JAPANESE CORPORATE GOVERNANCE REFORM: WHAT IS REQUIRED FOR EFFECTIVE FUNCTIONING OF OUTSIDE DIRECTORS?

Masaru Suzuki
Attorney at Ministry of Justice of Japan
E-mail: msuzuki1016@gmail.com

ABSTRACT

The topic of outside directors' functions has been attracting significant attention for many years now, especially in the discussions about corporate governance reform in Japan. Over the last two decades, most listed Japanese companies have voluntarily introduced outside directors into their boardrooms, in line with the gradual change in an overall corporate governance system toward a monitoring board model moving away from the more traditional management board model. It appears the recent trend is for companies to add outside directors to their boards of directors to increase corporate values. In the midst of transforming the management board model into the monitoring board model, closely reexamining the functions of outside directors is necessary. What can be concluded from the lessons learned from recent corporate scandals and the discussions concerning the functions of outside directors is: (1) outside directors should be truly independent from the company's management; and (2) outside directors need access to the company's corporate information in order to prevent corporate scandals and to provide appropriate advice to the company's management. This paper aims at considering how to make outside directors more effective and their roles more substantial, based on the history of corporate governance reform in Japan.

Keywords: corporate governance, reform, outside director.

A. INTRODUCTION

Corporate governance is usually defined as a structure for monitoring corporate management. In the history of Japanese corporate governance reform, it has been discussed in terms of corporate fraud or scandal prevention, as well as in terms of profitability and competitiveness of corporations (Hideki Kanda, 2018:179). In the Corporate Governance Code, released by the Tokyo Stock Exchange ("TSE") in 2015, the definition of "corporate governance" came to reflect the above-described trend, by taking on the meaning of a structure for a company's transparent, fair, timely, and decisive decision-making, with due attention to the needs and perspectives of stakeholders, including shareholders, customers, employees, and local communities. Consequently, outside directors play a central role in corporate governance reform in Japan, and are expected to prevent a corporate scandal and to provide advice based on their extensive expertise in corporate management. It is evident that merely introducing an outside director to a company's board of directors would not be meaningful; and if an outside director fails to monitor a company's corporate management properly, and as a result a corporate scandal arises, the company could develop a poor reputation, especially lacking an effective monitoring function within the company, notwithstanding the introduction of an outside director (Nippon Keidanren, 2009).

In the discussions concerning Japanese corporate governance reform, it has been pointed out that, if outside directors do not have sufficient access to corporate information, especially information related to management, the outside directors without the corporate information would be unable to fulfill their function to monitor corporate management (Hidetaka Aoki, 2017 : 341). Moreover, outside directors have recently become required to be more independent from the company's management and to have greater expertise in order to fully implement their monitoring function.

In this regard, the Corporate Law Subcommittee (Corporate Governance) of the Legislative Council ("Subcommittee") within Japan's Ministry of Justice has been discussing whether amending the Japanese Companies Act in terms of enhancing outside directors' functions is necessary. The discussion clearly showed that Japan's corporate governance system aims to prevent a corporate scandal and streamline corporate management by increasing the number of outside directors who would introduce a "breath of fresh air" into a company's board in view of the Subcommittee's proposal for a mandatory appointment of at least one outside director with wider functions in corporate governance. In fact, there has been a sudden great increase in the appointment ratio of outside directors in Japanese listed companies over the last five years (Tokyo Stock Exchange, 2018 : 3), and many empirical research has been conducted to prove the effectiveness of outside directors in terms of corporate governance (Hidetaka Aoki, 2017 : 335-368). Going forward, outside directors' ideal functions need to be explored further to establish effective corporate governance during the transition period from the traditional management board model to the new monitoring board model.

B. PROBLEM STATEMENT

According to the problems explained from the introduction, the author wants to discuss about what is required for effective functioning of outside directores in the context of Japanese corporate governance reform.

C. RESEARCH METHODS

The research is a normative legal research (doctrinal research). It used a qualitative analysis and legislation, case, as well as conceptual approaches. Thus, the choice of relevant material and integrated interpretation during interviews with stakeholders related to the main research issues.

