution, the Subcommittee also recommended that the TSE adopt a rule requiring at least one independent director for all listed companies.[108]

Table 3. Post-Olympus Reform Issues under Consideration by the Japanese Government[109]

Proposed amendments to Companies Act	*Issues considered by the FSA*
Duty of explanation for reporting companies without any outside directors	Strengthening of the function of audit firms
Introduction of new, optional form of "company with an audit and supervisory committee"	Regulation of outside financial advisers
New requirements for private placements that involve a change of control	Strengthening of information disclosure and government supervision
Parent-subsidiary relations, including derivative suits by shareholders of parent company based on subsidiary's actions	Information disclosure for M&A transactions

107. See Hômushô, Minjikyoku, Sanji Kanshitsu [Ministry Of Justice, Civil Affairs Bureau, Councilors' Office], Kaisha Hôsei No Minaoshi Ni Kan Suru Chûkan Shian [Interim Proposal Concerning Revisions Of Companies Act] (Dec. 2011) [hereinafter "Interim Proposal"], *available at* http://www.moj.go.jp/content/000082647.pdf. An English translation of this interim proposal is *available at* http://www.tse.or.jp/english/news/09/b7gje6000000tk7a-att/b7gje6000000tkaj.pdf.

The three options listed in the Subcommittee's Report with respect to outside directors are as follows: (1) companies with a board of auditors (required of all "large" public companies) must appoint at least one outside director, (2) reporting companies (a smaller group) must appoint at least one outside director, and (3) no change to current law under which there is no requirement to appoint any outside directors. *Id.*, at I-1. It also added an additional optional form of governance - a "one committee" system in which company auditors would be replaced by an audit committee of the board. *Id.*, at I-2. The proposed changes appear very modest in light of the significant challenge posed by recent events in corporate governance, particularly by the Olympus case.

108. See Hômushô, Minjikyoku, Sanji Kanshitsu [Ministry Of Justice, Civil Affairs Bureau, Councilors' Office], Kaisha Hôsei No Minaoshi Ni Kan Suru Yôkôan [Draft Outline Of Amendments To The Companies Act], Aug. 2012 [hereinafter "Draft Amendments"], *available at* http://www.moj.go.jp/content/000100819.pdf. The accompanying resolution on a new Tokyo Stock Exchange listing rule is *available at* http://www.tse.or.jp/english/news/09/20120801_a.html.

Following the release of the draft outline of amendments to the Companies Act, the TSE issued its own statement welcoming the comply or explain approach that incorporates a new disclosure requirement and assuring the public that it will "swiftly proceed" to review its listing regulations and "take the opportunity to again request listed companies to secure an independent outside director . . ." *See* Tokyo Stock Exchange, Inc., *Statement by President & CEO in Response to the Draft Outline of Amendments to the Companies Act* (Aug. 1, 2012), *available at* http://www.tse.or.jp/english/news/09/20120801_a.html.

109. Sources: Draft Amendments, *supra* note 108; Remarks by Shozaburo Jimi, *supra* note 105.

However, the delicate compromise described above may not fully satisfy anyone. Foreign institutional investors, who anticipated a clear requirement for outside directors following the Olympus case, were again disappointed.[110] Japanese businessmen still fear that a requirement for outside directors may follow, but at present have nothing to show top management that would require immediate action or preparation.

III. BACK TO BASICS: REVISITING THEORETICAL AND STRUCTURAL ISSUES

A. Purpose of Corporate Governance Reform

In the United States there is a familiar story of how the board of directors evolved over time from a business advisory board to a supervisory board.[111] This evolution was prompted by actual and potential conflicts of interest between management and shareholders highlighted by the hostile M&A boom in the 1980s, and by Delaware court decisions that emphasized the role of independent directors in dealing with these conflicts. The rise of activist institutional investors in the 1990s provided additional emphasis on board independence and the protection of shareholder interests.[112] By the 1990s the monitoring model of the board's function was widely accepted as a form of best practice for large corporations.[113] The monitoring model also provided

110. *See* Ishida, *supra* note 26. International institutional investors' renewed interest in, and sense of urgency concerning, corporate governance issues can be seen in their active participation (many for the first time) in the Ministry of Justice's procedure for public comment on proposed amendments to the Companies Act. *Id.*

111. For a general discussion of this evolution of corporate governance, *see* Robert W. Hamilton, *Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits*, 25 J. Corp. L. 349 (2000). With respect to the history of the rise of the monitoring model, *see* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. Rev. 1465 (2007).

112. *Id.*

113. As noted, however, there have always been dissenters, both conservative and progressive, who question the desirability and accuracy of this model. *See supra* note 13. Some law and economics scholars, who are strong proponents of market solutions for corporate governance problems, have always questioned the theory behind, and value of, independent directors, and were particularly opposed to the legal requirement under Sarbanes-Oxley that public companies have a majority of independent directors on their boards. *See, e.g.*, Stephen Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards,* 30 Sec. Reg. L.J. 370 (2002); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,* 114 Yale L. J. 1521 (2005).

On the other hand, some progressive scholars strongly question the monitoring model's effectiveness in limiting managerial authority. *See, e.g.*, George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 Hous. L. Rev. 1213 (2008) (arguing that "the status quo is not director primacy, shareholder primacy, or team production, but CEO pri-

benefits to management: defenses against takeovers became widespread and management compensation steadily increased, as compensation committees composed largely of independent directors hired compensation consultants and accepted their recommendations.[114]

In the early 2000s, Enron and other corporate financial scandals tested the monitoring model. These scandals resulted in the enactment of the Sarbanes-Oxley Act, which legally required widespread implementation of the monitoring model through federal securities laws, related regulations, and stock exchange listing standards.[115]

Despite the global influence of Sarbanes-Oxley, its basic premise of the monitoring model may not have been widely accepted overseas. Specifically, under the monitoring model that was implemented by Sarbanes-Oxley, the primary purpose of the board of directors is to supervise management to regulate potential conflicts of interest and better represent the interests of shareholders.[116] In contrast, many countries, such as Japan, were interested in more modest reform measures to provide a counterweight to traditional management discretion and thereby to achieve a better balance in corporate governance.[117]

In Japan, where businesses prefer an active insider-oriented board, the primary purpose of current corporate governance reform might best be described as improving business competitiveness and performance to provide value to stakeholders,[118] with a

---

macy—governance by managers largely for their own benefit"); Lawrence E. Mitchell, *The Trouble with Boards*, *in* PERSPECTIVES ON CORPORATE GOVERNANCE 17 (F. Scott Kieff & Troy A. Paredes eds., 2010) (arguing that the monitoring board model provides the strongest liability shield for directors and leaves actual power with management).

114. *See* Mitchell, *supra* note 113.

115. *See* Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act, Pub. L. No. 107-204 (codified as amended in scattered sections of 15, 18 U.S.C.).

116. *Id.*

117. *See, e.g.*, Chien-Chung Lin, *The Japanese Independent Director Mechanism Revisited: The Corporate Law Setting, Current Status, and its Explanations*, 24 TEMP. INT'L & COMP. L. J. 65, 89 (2010) (referring to efforts to reform the role of company auditors in Japan to achieve better "balance" in monitoring).

118. In corporate governance reports to the TSE the goals cited by a majority of listed companies were transparency (69.0 percent), stakeholders (59.4 percent), and corporate value (52.4 percent). *See* TSE WHITE PAPER, *supra* note 13, at 5. The least cited among the 12 goals was shareholder value (6.4 percent); monitoring and supervision was cited by 38.4 percent. *Id.*

In presentations of my research in Tokyo, some Japanese businessmen have objected to my characterization of the primary goal of corporate governance reform in Japan as seeking to improve business competitiveness and performance. As noted in the above TSE survey, they prefer to state the goal as improving "corporate value." The term "corporate value" has been very popular in Japan since it was prominently featured in a 2005 ministry-sponsored report that recommended allowing Japanese

secondary goal of mandating protection of shareholder interests as necessary to provide a counterbalance to increased management discretion. Reflecting the above priorities, both critics and supporters of Japan's efforts at corporate governance reform have characterized two-thirds of reform measures since 1996 as "pro-management" and one-third as "pro-shareholder."[119]

This emphasis on managerial discretion over shareholder rights is not a new or recent phenomenon that followed the collapse of the bubble economy in the early 1990s. Rather, it has existed from the beginning of postwar reform,[120] not only in Ja-

---

companies to utilize takeover defenses if such measures enhanced corporate value. *See* CORPORATE VALUE STUDY GROUP, CORPORATE VALUE REPORT (May 27, 2005), *available at* http://www.meti.go.jp/policy/economy/keiei_innovation/keizaihousei/pdf/houkokusyo_hontai_eng.pdf. For a discussion of this report, *see generally* Milhaupt, *supra* note 14. The definition of corporate value in the study group report is very similar to the American approach: corporate value represents the future earnings of the company, with stakeholders' claim being constant, and residual value belonging to shareholders. *See* CORPORATE VALUE STUDY GROUP, *supra*. Accordingly, "enhancing the share value (that belongs to shareholders) is tantamount to enhancing corporate value." *Id.* at 37.

Some Japanese commentators have adopted this approach of equating corporate value with shareholder value. *See, e.g.,* Kenichi Ōsugi, *Torishimariyakukai on Kantoku Kinô no Kyôka—Jô [Strengthening the Supervisory Function of the Board of Directors—Part I]*, 1941 SHÔJI HÔMU 17, 18 (Sept. 5, 2011). However, others, and I suspect many Japanese businessmen, take the view that in a stakeholder system enhancing corporate value refers to enhancing value for all stakeholders. For example, one commentator explains that enhancing corporate value is a two-step process involving: (1) expanding the corporate "pie" of future earnings, and (2) equitably dividing the pie among stakeholders. *See* Kazuhiro Takei, "Kansa Iinkai Setchi Gaisha" no Kaikin [Removal of Prohibition on "Company with Audit Committee"], 1900 SHÔJI HÔMU 13, at 13 (June 5, 2010).

