

Asia-Pacific Office of CFA Institute/CFA Society of Japan

Inter-Corporate Network Dealings and Minority Shareholder Protection — Cases in Japan



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Contents

Introduction

Improvements Under Way	1
Inter-Corporate Network Relationships	2

Japanese Corporate Structures

Mitsui Echigoya: Emergence of a <i>Zaibatsu</i>	3
Comparison with Korean <i>Chaebol</i>	4
<i>Keiretsu</i> and Changing Inter-Corporate Relationships	4
Inter-Corporate Relationships outside <i>Keiretsu</i> Structures	5
Unwinding Cross-Shareholdings and the Changing Role of Banks	5

Disclosure of Related-Party Transactions

Disclosure Based on Accounting Standards	8
Disclosure Based on Listing Rules	10

Case Studies

Case 1: Listed Subsidiaries Shift Cash to Unlisted Group Financing Firms . . .	11
Case 2: Inflating Profits by Using Unlisted Subsidiary of Listed Subsidiary . . .	13
Case 3: Issuing Shares to Companies of the Same <i>Keiretsu</i> , Thereby Diluting Holdings of Minority Shareholders—Mitsubishi Group	15
Case 4: Issuing Shares to Friendly Companies Not Related to <i>Keiretsu</i> , Thereby Diluting Holdings of Other Minority Shareholders— Bull-Dog Sauce	16
Case 5: Tax Savings, Transfer Pricing, and Inter-Corporate Dealings	17

International Comparison and Contemporary Japanese Corporate Governance Practices

19

Remaining Issues, Ongoing Developments, and Recommendations

Shareholder Approval for Substantial Transactions	21
Increased Frequency of Disclosures	21
Improved Contents of Disclosures	21
Reducing Parent/Subsidiary Listings	22

Epilogue to Analysts: Recognize the Importance of Issues Regarding Related-Party Transactions

22

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Introduction

In September 2004, a seemingly minor article appeared in Japan's major financial daily newspaper mentioning that Japan's corporate governance practices ranked second from the bottom in an international survey.¹ Despite its smallness, this article drew widespread attention in the financial community and was often referred to among investment professionals and regulators even years later. The basis for the article was a press release by GovernanceMetrics International, an independent corporate governance research firm, in which the results of the firm's research into corporate governance practices in 23 countries were presented. In the rankings (with 1 as the best governance practices), Japan was ranked 22nd.²

Back in those days, corporate governance was receiving more and more attention among financial experts in Japan. As early as 2001, the Pension Fund Association of Japan (PFA), the second-largest pension fund in Japan, had released proxy-voting guidelines to recommend to the association's external managers how they should vote proxies.³ These external managers were also expected to report their actual voting records to the PFA. In addition, the PFA launched a Japanese equity fund for which the sole stock-selection criterion was the state of corporate governance at listed companies.⁴ The approach of this fund, which still exists, is to invest in companies with comparatively sound corporate governance practices. It was the first fund of its kind to invest on a large scale, even globally.

Improvements Under Way

Since 2004, many aspect of corporate governance—in terms of awareness and willingness to improve—have changed and improved in Japan. Not the least of these changes is that the initiatives taken by the PFA since the beginning of this decade have borne fruit. Proxy voting has become almost standard for Japanese fund management firms,⁵ and this practice is not limited to asset managers who invest on behalf of the PFA.

Not only have Japanese investors changed their general attitude toward proxy voting, but regulatory agencies such as Tokyo Stock Exchange (TSE), the Financial Services Agency (FSA), and the Ministry of Economy, Trade and Industry (METI) have also made efforts aimed at improving corporate governance of companies listed in Japan. These organizations have set up study panels with the goal of advancing efforts to realize improvements related to such governance issues as board accountability.⁶

On the individual corporate level, governance improvements are manifested in, for example, the fact that the benefits of inviting outside directors onto company's boards are slowly but surely being acknowledged. In recent years, the number of companies with outside directors has been increasing.⁷ This trend led to the establishment in March 2003 of an organization called (in English) "Japan Independent Directors Network"⁸ to facilitate education and information exchange among outside directors as well as communication between corporations and outside directors.

¹"Nihon ha shita kara 2 ban me," *Nikkei Financial Daily* (10 September 2004).

²"GMI Releases New Global Governance Ratings," press release, GovernanceMetrics International (7 September 2004).

³For further details in English, see www.pfa.or.jp/english/index.html.

⁴An interesting evaluation of this fund's characteristics appeared in "Koporeto Gabanansu Fando Kara Mita Nihon Kigyo No Koporeto Gabanansu No Genjo To Kadai," Pension Fund Association (February 2005).

⁵Akemi Yamasaki, "Proxy Voting Practices by Domestic Institutional Investors and AGMs"; in Japanese in UFJ Institute Reports, vol. 9, no. 2 (March 2004): www.murc.jp/report/ufj_report/902/32.pdf.

⁶See, for example, "The Corporate Governance Study Group Report," Corporate Governance Study Group of METI (17 June 2009); "Report by the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets," FSA (17 June 2009); "For Creating a Better Market Environment Where Investors Feel Secure," Advisory Group on Improvements to the TSE Listing System for the TSE (23 April 2009).

⁷"TSE-Listed Companies White Paper on Corporate Governance 2009," TSE (January 2009).

⁸The literal translation of the Japanese name for this association is "Outside Directors Network," which actually describes the nature of this organization much more accurately because not all of their outside-director members would be considered independent by common standards; further details can be found at www.shagai-net.jp/e-index.htm.

Inter-Corporate Network Relationships

Although substantial improvements to corporate governance at Japanese companies can reasonably be expected in the midterm future, efforts so far have concentrated on such issues as the independence of outside directors and auditors and disclosure of executive compensation. The type of dealings between the various legal entities *within* corporate networks known as “related-party transactions” has not yet received sufficient attention, despite its substantial relevance to the assessment of corporate risk in the investment process.

From the standpoint of investors in listed companies, inter-corporate dealings covered by the definition of related-party transactions (see the section “Disclosure of Related-Party Transactions”) and knowledge about such transactions must not be overlooked because these practices may signify heightened risk at an investment target. In other words, neglecting the evaluation of such transactions may have a direct negative impact on investment performance.

Japanese Corporate Structures

This section aims to increase understanding of the case studies later in this study. To develop a basic understanding of the nature of contemporary Japanese corporate structures and organizational networks, and subsequently about inter-corporate network dealings in Japan, a look at history is helpful. Numerous present-day industry groups were founded several hundred years ago. We will examine the development of one representative group to provide insights into the forces at work in the creation of organizational relationships and networks in Japan. Among the examples available, one of particular interest is the Mitsui part of what is now known as the Mitsui Sumitomo Group. It is a Japanese business success and is frequently cited as representative of Japanese corporate structures; in addition, its history is well documented.

Mitsui Echigoya: Emergence of a *Zaibatsu*⁹

The Mitsui part of today's conglomerate Mitsui Sumitomo was originally established by Mitsui Takatoshi in Edo, the old capital of Japan, in August 1673. In the original draper's shop, Mitsui Echigoya, Takatoshi introduced a number of innovations that helped his business grow.

One of the most striking innovations was the way kimonos, the typical Japanese dress worn by both women and men, were sold. In those days, the custom was for a kimono salesperson to tour the area, visit potential clients, and take their orders or to carry merchandise with them, which they would sell on the spot. In general, payments were concentrated in the months of June and December, a practice that raised prices because extra fees were charged, and also resulted in low capital turnover. Takatoshi changed these practices by building shops where people could buy kimonos right there with cash. This change in business approach, which seems minor these days, resulted in a rise in popularity of kimonos among the common people because kimonos became much more affordable.

In addition to the innovations that Takatoshi introduced after he first created his kimono shop, he moved into the money exchange business in 1683. Again, he built the business by introducing innovative approaches. In 17th century Japan, merchants who did business with counterparties in other areas commonly sent cash through the country to pay for merchandise. This cash transport was not only labor intensive, but it was also rather risky because criminals would rob the money on the way to its owner. To solve this problem, Takatoshi introduced a payment system that used promissory notes. The Mitsui exchange house formed in this manner received widespread recognition and respect in the business world.

Business continued to develop favorably in the following centuries until about the time of the start of the Meiji Restoration in 1866. Demand for kimonos weakened, making the oldest business less viable. As a result, the kimono business was split off, and the Mitsui Group was formed, in 1872, with the money exchange business as its core.¹⁰ The year 1879 marked the formal start of the Mitsui Bank and the old Mitsui trading house.¹¹ Later on, in 1893, the Mitsui Clan, as it was called, was formally established to manage the increasing number of businesses. The group of businesses was run by the Mitsui family, and only family members were allowed to invest funds in the group after it was finally incorporated as a joint stock corporation in 1909. That year is widely considered the birth of the Mitsui *zaibatsu*, a family-owned conglomerate with a bank at its core.