D. DISCUSSION AND RESEARCH RESULT

1. History of Corporate Governance in Japan

When exploring the functions of outside directors, reviewing the history of Japanese corporate governance reform is worthwhile because the development of its transition can be clearly seen. The features of Japanese corporate governance until the 1980s are usually considered to be: the main-bank system, cross-shareholding system, and large-scale boards consisting of internal directors (Hideaki Miyajima, 2017 : 7). These features have been regarded to mutually complement the economic systems, including lifetime employment and long-term contracts with suppliers, so-called "*keiretsu*". These elements traditionally have played an important role in corporate governance in Japan as an alternative to outside directors, regardless of their actual monitoring capacity function and effectiveness.

First, in the main bank system, banks had contributed to a company' s healthy and sound development by monitoring its financial health and earning capacity when the banks provided the company with financing. In addition, in a financial crisis, the banks would request the company to follow the banks' instructions regarding, not only the company's business plans, but also its management policies for the purpose of the company's rehabilitation. Furthermore, in more critical cases, the banks made their best efforts to help a company through emergency lending, debt waivers, and other means. It is worth noting that monitoring through checking movements of account settlement and the main bank dispatching a director to the company were very important as the means for monitoring the company's management in the main-bank system (Hiroshi Osano and Keiichi Hori, 2011: 76). Such a monitoring system implemented by a company' s main bank has traditionally been considered to be a characteristic of the Japanese corporate governance system.

Second, the cross-shareholding system between Japanese companies has been characterized as a stable holding method by financial institutions and business firms. This shareholding system used to be supported, with long-term contract relationships, based on an implicit understanding that both companies did not intend to intervene in each other's management and did not sell their shares in the other company to another entity (Hideaki Miyajima and Keisuke Nitta, 2011 : 105). Group companies monitored and supported the other companies' management within its *keiretsu* based on a cross-shareholding system mainly by sending their directors to other companies in the group.

The above-described elements of these internal monitoring models, however, significantly changed during the 1980s and 1990s, followed by economic globalization and the relaxation of regulations. During this often-called bubble period, Japanese banks assumed a comparatively lower position of importance to companies because the companies' demand for financing decreased, while the companies had sufficient funds to repay their loans to their lending banks. As a result, the banks lost their power in monitoring the "*borrower*" companies. Moreover, over the past decades, the cross-shareholding system between companies dramatically dissolved (Bruce E. Aronson, 2017:16). The shareholding ratio of foreign institutional investors greatly rose concurrently with the dissolution of the cross-shareholding system (Hideaki Miyajima and Keisuke Nitta, 2011:115).

Soon thereafter, the traditional mutual monitoring model among group companies also became less viable. As the result of the main-bank system's power decline as well as the dissolution of the cross-shareholding system, the shareholding rate of institutional investors has drastically increased, and these institutional investors have since greatly affected the Japanese corporate governance system.

Furthermore, administrative authorities in Japan lost their power to take strong measures against companies, since the administrative authorities had developed cozy relations with companies under their supervision, through "*Amakudari*", the traditional Japanese practice in which high-level government officials take executive positions in private companies. After the Japanese economic bubble suddenly burst in 1991, many corporate scandals, such as accounting fraud using questionable techniques and concealing non-collectible loans, came to light under the circumstances of not having an effective corporate governance system.

These corporate scandals triggered the reform movement in Japan to find a better corporate governance system in order to prevent misconduct and improve a company's profitability. Foreign observers, however, continue to voice their criticism that the Japanese corporate governance is still behind the times, since no substantial change in the overall corporate management system has occurred and the number of outside directors Japanese companies have appointed was still low.