Practical differences emerge when Japanese companies emphasize a long-term, stakeholder-oriented view of corporate value while foreign institutional investors focus on shorter-term maximization of their returns in the form of capital gains and dividends (or "total shareholder return"). *See* Ishida, *supra* note 26.

119. *See* Milhaupt, *supra* note 86 (stating that about two-thirds of the changes were management-friendly "flexibility enhancing amendments," and about one-third were shareholder-friendly "monitoring enhancing amendments"); Zenichi Shishido, *The Turnaround of 1997: Changes in Japanese Corporate Law and Governance, in* CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY 310, 313-14 (Masahiko Aoki, Gregory Jackson, and Hideaki Miyajima. eds., 2007) (characterizing the majority of changes as "demand-pull" reforms requested by business and a minority as "policy-push" reforms to protect shareholders).

120. Occupation authorities replaced the prewar family-controlled conglomerates (zaibatsu) with new public corporations. As part of the broader goal of creating a peaceful and democratic Japan, it was thought both necessary and desirable for the management of these public corporations to have the authority to access the capital market for public financing and to manage corporate business for a diverse group of public shareholders. The result was a similar division of a majority of "pro-management" measures and a minority of "pro-shareholder" measures to provide balance. The latter were highly controversial. *See generally* Bruce E. Aronson, *Postwar Reform of Corporate Law and Corporate Governance: Democratization under the Occupation and the Japanese Reaction, in* THE BLACKMORE FOUNDATION & THE

pan, but also reportedly in other countries where there is historical Japanese influence such as Korea.[121]

The corporate governance purpose in Japan of improving business' competitiveness to add corporate value raises the long-standing issue of the relationship between corporate governance and business performance. Most of the empirical research in the U.S. has found no correlation between improved business performance and good corporate governance measures like a greater number of independent directors.[122] In Japan, business groups have used this finding to argue successfully that measures like requiring a minimum number of outside directors would not achieve the goals of corporate governance reform.[123] However, although business groups in Japan further use this argument to oppose a requirement for *any* outside directors,[124] research in the

---

INTERNATIONAL HOUSE OF JAPAN, LAW AND PRACTICE IN POSTWAR JAPAN: THE POSTWAR LEGAL REFORMS AND THEIR INFLUENCE 59 (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1600868.

121. *See, e.g.*, Young-Cheol K. Jeong, *Impending Amendments to Korean Corporate Laws in 2009: A Mystic Mix*, 4 ASIAN J. OF COMP. L. 1, Art. 6 (2009).

122. *See, e.g.*, Sanjai Bhagat and Bernard S. Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231-234, 266-267 (2002). Miwa and Ramseyer have performed a study on outside directors in Japan and have reached a similar conclusion that adding outside directors does not improve company performance. *See* Yoshiro Miwa & J. Mark Ramseyer, *Who Appoints Them, What Do they Do? Evidence on Outside Directors from Japan*, HARVARD LAW & ECON. DISCUSSION PAPER NO. 374 (2002), *available at* http://ssrn.com/abstract=326460.

It should be noted that some Japanese commentators have highlighted recent empirical research by Takuji Saito that does find a correlation between the addition of the first outside director into an all-insider Japanese board and improvements in operating performance and firm value. In English, *see*, Takuji Saito, *Presence of Outside Directors, Board Effectiveness and Firm Performance: Evidence from* Japan (Working Paper, 2009), *available at* http://s3.amazonaws.com/zanran_storage/www.e.okayama-u.ac.jp/ContentPages/47804533.pdf. For citations of Saito's subsequent Japanese articles, *see, e.g.*, American Chamber of Commerce in Japan, Comment Letter on Interim Proposal concerning Revision of the Company Law (Jan. 21, 2012), *available at* http://www.accj.or.jp/images/downloads/public/en/public_comments/17-120131_ACCJ_FINALEnglish.pdf; Ōsugi, *supra* note 118, at 21. Further research is required concerning the possibility that addition of the *first* independent director may correlate with improved firm performance and valuation even if the creation of a supermajority of independent directors does not show such a correlation.

123. For the discussion (in Japanese) on empirical research conducted by the Subcommittee charged with considering amendments to the Companies Act, *see* Minutes of the Subcommittee Meeting, Ministry of Justice (Jan. 26, 2011), *available at* http://www.moj.go.jp/content/000070210.txt. As noted, the Subcommittee's final report did not contain a recommendation for requiring any outside directors in proposed amendments to the Companies Act. *See* Draft Amendments, *supra* note 108.

124. Minutes of the Subcommittee Meeting, Ministry of Justice (Jan. 26, 2011), *id.*

U.S. has focused more on the question of the value provided by a supermajority of independent directors.[125]

This question of the most appropriate purpose for corporate governance reform has likely been a significant factor in the deadlock in Japan over the past 15 years over any legal requirement for at least one outside director. On one hand, foreign shareholders now own over one-quarter of the Japanese stock market and account for nearly 60% of trading.[126] They claim that the existing system of internal company auditors and insider-dominated boards lacks transparency and fails to protect their interests, and that poor corporate governance discourages outside investment and depresses share prices in the Japanese market.[127] Business groups respond that there is no evidence that the addition of outside directors improves performance, that each company should develop a corporate governance system to suit its own needs,[128] and that those who wish to add outside directors are free to do so.

Until recently this big business view was buttressed by what some commentators have called the "Toyota effect."[129] During the 2000s Toyota, the champion of the traditional system and the strongest opponent of the introduction of outside directors, greatly outperformed Sony, which had adopted the company by committees structure and was widely seen as the champion of "American-style" corporate governance. Toyota's own well-known corporate governance problems since 2010, together with the negative economic consequences resulting therefrom, have ended the popularity of this argument and may have removed an obstacle to reform efforts involving outside directors.[130]

In light of the Olympus case, it may be worthwhile for the Japanese to reconsider their views on the primary purpose of corporate governance reform and on the role of independent directors.[131] Several goals could be considered apart from the elusive quest for improved business performance. First, Japan faces its own potential conflicts of interest, including controversies over

125. *See* Bhagat & Black, *supra* note 122, at 234. They favor boards including independent directors for the purpose of monitoring self-dealing transactions and firing the CEO when necessary, but question the usefulness of creating a supermajority of independent directors as became common in the United States beginning in the early 2000s.

126. *See* TOKYO STOCK EXCHANGE, INC.. *supra* note 22.

127. *See, e.g.*, *ACGA White Paper*, *supra* note 2, at 18.

128. *See, e.g.*, KEIDANREN CORPORATE GOVERNANCE, *supra* note 3.

129. *See* Milhaupt, *supra* note 86.

130. For a discussion of Toyota's problems, *see* Aronson, *supra* note 27.

131. For a discussion of the role of independent directors, *see infra* notes 208-11 and accompanying text.

management buyouts.[132] Second, in terms of risk management, it might be useful to increase monitoring of management to some degree to reduce or minimize the possibility of catastrophic loss resulting from mismanagement, something akin to purchasing disaster insurance coverage. Finally, many Japanese companies have become global players and they may need to change governance structure and practices both to manage their global enterprises and, in the long term, to effectively access increasingly global capital markets. Consideration of these goals would naturally lead to a greater emphasis on the monitoring function of the board of directors in comparison with the current emphasis on a management board.

B. Monitoring Function of the Board of Directors

Although debate on corporate governance reform in Japan has focused on the structural question of adding outside directors, two fundamental issues related to board functioning are highly significant: the board's continuing combination of daily management and oversight functions and the president's practical authority to appoint both a successor and directors. Addressing these issues may be critical for strengthening the board's monitoring function.[133]

Both management and supervision are listed as functions of the board of directors under Japanese corporate law.[134] However, boards in most Japanese companies do not only engage in management at the level of policy formulation or decisions on very significant transactions, but they also remain heavily involved in daily operations of the company. The matters they discuss and approve are often relatively small and the result is more frequent meetings than at a typical U.S. company.[135] Conse-

132. Many foreign reformers have raised this point. *See, e.g.*, American Chamber of Commerce in Japan, *supra* note 122.

133. Business groups such as *Keidanren* are likely correct in their assertion that merely requiring the addition of an outside director would not meaningfully affect or improve Japanese corporate governance. *See* Keidanren Corporate Governance, *supra* note 3. As noted earlier, this view is shared by the Asian Corporate Governance Association. *See ACGA White Paper*, *supra* note 2, at 19-20.

134. *See* Companies Act, *supra* note 35, art. 362, ¶ 2. Choosing the company's representative director (who acts as chief executive) is a third listed function. *Id.*

135. For example, as a matter of law, the board must approve any "significant" borrowing. *See* Companies Act, *supra* note 35, art. 362. ¶ 4, Item 2. In practice, the minimal amount required for board approval can be relatively small. In addition, Japanese companies often require board approval for any amount of investment (including routine investments in subsidiaries and other group companies). Comments in Response to Presentation by Bruce E. Aronson at Corporate Governance Research Group, Meiji Institute for Global Affairs, Tokyo (June 29, 2012) [hereinafter "Meiji Institute, June 29, 2012"]. Of even greater importance are traditional practices whereby the board provides the final seal of approval for relatively minor cor-

quently, some tension exists between these supervisory and managerial duties, since in theory the directors have a fiduciary duty to monitor themselves as managers of the business. In practice, individual directors remain in charge of particular divisions or functions within the company, and director liability in court decisions is predicated on officer-like liability when a problem occurs within their assigned area.[136]

The emphasis on the board's management function carries over to the question of the role of outside/independent directors, as expectations for outside directors similarly focus on their managerial role rather than on their monitoring role.[137] This is reflected in the frequent complaint by Japanese companies that it is difficult to include outside directors due to their lack of familiarity with company affairs.[138] While it is true that it is often difficult to bring outside directors "up to speed" on the various day-

porate actions in what has been referred to as the *ringi* system. For an early view of how traditional Japanese decision-making struggled to respond to the new reality of overseas expansion and international business practices, *see generally* M. Y. Yoshino, *Emerging Japanese Multinational Enterprises*, in MODERN JAPANESE ORGANIZATION AND DECISION-MAKING 146 (Ezra F. Vogel ed., 1975).