In addition to the Mitsui *zaibatsu*, three other major *zaibatsu* developed in Japan—namely, Mitsubishi, Sumitomo, and Yasuda. Just as with the Mitsui *zaibatsu*, a common characteristic was that the business groups were centered around a bank. All these major Japanese *zaibatsu* started developing a long time before the 20th century, and they were not founded as *zaibatsu* from the beginning but grew into *zaibatsu* in the course of time.

⁹This section is largely based on historical descriptions presented by the Mitsui Public Relations Committee; in Japanese, at www.mitsuipr.com/history.

¹⁰“From the Mitsui Family to the Mitsui Group”; in Japanese, at www.mitsuipr.com/history/toukatsu.html.

¹¹Masahiko Aoki and Hyung-Ki Kim, *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks* (Washington, DC: World Bank, 1995).

Comparison with Korean *Chaebol*

Over the border, South Korea has similar big industry groups, the *chaebol* (e.g., Samsung, Hyundai, LG). *Chaebol* is written in Chinese exactly like the Japanese term *zaibatsu*. Although on the surface, *zaibatsu* and *chaebol* appear to be the same type of groups, there are fundamental differences between them, which makes a direct comparison rather difficult.

In Korea, the *chaebol* were formed under the auspices of the government.¹² Although they have also been controlled by families, they were not established until after the end of World War II. The most striking distinction between them and the *zaibatsu* in Japan is that *chaebol* do not have banks at their core. In fact, *chaebol* were prohibited from owning banks; therefore, unlike their Japanese counterparts, they could not rely on financing from a group-owned bank. In Japanese *zaibatsu*, inter-corporate structures have been characterized by close relationships with group-owned main banks. In Korean *chaebol*, there is no such relationship.¹³

Keiretsu and Changing Inter-Corporate Relationships

Mitsui and the other main *zaibatsu* organizations in Japan enjoyed strong growth in the first half of the 20th century up to about the end of World War II. During the pre-WWII years and the war years, *zaibatsu* companies increased their market power—to the extent that the U.S. military governor during the occupation decided to dissolve these powerful groups.¹⁴ The main reason given for the dissolution was the concentration of power in a few industry groups, which ran contrary to the ideals of the capitalistic market system that the occupation forces were planning to introduce.

The market power of these groups, by the way, was incredible. Just for the Mitsui *zaibatsu* alone, for example, some accounts suggest that it was split up into more than 220 different individual companies in 1946.¹⁵ As part of this process, the stock of the holding companies at the *zaibatsu* organizations was confiscated, all inter-corporate stakes among *zaibatsu* companies were unwound, and these shares were sold in the equity market. A market for corporate control quickly took off as Japanese companies pursued hostile takeovers of each other and raiders extracted greenmail from unwilling target companies.¹⁶

As a result, business groups called *keiretsu* were newly formed; some (e.g., Mitsui, Mitsubishi) were quite similar to their previous *zaibatsu* structures. A big difference existed, however, between the structure of these *keiretsu* groups and the structure of the previous *zaibatsu*. In *zaibatsu*, the structure was essentially that of a family-owned business, but the *keiretsu* are not family owned.

For the purpose of analysis, *keiretsu* structures may be classified as “horizontal *keiretsu*,” which include the Mitsui Group and Mitsubishi Group (i.e., the old *zaibatsu* types that are centered around banks), and “vertical *keiretsu*,” which are held together by capital ties and connect manufacturers to parts suppliers or manufacturers to wholesalers and retailers. They include names such as Hitachi, Toshiba, and Toyota, which were founded in the first half of the 20th century—long after the establishment of the major *zaibatsu*.

¹²Yishay Yafeh, “An International Perspective of Japan’s Corporate Groups and Their Prospects,” NBER Working Paper 9386 (December 2002).

¹³For further studies about Korean business groups, see, for example, Sang Woo Nam, “The Principal Transactions Bank System in Korea and a Search for a New Bank–Business Relationship” in *Financial Deregulation and Integration in East Asia*. Edited by Emmanuel Takatoshi and Anne O. Krueger. NBER Book Series: East Asia Seminar on Economics (April 1996):277–306.

¹⁴Randall K. Morck, “A History of Corporate Governance around the World: Family Business Groups to Professional Managers,” *NBER Conference Report* (Chicago: University of Chicago Press, 16 January 2006).

¹⁵Takeda Haruhito, “Post-War Reforms: Development of Japanese Economic Democratization Policies” in *Contemporary Japanese Economic History*; in Japanese, at www.e.u-tokyo.ac.jp/~takeda/gyoseki/GAKU00-17.htm.

¹⁶Masao Nakamura and Randall Morck, “Been There, Done That. The History of Corporate Ownership in Japan,” ECGI-Finance Working Paper 20/2003, Sauder School of Business working paper (July 2003).

Another important characteristic of the *keiretsu* structure is substantial cross-shareholding among member companies. This practice formally stabilizes business relationships and also has the welcome effect of serving as protection against hostile takeovers. Financial institutions commonly own equity stakes in other companies belonging to the same *keiretsu*, and corporations within a conglomerate own stakes in each other in addition to holding stakes in the core financial institution that may be part of the structure.

Inter-Corporate Relationships outside *Keiretsu* Structures

Close relationships accompanied by capital ties exist not only within *keiretsu* structures in Japan. As a number of recent cases involving activist investors have made clear, business ties between, for example, a company and its suppliers are often close. An interesting example, which will be discussed in detail later, is Bull-Dog Sauce Company, Ltd. In 2007, it was fighting off an attempt by a shareholder activist to take over the company, which the board viewed negatively. Although not part of a major noteworthy *keiretsu* structure, Bull-Dog Sauce received support in its fight against the activist shareholder from a variety of other major long-term shareholders, including major life insurance companies and a major bank.

A primary goal of inter-corporate capital ties is to secure stable shareholdings, which also serve, at times, as effective takeover protection. In some cases, these capital ties are further strengthened by the presence of interlocking directorates.¹⁷ In yet other cases, capital ties are complemented by a strong informal social network, with regular face-to-face meetings between key persons in the different organizations in an informal atmosphere cementing the relationships.

Unwinding Cross-Shareholdings and the Changing Role of Banks

In the 1990s, a big change occurred in the general approach to inter-corporate relationships. After a period of strong economic growth in the second half of the 1980s, the so-called Bubble Economy in Japan, the economy entered a phase of weak growth—at times, even contraction. In this environment, it became increasingly difficult for banks and corporations to economically justify the practice of cross-shareholdings, especially because the banks were facing the need to secure funds to dispose of nonperforming loans and to respond to Bank for International Settlements (BIS) regulations. Under the framework of BIS rules, unrealized capital gains and losses from shareholdings are counted as Tier 1 capital (see **Exhibit 1** for an explanation). Shares held by banks, which were, in fact, twice the size of Tier 1 capital in 1999, had an excessive impact on bank lending behavior as stock prices declined, leading to a credit crunch.

Exhibit 1. Tier 1 Capital and Unrealized/Gains Losses

Unrealized capital gains and losses from shareholdings are part of Tier 1 capital. If, for example, Tier 1 capital is US\$100.00 and shareholdings are twice the size of Tier 1 capital, shareholdings are US\$200.00. If shareholdings decrease by 20 percent, the value of shareholdings decreases by US\$40.00. Because losses from shareholdings are counted as Tier 1 capital, the US\$40.00 loss on the shareholdings decreases Tier 1 capital from US\$100.00 to US\$60.00. If a bank extends credit and loans to the extent of 20 times Tier 1 capital, then outstanding credit and loans would be 20 times US\$100.00, which is US\$2,000.00. If Tier 1 capital then becomes US\$60.00 (as in our example), the ratio of 20 times becomes more than 33 times when the outstanding amount is US\$2,000.00. As a result, coverage of outstanding credit and loans by Tier 1 capital decreases and subsequently raises the loan portfolio's risk as bank lending behavior becomes more excessive, leading to a credit crunch.