The increase in foreign institutional investors facilitated the introduction of a corporate governance system in line with the global standards in the 2000s. In particular, it should be noted that foreign investors, such as the California Public Employees' Retirement System (CalPERS), which obtained a large portion of shares in Japanese companies after the dissolution of the cross-shareholding system, exerted a strong influence on reforming Japanese corporate governance practices. In fact, the Asian Corporate Governance Association, which includes CalPERS as a member, recommended establishing a transparent process of independent, external supervision of management on behalf of all shareholders, and all companies, even those with traditional board structures, committed to appointing a minimum of three independent external directors (Asian Corporate Governance Association, 2006:5). Responding to such foreign shareholders' requests, Japan seems to have been moving toward a more market-oriented corporate governance system by increasing the number of outside directors and disclosing more information to shareholders. Considering the Japanese stock market has been highly globalized in recent years, foreign shareholders' "*voices*" became indispensable in determining corporate governance reform.

2. Changes in Corporate Governance Structure

As for corporate governance structure in Japan, a company auditor (*kansayaku*) and a board of auditors (*kansayaku-kai*) have traditionally been playing a key role in monitoring the management by directors. This traditional system emphasizes compliance with laws by all employees, rather than by independent directors who monitor the performance of the CEO and top corporate management (Bruce E. Aronson, 2017:438). Under the Japanese Companies Act, auditors report any director's misconduct to the directors on any director's misconduct, to attend board of directors meetings, and report violations of laws and the like to a shareholders meeting.

Moreover, the auditors are authorized to investigate at any time any execution of duties by directors and to prepare audit reports. On the other hand, under the Japanese Companies Act, the board of auditors must prepare audit reports; appoint and remove full-time company auditors; and decide audit policy, methods for investigating the status of the operations and financial status of a company with board of company auditors and other matters regarding the execution of the duties of company auditors.

The auditor and the board of auditors, however, have gained a reputation for ineffectiveness in their roles. They are criticized for their limitations in monitoring a company's management as lacking authority since they have no vote at board meetings and cannot hire or fire the company's CEO or directors (Wataru Tanaka, 2017: 376). The above-mentioned global institutional investors, wishing that listed Japanese companies would establish more transparent processes through independent, external supervision of management on behalf of all shareholders, severely criticized the conventional structure, in that the auditor and the board of auditors effectively give management almost total autonomy and seldom provide real, independent supervision over senior management decisions (ACGA, 18).

This criticism clearly shows that a company with an auditor or a company with a board of auditors failed to impress global investors. Even in companies with an auditor or board of auditors, specific instructions regarding how to monitor operations executed by directors do not exist for either of these organs, and this ambiguity in the provisions concerning the auditors' (or board of auditors) actual authority might develop a poor reputation regarding Japanese corporate governance among domestic and foreign investors (Minako Kojima, 2013).

In 2002, a type of company that developed a system based on establishing committees (*iinkai secchi kaisha, "Committee System"*) was introduced as an optional alternative to the traditional auditor and board of auditors system. This new Committee System for boards separates the functions of officers and directors by replacing the traditional German-inspired positions of representative director and company auditor with American-derived positions of representative officer and audit committee of the board of directors (Aronson, 438-439). Under the Committee System, Japanese companies have a representative executive officer and three board committees (audit, compensation, and nomination committees), with a majority of outside directors required for each committee. Since in a company with the Committee System management submits its books and other records to outside directors for examination, the Committee System is more transparent, and therefore accrues greater value in capital markets (Robert N. Eberhart, 2012 :9).

In fact, according to the empirical research conducted by Robert N. Eberhart, the Committee System produces higher corporate value than the traditional auditor and board of auditors system (Robert N. Eberhart, 2012 : 23). Refer to Companies Act Article 404 (1), in a company with the Committees System, the nomination committee appoints the directors. This mechanism is expected to function as a safeguard to nominate directors who are independent from the CEO. By 2018, however, only 2.9% of companies listed on the TSE's First Section adopted the Committee System (Tokyo Stock Exchange, 2018 :6). Even though prominent business groups adopted the Committee System, most of the TSE's listed companies have not adopted this Committee System (Aronson : 445).

Moreover, Japanese companies have shown a certain degree of resistance to the nomination committee, which removes from a representative director the *de* *facto* authority to appoint and remove directors, and this resistance is considered to be a reason why the Committee System has not been widely adopted in Japan (Aoki : 339).