136. This was true, for example, in the Daiwa Bank case involving a rogue trader at the bank's New York branch, which may be Japan's best known shareholder derivative suit. A number of "directors-in-charge" of specific functions were found liable for breach of fiduciary duty. *See Nishimura v. Abekawa*, 1721 HANREI JIHO 3 (Osaka Dist. Ct., Sept. 20, 2000). For an English translation of excerpts of the court's decision, *see* Aronson, *supra* note 87.

137. There appears to be a gap between the theory and practice of utilizing outside/independent directors in Japan. The TSE stresses the need for independent directors to represent the interests of general shareholders of listed companies, and cites examples, such as takeovers and private placements involving a possible change of control, where there may be a conflict between the interests of management and shareholder interests. *See* Tôkyô Shôken Torihikijô Jôjô Seido Seibi Kondankai [Tokyo Stock Exchange Listing System Preparedness Discussion Group], Dokuritsu Yakuin ni Kitai sareru Yakuwari [Anticipated Role of Independent Directors] (Mar. 31, 2010), *reprinted in* 1898 SHÔJI HÔMU 35 (May 5-15, 2010). And over two thirds of listed companies cite "independence" as a reason for appointing outside directors. *See* TSE WHITE PAPER, *supra* note 13, at 28-29. However, when I ask groups of Japanese businessmen what contribution they expect from outside directors, the typical answer is that outside directors should utilize their expertise and perspective to contribute to "better business decisions" rather than monitoring. Meeting of Corp. Governance Forum, Business Research Inst., Tokyo (Sept. 27, 2012). Japanese companies continue to appoint closely-affiliated bankers as board members even though they do not qualify as outside directors. The TSE attributes this phenomenon to a desire for "business execution [i.e., management], which incorporates the view of outsiders." *See* TSE WHITE PAPER, *supra* note 13, at 30. The function of monitoring may still seem remote and contingent to Japanese businessmen in contrast to the daily management activities of Japanese boards.

138. *See, e.g.*, KEIDANREN CORPORATE GOVERNANCE, *supra* note 3, at 9 (noting that the value of outside directors depends on their knowledge of, and experience with, the business of the company and the industry). There is also a more general complaint about the lack of qualified candidates for the position of outside director. *Id.* This claim is refuted by the Asian Corporate Governance Association. *See ACGA White Paper*, *supra* note 2, at 19.

to-day managerial issues that boards consider, the preferred solution may be to reconsider what matters the board acts upon rather than to limit the number of outside directors.

The second issue related to board function is the selection method for the CEO and directors. Under Japan's Companies Act the board of directors selects the individual(s) who have the authority to represent the corporation.[139] Under the traditional Japanese system they are generally called representative directors, although they often also have titles such as "president." By law, a company's president has no formal role in the selection of his successor or directors[140] other than his one vote as a director on the board. However, in reality, the president at most Japanese companies has the actual power to decide promotion to the board and his successor as president.[141] Such decisions are later formally adopted by the board of directors.

The traditional practice of selecting one's successor has tremendous negative implications for corporate governance. A well-known Japanese attorney active in corporate governance matters often states that "the best monitor of management is the successor management."[142] New top management that is not selected by the incumbent, particularly if it comes from outside the company, has the information and incentives to discontinue and even disavow any past management practices with which it disagrees. The possibility of an outside successor also acts on current management as a deterrent against unsound practices. The Olympus case is striking in that three successive company presidents came from the small office within the company's Finance Department that aggressively made high-risk investments[143] and incurred huge losses. In this case, a manager's knowledge of the

---

139. *See* Companies Act, *supra* note 35, art. 362, ¶ 2 Directors formally choose a representative director(s) from among the directors by means of a board resolution. The representative director(s) has the authority to bind the corporation. *Id,*, art. 362, ¶ 3.

140. Directors are formally elected by shareholders at the annual general meeting of shareholders. *See* Companies Act, *supra* note 35, art 329, ¶ 1. However, as in many systems, including the United States, the corporation chooses a single slate of candidates.

141. Meiji Institute, June 29, 2012, *supra* note 135; Comments in Response to Presentation at 21st Century Managers Forum, Business Research Institute (Sept. 25, 2012) [hereinafter "21st Century Managers Forum"].

142. Interview with Kenichi Fujinawa, Esq., Managing Partner, Nagashima Ohno & Tsunematsu, Tokyo (Nov. 30, 2011).

143. *See supra* note 56. The Investigation Report found that the president's authority over personnel matters contributed to a board that simply followed the wishes of the president rather than considering the best interests of the corporation and its shareholders. *See* INVESTIGATION REPORT, *supra* note 40, at 145-46. The successive involvement of company presidents was also treated as big news in Japan. Following the release of the Investigation Report on Dec. 6, 2011, the main headline on the Olympus case on page one of Japan's leading business daily read simply

losses and willingness to continue to conceal them was presumably an important or even decisive criterion in choosing the next president. The Olympus case thus provides a stark example of how the president's power to appoint a successor can be badly abused if not subject to an effective monitoring mechanism.

However, the president's informal power to choose a successor is deeply ingrained in many Japanese companies and might not be easy to reform. The most widely cited reason for the unpopularity among Japanese companies of the optional "American-style" company with committees structure of corporate governance is top management's opposition to the nomination committee, i.e., to the president being forced to surrender his power of appointment to that committee.[144] Thus, this informal presidential power has played an important role in deterring Japanese companies from adapting the new, optional board committee structure that is available under Japan's corporate law.

This deterrent effect is significant since both structural board issues discussed above would presumably be addressed by Japanese companies adopting the company with committees structure. Boards with a majority of outside directors are generally smaller and rely more on executive officers (*shikkôyaku*) for day-to-day management of the business.[145] Similarly, the nomination committee in a company with committees would presumably exercise the power of appointment of directors and the company president, and the majority of outside directors on this committee would help it to resist the influence of the outgoing president on nominations. However, to date the company with

---

"Olympus 3 Presidents' Knowledge." *See Orinpasu 3 Shacho Ninshiki* [*Olympus 3 Presidents' Knowledge*], NIHON KEIZAI SHINBUN, Dec. 7, 2011, at 1.

144. This was the consistent view of a large number of interviewees. One clear example is where a former president of one of the largest utility companies in Japan noted that when he first heard the term "nomination committee," he assumed that the function was limited to the review of proposed candidates selected in consultation with the company president. However, when he discovered that the nomination committee would, in fact, be given the authority to make such appointments, his company dismissed the idea of adopting the company with committees structure. 21st Century Managers Forum, *supra* note 141. However, questions remain about the actual functioning of the nomination committee and whether it has actually made such a large difference in practice. *See infra* note 215 and accompanying text.

145. In reports submitted to the TSE, the biggest difference in the goals of corporate governance listed by the small minority of companies that have adopted the company with committees system was an emphasis on monitoring and supervision (80.4 percent versus 37.4 percent of companies with company auditors) and execution, i.e., separation of management and supervisory functions (80.4 percent versus 37.8 percent of companies with auditors). *See* TSE WHITE PAPER, *supra* note 13, at 5. Under the Companies Act, it is not technically necessary for the board as a whole to have a majority of outside directors under the company with committees structure, but each of the three committees must have a majority of outsiders. *See* Companies Act, *supra* note 35, art. 400, ¶ 3.

committees structure has been unpopular with Japanese businesses,[146] and so reform efforts in Japan to improve the monitoring of management must include practical measures that can also be utilized by companies with auditors.

IV. PRACTICAL ISSUES: ACHIEVING "TRULY EFFECTIVE" CORPORATE GOVERNANCE REFORM

As noted in the Introduction, discussion of a "middle ground" in Japanese corporate governance between a management board and monitoring board generally begins with adding some outside directors to the traditional company with auditors. Although the addition of outside directors is a useful starting point, it is also necessary to provide such outside directors or other monitors of management with the necessary environment and means to fulfill their role and ensure an actual strengthening of the board monitoring function. The TSE has generally recognized the importance of this issue following the Olympus case, but its current proposal to address this matter involves only general, voluntary measures to be considered by listed companies.[147]

Looking to the United States as an example, the environment or means to enable monitors of management to be effective might well include the following: (1) sufficient information to provide notice of possible issues and the means to ask questions, (2) an incentive, such as the risk of legal liability, to encourage raising issues that may challenge the views of corporate management, and (3) additional outside monitors, such as professional service providers functioning as gatekeepers.[148] This section reviews the current situation in Japan with respect to these practical measures to enhance the monitoring function and highlights possible improvements.

146. As noted *supra* note 5, only 2.2% of Japanese listed companies have chosen this structure. *See* TSE WHITE PAPER, *supra* note 13, at 15.

147. *See* TOKYO STOCK EXCHANGE, INC., *supra* note 10. Measures that listed companies "may consider" include increasing information to independent directors or company auditors, improving their collaboration with other departments within the company, and providing them with a handbook subsequently published by the TSE. *Id.*, at 4. Critics have pointed out that the TSE proposal does not contain any mandatory provisions that would achieve the stated goal of "fortifying the environment to facilitate independent board member functions." *See, e.g.*, American Chamber of Commerce in Japan, Public Comment on Revisions to Listing Rules Regarding Corporate Governance to Restore Confidence in the Securities Markets, *available at* http://www.accj.or.jp/en/about/committees/committee-materials/doc_view/269-public-comment-on-revisions-to-listing-rules-regarding-corporate-governance-to-restore-confidence-in-the-securities-markets.