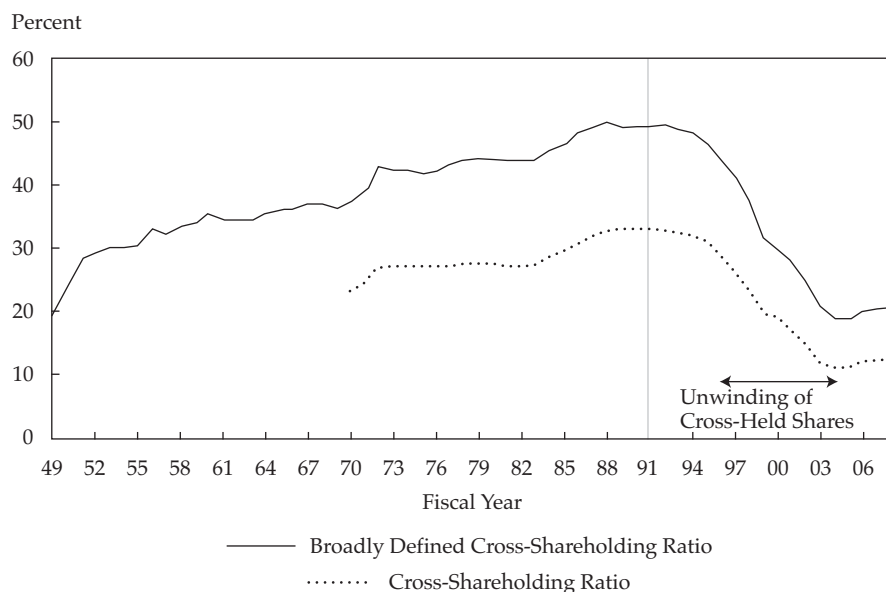
¹⁷An interesting example of interlocking directorates in Japan is Mitsubishi Heavy Industries; an interesting table in this regard can be found in “The Structure of Interlocking Directorates and Corporate Power in the U.S. and Japan through Social Network Analysis,” *Ritsumeikan Business Review*, vol. 45, no. 4 (November 2006):8.

Another factor influencing the trend away from cross-shareholdings was the introduction of current-value accounting. Another important factor to note is that bankers had grown increasingly aware of public criticism of their holding corporate shares.¹⁸

In the second half of the 1990s, after a big banking crisis, both banks and corporations started unwinding their holdings of client company shares, financial institution shares, and the shares of other friendly organizations. For example, as banks sold off shares as part of the process of unwinding cross-holdings, many of their client companies did the same, thereby accelerating the process. **Figure 1** shows how quickly this process developed.¹⁹

The effects of unwinding cross-holdings were manifold. The impact on the stock market was negative. What is more important for the purpose of this study, however, is the changing role of banks in the Japanese governance environment. Whereas in the past Japanese corporations had relied heavily on bank loans for financing, they now started issuing more bonds (actually, only in 1993 did the Financial System Reform Act open up investment banking for Japanese commercial banks). According to a study entitled “Is Universal Banking Justified?” between the first half of 1995 and the first half of 1997, the number of bond issues tripled—rising from 37 to 122. During that period, out of 439 issues, 46 percent were underwritten by banks.²⁰

Figure 1. Development of Cross-Shareholdings in Japan



Notes: (1) The “cross-shareholding ratio” is the market value of shares held by listed companies as a percentage of the total market capitalization of listed companies (excluding affiliates/subsidiaries and companies listed on the Jasdq Security Exchange). Broadly defined, the cross-shareholding ratio includes holdings of life insurance and non-life-insurance companies. (2) The data for fiscal year 2008 (FY08) are provisional—calculated from past data and trends in company shareholdings for nonfinancial companies and financial institutions that had not finished compiling data on the value of shareholdings because of the nature of the data. The cross-shareholding ratio for FY08, therefore, is provisional. (3) The data for FY1949–FY1989 are for reference; they are based on the Shareownership Survey by Japan’s stock exchanges.

Sources: Nomura Securities, based on Toyo Keizai’s major shareholder data, securities filings, and Shareownership Survey by the TSE, Osaka Securities Exchange, Nagoya Stock Exchange, Sapporo Stock Exchange, and Fukuoka Stock Exchange.

¹⁸Hideaki Miyajima and Kuroki Fumiaki, “The Unwinding of Cross-Shareholding: Causes, Effects, and Implications,” Discussion Paper 05006, Research Institute of Economy, Trade, and Industry (February 2005).

¹⁹Report published by Nomura Securities, “Changes in Structure of Share Ownership in FY 08” (2 July 2009).

²⁰Jun-Koo Kang and Wei-Lin Liu, “Is Universal Banking Justified? Evidence from Bank Underwriting of Corporate Bonds in Japan,” working paper presented at the American Finance Association Meetings (December 2003).

The role of banks changed further in the second half of the 1990s. The traditionally close relationships between corporations and banks gradually changed. Previously, a relationship with a main bank had been extremely important for corporations to gain access to capital through bank debt issuance, but the importance of these relationships diminished together with the deterioration in the economic environment. In the case of corporations with bond ratings of A or better, this change was especially significant. Of course, bank relationships and debt financing are still relatively more important to companies operating in low-growth areas or companies having difficulty accessing the capital markets.²¹

With the decrease in share holdings by banks, foreign investment in the Japanese stock market increased.²² As a result, institutional investors started to exercise more influence over companies to improve corporate governance and enhance shareholder value.

In the next section, we examine issues pertaining to the disclosure of related-party transactions in Japan. Without such disclosure, minority shareholders cannot assess the risks resulting from a potential mismatch of their interests with the interests of other stakeholders. Therefore, disclosure of related-party transactions is crucial for investor protection.

²¹Hideaki Miyajima and Yasuhiro Arikawa, "Relational Banking in Post Bubble Japan: Co-Existence of Soft and Hard Budget Constraint" in *Corporate Governance in Japan: Institutional Change and Organizational Diversity*, edited by Masahito Aoki, Gregory Jackson, and Hideaki Miyajima (August 2004).

²²See Table 2 in Miyajima and Fumiaki, "The Unwinding of Cross-Shareholding."

Disclosure of Related-Party Transactions

The rules regulating disclosure of related-party transactions in Japan emanate from accounting standards and the security exchanges.

Disclosure Based on Accounting Standards

Recent changes to Japanese corporate governance practices include improved information on related-party transactions. One significant development in this regard came in October 2006 when the Accounting Standards Board of Japan (ASBJ) approved ASBJ Statement No. 11: Accounting Standard for Related-Party Disclosures and ASBJ Guidance No. 13: Guidance on Accounting Standard for Related-Party Disclosures, Remarks on the Release, which were both aimed at improving disclosures regarding related-party transactions. The changes were intended to ensure convergence between Japanese accounting standards and international accounting standards; they took into consideration the results of analysis of the current rules associated with the Japanese Securities and Exchange Law, International Financial Reporting Standards, and U.S. Generally Accepted Accounting Principles.²³

Before 2006, information regarding “transactions with related parties” was formally required to be disclosed in the notes to consolidated and nonconsolidated financial statements and also was required to be audited. Related-party disclosures in Japan had been governed solely by rules of the Securities and Exchange Law (the Regulation for Financial Statements and the Regulation for Consolidated Financial Statements). Taking into account various recent developments, however, the ASBJ decided to prepare an accounting standard for related-party disclosures. The revision was based on the understanding that transactions between a reporting entity and its related parties, including transactions between the company and individuals related to the company, such as directors of the company, are not necessarily executed on an equal footing; as a result, they may affect the company’s financial position and performance. In addition, even if no direct transactions occur between the company and its related parties, the very existence of related parties may affect the company’s financial position and performance.

Another reason the ASBJ decided to revise the requirements for related-party disclosures was the increasing number of so-called pure holding companies (i.e., companies specializing in the formation of business strategies and management of a group of subsidiaries that controls companies engaging in actual business activities, such as manufacturing and sales, by way of their shareholdings). The intention was for related-party disclosures to provide appropriate information to the users of financial statements that is sufficient for them to assess the impact of transactions between the company and its related parties, or the existence of related parties, on the financial statements of the company.²⁴

In terms of what constitutes a related party, ASBJ Statement No. 11 requires that the scope of the related parties be determined by the substance of a relationship rather than any formal definition.

Exhibit 2 shows that the ASBJ definitions of related parties are basically in line with the definitions of the International Accounting Standards Board (IASB).²⁵

Figure 2 depicts the related parties in an inter-corporate structure, as defined by the ASBJ.

²³ASBJ Statement No. 11 and ASBJ Guidance No. 13 were released on 17 October 2006.