In 2014, *Abenomics,* which was a newly-adopted policy under the Abe Cabinet, listed corporate governance reform as a priority of the *Japan Revitalization Strategy Plan*. In 2015, a company with an audit and supervisory committee ("Company with Audit and Supervisory Committee") was introduced into the amended Japanese Companies Act. In a Company with Audit and Supervisory Committee, the company must establish an Audit and Supervisory Committee within its board and half the committee members need to be outside directors (Kanda : 250). By transforming to a Company with Audit and Supervisory Committee, separation of the monitoring and management functions would be improved, as the auditors or board of auditors' monitoring roles and the supervisory functions over the company's board were centralized in the Audit and Supervisory Committee.

The Audit and Supervisory Committee must have a majority of outside directors and has the authority to monitor directors' execution of their duties as with an auditor in a company with an auditor committee. The Audit and Supervisory Committee may also state its opinions on the election or dismissal, or resignation of directors who are Audit and Supervisory Committee members, as well as on the remuneration of directors (other than directors who are Audit and Supervisory Committee members). The board of directors of a Company with Audit and Supervisory Committee performs duties to supervise the execution of duties by directors, to appoint and remove representative directors, and to determine specific matters. In a Company with Audit and Supervisory Committee, it is expected that outside directors effectively supervise management by obtaining corporate information through their duties as members of the Audit and Supervisory Committee. Thus, a Company with Audit and Supervisory Committee is aimed at facilitating the corporate governance reform in Japanese listed companies based on the monitoring board model (Tanaka : 377).

As a result of these corporate governance reforms, large public companies have currently three options including a company with a board of auditors, a Company with Audit and Supervisory Committee, and a company with committees system. The Japanese Companies Act's intention is to allow each company to choose for itself its own corporate governance system, not only because it is uncertain what the best choice is for a company's corporate governance system, but also because each above-described system is appropriate as a corporate governance structure 9Kanda : 250).

In addition, when a company that is a company with a board of auditors (limited to a public company and a large company) and is required to submit a securities report to the Prime Minister with respect to shares pursuant to the Japanese Financial Instruments and Exchange Act does not have an outside director, directors must explain the reason why it is not appropriate to have an outside director in the annual shareholders meeting. This is considered as the "*comply-or-explain rule*" (Kanda : 207). Furthermore, the Stewardship Code providing a standard of conduct of institutional investors was also formulated and implemented in the same year.

It is said that 2015 is the "first year" in terms of Japanese corporate governance because two important systems concerning corporate governance were amended in this year. Along with the implementation of the above-mentioned amendment to the Japanese Companies Act in relation to outside directors and the Company with Audit and Supervisory Committee in 2014, the TSE formulated and released the Corporate Governance Code in 2015, as the basic principles of effective corporate governance. According to the Corporate Governance Code, the board of directors functions as a monitoring board and the appointment of more than two independent directors was recommended as the best practice Besides, the Corporate Governance Code requires the boards of listed companies to supervise the appointment of a representative director and directors' remuneration properly, and to establish a significant role for the independent outside directors in supervising management.

As mentioned above, the Corporate Governance Code includes the following basic principles aimed to being the monitoring model.

(1) In order to strengthen the independence, objectivity and accountability of board functions on the matter of nomination and remuneration of the senior management and directors, the company should seek appropriate involvement and advice from independent directors in the examination of such important matters, by establishing independent advisory committees under the board to which independent directors make significant contributions.
(2) In order to actively contribute to discussions at the board, independent directors should endeavor to exchange information and develop a shared awareness among themselves from an independent and objective standpoint by holding regular meetings consisting solely of independent directors.
(3) Independent directors should endeavor to establish a framework for communicating with the management and for cooperating with auditors or the board of auditors by appointing a lead independent director from among themselves.

(4) Companies should take measures to adequately provide the necessary information to outside directors.