148. *See* generally Aronson, *supra* note 39.

A. INFORMATION

1. Internal Sharing of Information

One surprising aspect of a number of Japan's corporate governance scandals over the past few years is the ineffectiveness of internal information sharing in the traditional insider-dominated corporate structure with respect to critical issues. One might think that a stable group of knowledgeable, experienced managers with long service to the company would make access to information an important strength of an insider-dominated system, compared to a system with a majority of outside directors (see Table 4). However, in both the case of Toyota's car recall in 2010[149] and the problem of nuclear plant safety at TEPCO, effective information sharing did not occur.[150]

Table 4. Comparison of Strengths of Insider-Dominated Corporate Auditor System and Outsider-Dominated Board Committee System[151]

Issue	company with auditors	company with committees
1. Board and Management Functions	Combination of Board and Management Functions	Separation of Management and Oversight Functions
2. Management Decisions	Overlap with Board Allows Incorporation of Strategic Corporate Goals in Decisions	Use of Executive Officers Allows Quicker Decisions
3. Board Decisions	Board has Familiarity with Business, Experience, Expertise, and Information	Board Exercises Greater Oversight over Management
4. Confidentiality vs. Transparency	Maintains Corporate Secrecy	Use of Board Committees and Outside Directors Increases Transparency
5. Inside Appeal	Preservation of Corporate Culture—Motivates Employees and Managers	Promotion and Compensation may be more Merit-based
6. Outside Appeal	Widely Accepted by Japanese Strategic Business Partners	Widely Accepted Governance Structure Familiar to Foreign Institutional Investors

Individuals serving as outside directors and outside company auditors at Japanese corporations consistently report a lack of adequate information as the biggest problem interfering with the

149. The problem was information on possible defects in Europe not being shared with the company's U.S. subsidiary, resulting in a failure to report to the U.S. government and a large fine. *See* Aronson *supra* note 27.

150. TEPCO'S nuclear power division not share information with corporate headquarters on studies related to the real possibility, and impact, of a large tsunami on plant safety and operations. *See* THE NAT'L DIET OF JAPAN, *supra* note 28.

151. Aronson, *supra* note 27, at 84.

effective performance of their role.[152] One reason, discussed *supra*, is the large number of nonmaterial matters handled by boards in Japan. Of similar importance are the typical corporate procedures in Japan whereby decisions are essentially discussed and made by a top management committee and then passed on to the board for formal approval.[153] Insiders will already have discussed the matter, often several times, before it reaches the board.[154] Only the limited number of outsiders consider an issue for the first time at the board level. As a result of the prior insider discussions, the volume and quality of information attached to board agenda items is typically much less than when the same matter was previously discussed by the management committee.[155]

Unlike company auditors, outside directors in Japan have no clear legal right to obtain information. When they do request additional information, they may be asked to vote on the agenda item first, with some additional information promised to follow.[156] And unlike in the U.S., with celebrated court cases like *Van Gorkom*,[157] there is no clear court precedent in Japan that states that a board decision made without reasonable information may constitute a breach of a director's fiduciary duty. Accordingly, despite the basic similarity of fiduciary duties for

152. Tadashi Kunihiro, Presentation at AIMA Japan Hedge Fund Forum 2012, Tokyo Stock Exchange, Tokyo (June 4, 2012) (a leading corporate governance attorney in Japan citing information as the biggest problem in Japanese corporate governance); Interview with Nick Benes, Representative Director, The Board Director Training Inst. of Japan, Tokyo (Feb. 10, 2012); Interview with Shiro Kuniya, Esq., Managing Partner, Ohebashi LPC & Partners, Tokyo (Feb. 3, 2012) (noting that if an outside board member or company auditor asks numerous questions at a board meeting, he may be invited to attend an internal discussion prior to the board meeting).

153. Meiji Institute, June 29, 2012, *supra* note 135, comment by Sumitaka Fujita, Executive Director, CFO Association, former Vice Chairman of major trading company Itoh Chu, and Independent Director (as of April 2012), Olympus Corporation.

154. *Id.* It is not unusual for the company's management committee to meet just before a board meeting to discuss all agenda items. The discussion is then repeated at the board meeting in the presence of outside directors and outside company auditors. *Id.* A few companies now permit outside company auditors to attend the management committee meeting. Comments at Meeting of Corporate Governance Research Group, Meiji Institute for Global Affairs, Tokyo, Oct. 12, 2012. I am aware of one unusual example, where the sole outside director also attends the management committee meeting. Kashiwagi, *supra* note 14. Although this is laudable from the viewpoint of providing information to the outside director and providing him an opportunity to raise issues before they are decided, it also means that the board meeting is a mere formality and has no separate function from the management committee meeting.

155. Fujita, *supra* note 153.

156. Interview with Nick Benes, *supra* note 152. Once the vote is taken and the pressure is off, reportedly the promised information does not necessarily follow. *Id.*

157. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) [Trans Union Case].

directors in Japan and those in the U.S., including a duty of oversight,[158] it remains difficult for directors to effectively fulfill their duties and they have few incentives to challenge the system. This internal information flow is an important area where reform of corporate practices may be necessary for outsiders to play a meaningful role in monitoring management.

2. *Public Information Disclosure*

Public information disclosure contributes to corporate governance in a number of ways, such as by strengthening the voice and functioning of independent directors and other monitors of management. Overall, public disclosure in Japan by both companies and the government has improved substantially over the past decade. For corporations, the revamped securities law[159] increased securities-related disclosures for public companies. The government has generally increased its information disclosure by utilizing the websites of its various agencies, and by engaging in more open and transparent comment procedures for its deliberation councils that consider changes to existing law and regulations.[160]

Nevertheless, recent corporate governance scandals have raised new questions about the effectiveness of actual public disclosure practices. In the Toyota recall case, the scandal was triggered by the failure of Toyota to make required disclosures of possible defects to the National Highway Traffic Safety Administration in the U.S.[161] In the TEPCO case, investigations have revealed both a process of collusion between the electric power industry and the government on pro-nuclear energy policies and failures to share and disclose important safety and other information following the Fukushima incident.[162] And one of the early issues in the Olympus case was the necessity to correct five years of false and misleading financial statements contained in securities filings to avoid delisting from the TSE. These cases may indicate the continuing influence of a traditional mindset that is willing to minimize or neglect public disclosure if such action is thought to be in the best interests of the corporation or organiza-

---

158. In Japan the duty of oversight is also included in a related statutory requirement for internal controls. For a discussion of the duty of oversight, including a Supreme Court case from 2009 and the statutory provision, *see* Aronson *supra* note 27, at 71-75.

159. *See* FIEL, *supra* note 35.

160. A good example is the extensive public comments received, many in English, with respect to the interim proposal for amendments to the Companies Act. *See supra* note 107. A number of international institutional investors participated in this process for the first time. *See* Ishida, *supra* note 26.

161. *See* Aronson *supra* note 27.

162. *See* THE NAT'L DIET OF JAPAN, *supra* note 28.

tion. Thus, despite an overall increase in public disclosure, it is still necessary to consider incentives and other means to assure effective and timely disclosure.

B. ENFORCEMENT

1. Public Enforcement

Litigation risk provides an incentive for both disclosure and effective monitoring, and public enforcement may provide a powerful incentive.[163] However, public enforcement has historically been weak in Japan. A prominent commentator on Japanese law, John Haley, has long cited the lack of enforcement divisions staffed by lawyers at government agencies as a distinctive feature of the Japanese legal system.[164] Although an attention-grabbing scandal like the Olympus case results in both civil and criminal investigations, the overall resources for public enforcement remain limited.[165] In addition, investigators tend to confine themselves to criminal actions in a small number of well-known cases, as government agencies lack the budgets and personnel to pursue meaningful civil actions.[166]

Government enforcement may also be hampered by a lack of clear statutory authority. The most prominent recent example of insufficient statutory authority was a series of dramatic insider trading cases in which large Japanese underwriters systematically tipped off favored hedge funds with nonpublic information on upcoming public offerings.[167] Japanese securities law enforcement has traditionally focused on administrative orders for business improvement and, in extreme cases, referrals for criminal

---

163. Although private enforcement has been emphasized in the literature concerning investor protection and the development of financial markets, public enforcement is of equal importance. *See* Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-based Evidence*, 93 J. FIN. ECON. 207 (2009).

164. *See* JOHN O. HALEY, AUTHORITY WITHOUT POWER: LAW AND THE JAPANESE PARADOX (1991).

165. For comparative data, *see* Jackson & Roe, *supra* note 163, at tbl. 2.

166. For a recent survey of regulation and enforcement of securities law in Japan, *see* INTERNATIONAL MONETARY FUND, JAPAN: IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION—DETAILED ASSESSMENT OF IMPLEMENTATION (Aug. 2012) [IMF Country Report No. 12/230], *available at* http://www.imf.org/external/pubs/ft/scr/2012/cr12230.pdf (noting that Japanese securities regulation shows a "high degree of implementation" of IOSCO principles, but also noting a number of areas that need improvement).

167. A series of recent insider trading cases caused the resignation of the CEO at Japan's largest securities company, Nomura. *See* Hiroko Tabuchi, *Nomura Chief Resigns Over Insider Trading Scandal,* N.Y. TIMES, July 26, 2012, *available at* http://dealbook.nytimes.com/2012/07/26/nomura-chief-resigns-amid-insider-trading-scandal/.

prosecution.[168] These enforcement tools were seen as insufficient, so a system of civil fines was initiated in 1995.[169] However the amounts of fines, particularly against corporate tippers in insider trading cases, can be laughably small,[170] which has led to criticism that such fines not only fail to deter insider trading but may actually encourage it as a small cost of doing business.[171] Following these recent cases, the FSA announced a new initiative to increase the maximum level of fines available and has conducted a crackdown on insider trading that reportedly has surprised market participants.[172] It remains to be seen whether recent increases in public enforcement can continue and be sufficient to provide an incentive to aid in the monitoring of management.