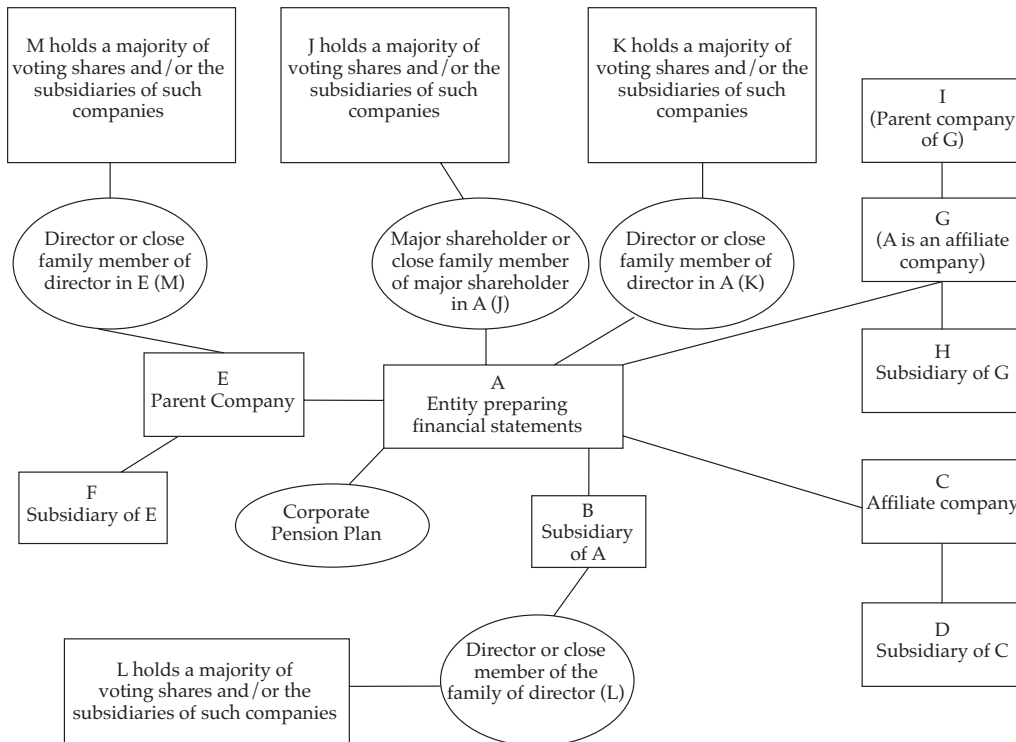
²⁴Kigyō Kaikēi Kijūn Iinkai, “Kigyō Kaikēi Kijūn Dai 11 Go: Kanrentōjisha No Kaiji Ni Kansuru Kaikēikijūn” (17 October 2006).

²⁵Exhibit 2 is based on Kigyō Kaikēi Kijūn Iinkai, “Kigyō Kaikēi Kijūn Dai 11 Go” and “Related-Party Transactions: Cautionary Tales for Investors in Asia,” CFA Institute (January 2009).

Exhibit 2. Definitions of "Related Party"

ASBJ Definition	IASB Definition
a. Major shareholders	a. Parties related through control (parent companies, subsidiaries, and fellow subsidiaries) or parties with joint control or significant influence over the entity
b. Parent company and subsidiaries of other related companies; companies in which a major shareholder of the reporting entity holds a majority of voting shares and the subsidiaries of such companies	b. Associates
c. Directors of parent company	c. Joint ventures
d. Important persons among directors of subsidiaries	d. Key management personnel
e. Close members of the family of major shareholders and directors	e. Close members of families or individuals referred to in clause a or clause d
f. Corporate pension plans	f. An entity in which any individuals referred to in clause d or clause e jointly control, significantly influence, or hold significant voting power
g. Jointly controlling investing entities and jointly controlled entities	g. Postemployment benefit plans for the benefit of employees of the entity or related parties of the entity

Figure 2. Scope of Related-Party Transactions



Source: Figure 2 was translated from Japanese and adapted for this paper; it was originally published by Suzuki Toshimitsu in "Kanrentojisha No Kaiji," Daiwa Institute of Research (28 December 2007).

Disclosure Based on Listing Rules

Based on the provisions set forth in the Securities and Exchange Law, related-party transactions need to be disclosed in financial statements. This practice ensures that relevant information is communicated to investors at least once a year, when the annual financial statements are submitted.

Relevant disclosures are required *only*, however, when annual financial statements are published. This timing may limit information. If, for example, significant related-party transactions take place during the business year, investors do not find out until after the end of that business year. In addition, in Japan (as in Korea), minority shareholders have no direct influence on a listed company's decision to enter into related-party transactions.²⁶ No prior shareholder approval of related-party transactions is required.

At this time, further regulation of disclosures of related-party transactions is not of high priority for the TSE in relation to other areas of concern.²⁷ A need to tackle issues surrounding private share placements to third parties has been acknowledged, however, to better protect the interests of minority shareholders. An interesting example related to this issue, which is not at all uncommon in Japan, involves the cases of Mitsubishi Motors and Steel Partners, which are presented in the next section.

²⁶TSE, "Section 2: Timely Disclosure of Corporate Information (Rule 402 to Rule 420)" in the Securities Listing Regulations. In English, at www.tse.or.jp/english/rules/regulations/securities.pdf.

²⁷Advisory Group on Improvements to the Listing System for the TSE, "For Creating Better Market Environment Where Investors Feel Secure" (23 April 2009).

Case Studies

The new treatment of disclosures of related-party transactions became mandatory in Japan for business years commencing in April 2008. Previously, related-party transactions had hardly been the focus of attention by investors and the media. This lack of attention is believed to be the major reason that obtaining detailed data about related-party transactions from public sources is so difficult. Although there appears to be an abundance of research on related-party transactions in Hong Kong, China, and Korea,²⁸ the situation in Japan is different. Broker research in this area, for example, hardly exists. Only occasional reports by securities firms in connection with comments on accounting standard revisions appear on the subject.

This lack of interest exists despite the fact that inter-corporate dealings in connection with related-party transactions are a vital aspect to investigate because the extent of the dealings can be a strong signal of a company's governance practices and sense of propriety. Moreover, although much literature about *keiretsu* as organizational structures exists, examples under the heading of related-party transactions are difficult to find. Therefore, to identify interesting cases about related-party transactions, we needed to study such sources as the disclosures in individual financial statements and news stories related to investigations into suspected fraud.

The following examples are intended to serve at least two purposes. First, they illustrate the problem of the usefulness of current disclosures for investors. Second, examining these cases is helpful in suggesting areas where improvements are expected.

Case 1: Listed Subsidiaries Shift Cash to Unlisted Group Financing Firms

In this category, prime examples are Nissan Shatai and Torii Pharmaceutical.

Nissan Shatai Co., Ltd.

This Japan-based manufacturing company, together with its subsidiaries and associated companies, is engaged principally in the manufacture and sale of various automobiles (such as passenger automobiles), commercial vehicles, and minibuses but also makes and sells automobile components, bodies, suspensions for specially equipped vehicles, and other automotive products. It offers automobiles and components to its parent company, Nissan Motor Co., Ltd. It has seven subsidiaries and one associated company in the country.²⁹

Nissan Shatai is listed on the TSE, as is Nissan Motor, making this example also an example of parent/subsidiary listings. Thanks to the listings of both the parent and the subsidiary, more data are publicly available than in other cases.

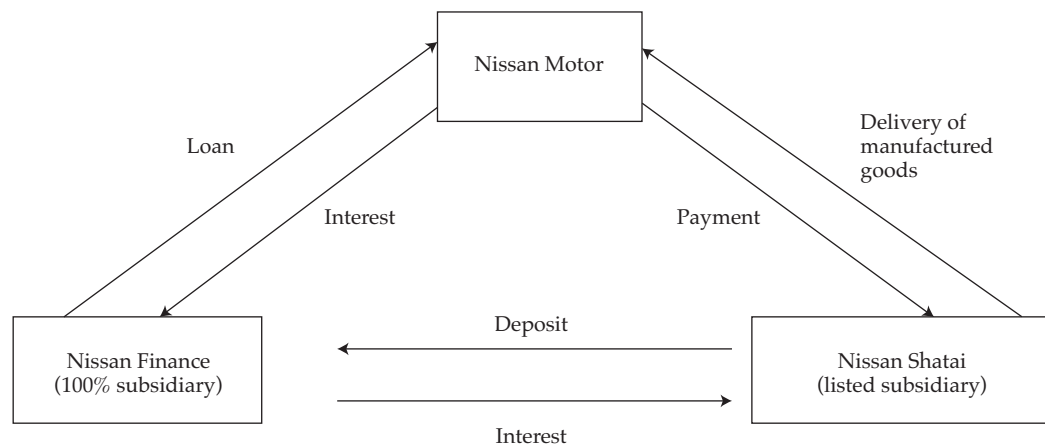
In July 2009, a Japanese newspaper reported, and subsequently so did the *Wall Street Journal*, that an activist fund took issue with the practice of one Nissan company extending low-interest loans to a sister financing company that was a 100 percent subsidiary of Nissan Motor. Such practices are common in Japanese business conglomerates. Specifically, the activist fund filed a legal complaint against Nissan Shatai, which belongs to the wider group of Nissan companies and is a cash-rich company, allegedly because of the low-interest loan it made to Nissan Finance.

Nissan Shatai's latest yearly reported financial statements reveal that it loaned ¥58.9 billion to a company called Nissan Finance, which is another Nissan Group company and engages in the management of funds for the Nissan Group. (To put things into perspective, ¥58.9 billion is slightly less than half of Nissan Shatai's market capitalization.) According to the annual report, Nissan Finance manages money for Nissan Shatai. The conditions for the corresponding agreement (interest rate, etc.) were set by both parties after Nissan Finance suggested the terms, according to the financial statements. **Figure 3** illustrates this relationship.

²⁸See, for example, CFA Institute, "Related-Party Transactions."