As the result of these reforms in Japanese corporate governance, the trend of introducing outside directors into Japanese companies and expecting them to make significant contributions to corporate governance has made significant progress (Kanda : 208).

3. Expansion of Outside Directors' Roles and Functions

Although a great deal of effort to enhance corporate governance has recently been made, corporate scandals in which corporate value has been damaged have repeatedly happened in Japan. Each time a corporate scandal is exposed, stakeholders have requested to increase the number of outside directors to prevent the recurrence of a corporate scandal. Before increasing the number of outside directors, however, clarifying how to make outside directors effective and substantial is necessary.

The important issue is not whether outside directors are to be appointed to Japanese companies, but rather, whether corporate governance system could actually benefit from having outside directors. Apparently, merely appointing outside directors is insufficient to prevent corporate misconduct. For this goal, critical information needs to be timely and appropriately communicated to outside directors. In fact, the recent corporate scandals showed that cutting off the directors' access to critical information was a primary cause behind the scandals. In many cases, the scandal occurred despite the companies having outside directors. This result was not because the existence of the outside directors was meaningless, but because the critical information related to the corporate scandal was not timely and appropriately communicated to the outside directors (ACGA, section 23). If information relevant to a corporate scandal could be appropriately delivered to an outside director, the outside director will be able to duly fulfill its role and function to provide an important safeguard against the potential for managerial self-interest and weak execution of duties by the company's management.

The draft proposal for amending the Japanese Companies Act ("Draft Proposal") to establish a path for outside directors to expand their roles and functions was publicly formulated by the Corporate Law Subcommittee of the Legislative Council (Kazuhiro Tanaka, 2014). The Draft Proposal includes plans to effectively utilize outside directors by entrusting management to an outside director in specified circumstances and by requiring the appointment of one outside director at least. First, to entrust management to an outside director based on a resolution of the board of directors would be appropriate if there is a situation that could lead to a conflict of interest between the company and its executive officer as seen in a management buyout scheme (The Director Office of the Civil Affairs Bureau of the Ministry of Justice, 2018: 40-41). Second, according to the Draft Proposal, a company would be obliged to appoint at least one outside director if the company is a company with a board of auditors (limited to a public company and a large company) and is required to submit a securities report in accordance with the Japanese Financial Instruments and Exchange Act (The Working Committee on the Corporate Governance under the Legislative Council of the Ministry of Justice : 12).

As explained above, such company is required under the comply-or-explain rule to explain the reason why it is not appropriate to have an outside director under the current Japanese Companies Act. On the other hand, it has been argued that appointing at least one outside director is required to represent all shareholders, including minor shareholders, having common interests, and requiring such appointment would not be burdensome since most listed companies have already appointed outside directors over the last five years (The Working Committee on Corporate Law (Corporate Governance and others related) under the Legislative Council of the Ministry of Justice, 2017 : 1)).

As described in this paper, an outside director's role is not confined to preventing a corporate scandal. An outside director's functions include ensuring fair trade in circumstances where a conflict of interest could arise. There are various theories regarding why the proposal concerning mandatory appointment of an outside director was finally adopted in the Proposal, including that appointing an outside director would not be overly burdensome on Japanese companies considering most of Japanese listed companies have already introduced outside directors and it is necessary to appoint at least one outside director who will represent the common interests of all shareholders, including minority shareholders. It is also noteworthy that there are many opinions insisting that mandatory appointment of an outside director is necessary to ensure effective monitoring of management in terms of misconduct and conflicts of interest (The Minutes of 18th Meeting : 6).