2. *Private Enforcement*

Perhaps the most distinguishing feature of the U.S. system of corporate governance is the relatively high level of private enforcement, including both shareholder derivative suits and securities class actions. Litigation risk strengthens the role of

---

168. The leading role in securities enforcement in Japan is played by the Securities and Exchange Surveillance Commission ("SESC"). *See generally*, SECURITIES AND EXCHANGE SURVEILLANCE COMMISSION, ANNUAL REPORT 2010/2011, *available at* http://www.fsa.go.jp/sesc/english/reports/re2010.pdf. Under the FIEL (*see supra* note 35) authority for securities regulation is given to Japan's Prime Minister, who delegates this authority to the FSA, which in turns delegates its authority to receive reports and conduct inspections and investigations to the SESC. For a brief summary of this relationship, *see* INTERNATIONAL MONETARY FUND, JAPAN, *supra* note 166, at 6. For an overview of the SESC's history and functions, *see generally* the SESC's pamphlet, SEC. AND EXCHANGE SURVEILLANCE COMMISSION, SEC. AND EXCHANGE SURVEILLANCE COMMISSION (Sept. 2011) [hereinafter "SESC PAMPHLET"], *available at* http://www.fsa.go.jp/sesc/english/aboutsesc/all.pdf.

For a brief summary of enforcement policy, *see* INT'L MONETARY FUND, supra note 166, at 10-11, 15. For details on investigations and formal complaints in criminal cases, *see* SEC. AND EXCHANGE SURVEILLANCE COMMISSION, ANNUAL REPORT 2010/11 117-23 (2011) [hereinafter "SESC ANNUAL REPORT"].

169. *See* SESC PAMPHLET, *supra* note 168, at 2. For details on administrative money penalties, see SESC ANNUAL REPORT, *supra* note 168, at 67-83.

170. A fine for insider trading against Sumitomo Mitsui Trust Holdings Inc., Japan's largest trust bank, was 50,000 yen (around $600 dollars). This was reportedly the first fine of a major financial firm for insider trading, as enforcement had focused on individuals and tippees. The small fines for tippers are based on the profit received from brokerage commissions rather than on the damage to investors. *See, e.g.*, Atsuko Fukase, & Kana Inagaki, *Japan Insider Penalty: $600; Small Fine on Sumitomo Mitsui Trust Unit is the First Sanction From a Long Probe*, WALL ST. J., Mar. 22, 2012, http://online.wsj.com/article/SB10001424052702304636404577294823 335589812.html.

171. Meiji Institute, June 29, 2012, *supra* note 135. The businessmen who participated in this study group seemed to strongly favor harsher penalties and enforcement for violations of law. *Id.*

172. *See Insight: How Japan's Securities Watchdog Found its Bite*, REUTERS, Aug. 1, 2012, http://ajw.asahi.com/article/economy/business/AJ201208140116.

independent directors who monitor management by providing both an incentive to question management decisions as appropriate and a relatively neutral, non-personal vocabulary for expressing concerns. The litigation system also helps to disclose problems with corporate governance, and court decisions in Delaware arguably help codify and encourage the implementation of best business practices.[173]

At first blush increasing litigation risk might appear to be a promising reform for Japanese corporate governance. Shareholder derivative suits exist in Japan and have been utilized regularly since the 1990s.[174] However, the level of litigation remains relatively low and is generally thought to be insufficient to provide monitors of management the incentive to question management decisions.[175] There is no explicit securities class action system under Japanese law, although a functional equivalent may be emerging.[176] It is too soon to tell whether business fears of a large increase in securities class actions will be realized.

One problem for Japan and other countries that might benefit from a higher level of private enforcement is that the American system is both costly and complex. It includes a number of complementary features or components that have evolved and meshed together over time. These features include the wide-

---

173. *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

174. *See generally* Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351 (2001); Aronson, supra note 14. Recently, a few shareholder derivative suits have reached Japan's Supreme court. *See, e.g.*, Curtis J. Milhaupt, *2012 Case Comment: Greenmail, Japanese Style* 25 COLUM. J. ASIAN L. 104 (2012) (regarding the Supreme Court decision in 2006 on the Janome Sewing Machine case).

175. There is an argument that the actual number of shareholder derivative suits and their significance in Japan may, in fact, be substantial. *See* Dan W. Puchnial & Masafumi Nakahigashi, *Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation*, 45 VAND. J. TRANSNAT'L. L. 1 (2012). However, in my interviews I have found little fear of derivative suits among businessmen. *See, e.g.*, Shimaoka, *supra* note 100 (stating that although such lawsuits may be unfortunate for the directors involved, companies do not generally fear them; rather companies' real fear is adverse reporting in the news media). One factor in this lack of fear may be the ability of Japanese companies to limit the amount of damages for directors through corporate action. *See* Aronson, *supra* note 87, at 232.

176. Securities-related shareholder litigation has increased following enactment of the FIEL, which unusually provides for strict liability in secondary market transactions as well as in securities offerings (*see* FIEL, *supra* note 35, art. 21, ¶ 2), and the increasingly widespread use of joinder to create groups of plaintiffs. In 2011 the Seibu Railway case reached the Japanese Supreme Court and developments in this area bear watching. *See, e.g.*, Asa Shinkawa et al., *Liability through an Olympus Lens*, INT'L FIN. L. REV. Apr. 1, 2012, Japan supp., at 5, *available at* http://www.iflr.com/Article/3007093/Securities-litigation-after-Olympus-Liability-through-an-Olympus-lens.html; Interview with Kazuhiko Takei, Esq., Partner, Nishimura & Asahi, Tokyo (May 30, 2012).

spread use of director and officer (D&O) liability insurance, discovery in civil trials, and settlement practices. The result is a litigation system that focuses on motion practice and settlements if the plaintiffs survive the defendant's motion to dismiss. Significantly, there is very little, if any, risk of individual directors or others actually paying significant sums as the result of a "successful" suit by plaintiffs. In Japan, D&O liability insurance is underdeveloped and not widely used; there is little discovery and few incentives for settlement.[177] Accordingly, the U.S. provides an example, but only limited practical guidance, as a model for increasing the level of private enforcement.

C. Gatekeeper Functioning

Enron and other scandals in the U.S. have been referred to as problems of gatekeeper functioning in light of the failure, among others, of external auditors to ensure accuracy in corporate financial statements.[178] A major thrust of Sarbanes-Oxley in response to this problem was new government regulation of external auditors under the Public Company Audit Oversight Board (PCAOB).[179] In addition, accounting firms face litigation risk in securities class actions that focus on the accuracy of financial statements and the audit function.[180]

In Japan there is no widespread use of the concept or term "gatekeeper" in discussions of corporate governance, and there has been little focus on the public dimension of professional services provided to corporate clients.[181] However, the Olympus

---

177. *See generally* Aronson *supra* note 14.

178. *See, e.g.*, John C. Coffee, Jr., *Understanding Enron: It's About the Gatekeepers, Stupid*, 57 Bus. Law. 1403, 1405 (2002); Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. Rev. 2173 (2010). The term gatekeepers refers to "reputational intermediaries" such as external auditors, credit rating agencies, investment bankers, and lawyers who are in a position to detect and prevent fraud by primary actors in the securities markets. *See* Coffee, *supra*, at 1405.

179. John Coffee refers to the PCAOB as the "centerpiece" of Sarbanes-Oxley. *See* John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform tends to be Frustrated and Systemic Risk Perpetuated*, 97 Cornell L. Rev. 1019, 1036-37 (2012). For an overview of the functions of the PCAOB, *see* its website, http://pcaobus.org.

180. *See, e.g.*, A.A. Sommer, Jr., *Accountants' Liability under the Federal Securities Law*, *in* 1-5A Federal Securities Exchange Act Of 1934 (2012).

181. As in the United States, professional services providers in Japan focus primarily on servicing their clients and tend to downplay any public or market role for such client services. Accountants object to the term "gatekeeper" and cite their reputational risk as sufficient incentive to assure they fulfill their role in ensuring the accuracy of corporate financial statements. Interview with Shozo Yamazaki, Chairman and President, The Japanese Institute of Certified Public Accountants, Tokyo (June 12, 2012). However, commentators in the United States have questioned whether such reputational concerns are, in fact, sufficient. *See, e.g.*, Jonthan Macey

case highlighted this problem, particularly with respect to the role of external auditors.[182] This issue has been recognized in Japan, as the FSA's post-Olympus reform agenda includes the re-examination of regulations for both external auditors and outside financial advisers.[183]

In Japan, there is presently no real litigation risk either for external auditors or for internal company auditors.[184] As a result, audit firms in Japan may generally lack the incentive of audit firms in the U.S. to challenge the accounting methods of their clients when it may be most effective, i.e., in the early stage of an audit well before the audit firm must issue a formal opinion. In addition, Japanese audit firms are fundamentally subject to self-regulation by the accounting profession with very limited government oversight, despite the government's creation of a PCAOB-

& Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1169 (2003) (noting that while in the past accounting firms' reputational risk was sufficient to help assure the quality of financial reporting, that was no longer the case since the balance between accounting firms and their clients had shifted "dangerously" away from accounting firms and in favor of corporate clients). *See also* Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime,* 79 WASH. U. L.Q. 491 (2001).

182. In the Olympus case, problematic accounting treatment to hide losses resulted in inaccurate financial statements and improper securities filings. When Olympus' external auditor questioned one aspect of its accounting treatment, Olympus changed external auditors. *See supra* notes 53-54 and accompanying text.

183. *See* Jimi, *supra* note 105; *supra* Table 3.