²⁹The description is from Google Finance at www.google.com/finance?q=TYO%3A7222.

Figure 3. Financing Relationship between Listed Subsidiary and Unlisted Financing Firm in Nissan Group



Nissan Motor owns 100 percent of Nissan Finance, and it also shares five directors with this company. In early 2002, Renault, the French car manufacturer, announced that it had acquired 44.4 percent of Nissan Motor. In the same month, Nissan Finance made a capital injection into Renault and created Nissan Renault, a new company. For Nissan Motor, the primary purpose of Nissan Finance is to provide financing for Nissan Group companies.

According to Nissan Motor's financial statements, as of March 2009, the average interest rate for its short-term debt was 2.28 percent. The activist fund asserts, however, that Nissan Shatai receives less than 1 percent for providing loans to other companies within the Nissan group through Nissan Finance. If the activist fund's assertion is correct (no reliable independent disclosure confirms it, but the company has made no denial), Nissan Motor and its shareholders would have an undeniable advantage over Nissan Shatai and its shareholders.

If Nissan Shatai were a simple organizational unit of Nissan rather than separately listed on the stock exchange, this lending practice would raise no questions. The fact that Nissan Shatai is a listed subsidiary, however, in which minority shareholders invest, gives rise to issues of minority shareholder protection.

Torii Pharmaceutical Co., Ltd.

The Nissan Shatai case is not at all unique in Japan. A similar case involves Torii Pharmaceutical, which is a subsidiary of Japan Tobacco Inc. Torii Pharmaceutical appears to have done the same thing as Nissan Shatai—that is, deposit cash with another group company. In the case of Torii Pharmaceutical, the financing company is referred to in English as JT Financial Services Corporation, which is an unlisted group company and belongs 100 percent to Japan Tobacco.

According to financial statements as of March 2009, Torii Pharmaceutical had "group cash management system deposits" amounting to ¥34 billion, which is significant in view of this company's net assets of ¥81 billion. As explained in a footnote in the financial statements, this type of system was created to centralize the cash management function for domestic group companies.

Recently, Japan Tobacco announced that the group cash management function performed by JT Financial Services would be taken over by the parent company.

The two cases shown in this section are typical examples of issues arising from parent/subsidiary listings. Such listings, in which both the parent company in a corporate network and a subsidiary are listed on a stock exchange, can give rise to potential conflicts of interest for the shareholders of the listed subsidiary, especially the minority shareholders. One such potential conflict may occur when a parent company in need of funds opts to raise them from its

subsidiary at terms advantageous to the parent company, resulting in the shareholders of the subsidiary earning lower returns from the surplus funds. Another example of such a conflict is the case where a subsidiary is taken private by the parent company by putting the shareholders in the subsidiary at a disadvantage (e.g., by offering a low purchase price). A third potential conflict is in the governance of the subsidiary when the parent company exercises significant influence in the appointment of directors in the subsidiary. In such cases, it raises questions whether the directors will act in the interest of the subsidiary or the parent company.

Case 2: Inflating Profits by Using Unlisted Subsidiary of Listed Subsidiary

The companies Nikko Cordial and Livedoor provide interesting examples of this practice aimed at inflating profits.

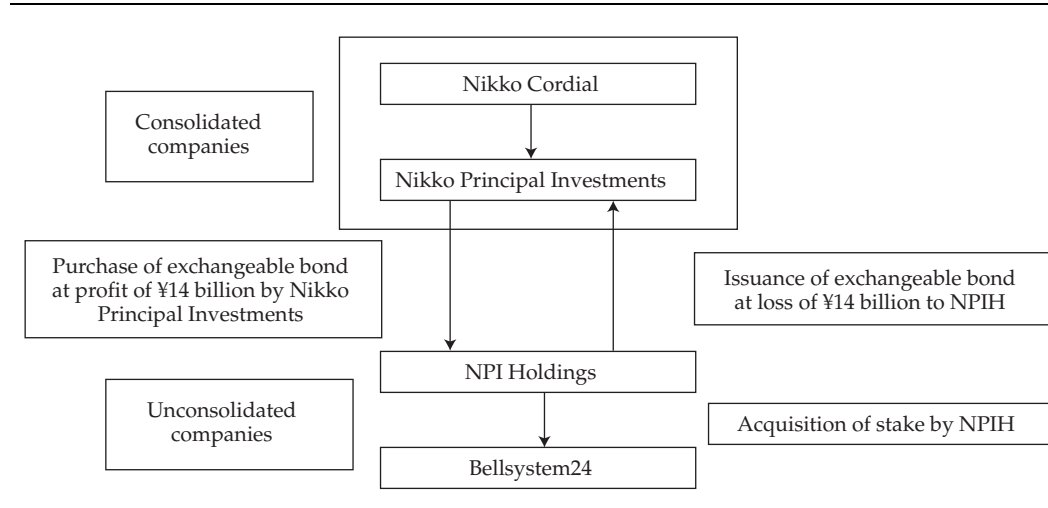
Nikko Cordial Corp.

Until recently, accounting standards did not require that certain related-party transactions be disclosed (e.g., transactions of the unconsolidated subsidiary of a consolidated subsidiary) because the definition of “related-party transaction” in Japan was narrower than it is today. The interesting case of Nikko Cordial helps explain some of the issues arising when related-party transactions were not disclosed. It also illustrates why it might be considered advantageous for management not to make such transactions known to the public.

On 16 December 2006, the press reported that Nikko Cordial was under investigation by the Securities and Exchange Surveillance Commission (SESC) for allegedly manipulating its earnings for the business year ended in March 2005. Nikko Cordial reportedly overstated its profit level in accounting for group companies. If the allegations proved to be true, it was reported that the SESC would probably urge the company to revise its financial statements and might ask the FSA to impose a fine.

Later, confirmation came that a consolidated subsidiary of Nikko Cordial, namely, Nikko Principal Investments Japan, Ltd. (NPI), had another subsidiary called NPI Holdings (NPIH), which was a special-purpose company and not consolidated. NPI made investments on its own account and also used NPIH to acquire a stake in a company called Bellsystem24 Inc., a call-center service provider. In the course of several transactions, the consolidated ordinary income of Nikko Cordial was inflated by around ¥14 billion. **Figure 4** depicts what was going on.

Figure 4. Nikko Cordial’s Profit-Inflating Scheme Using the Unconsolidated Subsidiary of a Subsidiary



NPIH acquired stocks of Bellsystem24 and then issued exchangeable bonds—for a loss of ¥14 billion. At the same time, NPI bought these exchangeable bonds and booked a valuation profit of ¥14 billion. Because NPIH was not consolidated, its loss did not appear in Nikko Cordial Group accounts. What appeared there, thanks to NPI being consolidated, was the ¥14 billion valuation profit of the same amount as the loss at NPIH. The criticisms were, of course, that both transactions were actually internal transactions within the group and that both the profit and corresponding loss should have appeared in the consolidated accounts.

It goes without saying that Nikko Cordial faced a number of challenges after this practice drew the attention of the SESC. Among the effects of this violation of the Securities and Exchange Law was a potential delisting of Nikko Cordial from the TSE, where it had been listed in the first section as one of the biggest security firms in Japan. Eventually, after the improprieties came to light, Citigroup Inc. bought Nikko Cordial and later merged it into Nikko Citi Holdings, Inc.

The Nikko Cordial case is noteworthy for another interesting development. The firm that audited Nikko Cordial's financial statements was Misuzu Audit Corporation, an audit firm that was the new incarnation of the old audit firm Chuo Aoyama PricewaterhouseCoopers, which had been forced to disband after an earlier accounting scandal involving accounting irregularities at Kanebo, a Japanese cosmetics manufacturer. Misuzu also was forced to disband because of its inability to discover financial misconduct in Nikko Cordial, the third largest brokerage company in Japan. It followed the same fate as the internationally known former Arthur Andersen.

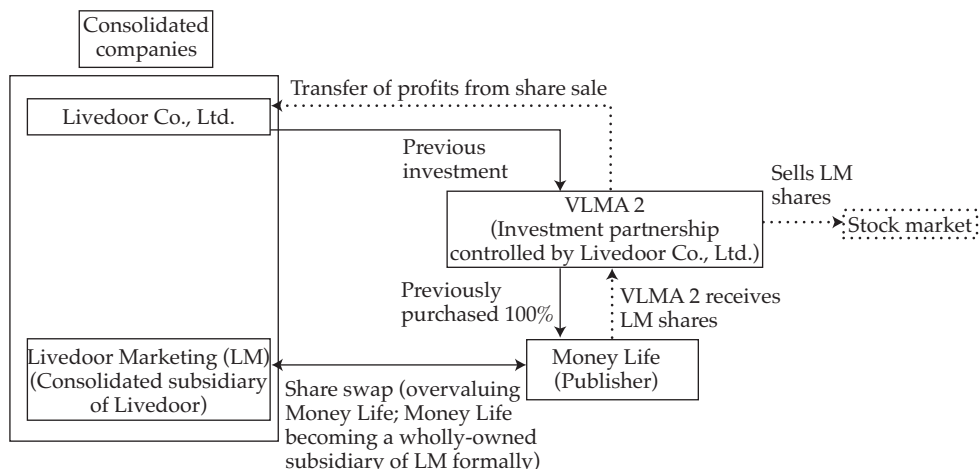
Livedoor

The case of Nikko Cordial does not exemplify a general habit of business conglomerates in Japan; the number of examples is too low. But a similar case does exist. It involves the Livedoor group of businesses, and Livedoor even made it into the international news back in 2004.