4. Do outside director functions preventing corporate scandal?

Corporate scandals have been exposed in Japan year after year even in companies with outside directors. Olympus Corporation ("Olympus") which engaged in so-called window dressing by concealing huge losses; Toshiba Corporation ("Toshiba") which revealed a large accounting fraud; and Suruga

Bank ("Suruga") which made illegal housing loans all had appointed outside directors to their respective boards. This paper does not intend to conclude with brief reviews of those cases that outside directors cannot prevent corporate scandals, but instead, it explores the reasons why the outside directors were unable to block each scandal, and considers the appropriate measures to be undertaken to enhance corporate governance in Japan. To answer this question, this paper takes a close look at the above-specified cases when scandals occurred regardless of the appointment of outside directors.

a. The Olympus Case

In 2011, it was revealed that top management at Olympus concealed huge losses amounting to more than $1.5 billion US dollars for over 20 years through three former presidents; utilized complex schemes to avoid updating their accounting standards; filed false and inaccurate securities reports for 5 consecutive years; and failed to provide important information to its own board of directors (Third-Party Investigation Committee). Since Olympus had no obvious weakness in its business model or corporate governance structure, the Olympus case called into question whether the fundamental aspects of Japan's corporate governance system were functioning effectively (Bruce E. Aronson, 2012:86). Although there were three outsider directors appointed at Olympus, they were ineffective in preventing the extensive wrongdoing and consequential severe financial penalties (Bruce E. Aronson, 2012:87).

The Third Party Committee pointed out in its Investigative Report: (1) Olympus's committee composed of outside professionals did not effectively fulfill its function; (2) the disclosure of information to the outside directors was insufficient; and (3) suitable people had not been appointed as the outside directors, and they were not fulfilling their functioning, in addition to raising other points (The Third-Party Investigation Committee: 178-182). It is worth noting that no information on the losses was ever fully disclosed to the board of directors, and management generally discouraged employees from providing information on questionable company practices to directors (Aronson : 91).

To address these failures of appointing outside directors, the Third Party Committee recommended the roles and functions of outside directors and outside auditors should be reinforced by preventing the election of the company's president's friends or people connected with the company's business partners as outside officers. In other words, it was determined that appointing only those who are truly suitable as outside officers (with no potential for a conflict of interest) was one measure that would help prevent recurrence of the same problems that arose in the Olympus case.

The Olympus scandal highlighted the dire consequences that can result from the lack of an effective system to monitor top management (Aronson: 96). In 2012, Olympus's plan to reform its corporate governance was implemented at an extraordinary shareholders general meeting (Olympus, 2012). By a resolution thereby, the number of board members was reduced from 15 to 11, outside directors comprised a majority of the board, and top management was replaced. The Olympus case has created both an opportunity to take action against corporate governance failures and public pressure to accelerate the pace of ongoing reform efforts.

b. The Toshiba Case

In 2015, it was revealed that Toshiba had padded its profits by $1.2 billion over the past six years. Toshiba was noted for its efforts in corporate governance reform, and it was one of the few Japanese companies that chose to replace their traditional governance structure with an "American-style" system of executive officers and a board committee with independent directors (Bruce E. Aronson, 2015:2). In addition, unlike the Olympus case, as of mid-2015 there were four outside directors who were reported to have been truly independent and to have participated actively in open board discussions. The huge accounting fraud occurring at such a prominent company greatly shocked Japanese society, and the entire investment world.

The Independent Investigation Committee stated that the internal control function (supervisory function) of the board of directors did not work properly because critical information relating to the huge losses that Toshiba suffered had never been reported to the board of directors, and this was one reason leading to the misconduct (Bruce E. Aronson, 2015:2). Furthermore, the Committee also revealed that the internal control function (audit function) of the audit committee with outside directors did not work properly, as well, because the audit committee did not take any action to point out the issues to the executive officers although the audit committee were aware of the inappropriate accounting practices. Even more disturbing was that the head of the audit committee was an inside director. In addition, none of the three external audit committee members had adequate knowledge of finance and accounting, which rendered it difficult for the audit committee members to fully understand the consequences of the inappropriate accounting practices being carried out and continued at Toshiba (Bruce E. Aronson, 2015:2).