184. Olympus essentially represents the first case in which liability of company auditors has been broadly addressed, as the corporation included five company auditors in its lawsuit against former directors and company auditors, as recommended by its third-party committees. *See* OLYMPUS CORPORATION NON-DIRECTOR MANAGEMENT LIABILITY COMMITTEE, INVESTIGATION REPORT, *supra* note 54. With respect to accounting firms, a prior accounting scandal at Kanebo Corporation resulted in a lawsuit and dissolution in 2007 of Chuo Aoyama, one of the Japanese affiliates of the Big Four accounting firms. *See generally* Numata & Takeda, *supra* note 49. However, in that case the accountants moved much of their practice to another firm and litigation over audits is rare. In the Olympus case the third-party committee did not recommend that Olympus include external auditors in its litigation. *See* OLYMPUS CORPORATION NON-DIRECTOR MANAGEMENT LIABILITY COMMITTEE, INVESTIGATION REPORT, *supra* note 54. Some commentators note that the legal basis for liability by company auditors and external auditors is sufficient in law, but that other factors, such as the lack of an effective discovery system in civil litigation, greatly reduces litigation risk in Japan. Comment by Kenichi Ōsugi.

like entity in 2003.[185] The FSA may consider means to increase government oversight of the profession.[186]

Another gatekeeper issue in Japan involves the role of lawyers, particularly in conjunction with third-party investigation committees. Originally envisioned as a substitute for a committee of independent directors in situations such as hostile takeovers, these ad hoc investigation committees have become a popular tool for corporations that are accused of wrongdoing with respect to accounting or other corporate governance issues. Their popularity was enhanced when the Japan Federation of Bar Associations ("JFBA") issued voluntary guidelines on forming and operating such investigatory committees in 2010.[187]

Although the JFBA guideline has been hailed as "epoch-making,"[188] its implementation has been inconsistent. For example, Olympus Corporation created such a committee in 2009 when accountants first questioned its M&A transactions. That committee's work has since been highly criticized.[189] Such committees, operating outside the provisions of the corporate and securities law, have no specific legal authority and must depend on the voluntary cooperation of the corporation, its employees, and related third parties to conduct an investigation.[190] The varying

185. The Certified Public Accountants and Auditing Oversight Board (CPAAOB) is an independent body within the FSA. It regulates the accounting profession in some respects, including administration of the CPA exam. *See generally* CPAAOB, http://www.fsa.go.jp/cpaaob/english/index.html (last visited Mar. 13, 2013); *See also CPAAOB, Certified Public Accountants And Auditing Oversight Board*, http://www.fsa.go.jp/cpaaob/english/pamphlet_e.pdf. However, with respect to the regulation and inspection of audit firms, the accounting industry association (The Japanese Institute of Certified Public Accountants, or "JICPA") directly conducts "quality control reviews" which are then further reviewed by the CPAAOB. For an explanation of the quality control review system, *see* the JICPA, http://www.hp.jicpa.or.jp/english/accounting/legal/index.html (last visited Mar. 13, 2013).

186. Interview with Kiyotaka Sasaki, Secretary General, Certified Public Accountants and Auditing Oversight Board, Tokyo (June 14, 2012).

187. *See* Nihon Bengoshi Rengokai [Japan Federation of Bar Associations], Kigyôtô Fushôji ni Okeru Daisansha Iinkai Gaidorain [Third Party Committee Guideline For Corporate Wrongdoing] (Dec. 17, 2010), *available at* http://www.nichibenren.or.jp/library/ja/opinion/report/data/100715_2.pdf.

188. Sasaki, *supra* note 186. The JFBA is dominated by solo practitioners and small law offices that generally do not deal with business law issues or corporate clients. The guideline on third-party committees is the only example of the JFBA taking clear action in the business law area. *Id.*

189. For a summary of the investigation and report of the 2009 third-party committee and problems related thereto, *see* Investigation Report, *supra* note 40, at 151-58.

190. This means, *inter alia*, that it is unrealistic for a third-party committee to investigate criminal liability. One important issue in the Olympus case was the question of whether there was any involvement by organized crime with respect to payments in the loss disposition scheme. The third-party committee found no evidence of such involvement. *See supra* note 69. However, it is likely that only a criminal

results of such committee investigations may ultimately depend on whether the company's management is "serious" about getting to the root of, and resolving, the problem.[191] In addition, unlike independent directors, third-party committee members are not subject to any particular definition of independence and have no fiduciary duty or other accountability to the corporation and its shareholders.[192]

It is unlikely that the role of gatekeepers will soon achieve prominence in Japan as it has in the U.S. However, gatekeeper functioning has good potential as a useful area of reform and deserves greater attention. Both accountants and lawyers are closely involved in important governance-related activities with their corporate clients through the provision of professional services. The frameworks exist—the CPAAOB for regulation of accountants and the JFBA's guideline for regulation of third-party committees and lawyers—that could be utilized to enhance gatekeeper functioning and contribute significantly to the monitoring of management.

---

investigation would be able to uncover any evidence, if it existed. *See, e.g.*, Linda Seig, *Panel Finds no Evidence of Organized Crime in the Olympus Scandal*, REUTERS, Dec. 6, 2011 (quoting Jamie Allen, Secretary-General of the Asian Corporate Governance Association, as saying, "I would have thought they didn't have the expertise to probe that . . . That's really a job for the police."), *available at* http://www.themalaysianinsider.com/business/article/panel-finds-no-evidence-of-organised-crime-in-olympus-scandal/.

191. A lawyer who has served on a substantial number of such committees stated that there was always time pressure to resolve accounting issues to make required securities filings, and some companies pursued these issues with greater vigor than others. One key issue was whether the company, in addition to the third-party committee, also retained a forensic accounting team from a major accounting firm that had the capacity to fully investigate, understand, and restate financial statements. Interview with Junya Sato, Esq., Partner, Ishizawa, Ko & Sato, Tokyo (Nov. 29, 2011). There was no forensic accounting team in the Olympus case, and the chair of the third-party committee admitted in an interview that the committee could not confirm the ultimate recipients of all of Olympus' payments. *See* Hiroko Tabuchi & Keith Bradsher, *The Culture was Corrupt at Olympus, Panel Finds*, N.Y. TIMES, Dec. 6, 2011, http://www.nytimes.com/2011/12/07/business/global/banks-aided-in-olympus-cover-up-report-finds.html.

192. Accordingly, advocates of a greater role for independent directors in Japanese corporations do not regard the ad hoc use of third-party committees as a substitute for the independent oversight provided by independent directors. *See, e.g.*, Nicholas Benes, *The Nut of the Problem: Olympus, Kyushu Electric, and the "Third Party Committee" Problem,* The Board Director Training Institute of Japan (Oct. 22, 2011, 9:55am), http://bdti.or.jp/english/node/327. Despite the important governance issues raised by this growing use of ad hoc third party committees in Japan, there has been very little academic research or discussion concerning this phenomenon to date. Comment by Kenichi Ōsugi.

V. TOWARDS A MIXED MODEL? CONSIDERING EFFECTIVE MONITORING OF MANAGEMENT UNDER THE JAPANESE CORPORATE GOVERNANCE SYSTEM

Despite failing to make progress on the most highly visible and divisive issues such as requiring outside/independent directors, many large Japanese companies are making interesting improvements in corporate governance. Although it is difficult for a large and diverse industry group to agree to new legal requirements, companies are experimenting with new ways to improve corporate governance, and are moving to develop mixed or hybrid systems that they hope will act to combine the best elements of the board management and monitoring models.

The goal of this hybrid approach is to form a system that combines the information access of insiders with the independence of outsiders in a way that results in real board discussion and management oversight. This has been an ongoing topic for some time and was highlighted in an FSA report on corporate governance in 2009 that emphasized the possibility.[193] This hybrid approach remains a subject of active discussion at METI's ongoing corporate governance deliberations.[194] In addition, the newly proposed company with audit & supervisory committee system in which company auditors would be replaced by (or essentially "upgraded" to) an audit committee of the board,[195] is one effort at formalizing such a mixed approach. The goal of this

193. The FSA report noted the idea that the governance at traditional companies with auditors might be strengthened by company auditors cooperating with a limited number of outside directors. These outside directors would also cooperate with the corporate departments responsible for internal controls and audit to form a corporate governance structure with greater appeal to foreign institutional investors than the company with auditors structure. *See generally* FINANCIAL SERVICES AGENCY, REPORT BY THE FINANCIAL SYSTEM COUNCIL'S STUDY GROUP ON THE INTERNATIONALIZATION OF JAPANESE FINANCIAL AND CAPITAL MARKETS: TOWARD STRONGER CORPORATE GOVERNANCE OF PUBLICLY LISTED COMPANIES (June 17, 2009), *available at* http://www.fsa.go.jp/en/news/2009/20090618-1/01.pdf. *See also* Zadankai, Jôjô Gaisho wo Meguru Kaisei to Wagakuni no Koporeto Gabanansu [Panel Discussion: Amendments for Listed Companies and Japanese Corporate Governance] 1879 SHÔJI HÔMU 16 (Oct. 25, 2009). Although the discussion began, in part, as an attempt to justify a requirement of at least one outside director in addition to company auditors, it has since expanded to include more basic issues of corporate governance.

194. One of the topics under discussion by the METI study group is the potential role of "non-executive directors" (*higyômu shikkô yakuin*), which includes not only independent directors, but also directors with ties to the company who currently hold no executive position. For information on the METI study group, *see supra* note 104. Toshiba Corporation provides a good example of the use of such non-executive directors in practice. *See infra* note 216 and accompanying text.