In simple terms, here is what happened: In the fall of 2004, Livedoor Co., Ltd., an internet service provider, acquired shares in Livedoor Marketing Co., Ltd., through a stock swap between Money Life Inc. and Livedoor Marketing Co., Ltd. (in this swap, the stock swap ratio overvalued Money Life's corporate value). Livedoor controlled Money Life because VLMA2 LLP, an investment partnership that had acquired a 100 percent stake in Money Life in June 2004, was already under Livedoor's control. VLMA2 was not consolidated.

In this scheme, Livedoor gained profit by selling off the shares in Livedoor Marketing after the price of Livedoor Marketing rose following a fictitious performance announcement and a stock split. For the financial statements as of 30 September 2004, Livedoor Marketing had created made-up revenues to make a loss on the income statement into a profit. **Figure 5** shows the general structure of the process.

Figure 5. Livedoor's Profit-Inflation Scheme



Note: Arrows with dotted lines indicate transactions that took place after the share swap.

The similarity of this case to the Nikko Cordial case is easy to see. Again, a nonconsolidated unit was used to inflate consolidated performance figures. Livedoor was eventually charged with violating the Securities and Exchange Law. Both Livedoor and Livedoor Marketing were delisted from the stock exchange.

Case 3: Issuing Shares to Companies of the Same *Keiretsu*, Thereby Diluting Holdings of Minority Shareholders—Mitsubishi Group

As we have discussed, the unwinding of the cross-shareholdings among *keiretsu* groups has accelerated in recent years. Nonetheless, the bond within each *keiretsu* group is still strong. The close relationships sometimes include centralized cash management systems whose purpose is to provide financing to other group companies—at times, listed group companies. The case in this subsection shows how *keiretsu* group companies support each other in times of extraordinary capital needs. It also shows that the financial institution that often exists within a *keiretsu* is not necessarily at its center.

Mitsubishi Motors Corporation (MMC) is a Japan-based automobile manufacturer. The company, together with its subsidiaries and associated companies, is engaged in the development, production, purchase, sale, import, and export of general and small-sized passenger vehicles, mini-vehicles, sport utility vehicles, vans, trucks, automobile parts, and industrial machines. It is also engaged in the checking and maintenance of new vehicles and the provision of automobile sales financing and leasing services.³⁰

MMC in 2004 was Japan's only unprofitable car maker. It was struggling to rebuild after DaimlerChrysler, the German automobile giant, had pulled out as the majority owner in the company. This pullout followed a substantial loss of customers after a series of scandals, including a defect cover-up, came to light. Facing a potentially existence-threatening crisis, MMC turned to other group companies for help.

In a press release issued on 21 May 2004, MMC announced a revitalization plan.³¹ To shore up its financial standing, it would obtain capital enhancement of ¥450 billion, with ¥270 billion coming from Mitsubishi Group companies, ¥10 billion from the MMC's strategic partner (China Motor Corporation), and ¥170 billion from the market. Preferred shares totaling ¥140 billion would be issued to Mitsubishi Heavy Industries, Mitsubishi Corporation, the Bank of Tokyo-Mitsubishi, and other Mitsubishi Group companies; at the same time, the Bank of Tokyo-Mitsubishi and Mitsubishi Trust & Banking Corporation would swap ¥130 billion of debt for equity. MMC would use ¥130 billion of the funds to pare debts and ¥320 billion to revitalize the company's operations.

Three types of preferred shares were to be issued, all of which could be converted to common stock in the future. Moreover, the preferred shares issued to Mitsubishi Group companies and China Motor Corporation were designed to be held for a relatively long period.

A press release issued on 12 December 2005 announced that preferred shares had been converted into common shares, which increased the ownership percentage of the Mitsubishi Heavy Industries, Mitsubishi Corporation, and the Bank of Tokyo-Mitsubishi from approximately 27.5 percent to approximately 34 percent.

This type of transaction—that is, issuing securities (in this case, preferred shares) to favored shareholders, converting the shares into common shares, and thereby increasing the holdings of the favored shareholders—is not uncommon in Japan. In such arrangements to increase capital, the allocation of shares to a limited group of parties is generally not perceived positively by the remaining shareholders. One of the reasons is the resulting dilution of voting rights of the other shareholders. When the stocks issued to the favored parties are considered to be too cheap, minority shareholders lose out even more.

³⁰This description is from Google Finance at www.google.com/finance?q=TYO:7211.

³¹“Mitsubishi Motors Announces FY03 Financial Results, FY04 Forecast and Business Revitalization Plan” (24 May 2004): media.mitsubishi-motors.com/pressrelease/e/corporate/detail1049.html.

Moreover, Mitsubishi Heavy Industries, Mitsubishi Corporation, and the Bank of Tokyo-Mitsubishi, as well as other Mitsubishi Group companies involved in the arrangement, are listed entities themselves. Therefore, a question that might be posed is whether helping out struggling Mitsubishi Motors was, in fact, advantageous to the shareholders of these companies.

Case 4: Issuing Shares to Friendly Companies Not Related to *Keiretsu*, Thereby Diluting Holdings of Other Minority Shareholders—Bull-Dog Sauce

The case of Bull-Dog Sauce illustrates how inter-corporate relationships outside the *keiretsu* framework are used to promote the long-term mutual benefit of the companies—but with shareholders' interests being sidelined.

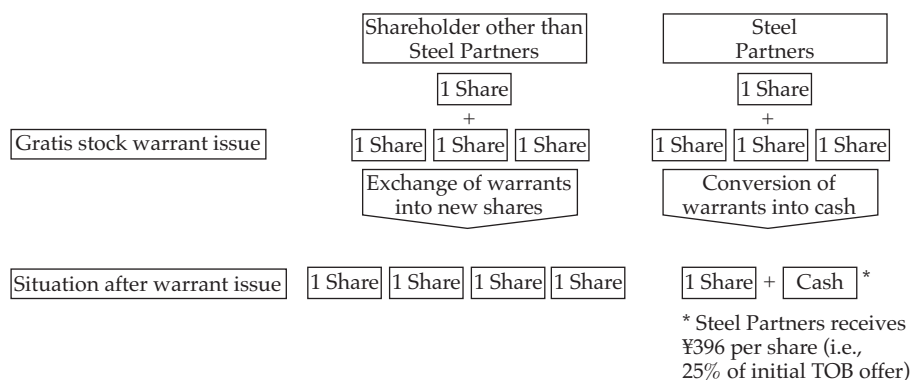
Bull-Dog Sauce is a Japan-based company principally engaged in the manufacture and sale of food seasonings. The company operates in two business segments. Operating in the seasoning and sauce segment, Bull-Dog manufactures and sells household products, including *okonomiyaki* (Japanese pancakes) sauce, onion sauce, Japanese plum sauce, sesame pork cutlet sauce, and cooking sauce. It also sells products for business use, including powder sauce, tabletop sauce, and Western style sauces, among others.³²

Starting in 2002, Steel Partners LLC, an activist fund based in the United States, accumulated shares of Bull-Dog Sauce. According to filings with local finance authorities, in May 2007, Steel Partners was the largest single shareholder, with 10.52 percent of shares outstanding. On 18 May in that year, Steel Partners commenced a tender offer for all the outstanding shares of Bull-Dog that the fund did not already own. The fund offered a 20 percent premium over the company's share price at that time.

In reaction, Bull-Dog Sauce introduced takeover defense measures. Specifically, the company designed a poison pill that was intended to reduce Steel Partner's holdings to 2.86 percent. Equity warrants would be issued and then exchanged for new shares in Bull-Dog Sauce. Steel Partners, however, would be refused the right to convert the equity warrants into new Bull-Dog shares. Instead, Bull-Dog Sauce would buy the warrants back in cash from Steel Partners for a predetermined price. The structure of the poison pill is shown in **Figure 6**. This scheme was approved by more than 80 percent of Bull-Dog Sauce shareholders.

Steel Partners did not, of course, sit passively by and watch the situation develop. It requested a temporary injunction to prevent Bull-Dog Sauce from implementing its gratis stock warrant issue. The request was first denied by the Tokyo District Court. Not satisfied with that ruling, Steel Partners took its case up to the Supreme Court of Japan, but it was rejected there also.