In light of these issues, the Independent Investigation Committee recommended, first, to increase the volume of information provided to the board and to clarify and expand the matters to be reported at the board of directors meeting to enhance the supervisory function of the board of directors; second, for example, to increase the number of members of the audit committee who are familiar with finance and accounting, and nominate an external director to be chair of the audit committee to improve the corporate governance structure (Bruce E. Aronson, 2015:79). Furthermore, the Independent Investigation Committee also proposed increasing the number of outside directors with legal knowledge, or finance/accounting expertise (Bruce E. Aronson, 2015:75). The Toshiba case clearly illustrated the tension and difficult trade-offs between insider and outsider perspectives. The lesson learned from the Toshiba case is that director competence and expertise should also be a consideration for an outside director, in addition to director independence.

c. Suruga case

In 2018, the Third Party Committee which was set up by Suruga discovered many loan screening documents in asset-building loans related to shared houses and income-producing buildings were altered and fabricated, where a significant number of Suruga's employees had become involved in this wrongdoing, and other employees knew or suspected the fabrications while they were handling loan procedures (Suruga Bank, Ltd.,2018:84-116). Suruga's board of directors was composed of three outside directors and seven inside directors. The board of directors, however, failed to properly supervise the management of the corporation as a substantial meeting committee because the board was unable to collect information related to the management. Although the outside directors actively spoke up at the board of directors meetings, they were not effective in preventing the corporate scandal because the board of directors did not have the authority to determine management matters (Suruga Bank, Ltd.,2018:277). While the Investigation Report concluded there was no evidence showing the outside directors knew or had come to know the information related to the fraudulent loans, it pointed out that the failure to provide the outside directors with critical information was significant because they could have effectively supervised the management if they had had access to the information (Suruga Bank, Ltd.,2018:273). As a result of this fraudulent loans scandal, the Third Party Committee recommended that outside directors have a simple majority in the board of directors, or Suruga transform its current governance system into a company with committees system, as an example (Suruga Bank, Ltd.,2018:277). The lesson learned from the Suruga case is that outside directors need to be provided corporate information which has to be reviewed by the board of directors, and authorized to determine management matters.

5. Discussion about Outside Directors' Functions and Roles

There has been considerable outside pressure on the Japanese system to adopt American-style corporate governance reform (Aronson : 99). Foreign investors criticizing the weakness of the existing Japanese corporate governance system from the viewpoint of the U.S. monitoring model think that appointment of some "independent outside directors" would be effective to improve and strengthen a company's board of directors' management monitoring function. Foreign investors assert that the current monitoring system composed of internal company auditors and an insider-dominated board lacks transparency and fails to protect investors' interests, and that poor corporate governance discourages outside investment and depresses share prices in the Japanese market. Responding to this criticism, Keidanren countered that Japanese companies' voluntary efforts should be focused on enhancing corporate governance, and the markets would assess these efforts in the end. Keidanren also argued it is inappropriate to comprehensively apply corporate governance rules used in a specific country or market without changing them in any way to render them suitable for all Japanese companies (Nippon Keidanren, 2009 : 4). Now, however, foreign shareholders own over 20-30% of the Japanese stock market and account for nearly 70% of trading. Considering these circumstances of a globalized stock market, it is likely Japanese companies will be unable to ignore the voices of foreign investors for much longer.

Recently, some corporate law scholars and global investors advocated for a so-called "hybrid" board structure as a suitable corporate governance system in Japan (ACGA : 18). A "hybrid" board structure means one or more external directors are invited onto the boards of companies that still follow the auditor system and such companies are establishing functional board committees. This proposal, however, would be meaningful only if the external directors are genuinely independent and are fully conscious of their fiduciary duty to all shareholders as their representatives. Traditionally, under the Japanese Companies Act, a board of directors has the authority to decide the execution of the company's operations, to supervise the directors' execution of their duties, and to appoint and remove representative directors.

Accordingly, operational decisions would be made by representative directors and the executive directors appointed by the board of directors, through instructing and supervising employees, and this operational execution would be monitored by the board of directors from the perspectives of legality as well as suitability. In reality, however, as evidenced by the above-described corporate scandals, the board of directors' monitoring function does not currently work well enough to prevent directors from committing illegal acts. First, it is unlikely that the board of directors monitors strictly and severely a representative director's execution of operations, since the board of directors members are mainly selected by the representative director, who is usually a substantial owner of the company. Second, proper monitoring is less likely to be expected, because almost all directors are in charge of the execution of operations, and therefore the execution itself is in accordance with the directors' conduct. No one wishes to take a hard look at their own actions.