195. *See* Draft Amendments, *supra* note 108; *supra* Table 3.

proposal is to allow Japanese boards to retain some of their current management role and to add a clearer supervisory role.[196]

The effectiveness of company auditors is a fundamental issue underlying this approach. They are criticized as lacking authority since they have no vote at board meetings and cannot hire or fire the CEO or directors.[197] In addition, they have historically been regarded as lifetime company employees who are not in a good position to question management and do not aggressively pursue their responsibilities.[198]

On the other hand, company auditors have some authority that directors do not, including a right of investigation (enabling them to obtain all relevant information) and the ability to obtain a court injunction against proposed illegal acts of the corporation.[199] They must attend board meetings and can voice their opinions;[200] over time their powers have increased and the qualifications, particularly of outside company auditors, have steadily improved.[201]

---

196. *See, e.g.*, Takei, *supra* note 118, at 13. The author notes that Japanese companies generally wish to retain a substantial management role for the board since they view a "hands-on" or "front line" management style (in Japanese "genba shugi" or literally "on-site ism") as an important method for Japan's high-ranking executives to contribute to the company, or (in the currently popular parlance) "add corporate value." *Id.* at 16. This proposed form looks closer to the company with auditors model than the company with committees model; however, it is relatively flexible and would hopefully, according to its proponents, satisfy the demands of foreign institutional investors for more independent directors without increasing the number of outsiders in top positions. *Id.* at 21. Whether it will satisfy foreign investors or have appeal for Japanese companies remains unknown. For the actual proposal on a company with an audit and a supervisory committee, *see* Draft Amendments, *supra* note 108.

197. *See, e.g., ACGA White Paper*, *supra* note 2, at 18.

198. *Id.*

199. *See* Companies Act, *supra* note 35, art. 381, ¶ 2 & art. 385, ¶ 1. For a summary of their role and authority, *see* the Japan Corporate Auditor Association's website, http://www.kansa.or.jp/en/about-corporate-auditor/about.html. Also, *see generally* Lin, *supra* note 117.

200. *See* Companies Act, *supra* note 35, art. 383, ¶ 1.

201. However, company auditors generally do not use a number of the powers granted to them under the Companies Act, such as their power to report problems to shareholders. *See* Takei, *supra* note 118, at 17-18. More generally, a new outside company auditor noted in a confidential interview that if company auditors actually exercised all their legal powers regularly they could be in influential positions. However, in practice many company auditors do not normally voice their views at board meetings, but rather convey their opinions at separate meetings of the board of audit (comprised of all the company auditors), so that the inside company auditors can inform management. Interview (confidential), Tokyo (Oct. 15, 2012). On the other hand, an active outside company auditor can make a real difference in a company where directors do not generally voice opinions at board meetings. At such companies, meetings can take on the tone of a dialogue between the company president and the active outside company auditor. Kuniya, *supra* note 152.

The best way to consider this issue may be in terms of functional strengths and weaknesses. Company auditors are relatively effective on certain issues such as scrutinizing proposed transactions for accounting or legal issues. They are weaker, however, in the important areas of handling conflicts of interest and monitoring top management; these areas have not been emphasized in Japan to date.[202]

One Japanese commentator characterizes this fundamental issue as Japanese companies conflating the audit function of company auditors with the supervisory function that would normally be carried out by a supervisory board (in Germany) or the board of directors (in the U.S.).[203] Although Japanese law and practice may be strong in auditing individual transactions, it is weak in the oversight of formulation and implementation of the company's strategic plans, as well as in personnel and compensation issues related to directors and top management.[204]

In fact, the board's lack of supervision over the CEO, including matters such as hiring and firing, may be the biggest corporate governance problem at traditional Japanese corporations.[205] In a stakeholder system in which the CEO acts on behalf of all interested parties, and not just the shareholders, it is unclear to whom the CEO is accountable.[206] In theory,

---

202. The function of company auditors is characterized by the Asian Corporate Governance Association as a "quasi-compliance officer" who will take action only when the company is violating the law or a reporting standard and concludes that the position of company auditor "seldom provides for real, independent supervision of senior management decisions." *See ACGA White Paper, supra* note 2, at 18. One interviewee characterized the Japanese and American corporate governance systems as comprising opposite extremes: the Japanese focus heavily on employees and compliance (and relatively little on monitoring of management) while Americans concentrate on supervising top management (and pay less attention to employees and compliance). *See* Shimaoka, *supra* note 100.

203. *See* Ōsugi, *supra* note 118, at 17.

204. *Id* at 19. Although these problems are often ascribed to entrenched corporate practices in Japan, the law also plays a role. Professor Ōsugi notes that the Companies Act provision on matters to be decided by the board (art. 362, ¶ 4, Item 2) is both underinclusive and overinclusive—i.e., it includes some relatively minor matters, but also does not provide explicitly for the board to decide basic business strategy. Similarly, in the personnel area, the board formally votes to decide the president, but there is no provision on procedures, standards, or a succession plan. *Id.* at 19.

205. *See, e.g.,* Lin *supra* note 117; Noboru Tsuda, Mitsubishi Kemikaru Hôrudingu Grûp no Gabanansu to Naibu Tosei [Governance and Internal Controls of the Mitsubishi Chemical Holdings Group], Business Research Institute, Tokyo, Oct. 18, 2012.

206. *See* discussion on corporate value in Japan, *supra* note 118. If the corporate purpose is to represent the interests of, and provide value to, all stakeholders, this can result in a concentration of power and discretion in the hands of management. This is one objection often cited by proponents of shareholder-oriented systems with respect to broader corporate goals regarding stakeholders and the public. *See, e.g.,* Hansmann and Kraakman, *supra* note 11.

under Japanese law the directors supervise the representative director (i.e., CEO).[207] In reality however, directors are often selected by the individual they are expected to supervise. Thus, instead of the CEO being accountable to shareholders or a board of directors, the CEO is the person to whom the board is accountable.

It is here that independent directors can play a critical role. Even if they do not constitute a majority of the board, a group of independent directors can potentially be effective in the most fundamental role of monitoring self-dealing and top management, particularly if the necessary information can be obtained. In a "mixed" system independent directors are expected to cooperate with knowledgeable insiders, such as company auditors or the company's internal audit and internal control departments, to be effective. This goes beyond the proposal for a single independent director, as has been discussed in recent corporate law reform efforts,[208] because it is unlikely that one independent director would feel comfortable or be effective as the sole voice to challenge management when necessary.[209] With respect to the question of how many independent directors would be necessary, the Asian Corporate Governance Association has proposed a minimum of three,[210] and other proposals utilize a similar approach as a starting point.[211]

This movement towards a mixed system is premised on the view of many leading Japanese companies that corporate govern-

207. The board of directors has the authority and duty to monitor the executive acts of both directors and executives. Companies Act, *supra* note 35, art. 362, ¶ 2, Item 2. The board has the authority to remove the representative director from his position at any time. Companies Act, *supra* note 35, art. 363, ¶ 2, Item 3.

208. Interim Proposal,, *supra* note 107 (listing such a requirement as one option).

209. For example, the Asian Corporate Governance Association bases its recommendations on the minimum number of independent directors for Japanese boards on "practical experience in other developed markets regarding the minimum number of independent directors required for the effective functioning of boards." *See ACGA White Paper*, *supra* note 2, at 21.

210. *See ACGA White Paper, supra* note 2, at 21. Although this is their recommendation for immediate action, they expect the percentage of independent directors to rise to one-third in the medium term and one-half in the long term. *Id.* The chairman of the Corporate Governance Research Group, Meiji Institute for Global Affairs, stated that while three independent directors would be ideal, two independent directors would both represent substantial progress and be more achievable at this point in time. Fujita, *supra* note 153.

211. *See, e.g.*, Nicholas Benes, *My Proposal for Company Law Reform in Japan: Ready To Be Dusted Off in Another Five Years*, BDTI (Dec. 1, 2011), http://bdti.or.jp/english/node/544 (proposing that public companies have the following choice: (1) appoint three independent directors who form an independent committee to make decisions on particular board decisions, defined by statute, in which managers have a conflict or self-interest, or (2) failing that, in shareholder derivative litigation directors will be subject to a rebuttable presumption of liability for alleged damages once plaintiffs have established causation and damages).

ance functioning is of greater importance than board structure. Although relatively few companies have adopted the company with committees structure and the political debate is deadlocked, leading Japanese companies do not necessarily see corporate governance as a stark choice between adopting this new structure or retaining the traditional company with auditors form. In fact, some industry leaders see some functional or practical similarities in approaches by companies with different board structures due to modifications of both types of structures by Japanese companies to achieve desired results.[212]

For example, as noted *supra*, the most commonly-cited reason for the unpopularity of the company with committees structure is the role of the nomination committee in theoretically supplanting the president's prerogatives.[213] However, some companies with auditors have a process to screen the president's preferred choices to ensure they are based on the merits and not on cronyism. In fact, a number of these companies have established formal committees with outsiders for that purpose.[214] Such a process theoretically retains the president's prerogative, while giving some real monitoring power to outsiders.

At the same time, the actual work of nomination committees at "American-style" companies with committees may not be very different from that of the traditional companies with auditors that have formed nomination committees. The reported role of such "American-style" nomination committees is often similarly limited to vetting candidates chosen by management (the presi-

---

212. *See, e.g.*, Shimaoka, *supra* note 100. This is also reportedly the premise of many participants in the current METI study group. For a description of this study group, *see supra* note 104. *See also* John Buchanan & Simon Deakin, *Japan's Paradoxical Response to the New 'Global Standard' in Corporate Governance*, 26 J. JAPANESE L. 59 (2008) (finding in a series of interviews that reform at Japanese companies did not depend on corporate form, and that both companies with auditors and companies with committees were engaged in streamlining their decision-making processes), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1013286.

213. *See, e.g.,* Managers Forum, *supra* note 141.