Figure 6. Bull-Dog Sauce Takeover Defense, June 2007



Source: Figure 6 is translated from the Japanese and adapted for this paper from “Legality of Bull-Dog’s Takeover Defense,” a report issued in Japanese by Daiwa Institute of Research (13 July 2007).

³²This description is from Google Finance at www.google.com/finance?q=TYO%3A2804.

Bull-Dog Sauce's defensive scheme eventually led to the intended result, namely, the dilution of Steel Partner's stake in the company and elimination of Steel Partner's voting rights. In April 2008, Steel Partners sold off its whole stake in the company, just as Bull-Dog Sauce had hoped.

Steel Partners is estimated to have made a hefty profit of ¥2 billion from Bull-Dog Sauce when it bought back the stock warrants. At the same time, speculation was that this profit had come at a huge cost to Bull-Dog Sauce—up to 70 percent of its sales revenue from the previous year. Bull-Dog Sauce, although it had previously said that it expected to make a profit of ¥500 million, now expected a loss of ¥980 million (US\$8.3 million) for the year to March 2008.

This case is of special interest for a number of reasons. In the end, Bull-Dog Sauce won with the help of friendly individual shareholders. The legal proceedings ended in their favor. The win came at such a high cost to the company, however, that its corporate value was significantly negatively affected. This outcome was subsequently reflected in a considerable drop in Bull-Dog Sauce's share price. In the end, Bull-Dog did not win in a monetary sense, nor did the individual or institutional shareholders benefit from the company's actions. A discussion about the nature of minority shareholder protection in general follows.

Major long-term shareholders in Bull-Dog Sauce include Mizuho Bank; food producer Yomeishu Seizo Co., Ltd.; an unlisted printing company, Toppan Printing; Aichi Bank; and Sakata Seed Corporation, a supplier of gardening products. According to 2009 financial statements, Bull-Dog Sauce owns stakes in all of these companies, making this case a classic example of cross-shareholding in Japan outside the traditional *keiretsu* structure.

The warrant-issue transactions that took place between these cross-shareholding parties are not considered to be related-party transactions. Because the holdings did not exceed 10 percent of Bull-Dog Sauce, none of these listed shareholders were considered to be "major shareholders" under Japanese accounting standards or the Japanese Securities and Exchange Law. Nevertheless, depending on whether a shareholder wields significant influence over the reporting entity, or vice-versa, no matter what the specific number of voting rights are, one might well conclude that these are related-party transactions.

In any case, significant shareholdings are now to be disclosed in yearly financial statements, and if such holdings exceed 5 percent of a company, they must be disclosed on an ongoing basis.

Case 5: Tax Savings, Transfer Pricing, and Inter-Corporate Dealings

Many Japanese companies operate on an international level, and related-party transactions within these groups of companies are rarely publicized, although they can reasonably be assumed to exist. Questionable cases in terms of inter-corporate transactions within such corporate networks do occasionally come to light in the course of investigations by, for example, tax authorities. Two recent examples in this regard involve Sony Corporation and Honda Corporation, well-known international Japanese companies. They came under the suspicion of tax authorities for using related-party transactions to save taxes. We do not intend to make a judgment in this paper about whether these companies engaged in wrongdoing. At the time of this writing, evidence to draw any conclusions was not sufficient. Practices similar to the ones described here can, however, pose significant risks for the investor and thus should not be overlooked.

Sony

According to a press release issued on 30 June 2006, the Tokyo Regional Taxation Bureau ordered Sony to pay ¥27.9 billion (US\$243 million) resulting from a transfer-pricing dispute. The Japanese authorities found that Sony had allocated profits between its subsidiaries but had failed to declare the transfers in Japan. Sony officials released a press statement saying that the company would pay the fine in full but would file an appeal.

The parts of Sony involved in these allegations were Sony Corporation and Sony Computer Entertainment Inc. (SCEI). Both entities received notification of reassessments by the Tokyo Regional Taxation Bureau. SCEI's profits that it had reported from transactions between SCEI and its subsidiary, Sony Computer Entertainment America Inc., for the fiscal years

ended 31 March 2000 through 2005, were reassessed. Sony received notification on the same date of a reassessment of the profits it reported from transactions related to CD and DVD manufacturing operations with several of its overseas subsidiaries for the fiscal years ended 31 March 2004 and 2005. The tax authorities in Japan claimed that Sony had a duty to report these transactions because they had occurred below satisfactory prices. Sony apparently transferred money from Japan to its U.S. subsidiaries to save on tax payments and thus increase profits. The tax authorities did not levy penalties on Sony other than the additional taxes. Furthermore, no disciplinary actions were taken against anyone at Sony.

With no real penalties being applied other than being forced to pay taxes that they would have had to pay anyway, Sony had no meaningful incentive to comply with Japanese transfer-pricing regulations. In fact, Sony was a repeat offender. Sony was forced to pay ¥4.5 billion for unlawful transfer-pricing activities between the Japanese parent company and worldwide CD and DVD manufacturing subsidiaries between 1998 and 2002. Since the 2006 actions by the tax authorities, however, Sony has reached out to U.S. and Japanese tax authorities for guidance on how to avoid further transfer-pricing entanglements.

Honda

According to a press release issued by Honda in April 2008, the company was being examined by the Tokyo Regional Taxation Bureau on matters related to transfer pricing. In the examination, the authorities claimed that over the five-year period ended 31 March 2006, allocation of the total profit of Honda and its Chinese joint venture companies from their automobile business in China assigned too much of the profit to the joint venture companies.

Honda stated that the prices it established for transactions with the Chinese joint venture companies were intended to comply with the local laws and regulations of both Japan and China and resulted in the appropriate amount of taxes in both countries.

According to press reports, the company had failed to report about ¥140 billion in income and had set aside a ¥80 billion provision to cover possible taxes resulting from the investigation. Honda's annual report for the year ended 31 March 2008 shows that the effective tax rate was 43.2 percent, an increase of 7.4 percentage points from the previous fiscal year. This increase was mainly a recognition of liabilities for unrecognized tax benefits as a result of the ongoing examination of the company's tax filings by the Tokyo Regional Taxation Bureau with regard to transfer pricing.

Naturally, Sony and Honda are not the only listed companies facing such transfer-pricing issues. Moreover, the practices described here are not limited to Japanese companies.

International Comparison and Contemporary Japanese Corporate Governance Practices

One of the main reasons Japanese corporate governance did not rank highly in an international comparison five years ago is the relatively low proportion of independent directors on Japanese boards.³³ This situation raised questions about the degree of board accountability in Japan. In addition, Japanese companies' boards tended to have too many members to make the necessary strategic decisions in an appropriate manner. This problem was particularly evident in the case of construction companies. In some cases, boards had 40 or more members. Additionally, the terms many directors served were long, especially when compared with the terms of directors in other countries. For example, nearly two-thirds of directors at Nikkei 225 companies had served for more than 15 years at the same company.³⁴

In addition, because of the lax disclosure requirements in Japan, especially when compared with U.S. or U.K. standards, the general degree of information being disclosed in Japan left room for improvement.

Of course, not everything was bad in Japan five years ago. Both fair and "green" procurement practices were widespread among Japanese companies. These practices were sometimes accompanied by monitoring systems. An example would be Sony's "Green Partner Environmental Quality Approval Program." In addition, a few companies (including Olympus Group and Hitachi Group) had started issuing intellectual property reports aimed at combating counterfeit and pirated goods, thus voluntarily following the guidelines set by the METI. Moreover, whereas potential dilution through the issuance of stock was becoming more and more an issue in the United States, the same was not true in Japan; stock options there were not generally a feature of compensation practices.

Through an amendment to the Japanese Commercial Code in April 2003, an improvement to board practices became available thanks to the introduction, as an option, of the kind of committee system practiced by U.S. companies. In the traditional Japanese model, a board of directors and a board of statutory auditors exist in parallel; the new system calls for the creation of nomination, auditing, and remuneration committees. Some well-known companies, including Nomura Holdings, have adopted such a committee structure.

Although these aspects are all of general relevance in corporate governance, what matters to an investor, who is in a principal-agent relationship with a company's management, are board accountability and information disclosure. In these areas, Japanese regulatory institutions have been working hard to improve the governance practices.

Indeed, major efforts to improve corporate governance in Japan have been going on since the beginning of the 21st century. Until about 2002, top management at Japanese companies did not particularly take the shareholders into account when making strategic decisions. In their relationships with stakeholders, managers placed much more emphasis on employees or banks. Nowadays, the FSA, TSE, and METI are all working toward a regulatory framework that encourages companies to be more aware of the rights and interests of shareholders.

In addition to these efforts of regulatory authorities, many companies have responded to the requirements of present-day investors. Activities by such Japanese investors as the PFA and by foreign investors have led some companies to introduce independent directors. Nonindependent outside directors have also been added to improve information sharing, for example, with the parent company.