Unlike such "representative director-biased" directors, outside directors could be expected to appropriately monitor the execution of management and conflicts of interest between a company and a director. This viewpoint supports the argument for appointing more independent outside directors. There has been a noteworthy change in the characteristics of outside directors appointed in the last decades. In the late 1990s, for example, the number of Japanese companies that introduced outside directors increased, and most appointed outside directors were active executive officers of other listed companies (Takuji Saito, 2011 :187). As a result, there were only a few outside directors who were genuinely independent from the company's management (Takuji Saito, 2011 :188).

In the 2000s, however, the characteristics of outside directors has been greatly changed with an increasing number of appointed outside directors. Although there were no outside directors from the legal profession in 1997, this number has significantly increased from around 2001. Likewise, the number of outside directors from academia, accounting and government officials has also increased remarkably. This trend clearly shows there has been an increase in the number of outside directors who are genuinely independent from a company's management and have certain expertise, within the boards of Japanese companies. According to the TSE, 91.3% of companies listed on the TSE's First Section appointed two or more outside directors (Tokyo Stock Exchange : 2). This data shows that there is an apparent trend to appoint outside directors among Japanese listed companies.

Can introducing outside directors into boards of Japanese companies improve corporate governance in Japan? What can be learned from the lessons of the Olympus case, the Toshiba case, and the Suruga case are that outside directors should be genuinely independent from the company's management and that outside directors need access to corporate information to function effectively.

First, being fully independent from the company's management is essential to be able to monitor management's performance. In the Olympus case, as stated above, the lack of the outside directors' independence due to their close relationship with the management was regarded as a main factor in the outside directors' failure to function effectively in their monitoring of management's performance.

Second, having full access to all corporate information is also essential for the outside directors to monitor the management effectively and to be able to provide appropriate advice on corporate strategy. In general, however, it is not so easy for outside directors to obtain such internal information. From this perspective, one study concluded that a high percentage of internal directors on a company's board would be preferable if outside directors have difficulty in obtaining the necessary information to monitor and provide advice to management (Saito : 191-192 and Aoki : 341). Nevertheless, there is a need to appoint outside directors, with a proper distribution system of corporate information, to prevent corporate scandals by the strengthening monitoring function through the outsiders' "eyes" (Aoki :340).

Thirdly, recent studies found that outside directors need to have the relevant expertise to function effectively because outside directors are required to properly understand the corporate information so they can provide appropriate advice to the company's management and to prevent corporate scandal from arising. It would be very difficult for outsiders with no specific expertise on accounting practices or with no knowledge of business operations to be able to discover corporate fraud by reviewing the materials prepared by the company (Aoki : 341).

Furthermore, a primary reason concerning an outside director's dysfunction is due to a structural issue, where the person to be monitored selects the person to conduct the monitoring. Under the current Japanese corporate governance system, effective monitoring cannot be expected because a company's management could appoint outside directors who have amicable or harmonious relationships with the company (Aoki : 341).

For the above-explained reasons, establishing a truly effective corporate governance system requires increasing the number of outside directors, and appointing outside directors with the relevant expertise, under the environment having a mechanism to provide corporate information to the outside directors (Aronson : 440).

E. CLOSSING

Most Japanese listed companies have already introduced outside directors as a key factor in their corporate governance reform. Some companies, however, do not seem to be able to fully implement the outside directors' roles and functions. The discussion on the methodology for effective functioning of outside directors has just begun. Nevertheless, as seen in the discussion concerning the mandatory appointment of an outside director, utilization of outside directors will likely be accelerated. It is time to further the study on effective functioning of outside directors, including the appropriate ratio of outside directors in boards of directors and their required expertise. Much attention would be paid to empirical research on effective functioning of outside directors to ensure the future success of appointing outside directors.

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