214. Teijin Limited has established an advisory board and one of its functions is to select CEO candidates and to recommend them to the board of directors. See *Corporate Governance Guide,* TEIJIN, http://www.teijin.co.jp/english/ir/governance/guide.html (last visited at Mar. 13, 2013). The company president does not, "in principle," participate in committee discussions. *Id.* Teijin also has three independent directors in a board of up to 10 directors. Another variation is the example of Asahi Glass Co., Ltd., a company with auditors that has established a nomination committee and a compensation committee. The nomination committee currently consists of four directors, the president and three outside directors. *See Corporate Governance,* ASAHI GLASS CO., http://www.agc.com/english/company/governance.html (last visited Mar. 13, 2013).

dent or chairman) and they generally do not seek to independently identify and screen potential candidates.[215]

In fact, the small number of Japanese companies that have adopted the company with committee structure have more generally modified the system in practice to address Japanese circumstances. For example, Toshiba emphasizes an equal division between executive directors and non-executive directors. A number of non-executive directors are valued as important former (well-informed) Toshiba officials who are senior to, and can more easily question, the current top management even though they do not qualify as outside directors under the Companies Act.[216] Companies' use of this structure can also evolve over time. For example, commentators originally criticized Hitachi as a company that utilized the company with committees structure for the traditional purpose of more closely coordinating the activities of its group companies.[217] However, it has more recently been praised for adding independent directors.[218]

---

215. *See* 21st Century Managers Forum, *supra* note 161, Comments at Meeting of Corporate Governance Forum, Business Research Institute, Tokyo (Sept. 27, 2012). It should also be noted that, as a practical matter, search firms for high level placements such as directors and CEOs are not well developed or generally relied upon in Japan as compared to the United States. Accordingly, it might not be easy for a nomination committee to conduct a thorough, completely independent search. *Id.*

216. At present, four of the non-executive directors qualify as outside directors. *See Corporate Governance*, TOSHIBA, http://www.toshiba.co.jp/csr/en/governance/governance.htm (last visited Mar. 13, 2013). Under the Companies Act a current or former executive director, executive, officer or employee of a company or any of its subsidiaries is excluded from the definition of outside director. See Companies Act, Art. 2, Item 15. Toshiba's approach is in keeping with the concept of combining insider expertise and authority with outsiders. The use of non-executive inside directors was, as noted above, included as a topic of the METI study group, *supra* note 104, and is considered a strong positive contribution to corporate governance by Toshiba. *See* Shimaoka, *supra* note 100.

217. *See* Gilson & Milhaupt, *supra* note 95. This was possible due to the broad definition of "outside director" under the Companies Act. Recently proposed amendments to the Companies Act seek to narrow this definition by excluding directors from group affiliates. *See* Draft Amendments, *supra* note 108.

218. *See* REUTERS, *supra* note 19. Adoption of the company with committees structure is also no guarantee of effective board monitoring. Ironically, Sony Corporation, which in the past was cited as the champion of "American-style" corporate governance, has recently been criticized for the board's failure to supervise management during the company's continued poor performance under CEO Howard Stringer from 2005-2011. With respect to corporate governance aspects, *see*, Tsuda, *supra* note 205. For Stringer as a failure, *see* William Pesek, *Apple Offers Clues to Where Sony Needs to Head*, BLOOMBERG (Feb. 7, 2012), http://www.bloomberg.com/news/2012-02-07/apple-offers-clues-to-where-sony-needs-to-go-commentary-by-william-pesek.html. Others have defended both Stringer and Sony as doing reasonably well given the poor position and declining profits of domestic Japanese electronic companies generally. *See, e.g., Sony and its Boss: Stringer Theory,* ECONOMIST, May 26, 2011, http://www.economist.com/node/18745381. In addition to the issue of monitoring of management performance, there was also a significant dispute at Sony about hiring Stringer's hand-picked successor as CEO. *See* Damion Rallis, *At Sony*

Thus, such innovative experimentation may be limited so far to leading Japanese companies that have made real efforts in the field of corporate governance. For such measures to have a significant impact on Japanese corporate governance generally (and perceptions of it), these best practices must somehow be codified and spread more broadly. Big business generally opposes mandatory legal requirements,[219] but the effectiveness of other methods for improving corporate governance remains uncertain. A more robust "comply or explain" system involving the TSE may be one method worth exploring, but there are limits on how far stock exchanges can promote corporate governance issues that are not based in law.[220] Some kind of code of best practice might also be considered, and the Asian Corporate Governance Association and others have advocated for such an approach in combination with a "comply or explain" requirement for listed companies.[221]

To date, the interesting reforms at leading Japanese companies, and an emerging "middle ground" of corporate governance practices, have gone largely unnoticed. Japan still has a reputa-

---

Corporation It's the Same Old Sony, GMI RATINGS (Oct. 10, 2012), http://www3.gmiratings.com/home/2012/10/at-sony-corporation-its-the-same-old-sony/.

219. *See, e.g.*, KEIDANREN CORPORATE GOVERNANCE, *supra* note 3. A government-sponsored proposal in 2002 to require at least one outside director was defeated, as business groups mobilized politicians to oppose the government's plan. *See* Gilson & Milhaupt, *supra* note 95.

220. Many Japanese seem to place their hope in the TSE acting as the champion of corporate governance reform, due both to the TSE's positive attitude toward reform and to the cautious attitude of other actors including business groups, the FSA, and Japanese institutional investors. Yumiko Miwa, Koporeeto Gabanansu Seido Hikaku to Nichi Futsu Kikan Tôshika [A Comparison of Corporate Governance Systems and Institutional Investors in Japan and France]; Mitsu Mizuno, SBF120 wo Kôsei suru Furansu Kigyô no Gabanansu Kaikaku—Wagakuni e no Shisa [Governance Reform of French Companies in the SBF 120—Suggestions for Japan], Corporate Governance Research Group, Meiji Institute for Global Affairs, Tokyo, Oct. 12, 2012 (comparing progress in corporate governance reform in Japan unfavorably to efforts in France, another stakeholder system, and expressing the hope that the TSE would take the lead in reform in Japan). In the United States, for example, the corporate governance section of the listing rules of the New York Stock Exchange were added in 2003 after the enactment of Sarbanes-Oxley.

221. *See, e.g.*, Presentation by Asian Corporate Governance Association, Corporate Governance in Japan: Issues for Long-Term Investors 41 (Mar. 9-11, 2009) (recommending that Japan develop an official code of best practice, as has been done in many other countries, to combine traditional strengths with new standards), *available at* http://www.acga-asia.org/public/files/ACGA_Investor_Delegation_Japan_March2009_Issues_Document_Final.pdf. Japan has a corporate governance code that sets forth general principles, but it has not been very effective in promoting good corporate governance practices compared to other countries such as Germany. *See* JAPAN CORPORATE GOVERNANCE COMMITTEE, JAPAN CORPORATE GOVERNANCE FORUM, REVISED CORPORATE GOVERNANCE PRINCIPLES (Oct. 26, 2001), *available at* http://www.ecgi.org/codes/documents/revised_corporate_governance_principles.pdf.

tion for poor corporate governance, at least among foreign institutional investors. Accordingly, further efforts must be made to determine acceptable minimum standards that are visible, accessible, and readily explainable so that progress can be more widespread and more readily demonstrated.

CONCLUSION

It is very difficult to prevent or detect the kind of deliberate fraud that occurred in the Olympus case. Nevertheless, the Olympus scandal strongly highlights the greatest problem in Japanese corporate governance: the lack of an effective system for monitoring management.

Japan's corporate governance reform efforts have been hampered by a perceived all-or-nothing choice: retention of the traditional company auditor system and downplaying or ignoring of monitoring issues or wholesale adoption of a form of the American-style monitoring model through selection of the optional company with committees structure. As a result, there has been little progress on the most widely debated issue of whether to require a minimum number of outside/independent directors.

This Article suggests several approaches to escape from the above deadlock. A rethinking of Japanese goals for corporate governance reform, including managing potential conflicts of interest, risk management, and global management would demonstrate both the importance of an effective system of monitoring management and its necessity to achieve these goals. It is not a question of a few "bad apples" at particular companies, but rather a fundamental issue for Japanese corporate governance that requires a systemic response.

Japanese companies could also utilize the post-Olympus debate as a useful opportunity to reconsider the basics of board functioning. A clearer separation of the board's functions of monitoring and management and a greater board role in the actual selection of the company president and directors would also contribute significantly to clarifying and strengthening the board's monitoring function.

"Fortifying the environment" for the exercise of independent judgment by independent directors and company auditors, as proposed by the TSE, is also important in creating an effective monitoring role for the board. Using the United States as an example, the means to accomplish this goal should include greater emphases on information and enforcement, and a more robust role for gatekeepers, particularly external auditors.

A "mixed" system, in which a number of independent directors cooperate with company auditors and other insiders, offers

some promise of a "middle ground" between the managing and monitoring models. In the absence of any overall agreement under the Companies Act or elsewhere on the contents or requirements for such a system, it has been left to individual companies to deal with corporate governance aspects of globalization of their activities and increased scrutiny from foreign institutional investors. In fact, a number of individual Japanese companies are already experimenting with more ambitious kinds of mixed or hybrid models that go beyond adding a small group of independent directors.

It is too soon to judge whether the current post-Olympus ferment in Japan will lead to a more effective management monitoring function within the traditional Japanese corporate structure. Such a result is achievable within the basic framework of the Japanese system of corporate governance without wholesale adaptation of an American monitoring model. Although amendment of the Companies Act has been a very cautious process, there is now a recommendation for Japan's first use of a "comply or explain" approach and the likelihood that the TSE will require one outside/independent director for listed companies in the near future. This approach could eventually lead to a code of best practice that is based on a mixed system with company auditors and a number of independent directors and is implemented through a "comply or explain" approach for listed companies. Such a development would represent a welcome improvement in Japanese corporate governance for Japanese stakeholders and foreign shareholders alike.

However, it is unclear how long the post-Olympus window of opportunity to reform corporate governance will remain open and whether business groups will act in time. Some major business groups still remain opposed to reform, but others fear that if the current opportunity to improve corporate governance in a flexible manner is not seized, the next major corporate governance scandal conceivably could result in rigid and costly mandatory requirements similar to the Sarbanes-Oxley Act. We will soon see whether reformers can utilize the post-Olympus opportunity to make progress in the monitoring of management through hybrid models and practical measures to make such monitoring effective.