The activities of the PFA are particularly important; without its clear support for shareholder interests, corporate governance at Japanese companies would not have improved to the great extent it has in the past several years. Active proxy voting by the PFA has been a major driver of corporate governance changes. In 2009, for example, the PFA voted against the reappointment of directors for companies whose return on equity (ROE) was less than 8

³³ See a summary of the speech given on 21 January 2005 at the Pension Fund Association; in Japanese, at www.pfa.or.jp/jigyo/shisan/gava_giketsuken/suishin/files/cg_kaigi02_roku.pdf.

³⁴ GovernanceMetrics International, "GMI Launches Japanese Corporate Governance Ratings" (27 May 2003): <http://gmiratings.com/Release20030527.html>.

percent in the previous three consecutive fiscal years and which had failed to provide convincing explanations of business plans, capital policy, and so forth, to shareholders, including reasons for the current state of affairs and effective measures to rectify it. In general, the PFA takes the position that for a company whose ROE has been less than 8 percent for three consecutive years, the reappointment of incumbent directors is hard to justify.

The PFA has turned into a vocal shareholder at many of the companies it invests in. As a shareholder, it takes part in the approval process for such issues as the appropriation of retained earnings, partial amendment to articles of incorporation, appointment of directors, granting of stock options, revision of executive remuneration, and allowing retirement bonuses.

The strengthening of the shareholder's position as a stakeholder has had a big impact on governance behavior at Japanese companies. As we have noted, before WWII, the big family-dominated *zaibatsu*, which controlled up to 35 percent of economic activity,³⁵ had no need to communicate to outside capital providers. After the war, relationships of the *zaibatsu* with banks changed profoundly. With the unwinding of cross-holdings in the 1990s and increase in shareholdings by foreign investors, one of the major new challenges was dealing with increased requests for oversight by shareholders. The result has been an increasing emphasis on such governance factors as board accountability. Although a detailed description of recent improvements to corporate governance behavior at Japanese companies is beyond the scope of this paper, **Exhibit 3** summarizes important recent developments.

Exhibit 3. Recent Corporate Governance Improvements in Japan

Development	Comment
Introduction of committee system with revision of Commercial Code in 2003	Companies that adopt the committee system are required to form a nomination committee, a remuneration committee, and an audit committee; each of these committees must comprise three or more members, of whom outside directors must make up the majority; although at present the number of companies that have adopted this system is limited, the ones that did introduce it are seen as eager to adopt sound governance practices
Number of board directors significantly decreased in recent years*	Although there was a major company with 50 directors on its board as late as 2004, things are changing; in 2008, only 20 companies had more than 20 directors on the board; the average number of board members at companies listed on the TSE is 8.68 today, which is lower than in 2006
Improvements in information disclosure	Today, more companies disclose total remuneration amounts for inside and outside directors separately;** recent changes to accounting standards have led to improved disclosure of related-party transactions
Improved internal control mechanisms	Under the Companies Act (informally, the J-SOX law because it is seen as the Japanese version of the U.S. Sarbanes–Oxley Act of 2002), since May 2006, large companies and companies adopting a committee system are required to provide an assessment of the internal control over their financial reporting***
Takeover defenses	In 2008, 23.8% of the companies listed in the first section of the TSE had some kind of takeover defense in place; this figure was up 6.9 percentage points compared with only two years earlier; increased investments by “vocal” foreigners and the so-called cheapness of Japanese companies are thought to be the major reasons; recently, however, the trend to introduce poison pills has ebbed, with a total net increase of only four companies during the 12-month period until May 2009

*TSE, “TSE-Listed Companies White Paper on Corporate Governance 2009” (January 2009).

**Also see TSE, “TSE-Listed Companies White Paper on Corporate Governance 2007” (March 2007).

***See, for example, “Financial Instruments Exchange Law (J-SOX)” at www.deloitte.com/view/en_US/us/Services/additional-services/Japanese-Services-Group/Financial-Instruments-Exchange-Law-J-SOX/index.htm.

³⁵Aoki and Kim, *Corporate Governance in Transitional Economies*.

Remaining Issues, Ongoing Developments, and Recommendations

The cases cited in this report explain why issues arising from inter-corporate dealings in the form of related-party transactions are important. Significant risks are involved if such transactions are not disclosed to investors in a timely fashion. In the case of Japan, the issue is not necessarily too much control concentrated in the hands of a founding family, as it is in some other countries in Asia. Indeed, in a 1999 World Bank study, the Japanese companies had the least concentrated ownership in comparison with other major Asian countries.³⁶ In Japan, related-party transactions on the part of founding families against the interests of minority shareholders are relatively rare. What is common are groups of companies, independently listed companies, helping each other out, as in the case of Mitsubishi. The minority shareholders in the “supporting” companies may be at a disadvantage to the minority shareholders in the “supported” company.

No country in the world has a perfect regulatory framework for the corporate governance of listed companies in relation to minority shareholder protection. Room for improvement exists in Japan as it does elsewhere. In terms of inter-corporate transactions, defined as related-party transactions, the following issues are likely to receive priority treatment in the ongoing process of improving corporate governance and, in turn, investor protection in Japan: requiring shareholder approval for substantial transactions, increasing frequency and expanding content of disclosures, and reducing the number of parent/subsidiary listings.

Shareholder Approval for Substantial Transactions

Most board decisions that will have a significant impact on the corporation—such as a change to the articles of incorporation, a merger, and acquisition or sale of business units—are subject to shareholder approval in Japan, as in most other countries and global best practice. However, some significant transactions require only board approval. For example, with two exceptions, Japanese Corporate Law gives the boards of directors of public companies the authority to decide on implementing private placements without shareholder approval; the two cases that do require shareholder approval are (1) when new shares are to be issued at a price particularly advantageous to private placement purchasers and (2) when new shares are to be issued without reasonable justification. Japanese regulatory authorities have acknowledged that all *material* transactions, such as transfers of assets or transactions accompanied by the dilution of minority shareholders’ rights, should, in principle, be subject to shareholder approval.

Increased Frequency of Disclosures

Disclosure of related-party transactions is basically mandatory once a year. For investors to evaluate potential risks at the companies they are investing in, however, more frequent disclosure of such transactions would be desirable. Indeed, it is in the interest of minority shareholders if disclosures of significant transactions are mandatory each time a company decides to enter into such a transaction. Adequate thresholds have to be established to determine the size of transaction that needs reporting and approval. This practice will be in line with global best practice as described in OECD’s *Guide on Fighting Abusive Related Party Transactions in Asia*, published in September 2009.

Improved Contents of Disclosures

The very existence of a related-party transaction might be of interest to shareholders, but without details about the contents of such a transaction, the value of the disclosure is limited. In the case of Nissan Shatai, for example, the contents of the agreement with Nissan Finance

³⁶Stijn Claessens, Simeon Djankov, Joseph P.H. Fan, and Larry H.P. Lang, “Expropriation of Minority Shareholders: Evidence from East Asia,” World Bank Policy Research Working Paper 2088 (June 1999).

were needed for an investor to draw conclusions about whether minority shareholders were put at a disadvantage for the benefit of Nissan Shatai's parent company. Shareholders should be provided with sufficient information to evaluate the impact of the transaction on the value of the company.

Reducing Parent/Subsidiary Listings

Although the problems for shareholders that arise from allowing parent and subsidiary listings have been widely acknowledged, this issue is of particular importance in Japan. Some 12.6 percent of TSE-listed companies have parent companies, and some 85.7 percent (10.8 percent of the total) of these parents are also listed companies.³⁷ New subsidiaries are being listed even now, even though evidence indicates that potential and actual conflicts of interest arise in the related-party transactions between these listed organizations (and within their groups) that are not in the interest of minority shareholders.

According to an interview given to *Bloomberg* in December 2009, the CEO of the Tokyo Stock Exchange voiced his concern about the practice of parent/subsidiary listings and acknowledged the potential of conflicts. The key problem lies with the governance of the subsidiary when the parent company has significant influence to appoint the directors of the subsidiary. There is already a move by regulators and market participants to reassess the parent/subsidiary situation. The problem can be rectified by making the subsidiary a wholly owned unit of the parent or by selling it off entirely. CFA Institute supports such initiatives to improve the governance landscape in Japan.

Epilogue to Analysts: Recognize the Importance of Issues Regarding Related-Party Transactions

Analysts tend to emphasize quantifiable factors, such as sales figures, while neglecting qualitative factors, such as corporate governance. Disclosures of related-party transactions may be easily read over and forgotten, and the potential for such transactions to disadvantage minority shareholders may not be recognized. To fulfill their fiduciary duty, however, institutional investors must be aware of the risk at the companies they invest in. Therefore, they must recognize the risk inherent in related-party transactions in Japan and elsewhere.

³⁷TSE, "TSE-Listed Companies White Paper on Corporate Governance 2009."

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